The BOJ's Difficult Path Towards an Exit from Current Easing: A difficult balancing act between the merits and demerits of easing

Ueda Kazuo, Professor, Kyoritsu Women's University

Key Points

- Concerns over side effects of interest rate manipulation and ETF purchases
- The new version of Forward guidance is extremely weak
- The longer price stagnation persists, the stronger the side effects of the measures

Prof. Ueda Kazuo

The BOJ's monetary policy has entered a difficult phase. Despite the current buoyancy in the economy and the job market in particular, inflation remains low, and there is no prospect of achieving the inflation target. An exit is still a long way off. At the same time, the BOJ is now finally running out of options for additional easing, having already adopted a panoply of easing tools over the past two decades.

Thus, BOJ policymakers are absolutely stuck, failing to move in either direction. Worse still, there has been no progress among academics in economic theories on the central bank's response in the event that achievement of the monetary policy target takes time.

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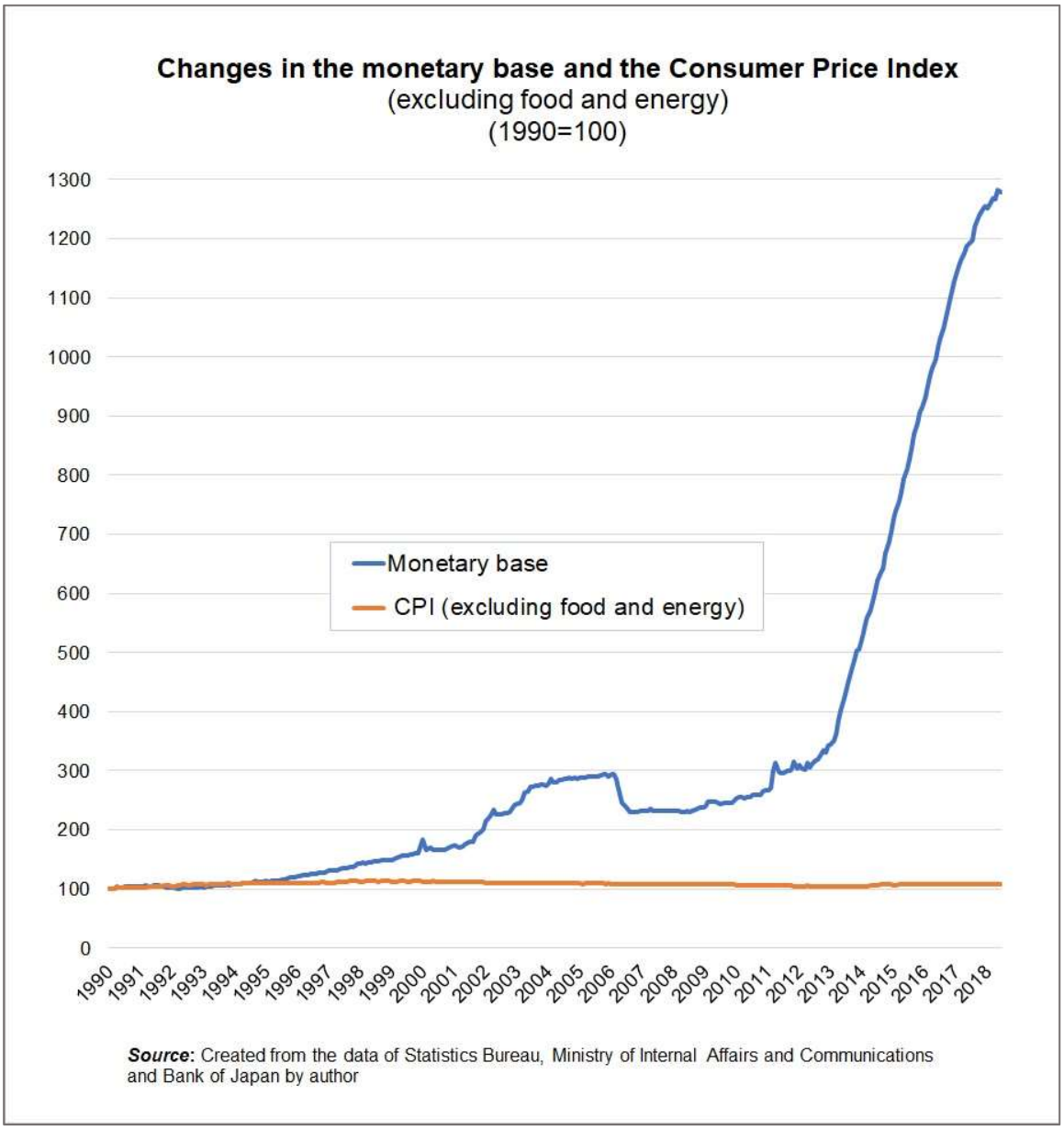
The ineffectiveness of two decades of easing is clearly illustrated in the figure which shows changes in the monetary base (currency in circulation and commercial banks' deposits at the BOJ) and the Consumer Price Index (excluding food and energy) since 1990.

Since the mid-1990s, the monetary base has continued to expand, increasing sharply during the quantitative easing of the early 2000s and the latest quantitative and qualitative easing program, and it is currently around 13x larger than in 1990. Meanwhile, prices have remained almost flat, with an average inflation rate over the period of exactly 0%. If the quantity theory of

money states that an increase in the money supply will, over the course of a few years, cause a proportional increase in prices, then the Japanese economy during this period serves as a clear counter example to this theory.



Policymakers have known perfectly well since the 1990s that, once interest rates reach zero, further increases in the money supply alone cannot be expected to have a strong easing effect. This is because the public simply swaps short-term government securities with yields of zero percent for money which also bears no interest. However, from 2013 onwards, partly due to the BOJ's large-scale purchases of long-term JGBs still offering positive yields and its large-scale purchases of equity-linked exchange traded funds (ETFs) aimed at lowering risk premia (excess

returns sought by investors), the decline in long-term interest rates, the depreciation of the yen and the increase in stock prices were dramatic.

And yet there is still no sign of any clear increase in the rate of inflation. These past few months, the inflation rate has, if anything, trended down and, at its Monetary Policy Committee meeting at the end of July, the BOJ had no choice but to lower its price growth forecast.

The phenomenon of slow wage growth despite a buoyant labor market is one that is seen in other developed economies as well and is referred to as the mystery of the flat Phillips Curve. Factors such as sticky inflation expectations, advances in information technology (IT), robotics and other technology, and the special nature of the labor markets of each country have been pointed out as possible causes but the phenomenon has yet to be fully explained.

However, over the past few months, wage growth in Japan has picked up and, though data may be affected by sample factors, there is still hope that inflation will move up materially in the future.

The side effects of the prolonged unprecedented easing have also become noticeable. With the quantitative limits of large-scale JGB purchases also becoming apparent, the BOJ shifted the focus of its monetary policy in 2016 to control of interest rates rather than the quantity of bonds purchased, adopting a negative short-term policy rate and an operating target for the long-term interest rate. However, this has, of course, significantly impaired the price discovery function of the bond market and has also had an undeniable negative impact on the financial intermediation function of market players such as banks whose margins narrowed and institutional investors whose investment targets became limited.

The impact of ETF purchases on market functions also raises concern as the BOJ becomes a major shareholder of one company after another. Even the trends of yen depreciation and stock price increases which had offset the negative impact of monetary easing also appear to be reaching their limits recently.

While the labor market is expected to remain overheated for the time being, the extent to which this will spill over into wages and prices is, as mentioned earlier, extremely uncertain. The US economy is still strong but there is concern over deterioration such as a downward swing in a prolonged upward cycle, a worsening of trade tensions and disarray caused by the excessive debt of certain emerging economies.

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Under these conditions, the only option open to the BOJ at present seems to be to stick to its existing monetary policy and wait for prices to rise while keeping an eye out for any side effects.

In doing so, there will be times when the measures to control side effects are inconsistent with the continuation of monetary easing and this, therefore, needs to be taken into consideration.

In fact, the revisions to the monetary easing framework announced on July 31 appear to be changes of this nature. To increase the sustainability of monetary easing whilst inflation fails to grow, the BOJ took measures to mitigate side effects giving consideration to market functions, saying that it would expand the range of movement for the benchmark 10-year JGB yield from between minus 0.1% and plus 0.1% to between minus 0.2% and plus 0.2% and would buy ETFs more flexibly depending on market conditions.

This change will have the effect of raising interest rates since, if economic conditions are good, the 10-year JGB yield is expected to hover in the upper end of the permissible range. Therefore, to curb speculation about over-hasty monetary tightening, the BOJ also adopted a forward guidance on future policy, saying it will keep rates "very low" for an "extended period of time." However, the expression "for an extended period of time" can be interpreted in various ways. Subtle changes to this expression depending on inflation could also lead to further expansion in the range of movement of the interest rate or an increase in the interest rate. In other words, this is an extremely weak forward guidance.

Currently, introduction of the new framework has caused the 10-year JGB yield to edge up slightly but, partly due to the effect of the forward guidance, concerns over hasty interest rate hikes have not caused the yen to strengthen.

That said, the BOJ only expanded the movement range of the interest rate by 0.1% in both directions. The recovery in the price discovery function of the bond market will probably be very slight and the change will probably have virtually no impact on the returns of financial institutions. Hopefully, the flexibility of ETF purchases will lead to a reduction in the level of purchases but, on the flip side, this change may end up strengthening the put option (right to sell) nature of the BOJ operation. Consequently, there are obvious limits to the effectiveness of new measures in easing the side effects and strengthening the sustainability of the existing framework.

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If the situation in which inflation is far below the target persists much further, the debate surrounding the tradeoff (contradiction) between efforts to achieve the target and the side effects of the tools used to achieve it is likely to heat up.

The price stability target is set at 2% inflation and not 0% because the CPI has an upward bias and also because the BOJ intends to reduce the risk of monetary easing being obstructed by zero interest rates by raising the nominal interest in the long-run equilibrium; in other words, the BOJ

intends to create a buffer for monetary easing. However, the meaning of price stability in the first place is to stabilize the value of money and to facilitate the exchange of goods and services in a market economy and the lending of funds through the financial system.

Therefore, if efforts to create a buffer of around 2% are going to disrupt the market function and cause serious economic instability in the long term, then the policy will not pay off. What is more, this tradeoff also involves sticky inflation expectations and is complex in that it is a dynamic tradeoff that changes as time goes on. The longer inflation refuses to rise, the stickier inflation expectations become, and the tools used to change this situation will inevitably have serious side effects.

Tools that go far beyond those currently adopted such as helicopter money whereby the government and central bank inject huge amounts of cash into the market or the full-scale adoption of negative interest rates by abolishing notes in favor of digital currency are examples of effective policies with serious side effects. The 2% inflation target might be achieved, but the risk that the former will result in more than 2% inflation and that the latter will cause a loss of confidence in the currency give cause for concern and it is extremely difficult to accurately grasp the tradeoff.

Another possible option is to stop trying so hard and to make achievement of 2% inflation a medium-to-long-term goal and to aim to achieve the goal at a time when the trade-off has eased due to some kind of external factor and the side effects are less serious. At any rate, these kinds of discussions need to be held with greater intensity both inside and outside the BOJ in the near future.

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UEDA Kazuo, Ph.D.

Born in 1951; Ph.D. graduate from MIT; Expert on economic theory; Professor Emeritus of Tokyo University; Former member of the BOJ's Policy Board

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