BANK OF JAPAN

Review of Monetary Policy from a Broad Perspective

Summary

December 2024

Bank of Japan

Major Initiatives for the Review of Monetary Policy from a Broad Perspective

- Since the late 1990s, when Japan's economy fell into deflation, achieving price stability has been a challenge.
- In April 2023, the Bank decided to conduct a review of monetary policy from a broad perspective in order to deepen its understanding of monetary policy during that period and gain insights that would be useful for future policy conduct.

Analyses by the Bank

Research and Analysis

42 papers[1]

- Economic activity and prices
- Monetary policy
- Financial markets
- Financial system

Note 1: Only papers written in English are counted.

Outreach Initiatives to Incorporate a Wide Range of External Expertise

Exchange of Views

- Meetings of the Policy Board members with local and business leaders (17 sessions with local firms, financial institutions, etc.)
- Conferences and workshops (6 events with academics and experts)

Surveys

- Survey on corporate behavior (2,509 firms, including local SMEs)
- *Opinion Survey on the General Public's Views and Behavior* (Households)
- *Bond Market Survey, Special Survey* (70 financial institutions)

Public Consultation

- Opinions gathered via the internet and by mail (172 responses)

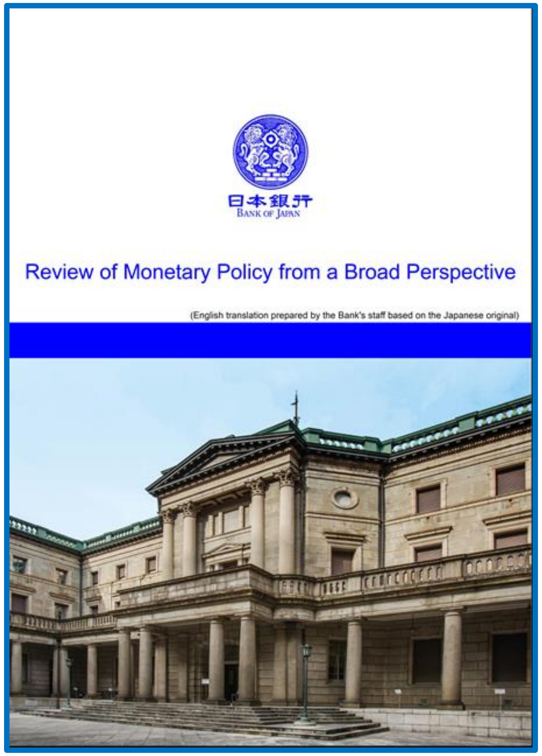
Experts' Commentaries

- Commentaries from academic experts (8 experts)

Outline of the Review of Monetary Policy from a Broad Perspective

Developments in Economic Activity, Prices, and Financial Conditions and the Conduct of Monetary Policy in Japan over the Past 25 Years

- Developments in Economic Activity, Prices, and Financial Conditions in Japan since the Latter Half of the 1990s
- Monetary Policy Conduct until the Early 2010s
- Impact of the Large-Scale Monetary Easing since 2013 on Economic Activity and Prices
- Impact of Large-Scale Monetary Easing on Market Functioning, the Functioning of Financial Intermediation, and the Growth Potential
- Assessment of the Effects and Side Effects of Large-Scale Monetary Easing



Implications for the Future Conduct of Monetary Policy

- The Bank's Thinking on Unconventional Monetary Policy
- Price Stability Target of 2 Percent
- Fiscal and Monetary Policy
- Issues regarding Individual Monetary Policy Measures

Developments in Economic Activity, Prices, and Financial Conditions in Japan since the Latter Half of the 1990s

Since the latter half of 1990s: prolonged moderate deflation

- **Chronic demand shortages** with **a decline in the natural rate of interest**
  - ➢ Conventional monetary policy measures were unable to sufficiently stimulate the economy due to the effective lower bound on nominal interest rates.
  - ➢ The decline in the natural rate of interest was attributable to factors such as asset prices falling and growth expectations taking a downward turn after the burst of the bubble economy; firms becoming more cautious in their risk-taking, particularly due to the Global Financial Crisis; and demographic changes.
- Downward pressure on prices due to globalization and IT innovations
- **Entrenchment of behavior and a mindset based on the assumption that wages and prices will not increase easily**

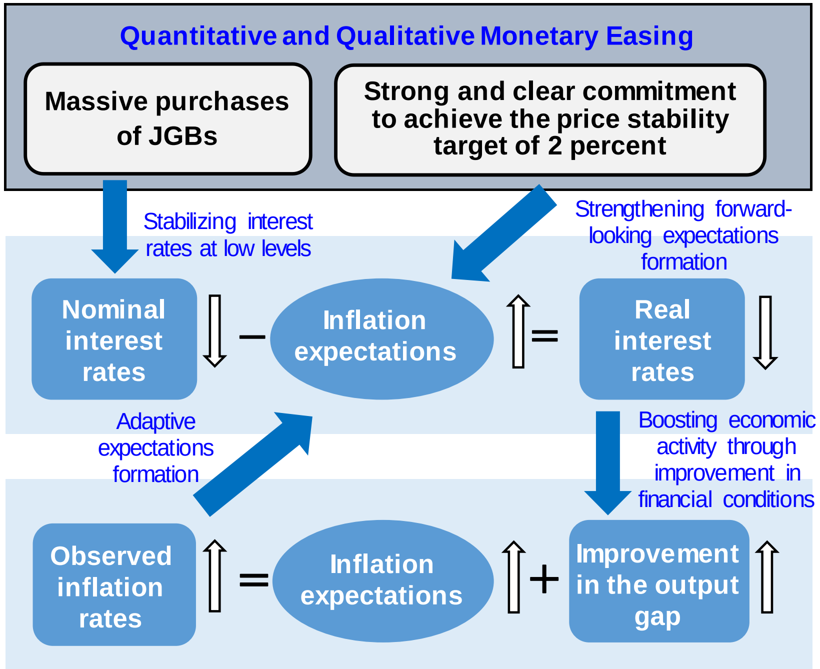
Since 2013: moved out of the state of deflation

- The chronic shortage of demand abated, mainly due to large-scale monetary easing and fiscal stimulus packages, as well as changes in the external environment
- Inflation expectations rose somewhat, and **the rate of change in prices turned positive but remained below 2 percent**
  - ➢ There remained room for increases in the labor supply, such as from women and seniors.
  - ➢ It took time for the behavior and mindset based on the assumption that wages and prices will not increase easily to change.

In the 2020s: changes since the COVID-19 pandemic

- Firms' **behavior has shifted more toward raising wages and prices**
  - ➢ Labor shortages became more pronounced (shrinkage of the room for additional labor supply and increased number of employed persons due to monetary easing and other factors).
  - ➢ Import prices rose significantly and government measures were taken to support firms to pass on higher input prices to their selling prices and raise wages.

Impact of the Large-Scale Monetary Easing since 2013 (1)



Influencing Expectations

- Affected inflation expectations to some degree
  - ✓ But not sufficiently effective to anchor inflation at 2 percent

Reduction in Nominal Interest Rates

- Large-scale JGB purchases exerted downward pressure across the yield curve
  - ✓ Long-term interest rates were pushed down by about 1 percentage point since 2016

Impact on Economic Activity and Prices

- **Large-scale monetary easing pushed up economic activity and prices**
- However, mainly due to the difficulties of influencing expectations, **the effect was not as large as expected at the time when it was introduced**[1]

Note 1: The Bank initially aimed to achieve the price stability target of 2 percent at the earliest possible time, with a time horizon of about two years.

Impact of the Large-Scale Monetary Easing (Average from 2013 Onward)

	Real GDP (level)	CPI (y/y chg.)
Macroeconomic model (Q-JEM)	+1.3 to +1.8%	+0.5 to +0.7% points
Time-series model (FAVAR)	——	+0.6 to +1.1% points

Impact of the Large-Scale Monetary Easing since 2013 (2)

Side Effects of Large-Scale Monetary Easing etc.

Functioning of financial markets	**Negative impact** on the functioning of the JGB market ✓ Amid the prolonged large-scale JGB purchases, the functioning of the JGB market deteriorated as the effect of YCC in suppressing long-term interest rates became more pronounced.
Functioning of financial intermediation	**Downward pressure on financial institutions' interest margins on loans and other assets** but **no evidence of financial intermediation activities being impeded** ✓ Downward pressure has been exerted on financial institutions' interest margins on loans and other assets, while their capital adequacy ratio has been enhanced through lower credit risk etc. Corporate demand for funds has increased through improvements in the economy.
Supply side of the economy	**No clear conclusion reached**, either positive or negative ✓ Theoretically, both positive impact (e.g., promoting capital accumulation) and negative impact (e.g., distortions in resource allocation due to low-productivity firms surviving) can be considered.

Assessment of the Effects and Side Effects of Large-Scale Monetary Easing

- Although there have been certain side effects on financial markets and financial institutions' profits, **the overall effect on the Japanese economy so far appears to have been positive**.
- However, **attention should be paid to the possibility that the negative effects may become larger in the future**, such as the possibility that the functioning of the JGB market does not fully recover or possible side effects of large-scale monetary easing materialize at a later date.
  - ✓ The Bank's share of JGB holdings is expected to remain extremely large for some time, and it may take a period of time for the functioning of the JGB market to recover.
  - ✓ Some of the bank lending may contain loans to borrowers with relatively low resilience to a decline in income or an increase in loan interest rates, and the durations of loans provided and bonds held by financial institutions have been getting longer. These points could be factors that impede financial intermediation activities in the event of a significant change in the external environment.

Implications for the Future Conduct of Monetary Policy

The Bank's Thinking on Unconventional Monetary Policy

- Unconventional monetary policy measures were effective in pushing up Japan's economic activity and prices. However, the quantitative degree of their effects are uncertain compared with conventional monetary policy measures (guiding short-term interest rates). When unconventional monetary policy measures are implemented at a large scale for a long period of time, they could bring about side effects.
- Going forward, if it becomes necessary to implement unconventional monetary policy measures, it will be important to **weigh the benefits and costs**, while taking account of the developments in economic activity and prices as well as financial conditions at that point in time.
- **The Bank should not exclude at this point any specific measures when considering the future conduct of monetary policy**. Looking ahead, in considering the implementation of each measure, it will be necessary for the Bank to design policy measures that can exert positive effects while minimizing side effects as much as possible, taking account of the findings of the Review.

Price Stability Target of 2 Percent

- It is appropriate for the Bank to continue to **conduct monetary policy from the perspective of sustainable and stable achievement of the price stability target of 2 percent**.
  - ✓ Unconventional monetary policy measures cannot fully substitute for short-term interest rate control, and it is desirable to conduct monetary policy so that the zero lower bound would not be reached. It is important to maintain a moderate positive inflation rate in a stable manner so that real interest rates can be lowered in the case of an economic downturn.
  - ✓ Bias in the CPI serves as supporting evidence.
  - ✓ Many central banks in major advanced economies have set their inflation targets at 2 percent.
  - ✓ When Japan was under the prolonged deflation, or in a low-inflation environment, prices of individual items became more rigid and the regular pay tended to be unchanged, and this may have distorted resource allocation or have constrained proactive investment by firms.