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Bank of Japan

Japan's Experience of Overcoming the Zero Lower Bound

Remarks at the Farewell Symposium for
Honorary Governor Christian Noyer
Held by the Banque de France and Bank for International Settlements

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This is the text of remarks by Governor Kuroda prepared for the symposium held at the Banque de France on January 12, 2016. As Governor Kuroda was unable to attend the symposium, the text was circulated among participants by the organizer.

Thank you very much for inviting me to the farewell symposium for Mr. Christian Noyer. Mr. Noyer's outstanding performance as Governor of the Banque de France over the past 12 years has certainly contributed to the developments of the French economy, but it also has shaped the history of the euro area economy as a whole. I have the deepest respect for his great achievements. In addition, I would like to express my gratitude to Mr. Noyer for keeping a close cooperation and a very good relationship between the Banque de France and the Bank of Japan.

The theme of this session is "Beyond the Zero Lower Bound: Lessons for Monetary Policy." I am perhaps one of the most qualified people in the world to talk about this topic, because I am leading the Bank of Japan, which has been struggling with the zero lower bound for more than a decade. Today, I will explain our experience and how our monetary policy strategy has evolved.

Since the global financial crisis in 2008, overcoming the zero lower bound has become a common challenge for central banks in advanced economies. However, Japan was confronted with the zero lower bound in the late 1990s, when many financial institutions failed after the collapse of the bubble economy and the economy fell into deflation. Many of you may remember that Professor Paul Krugman dubbed this situation "Japan's trap." He pointed out that Japan had actually fallen into a "liquidity trap," which had long been regarded as just a theoretical possibility written in the back pages of macroeconomic textbooks.

In order to get out of the trap, the Bank of Japan adopted a series of unprecedented policy actions. In 1999, it introduced the zero interest rate policy (ZIRP), in which the overnight interest rate was guided to "as low as possible." In 2001, the Bank introduced quantitative easing (QE), a first such attempt in modern monetary history, by setting financial institutions' current account balances at the Bank, rather than the short-term interest rate, as its main operating target. Those measures were enhanced by the commitment that they should be in place until certain conditions about inflation were met. The Bank is a pioneer of what is now called "forward guidance."

Around the turn of the century, many European countries were celebrating the introduction of the euro, their new currency. On the other side of the globe, the possibility was being discussed of Japan's economy falling into a deflationary spiral, as experienced by the U.S. economy during the Great Depression in the 1930s. However, such a worst-case scenario was averted. One reason is that the Bank provided ample funds into the financial markets, alleviating anxiety about liquidity. It played an important part in avoiding a significant economic slowdown. In fact, it appears that the lesson learned then -- that the provision of ample liquidity by a central bank at a time of financial crisis can help restore stability -- has played a role in central banks' response to the recent global financial crisis. However, these measures were not strong enough to terminate prolonged deflation and bring about sustainable economic growth.

Why did Japan's economy fail to get out of the liquidity trap? We can see that it experienced simultaneous declines in the 2000s in inflation expectations and the potential growth rate. Once nominal interest rates are lowered to hit the zero lower bound, real interest rates cannot decline further without a rise in inflation expectations. On the other hand, from the so-called Wicksellian perspective, a decline in the potential growth rate leads to a decline in the "natural interest rate." With these two developments happening at the same time, the Bank was unable to lower real interest rates to the level significantly below the natural interest rate. In other words, it had lost the most important channel of monetary policy.

To make a major breakthrough in this situation, the Bank introduced "quantitative and qualitative monetary easing (QQE)" in April 2013, immediately after I was installed as the governor. What makes QQE different from our previous attempts is that it is designed to work directly on inflation expectations. Specifically, QQE consists of two pillars. The first is a strong and clear commitment to achieving the price stability target of 2 percent. The second is an unprecedented scale of asset purchases in order to underpin that commitment. The former is unique to Japan. The latter is more or less a common element within unconventional monetary policy measures adopted by central banks in advanced economies after the global financial crisis, but the sheer size of purchases by the Bank is truly unprecedented. In fact, the ratio of the monetary base to nominal GDP is now over 60 percent in Japan, with equivalent figures in the United States and the United Kingdom being in the range of about 20-30 percent.

More than two and a half years have passed since the introduction of QQE. QQE has exerted its intended effects. The underlying trend in inflation has been improving steadily. For example, the CPI inflation rate excluding fresh food and energy has been positive for 26 consecutive months, which is the first time this has happened since the late 1990s. The latest figure is 1.2 percent for November. These improvements have been supported by very favorable employment conditions. The unemployment rate has declined to around 3 percent, the level that can be considered as full employment in Japan. Wages have been increasing moderately. In this context, it should be emphasized that a common practice of base wage hikes, which went dormant during the deflation period, has returned in the annual labor-management wage negotiations. Under these circumstances, mark-ups by retailers have been increasingly accepted by consumers.

Nonetheless, the Bank's efforts to achieve the price stability target of 2 percent under QQE are only halfway there. Given that Japan's economy has been mired in deflation for 15 years, eradicating the deflationary mindset that was entrenched among the public is no easy task. However, somebody has to act decisively. As price stability is at stake, it is the central bank that should play this role.

Currently, the European Central Bank (ECB) is also carrying out very aggressive monetary easing through its asset purchases as well as the negative interest rate. In contrast to the case for Japan, long-term inflation expectations have been reasonably anchored at around 2 percent in the euro area. I understand that the ECB is implementing bold monetary easing to preempt potential risks. Although the two economic environments differ, both of us have a strong determination to achieve price stability. In this context, it is no coincidence that the ECB and the Bank are implementing similarly aggressive monetary easing measures. I believe that monetary policy in both the euro area and Japan will succeed in the near future, thereby starting a new chapter for macroeconomics.