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Bank of Japan

**On the Recent Changes in the Bank of Japan's
Monetary Policy Framework**

*Remarks at the Peterson Institute for International Economics
(April 19, 2024)*

UEDA Kazuo

Governor of the Bank of Japan

In the March monetary policy meeting, taking into consideration the improving inflation outlook, the Bank of Japan (BOJ) opted to discontinue the policy framework known as Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control (YCC), which had been in effect since 2013 with revisions made after 2016. In its place, we introduced a new framework. First, I will give a brief outline of the changes made, followed by an explanation of the background behind these adjustments.

Regarding interest rates, under YCC, we controlled both short- and long-term interest rates. The short-term policy rate -- the interest rate the BOJ pays on the policy component of excess reserves -- stood at -0.1% as of early March this year. Meanwhile, the target for the 10-year JGB rate was set at around 0%, with a permitted fluctuation range around the target capped at 1.0%.

On March 19, we decided to establish a new short-term interest rate target, now defined as the uncollateralized overnight call rate, set between 0 and 0.1%. The target for the 10-year JGB rate has been removed.

As for asset purchases, we will maintain our acquisition of JGBs at a pace similar to before, thereby keeping the amount of JGBs held by the BOJ relatively stable for the time being. However, we remain prepared to respond swiftly to any rapid increase in long-term interest rates by increasing our purchases of JGBs. Other than these, the determination of long-term interest rates is left to the market.

We have ended the acquisition of equity-linked ETFs and J-REITs, gradually reducing purchases of CP and corporate bonds to zero within approximately one year.

We will begin to reduce JGB purchases at an unspecified point in the future. However, the extent of this reduction remains undetermined. We will need to take time to consider what to do with the ETFs we hold.

Given these changes, the primary tool of our monetary policy has become control of the short-term interest rate, with the policy target continuing to be the attainment of 2%

inflation in a sustainable manner. Based on our current economic and inflation outlook, we anticipate accommodative financial conditions to prevail for the time being.

Turning to the background for this policy change, let me discuss how the inflation outlook has improved. Our previous monetary policy framework involved the commitment to maintain YCC until a sustainable 2% inflation target was within reach. In other words, we promised to persist with YCC until we were sufficiently confident that inflation would soon reach 2% on a sustained basis.

Figure 1 provides a simple illustration of Japan's inflation dynamics. Recent inflation, which has exceeded 2% for nearly two years, consists of two main components: the direct (first-round) effects of global inflation during 2021-23, and second-round effects, which represent the spillover to wages and, subsequently, to prices. The latter component has been accompanied by rising inflation expectations. The first component, deemed transitory, has been diminishing since late last year. The second component, often referred to as underlying inflation, is more enduring.

This broader inflation picture mirrors that of many other countries. A notable distinction between Japan and others lies in Japan entering the pandemic era with nearly zero inflation, while others were already at around 2%. Consequently, the BOJ has endeavored to cultivate the second component by maintaining an ultra-easy monetary policy, contrasting with the efforts of other central banks to contain it.

Estimating underlying inflation accurately is particularly challenging because of the varied forms temporary inflation changes can assume. These changes may manifest as alterations in energy and fresh food prices or may extend to impacts on transportation costs and dining-out expenses. Figure 2 shows some easily available inflation variables that have some bearing on underlying inflation. One is the inflation of those items whose prices do not change frequently. Another is an estimated trend component of inflation of service prices. Both have been rising recently but need to rise slightly more to get to 2%. We use more sophisticated statistical techniques to estimate underlying inflation in a variety of ways, yielding consistent conclusions. The figure also includes the rate of change in regular wages of full-time workers. The broad picture is the same. Please note that wages need to

rise faster than 2% to be consistent with prices rising at 2% in the presence of positive productivity gains.

Medium- to long-term inflation expectations closely track underlying inflation trends. Figure 3 shows the weighted average of such expectations, indicating a rising trend but remaining below 2%.

Let me try to add some color to this outline sketch. People often ask why inflation in Japan got stuck at around zero despite the heavy dose of unconventional monetary policy measures over three decades. One possible answer is that inflation expectations became so entrenched at around zero that economic agents changed their behavior to make zero inflation more enduring.

Theoretically, easy money could have produced higher inflation; in reality, it did not. This may be a multiple equilibrium type situation where easy money is consistent with either zero or higher inflation. The driver of equilibrium multiplicity seems to have been the strategic pricing behavior of firms in the economy. When firms believe their peers will not raise prices, they think it is best to keep their own prices and wages unchanged, even in the face of small changes in costs or demand, making overall inflation or inflation expectations more entrenched at around zero. An economy in this situation needs a large shock to move from one equilibrium to the other.

Figure 4 shows Japanese firms' expectations of the price level of their products/services, not the general price level, at both one- and five-year horizons sourced from our Tankan survey. These presumably reflect firms' expectations about what their competitors in the same industry are likely to do with their prices. While one-year expectations peaked in late 2023 before declining, five-year expectations have continued to rise. Apparently, the global inflation experienced during 2021-23 has created a lasting change in firms' pricing behavior,

perhaps providing a catalyst for movement from the zero to a positive inflation equilibrium.¹

Returning to the explanation of the recent BOJ policy change, alongside these observations on underlying inflation and inflation expectations, robust initial wage settlements from spring wage negotiations have emerged since mid-March. Figure 5 shows these settlements to be at their highest level in three decades, while evidence of a moderate upward trend in domestic demand for goods and services has further bolstered our confidence. Based on these factors, we concluded in the March Monetary Policy Meeting that the probability of achieving a stable 2% inflation rate has increased enough to justify the outlined policy normalization.

What lies ahead? Given that underlying inflation is still somewhat below 2%, we need an easy financial environment. Figures 2-4 suggest that long-term inflation expectations are above 1%, perhaps closer to 1.5%. Estimates of the neutral interest rate vary widely. However, unless the real neutral rate is deeply negative, the nominal policy rate of 0.1% implies a fairly accommodative financial environment. We will proceed cautiously, initially assessing the impact of the recent policy changes on the economy and inflation, and then considering further adjustments as deemed appropriate, perhaps extracting insights on the neutral rate along the way.

References:

- Lagarde, Christine (2023) "Policy making in an age of shifts and breaks"
Speech at the annual Economic Symposium "Structural Shifts in the Global Economy"
organized by Federal Reserve Bank of Kansas City in Jackson Hole, 25 August.
- Taylor, John B. (2000) "Low inflation, pass-through, and the pricing power of firms"
European Economic Review 44, 1389-1408.

¹ Lagarde (2023) argues that the recent global inflation acted as a coordinating device to generate changes in firms' price setting behavior. Taylor (2000) discusses, in the U.S. context, the interaction between the persistence of inflation and firms' price setting behavior. Let me note that, given this possibility, the decomposition of inflation into the two components in Figure 1 is not straightforward. As firms adjusted the expectations of competitors' pricing behavior, the pass-through of import prices to domestic prices became larger, raising the size of the first component. At the same time, the increased perception of a more inflationary environment likely led to higher wage settlements, leading to upward adjustment in the second component.

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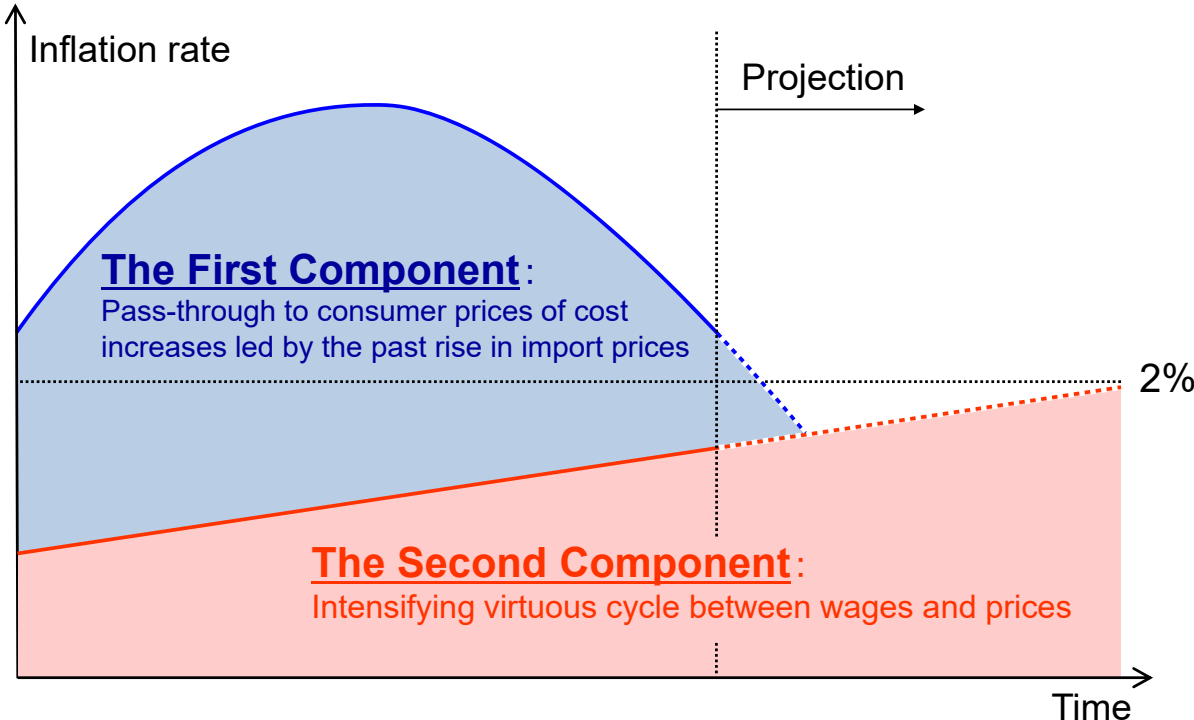
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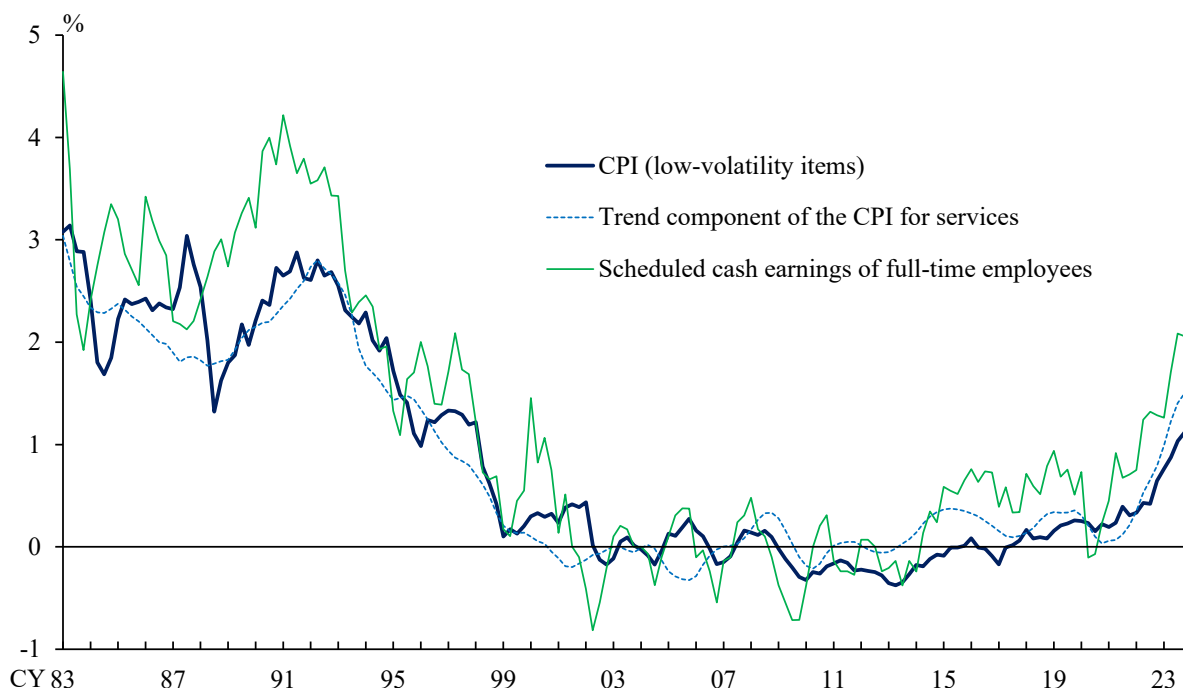
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Chart 1

Japan's Recent Inflation Dynamics: An Illustration



CPI and Scheduled Cash Earnings

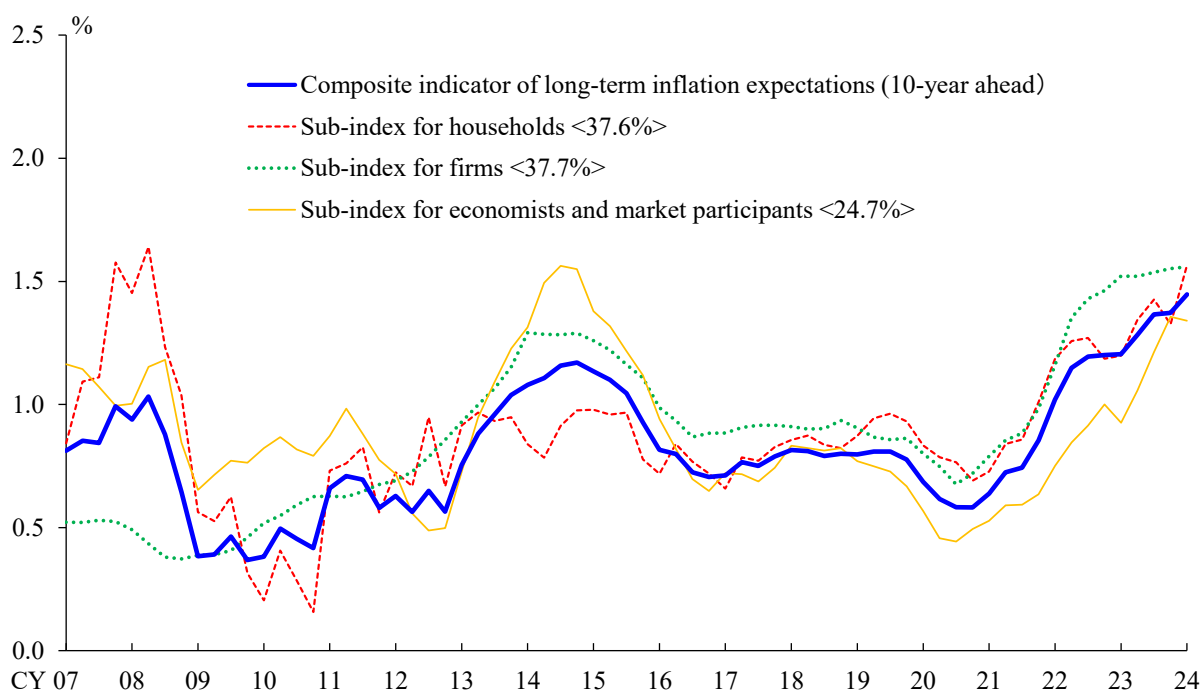


Notes: 1. Figures for low-volatility CPI items and scheduled cash earnings of full-time employees are year-on-year percentage changes, while those for the trend component of the CPI for services are the 6-quarter backward moving averages of annualized quarter-on-quarter percentage changes. Figures for scheduled cash earnings of full-time employees before 1994 are those for regular employees. Moreover, figures from 2016 onward are based on continuing observations following the sample revisions.

2. Figures for the trend component of the CPI for services are the composite of the sector-specific price trend for services and the common trend in services prices and wages. The figures are estimated using category-level services prices and industry-level scheduled cash earnings

Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Bank of Japan.

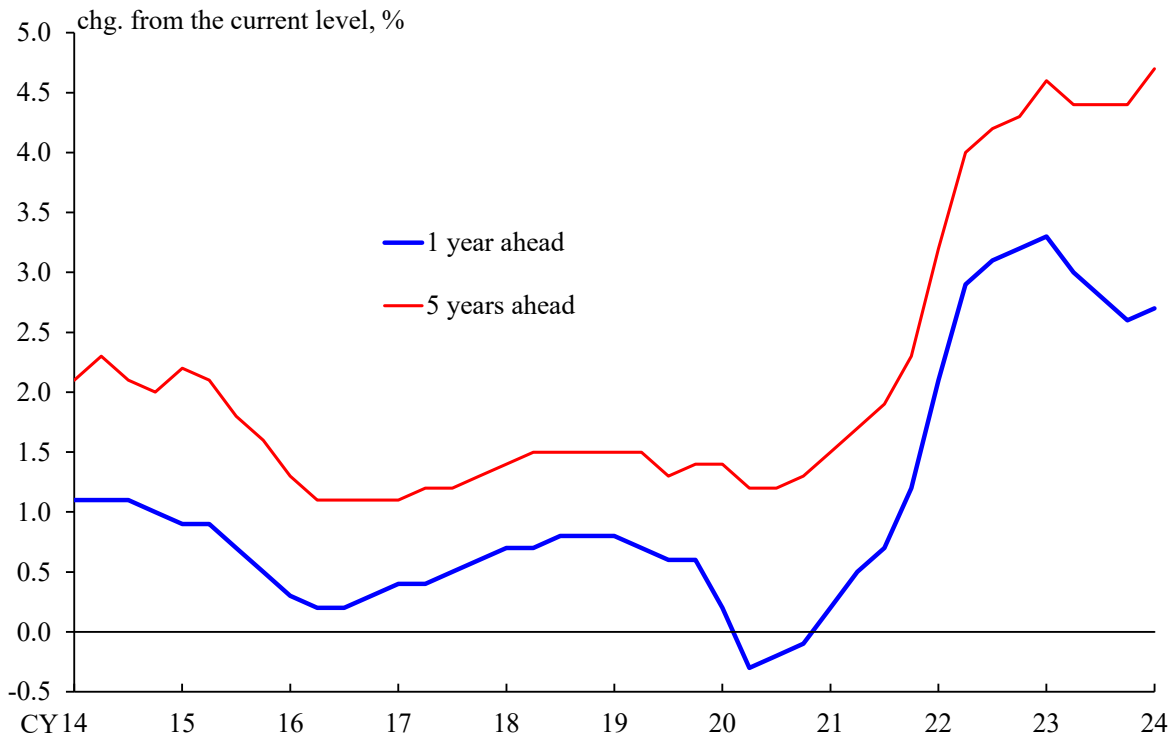
Long-Term Inflation Expectations



Note: Based on the first principal component extracted from the following six indicators: two indicators for households from the *Opinion Survey on the General Public's Views and Behavior*, one indicator for firms from the *Tankan*, and three indicators for economists and market participants from the *QUICK Survey*, the *Consensus Forecasts*, and data based on inflation swap rates. Numbers in angular brackets indicate share of each sub-index in the overall composite indicator.

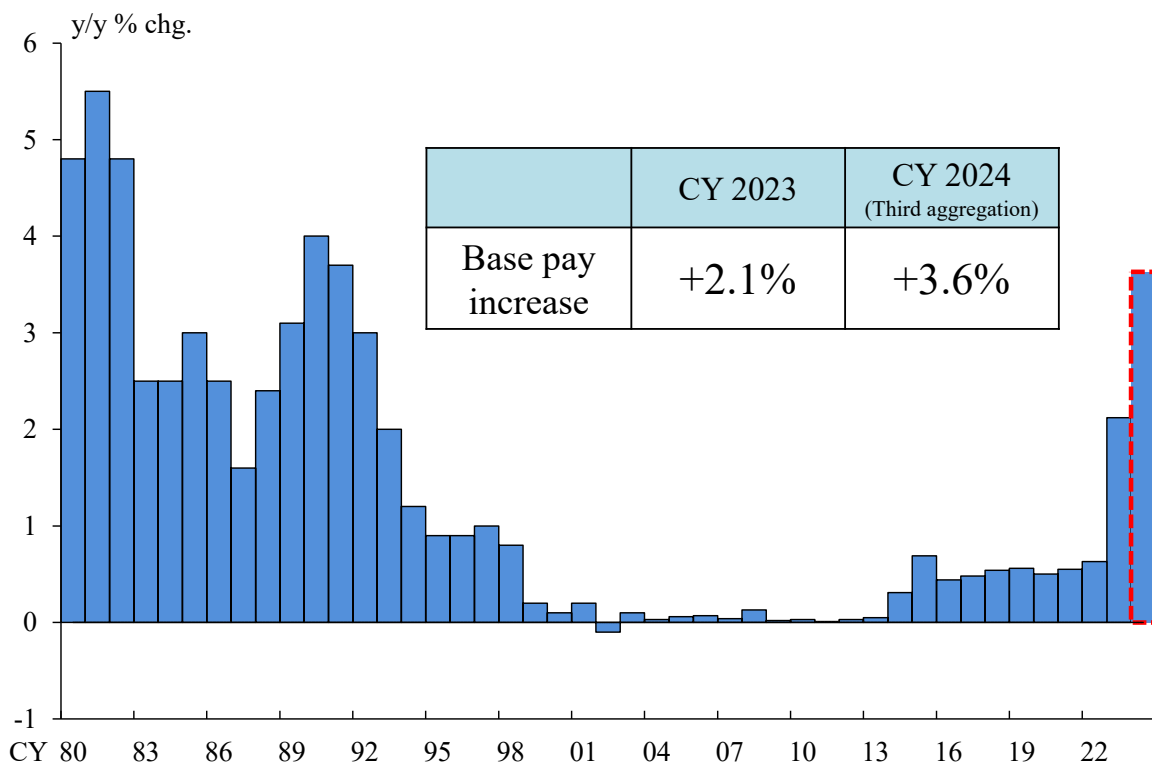
Sources: Bank of Japan; Consensus Economics Inc., "Consensus Forecasts"; QUICK, "QUICK Monthly Market Survey <Bonds>"; Bloomberg.

Firms' Inflation Outlook for their Products/Services



Note: Based on the *Tankan*: outlook for output prices, all industries, all enterprises.
Source: Bank of Japan.

Base Pay Increase (Spring Wage Negotiation)



Note: Figures from 1980 to 2014 are those published by the Central Labour Relations Commission, while those from 2015 to 2024 are figures released by Rengo. The figure for 2024 is from Rengo's third aggregation.
Sources: Japanese Trade Union Confederation (Rengo); Central Labour Relations Commission.