September 21, 2016

Bank of Japan

**New Framework for Strengthening Monetary Easing:**
**"Quantitative and Qualitative Monetary Easing with Yield Curve Control"**

1. At the Monetary Policy Meeting held today, the Policy Board of the Bank of Japan conducted a comprehensive assessment of the developments in economic activity and prices under "Quantitative and Qualitative Monetary Easing (QQE)" and "QQE with a Negative Interest Rate" as well as their policy effects, and compiled "The Bank's View" as provided in Attachment 1. The Policy Board's view on the current situation of and outlook for economic activity and prices is provided in Attachment 2.

2. Based on these, with a view to achieving the price stability target of 2 percent at the earliest possible time, the Bank decided to introduce "QQE with Yield Curve Control" by strengthening the two previous policy frameworks mentioned above. The new policy framework consists of two major components: the first is "yield curve control" in which the Bank will control short-term and long-term interest rates; and the second is an "inflation-overshooting commitment" in which the Bank commits itself to expanding the monetary base until the year-on-year rate of increase in the observed consumer price index (CPI) exceeds the price stability target of 2 percent and stays above the target in a stable manner. Specifically, the Bank decided upon the following.

   (1) Yield curve control

      a) Guideline for market operations (by a 7-2 majority vote)[Note 1]

      The guideline for market operations specifies a short-term policy interest rate and a target level of a long-term interest rate. The Bank decided to set the following guideline for market operations for the intermeeting period. The Bank will cut the interest rates further if judged necessary.

      The short-term policy interest rate:

      The Bank will apply a negative interest rate of minus 0.1 percent to the Policy-Rate Balances in current accounts held by financial institutions at the Bank.

The long-term interest rate:

The Bank will purchase Japanese government bonds (JGBs) so that 10-year JGB yields will remain more or less at the current level (around zero percent). With regard to the amount of JGBs to be purchased, the Bank will conduct purchases more or less in line with the current pace -- an annual pace of increase in the amount outstanding of its JGB holdings at about 80 trillion yen -- aiming to achieve the target level of a long-term interest rate specified by the guideline. JGBs with a wide range of maturities will continue to be eligible for purchase, while the guideline for average remaining maturity of the Bank's JGB purchases will be abolished.

b) New tools of market operations for facilitating yield curve control (by an 8-1 majority vote)[Note 2]

The Bank decided to introduce the following new tools of market operations so as to control the yield curve smoothly.

(i) Outright purchases of JGBs with yields designated by the Bank (fixed-rate purchase operations)[1]

(ii) Fixed-rate funds-supplying operations for a period of up to 10 years (extending the longest maturity of the operation from 1 year at present)

(2) Guidelines for asset purchases

With regard to asset purchases except for JGB purchases, the Bank decided, by a 7-2 majority vote, to set the following guidelines.[Note 3]

a) The Bank will purchase exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their amounts outstanding will increase at annual paces of about 6 trillion yen and about 90 billion yen, respectively.

b) As for CP and corporate bonds, the Bank will maintain their amounts outstanding at about 2.2 trillion yen and about 3.2 trillion yen, respectively.

[1] In case of a spike in interest rates, the Bank stands ready to conduct fixed-rate JGB purchase operations -- for example, those with regard to 10-year and 20-year JGB yields -- in order to prevent the yield curve from deviating substantially from the current levels.

(3) Inflation-overshooting commitment[Note 4]

The Bank will continue with "QQE with Yield Curve Control," aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner.

The Bank will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds the price stability target of 2 percent and stays above the target in a stable manner. Meanwhile, the pace of increase in the monetary base may fluctuate in the short run under market operations which aim at controlling the yield curve. With the Bank maintaining this stance, the ratio of the monetary base to nominal GDP in Japan is expected to exceed 100 percent (about 500 trillion yen) in slightly over one year (at present, about 80 percent in Japan compared with about 20 percent in the United States and the euro area).

The Bank will make policy adjustments as appropriate, taking account of developments in economic activity and prices as well as financial conditions, with a view to maintaining the momentum toward achieving the price stability target of 2 percent.

3. In light of the findings of the comprehensive assessment, the thinking behind the newly introduced policy framework is as follows.

(1) Background to the introduction of yield curve control

As shown in the comprehensive assessment, QQE has brought about improvements in economic activity and prices mainly through the decline in real interest rates, and Japan's economy is no longer in deflation, which is commonly defined as a sustained decline in prices. With this in mind, "yield curve control," in which the Bank will seek for the decline in real interest rates by controlling short-term and long-term interest rates, would be placed at the core of the new policy framework.

The experience so far with the negative interest rate policy shows that a combination of the negative interest rate on current account balances at the Bank and JGB purchases is effective for yield curve control. In addition, the Bank decided to introduce new tools of market operations which will facilitate smooth implementation of yield curve control.

(2) Measures to raise inflation expectations

The price stability target of 2 percent has not been achieved. In the course of the Bank's attempt to raise inflation expectations toward 2 percent, observed inflation rates declined due to a variety of exogenous factors such as a fall in crude oil prices. Under these circumstances, inflation expectations declined, as the adaptive mechanism has been playing a relatively large role in the formation of inflation expectations in Japan. This seems to be the main factor that hampers achieving the price stability target of 2 percent.

In order to address this situation, the Bank judged it necessary to adopt measures that will raise inflation expectations in a more forceful manner.

First, the Bank decided to adopt a commitment that allows inflation to overshoot the price stability target so as to strengthen the "forward-looking mechanism" in the formation of inflation expectations. Achieving the price stability target means attaining a situation where the inflation rate is 2 percent on average over the business cycle. Given the fact that both observed and expected inflation rates are below 2 percent currently, the Bank judged it appropriate to enhance the credibility for the price stability target among the public by committing itself to "expanding the monetary base until the year-on-year rate of increase in the observed CPI exceeds the price stability target of 2 percent and stays above the target in a stable manner."

Second, it is necessary to have momentum in order to shift peoples' deflationary mindset which had been entrenched amid the prolonged period of deflation. Thus, the Bank adheres to its commitment to achieving the 2 percent inflation "at the earliest possible time." Meanwhile, a further rise in inflation expectations through the adaptive mechanism is uncertain and may take time. Considering these, the Bank judged it appropriate to adopt a new policy framework with the mechanisms for yield curve control placed at the core that enables the Bank to make more flexible adjustments according to developments in economic activity and prices as well as financial conditions and that enhances the sustainability of monetary easing.

(3) Possible options for additional easing

With regard to possible options for additional easing, the Bank can cut the short-term policy interest rate and the target level of a long-term interest rate, which are two key benchmark rates for yield curve control. It is also possible for the Bank to expand asset purchases as has been the case since the introduction of QQE. Moreover, if the situation warrants it, an acceleration of expansion of the monetary base may also be an option.

4. In January 2013, the Government and the Bank released the joint statement, which sets out that both parties strengthen their policy coordination and work together in order to overcome deflation early and achieve sustainable economic growth with price stability. The Bank will pursue "QQE with Yield Curve Control" and achieve the price stability target of 2 percent at the earliest possible time. The Bank believes that its monetary policy and the Government's fiscal policy as well as initiatives for strengthening Japan's growth potential will produce synergy effects, and thereby will navigate Japan's economy toward overcoming deflation and achieving sustainable growth.[Note 4]

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[Note 1] Voting for the action: Mr. H. Kuroda, Mr. K. Iwata, Mr. H. Nakaso, Mr. Y. Harada, Mr. Y. Funo, Mr. M. Sakurai, and Ms. T. Masai. Voting against the action: Mr. T. Sato and Mr. T. Kiuchi. Mr. T. Sato dissented considering that setting the short-term policy rate at minus 0.1 percent and the target level of 10-year JGB yields at around 0 percent could lead to holding JGB yields in negative territory up to a maturity of 10 years and thus could have an adverse impact on the functioning of financial intermediation. Mr. T. Kiuchi dissented considering that, with a view to maintaining the stability of the JGB market and the functioning of financial intermediation, (1) the short-term policy interest rate should be set at 0.1 percent and (2) the adoption of a target level of a long-term interest rate was not appropriate because it would entail a risk that the Bank might need to further increase a pace of its JGB purchases.

[Note 2] Voting for the action: Mr. H. Kuroda, Mr. K. Iwata, Mr. H. Nakaso, Mr. T. Sato, Mr. Y. Harada, Mr. Y. Funo, Mr. M. Sakurai, and Ms. T. Masai. Voting against the action: Mr. T. Kiuchi. Mr. T. Kiuchi dissented because the new tools of market operations could impair the functioning of the JGB market and could distort the pricing mechanism in overall financial markets.

[Note 3] Voting for the action: Mr. H. Kuroda, Mr. K. Iwata, Mr. H. Nakaso, Mr. Y. Harada, Mr. Y. Funo, Mr. M. Sakurai, and Ms. T. Masai. Voting against the action: Mr. T. Sato and Mr. T. Kiuchi. Mr. T. Sato dissented considering that ETF purchases of about 6 trillion yen annually would be excessive in light of their adverse impact on the pricing mechanism in the stock market and the Bank's financial soundness. Mr. T. Kiuchi proposed that the Bank continue to use amounts of asset purchases as its operating targets and set the guidelines for asset purchases in which the Bank would purchase JGBs so that their amount outstanding would increase at an annual pace of about 45 trillion yen, purchase ETFs so that their amount outstanding would increase at an annual pace of about 1 trillion yen, and so on. The proposal was defeated by a majority vote.

[Note 4] Mr. T. Sato opposed the "inflation-overshooting commitment" regarding an expansion of the monetary base considering that this was not a realistic target and would not be effective. Mr. T. Kiuchi proposed that Section 2.(3) be deleted and that the Bank aim at achieving the price stability target of 2 percent in the medium to long term in its future conduct of monetary policy. The proposal was defeated by an 8-1 majority vote. Voting for the proposal: Mr. T. Kiuchi. Voting against the proposal: Mr. H. Kuroda, Mr. K. Iwata, Mr. H. Nakaso, Mr. T. Sato, Mr. Y. Harada, Mr. Y. Funo, Mr. M. Sakurai, and Ms. T. Masai.

Attachment 1

**Comprehensive Assessment:**
**Developments in Economic Activity and Prices as well as Policy Effects**
**since the Introduction of Quantitative and Qualitative Monetary Easing (QQE)**

**The Bank's View**[Note 5]

## I. Comprehensive Assessment

### A. Transmission Mechanism of QQE

QQE has lowered real interest rates by raising inflation expectations and pushing down nominal interest rates. Although the natural rate of interest has followed a downward trend, real interest rates have been well below the natural rate of interest, leading to an improvement in financial conditions. As a result, economic activity and price developments improved, and Japan's economy is no longer in deflation, which is commonly defined as a sustained decline in prices.

### B. Factors That Have Hampered Achieving the 2 Percent Price Stability Target

However, the price stability target of 2 percent has not been achieved. In terms of the mechanism described above, this is largely due to developments in inflation expectations. The following two factors have played a role in the development of inflation expectations. First, exogenous developments, including (1) the decline in crude oil prices, (2) the weakness in demand following the consumption tax hike in April 2014, and (3) the slowdown in emerging economies and volatile global financial markets, have lowered the observed inflation rate. And second, amid this decline in the observed inflation rate, inflation expectations -- after having been largely flat -- weakened, reflecting the fact that expectations formation in Japan is largely adaptive, that is, backward-looking.

### C. The Mechanism of Inflation Expectations Formation

Inflation expectations need to be raised further in order to achieve the price stability target of 2 percent. However, it should be noted that, since the observed inflation rate is likely to remain subdued for the time being, a further rise in inflation expectations through the adaptive mechanism is uncertain and may take time. This highlights the important role played by the forward-looking expectations formation mechanism.

The expansion of the monetary base, together with the commitment to achieving the price stability target and the Bank's purchases of Japanese government bonds (JGBs), by bringing about a regime change in monetary policy, has transformed peoples' perceptions of inflation and has led to a rise in inflation expectations. The relationship between the monetary base and inflation expectations seems to be of a long-run rather than a short-run nature. Therefore, what is important is the Bank's commitment to expanding the monetary base in the long run.

### D. Pushing Down the Yield Curve through the Negative Interest Rate and JGB Purchases

The negative interest rate policy introduced by the Bank in January 2016, in combination with JGB purchases, has pushed down not only short-term but also long-term interest rates substantially. This shows that the combination of these policy measures is an effective means for the central bank to exert influence on the entire yield curve.

### E. The Effects and Impact of the Decline in the Yield Curve

The decline in JGB yields has translated into a decline in lending rates as well as interest rates on corporate bonds and CP. Financial institutions' lending attitudes continue to be proactive. Thus, so far, financial conditions have become more accommodative under the negative interest rate policy. However, because the decline in lending rates has been brought about by reducing financial institutions' lending margins, the extent to which a further decline in the yield curve will lead to a decline in lending rates depends on financial institutions' lending stance going forward.

The impact of interest rates on economic activity and prices as well as financial conditions depends on the shape of the yield curve. In this regard, the following three points warrant attention. First, short- and medium-term interest rates have a larger impact on economic activity than longer-term rates. Second, the link between the impact of interest rates and the shape of the yield curve may change as firms explore new ways of raising funds such as issuing super-long-term corporate bonds under the current monetary easing, including the negative interest rate policy. Third, an excessive decline and flattening of the yield curve may have a negative impact on economic activity by leading to a deterioration in people's sentiment, as it can cause uncertainty about the sustainability of financial functioning in a broader sense.

## II. Directions for Monetary Policy Suggested by the Comprehensive Assessment

These findings of the comprehensive assessment suggest the following directions for monetary policy.

(1) Inflation expectations need to be raised further in order to achieve the price stability target of 2 percent. Given that a further rise in inflation expectations through the adaptive mechanism is uncertain and may take time, measures to strengthen the forward-looking expectations formation mechanism are warranted. At the same time, the Bank needs to adopt measures that enable the Bank to make flexible adjustments according to developments in economic activity and prices as well as financial conditions and that enhances the sustainability of monetary easing.

(2) The Bank should commit itself to expanding the monetary base in the long run.

(3) The Bank can exert influence on interest rates along the entire yield curve through the appropriate combination of a negative interest rate and JGB purchases.

(4) To work toward the formation of an appropriate yield curve, the Bank should take account of economic, price, and financial conditions, including (i) the extent to which a decline in JGB yields translates into a decline in lending and corporate bond rates, (ii) the effects of a decline in JGB yields on economic activity, and (iii) the impact of a decline in JGB yields on financial functioning.

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[Note 5] Voting for the proposal: Mr. H. Kuroda, Mr. K. Iwata, Mr. H. Nakaso, Mr. Y. Harada, Mr. Y. Funo, Mr. M. Sakurai, and Ms. T. Masai. Voting against the proposal: Mr. T. Sato and Mr. T. Kiuchi. Mr. T. Sato opposed the expressions such as "the relationship between the monetary base and inflation expectations seems to be of a long-run rather than a short-run nature." Mr. T. Kiuchi dissented because the comprehensive assessment (1) did not examine a decline in sustainability of the Bank's JGB purchases and an increasing risk to the Bank's financial soundness and (2) differed from his own view regarding price determination mechanisms and achievement of the price stability target.

Attachment 2

## Current Situation of and Outlook for Economic Activity and Prices in Japan

1. Japan's economy has continued its moderate recovery trend, although exports and production have been sluggish due mainly to the effects of the slowdown in emerging economies. Overseas economies have continued to grow at a moderate pace, but the pace of growth has somewhat decelerated mainly in emerging economies. In this situation, exports have been more or less flat. On the domestic demand side, business fixed investment has been on a moderate increasing trend as corporate profits have been at high levels. Against the background of steady improvement in the employment and income situation, private consumption has been resilient, although relatively weak developments have been seen in some indicators. Housing investment has continued picking up, and the decline in public investment has leveled off. Reflecting these developments in demand both at home and abroad, industrial production has continued to be more or less flat. Financial conditions are highly accommodative. On the price front, the year-on-year rate of change in the consumer price index (CPI, all items less fresh food) has been slightly negative. Although inflation expectations appear to be rising on the whole from a somewhat longer-term perspective, they have recently weakened.

2. With regard to the outlook, sluggishness is expected to remain in exports and production for some time, and the pace of economic recovery is likely to remain slow. Thereafter, domestic demand is likely to follow an uptrend, with a virtuous cycle from income to spending being maintained in both the household and corporate sectors, and exports are expected to head toward a moderate increase as overseas economies move out of their deceleration phase. Thus, Japan's economy is likely to be on a moderate expanding trend. The year-on-year rate of change in the CPI is likely to be slightly negative or about 0 percent for the time being, due to the effects of the decline in energy prices, and, as the underlying trend in inflation steadily rises, accelerate toward 2 percent.[Note 6]

3. Risks to the outlook include the impact that uncertainties associated with the United Kingdom's vote to leave the European Union would have on the global financial markets and global economy, uncertainties surrounding emerging and commodity-exporting economies, particularly China, developments in the U.S. economy and the impact of its monetary policy on global financial markets, prospects regarding the European debt problem -- including the

financial sector -- and the momentum of economic activity and prices in Europe, and geopolitical risks.

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[Note 6] Voting for the proposal: Mr. H. Kuroda, Mr. K. Iwata, Mr. H. Nakaso, Mr. T. Sato, Mr. Y. Harada, Mr. Y. Funo, Mr. M. Sakurai, and Ms. T. Masai. Voting against the proposal: Mr. T. Kiuchi. Mr. T. Kiuchi opposed the expression that the year-on-year rate of change in the CPI was likely to accelerate toward 2 percent.

(Reference)

Meeting hours:

Tuesday, September 20: 14:00-16:04

Wednesday, September 21: 9:00-12:58

Policy Board members present:

Haruhiko Kuroda (Governor)

Kikuo Iwata (Deputy Governor)

Hiroshi Nakaso (Deputy Governor)

Takehiro Sato

Takahide Kiuchi

Yutaka Harada

Yukitoshi Funo

Makoto Sakurai

Takako Masai

(Others present)

September 20

From the Ministry of Finance:

Mitsuru Ota, Deputy Vice Minister for Policy Planning and Co-ordination (14:00-16:04)

From the Cabinet Office:

Shigeki Habuka, Vice-Minister for Policy Coordination (14:00-16:04)

September 21

From the Ministry of Finance:

Taku Otsuka, State Minister of Finance (9:00-12:18, 12:39-12:58)

From the Cabinet Office:

Takao Ochi, State Minister of Cabinet Office (9:00-12:18, 12:39-12:58)

Release Dates and Time:

New Framework for Strengthening Monetary Easing: "Quantitative and Qualitative Monetary Easing with Yield Curve Control" -- Wednesday, September 21 at 13:18

Release Schedule:

Summary of Opinions -- Friday, September 30 at 8:50

Minutes -- Monday, November 7 at 8:50