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Bank of Japan

Quantitative and Qualitative Monetary Easing

*Remarks at the International Council Meeting
of the Bretton Woods Committee*

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Introduction

It is my honor to take part in this wonderful meeting as a panelist today.

When I first looked at the list of questions prepared by the Committee to shape my remarks, I was stunned by the sheer number and scope of the questions. This points to the fact that we are surrounded by daunting challenges in this interconnected world, and it is our responsibility to sincerely meet those challenges. Given the time constraints today, my focus will naturally be on monetary policy.

The steering of policy has become increasingly difficult in recent times, and many of my fellow central bankers have found themselves in uncharted waters. Since the outbreak of the Lehman crisis, major central banks around the globe have introduced unconventional monetary policy measures, including asset purchases, amid the constraints of a zero lower bound for nominal interest rates. The Bank of Japan has also implemented unconventional monetary policy several times, since more than a decade ago, and has successfully accumulated ample experience. However, we have not been successful in overcoming deflation. To this end, in April, immediately after I became the Governor of the BoJ, we introduced quantitative and qualitative monetary easing, dubbed the QQE. The QQE is markedly different from the policies the BoJ implemented in the past and from unconventional monetary policies other central banks have been carrying out. Today, in the time allotted to me, I would like to explain the uniqueness of the QQE.

Challenges and Economic Situation

Japan's economy has been mired in deflation for the past 15 years. In the meantime, people's inflation expectations declined and the recognition that prices will not increase -- namely, deflationary expectations -- became entrenched. Amid the situation of prices not increasing, the holding of cash or deposits became a better investment, and thus firms and households hoarded cash and did not make other productive investments. Persistent deflation encouraged behavior to stay status quo, and this deprived Japan's economy of vitality.

There were phases of economic recovery in the meantime, but they did not lead to a sustainable increase in prices. The Phillips curve, which shows the relationship between the output gap and inflation, shifted downward in tandem with a decline in inflation expectations. The average inflation rate envisaged when the economy is at an average state has been 0 to 0.5 percent for the past 15 years or so. Those in the other six G7 countries have been anchored around the inflation target of 2 percent.

The largest problem for Japan's economy is that prices will not increase even if the level of economic activity rises. Therefore, the greatest challenge is to raise inflation expectations.

Uniqueness of the QQE

Based on this recognition, the BoJ introduced the QQE in April. This new policy aimed at increasing inflation to the global standard of 2 percent by working directly on inflation expectations. Specifically, the policy comprised two features. First, to show the BoJ's determination that it would overcome deflation at the earliest possible time through a strong and clear statement. Therefore, the period in which the BoJ would achieve the target was clearly specified as "about two years." The second feature, for the purpose of underpinning such determination, was to launch massive monetary easing that clearly differed from the past policies. Specifically, the BoJ declared that there would be a doubling in two years of the monetary base that it provides. As a result, Japan's monetary base two years from now will become 270 trillion yen, or 2.8 trillion dollars, reaching more than 50 percent of nominal GDP. This ratio is 20 percent for the U.S. Federal Reserve and 23 percent for the Bank of England. As the BoJ will double the holdings of Japanese government bonds (JGBs) on its asset side when increasing the monetary base, the QQE also aims at putting strong downward pressure on long-term interest rates.

A core mechanism of the policy is to raise inflation expectations and contain long-term interest rates. Under the BoJ's clear commitment and a new phase of massive monetary easing, inflation expectations will be raised, while an increase in long-term interest rates will be contained through massive purchases of JGBs. As a result, real interest rates will decline and this will create stimulative effects for economic activity. If this leads to an actual rise in price indices, it will in turn lead to an increase in inflation expectations.

State of Progress under the QQE

Six months have passed since the introduction of the QQE, and this mechanism has steadily been operating. In Japan's economy, real GDP has marked annualized growth of around 4 percent for two consecutive quarters and the CPI inflation rate (excluding fresh food) turned positive in June for the first time in 14 months, accelerating to plus 0.8 percent. The outlook for economic activity and prices has improved and stock prices have risen by more than 30 percent since the beginning of the year. While these should be factors that lead to increases in long-term interest rates, Japan's long-term interest rates have declined from about 0.8 percent as of the beginning of the year to less than 0.7 percent. These rates have declined since end-May, even in a situation of long-term interest rates in the United States and many other countries having substantially increased across the board. The break-even inflation rate and expected inflation rates judged from various surveys have been increasing. Thus, the QQE has been exerting its intended effects and Japan has been steadily moving toward overcoming deflation.

Concluding Remarks

The QQE is an unprecedented policy, in that it aims to increase inflation expectations in a situation where there is no room to further reduce nominal interest rates. While this is a daunting challenge, developments thus far have been encouraging. With the aim of achieving the 2 percent price stability target, the BoJ will continue with the QQE as long as it is necessary for maintaining that target in a stable manner.

Thank you for your attention.