



February 11, 2015  
Bank of Japan

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**The Bank of Japan's  
Efforts toward Overcoming Deflation**

*Remarks at the 7<sup>th</sup> Japan Securities Summit in London*

**Takehiro Sato**

*Member of the Policy Board*

I am truly honored to have this opportunity to be a panel member at the 7<sup>th</sup> Japan Securities Summit.

Japan's economy has continued to recover moderately as a trend with a virtuous cycle from income to spending operating steadily in both the household and corporate sectors. As for the outlook, it is expected to continue its moderate recovery trend. In the Bank of Japan's January 2015 interim assessment of the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), the median of the Policy Board members' forecasts for the growth rate for fiscal 2015 and 2016 were revised upward from the forecasts presented in the October 2014 Outlook Report, partly due to the drop in crude oil prices and the effects of the economic measures by the government.

On the price front, the inflation rates in major countries, including Japan, have been declining as a trend mainly due to the recent drop in crude oil prices. Under those circumstances, central banks in major countries have a common concern that major economies are trapped in a feedback-loop -- the decline in the inflation rates would lead to a fall in people's medium- to long-term inflation expectations, and it would result in a further decline in the actual inflation rates. That is why the Bank decided to expand the QQE last October.

As I cast a dissenting vote on that decision, I may not be an appropriate person to explain this policy. However, I share the Bank's firm resolution to overcome deflation. In this session, I will share with you my views on the effects of the QQE, the Bank's price stability target, and the importance of the government's effort toward fiscal consolidation to ensure the ultimate success of the QQE.

First of all, the effects of the QQE have been increasing in a cumulative manner with the progress in the asset purchases by the Bank. The Bank purchases the Japanese government bonds (JGBs) so that their amount outstanding increases at an annual pace of about 80 trillion yen. This amount, "about 80 trillion yen", substantially exceeds the planned amount of new financial resource bonds by the government, which means that final

investors decrease their outstanding holdings of JGBs. However, Japanese institutional investors' preference for JGBs is strong partly in response to the international financial regulations, and partly due to a lack of attractive domestic investment opportunities. Therefore, as the Bank continues to purchase large-scale assets, that effect on the interest rate formation has been more strongly pronounced especially after the expansion of the QQE. In fact, the yield curve has flattened further, with the yield in the medium-term zone falling into negative territory albeit temporarily, and the super-long end of the yield curve also declining considerably. Meanwhile, an increase in the volatility of the interest rate has been observed recently. I have been monitoring carefully how that shape of the yield curve will influence a variety of asset prices and investors' asset allocation as a policy effect. On the other hand, I have been monitoring the side effects -- such as the effects on financial system stability, including the broadly-defined settlement system, and the market functioning. Also a smooth restoration of markets' price discovery function will be an issue from somewhat a longer perspective, in the process of seeking for an exit from QQE, as the Bank purchases about 90 percent of the total amount of JGBs' market issuance on a gross basis.

Second, my understanding is that in the assessment of the achievement of the Bank's price stability target, what is important is not to focus on the specific price indicators, but to examine whether various economic entities such as firms and households change their behavioral patterns based on the assumption of a certain level of inflation with monitoring a wide range of indicators including those related to wages carefully. It seems that there is no silver bullet for estimating people's medium- to long-term inflation expectations, and therefore whether or not they have started to heighten their expectations, which have consistently remained lower than those in the United States and the Euro Area, can only be judged qualitatively from various economic entities' behavioral patterns. In that regard, households have had an outstandingly sticky preference for extremely inexpensive goods and services under deflation. However, such preference is not so strong as that in the past, and firms' price-setting behavior has also been changing in a positive manner. More importantly, a basic wage-setting mechanism -- base salaries are revised in line with price increases, which was almost forgotten under deflation -- has started to revive in labor-management wage negotiations. It could lead to a breakthrough in changing

people's fixed idea under deflation that base salaries would not rise. That would have positive effects on peoples' medium- to long-term inflation expectations.

In addition, my understanding is that what is essential to achieve the price stability target is a rise in productivity by the efforts of various entities to carry out structural reform and a resultant increase in the potential growth rate as well. On that basis, the inflation rate would increase moderately and wages would continuously improve in line with the increase in productivity, and consequently people would enjoy benefits from the overcoming of the deflation. The driving force for an increase in productivity is capital investment, and I expect that the recent tight labor market conditions are likely to act as a catalyst for the change of firms' behavior.

Third, securing the credibility of fiscal management is important in ensuring the ultimate success of the QQE. In that regard, the joint statement by the government and the Bank released in January 2013 stated that the government will steadily promote measures aimed at establishing a sustainable fiscal structure. My understanding is that the government continues to make efforts toward fiscal consolidation in the fiscal 2015 budget draft.

The Bank's purchases of JGBs are carried out only in the context of the conduct of monetary policy and not in any way to finance the fiscal deficit. It is thanks to the government's efforts toward fiscal consolidation that the Bank's such explanation is persuasive. If market participants have concern over the government's efforts toward fiscal consolidation, the effects of the QQE will be dampened, due to an expansion in risk premiums. Once risk premiums expand, it would be difficult to control. Some market participants mention that there is little room for the expansion in risk premiums in the JGBs market due to the Bank's large-scale purchases. However, the expansion in risk premiums may not be limited to the JGBs market.

The government's efforts toward fiscal consolidation are likely to be important from a longer-term perspective as well, when the Bank achieves the price stability target and seeks for an exit from the QQE. The Bank expects that the government will continue to steadily promote measures aimed at establishing a sustainable fiscal structure.

The QQE is a highly difficult policy. While containing a rise in nominal rates through the massive purchases of the JGBs, the Bank is trying to heighten the people's inflation

expectations which would result in lowering the real interest rates. My assessment is that the QQE has been exerting its intended effects so far. Positive changes have started to be observed in the asset markets and households' and firms' behavioral patterns. The Bank will continue with the QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate. In my view, the criteria for such judgment is that whether various economic entities such as firms and households change their behavioral patterns based on the assumption of a certain level of inflation as I have stated earlier.

Thank you.

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Chart 1

## "Outlook for Economic Activity and Prices" (January 2015)

### Forecasts of the Majority of Policy Board Members

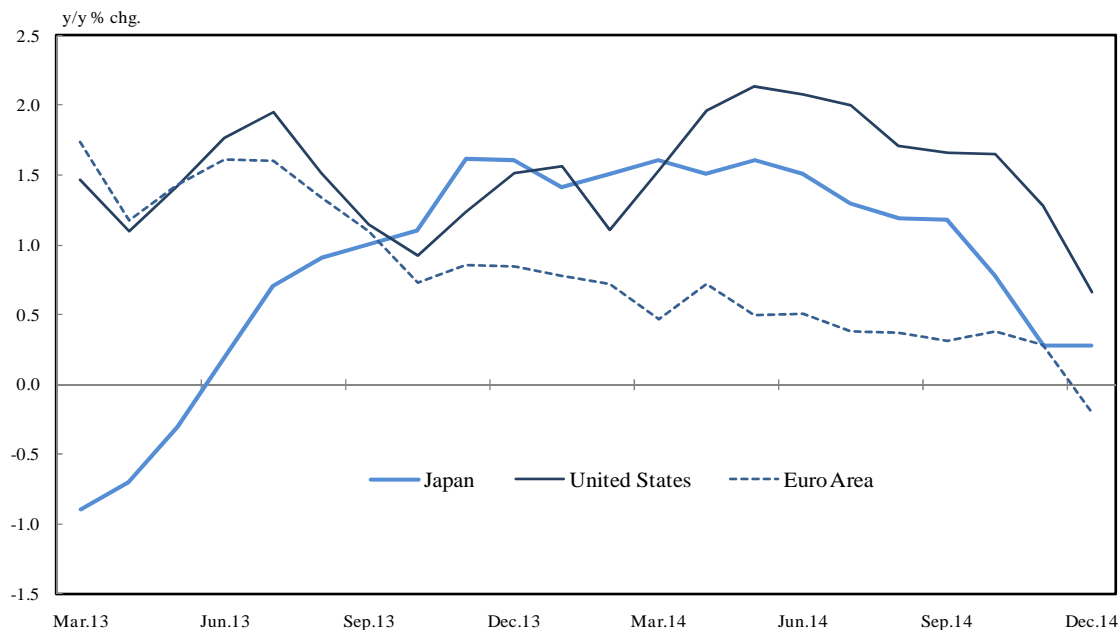
y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2014	-0.6 to -0.4 [-0.5]	+2.9 to +3.2 [+2.9]	+0.9 to +1.2 [+0.9]
Forecasts made in October 2014	+0.2 to +0.7 [+0.5]	+3.1 to +3.4 [+3.2]	+1.1 to +1.4 [+1.2]
Fiscal 2015	+1.8 to +2.3 [+2.1]	+0.4 to +1.3 [+1.0]	
Forecasts made in October 2014	+1.2 to +1.7 [+1.5]	+1.8 to +2.6 [+2.4]	+1.1 to +1.9 [+1.7]
Fiscal 2016	+1.5 to +1.7 [+1.6]	+1.5 to +2.3 [+2.2]	
Forecasts made in October 2014	+1.0 to +1.4 [+1.2]	+1.9 to +3.0 [+2.8]	+1.2 to +2.3 [+2.1]

Note: Figures in brackets indicate the median of the Policy Board members' forecasts (point estimates).  
Source: Bank of Japan.

# Inflation Rates in Major Economies

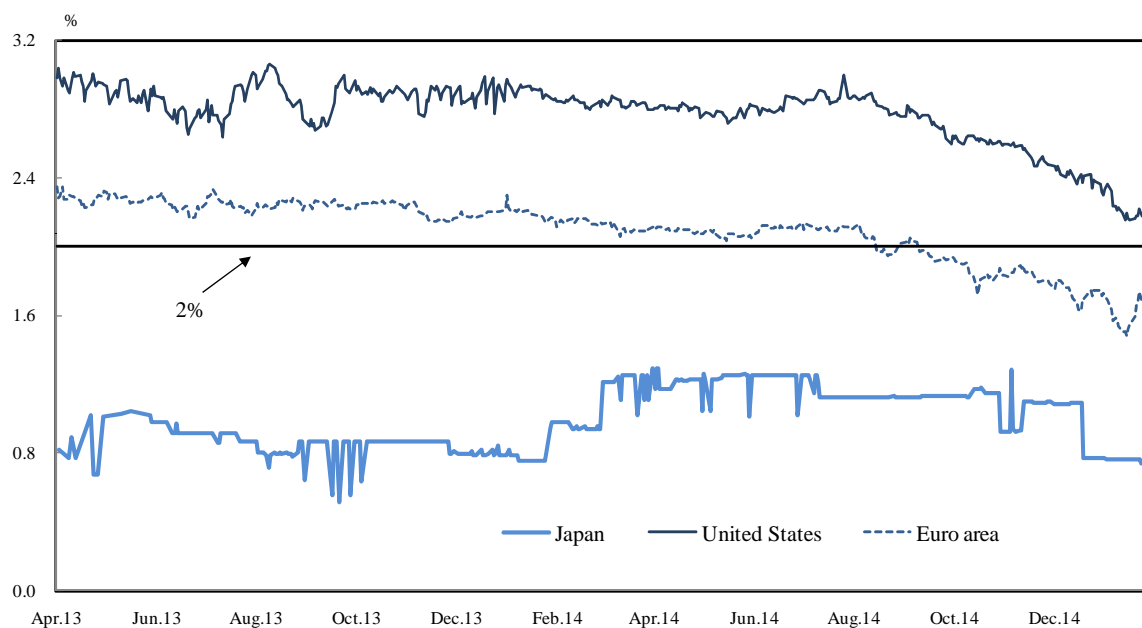
## CPI Headline Inflation Rates



Note: Figures for Japan for April 2014 and onward are estimated after adjusting for the direct effects of the consumption tax hike.  
Sources: Bloomberg.

# Medium- to Long-Term Inflation Expectations in Major Economies

## 5-year / 5-year inflation swap rate



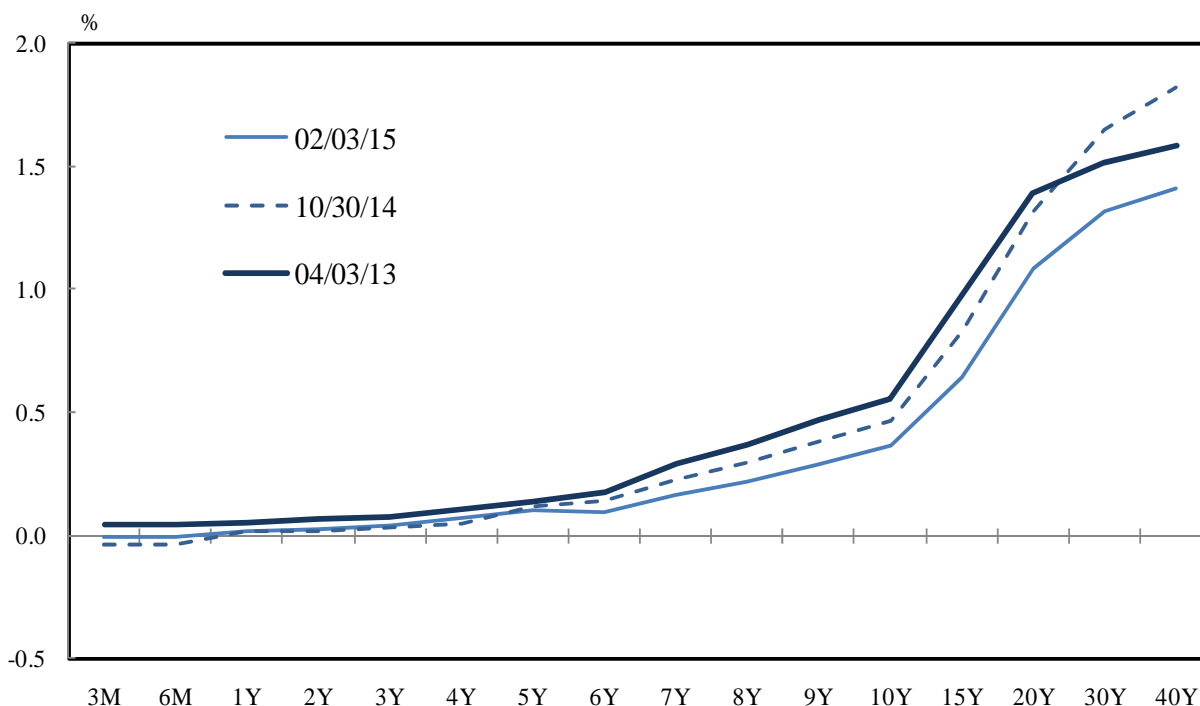
Source: Bloomberg.

## Expansion of the Quantitative and Qualitative Monetary Easing (QQE)

- Accelerating the annual pace of increase in the monetary base from about 60-70 trillion yen to about 80 trillion yen.
- Increasing the annual pace of the Bank's JGB holdings from about 50 trillion yen to about 80 trillion yen.
- Extending the average remaining maturity of JGB purchases from about 7 years to about 7-10 years.
- Increasing the Bank's holdings of ETFs and J-REITs so that the annual paces of increase are tripled to about 3 trillion yen and about 90 billion yen, respectively.

Chart 5

## Changes in the yield curve

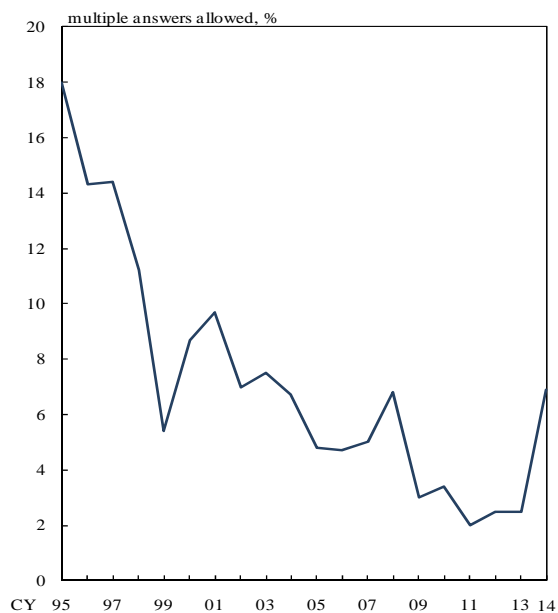
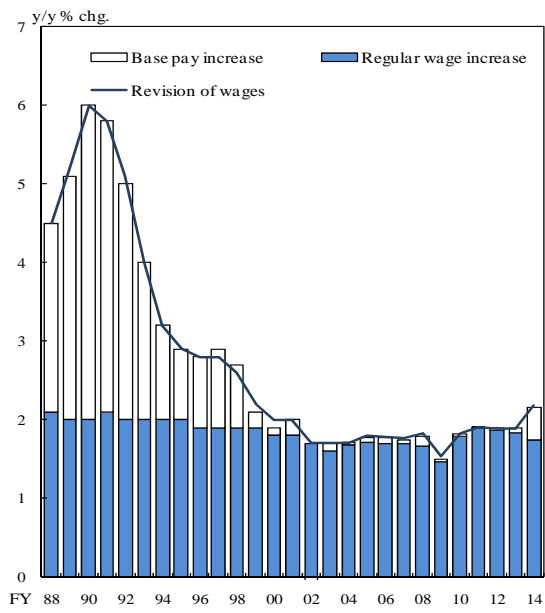


Source: Bloomberg.



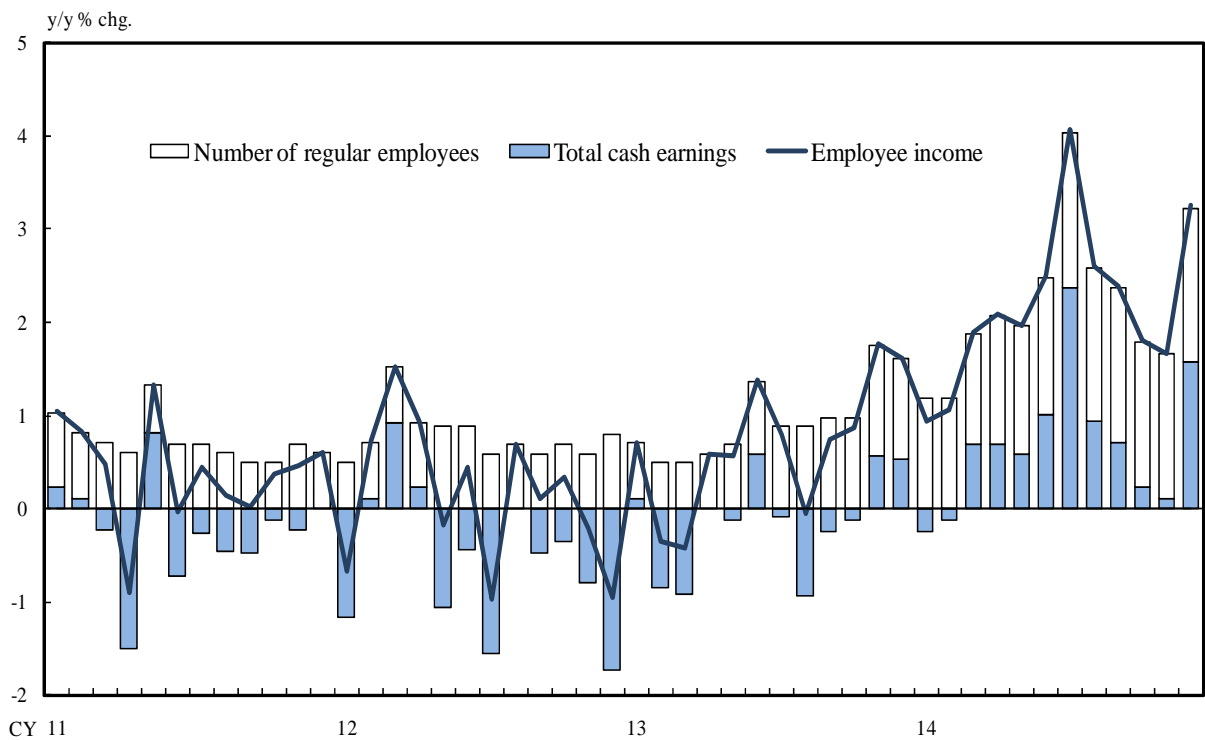
# Increases in Wages

- (1) Base Pay and Regular Wage increase (2) The percentage which emphasized the inflation rate at the time of wage increase



Source: Ministry of Health, Labor and Welfare.

# Employee Income



Note: Employee income is calculated as the number of regular employees times total cash earnings.  
Source: Ministry of Health, Labor and Welfare.

# Factors Affecting Long-Term Interest Rates

