

Japan's Unconventional Monetary Policy and Initiatives Toward Ensuring Stability of the Global Financial System

Haruhiko Kuroda

Introduction

I am honored by the invitation to be a panelist at this traditional policy symposium hosted by the Federal Reserve Bank of Kansas City.

The global economy is yet to completely recover from the aftermath of the Lehman shock, and each country is grappling with its own thorny issues. Japan has not been able to escape from a vicious cycle of deflation and stagnant economic activity for the past 15 years and dynamism has gradually vanished from economic activity. For a sustained economic recovery, it is necessary to overcome deflation and turn firms' and households' actions into more proactive ones.

In the first section, I will outline the "Quantitative and Qualitative Monetary Easing" (QQE) that the Bank of Japan introduced in April, and then follow this with the characteristics of the QQE's transmission channels, focusing on the effects on real interest rates and on the natural rate of interest. I will conclude by touching on several issues on the relationship between unconventional monetary policy and the global financial markets.

I. Unconventional Monetary Policy in Japan

I.i. Outline of the QQE

As represented in the wording “quantitative and qualitative,” the Bank’s QQE aims to overcome deflation through both a “quantitative” increase and “qualitative” changes in the Bank’s balance sheet. There are three points in this policy.

First, the Bank aims to achieve the price stability target of 2 percent in terms of the year-on-year rate of change in the consumer price index (CPI) at the earliest possible time, with a time horizon of about two years.

Second, as shown in Chart 1, in terms of “quantity,” through purchases of various assets, mainly Japanese government bonds (JGBs), the Bank aims to double the monetary base in two years from 138 trillion yen at the end of 2012 to 270 trillion yen at the end of 2014. When looked at as a ratio to nominal GDP, this has already exceeded 30 percent in the second quarter of 2013. Although it depends on future growth in nominal GDP, the ratio is likely to increase to more than 50 percent in the fourth quarter of 2014.

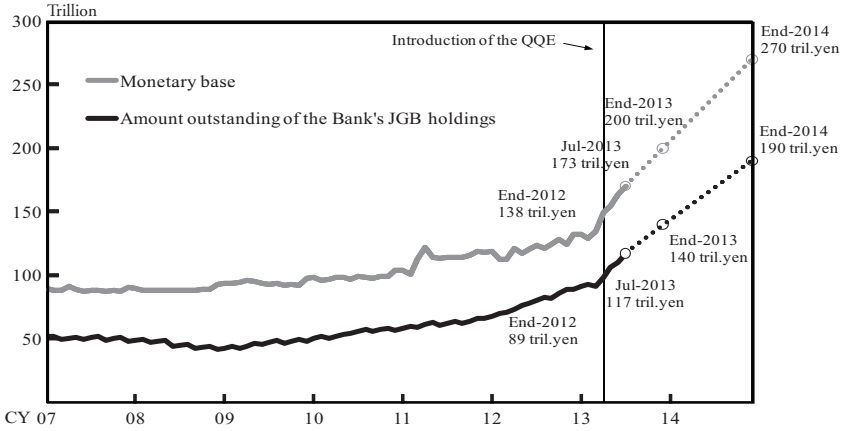
Third, on the “quality” front, JGBs with all maturities, including 40-year bonds, were made eligible for purchase. As a result, the average remaining maturity of the Bank’s JGB purchases will more than double to about seven years. By working on interest rates across the yield curve, it is expected that the effects of the QQE on financial conditions and economic activity will be strengthened. In addition, to affect premiums of risk assets, purchases of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) were increased.

I.ii Assessment of the QQE to Date

The QQE has already started to exert effects. Let me point to three favorable turns here.

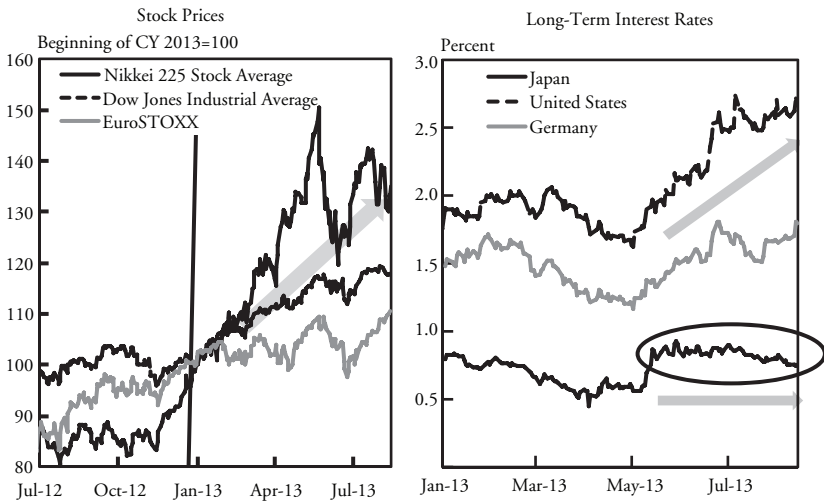
First, there has been a favorable turn in financial markets and corporate finance. As shown in Chart 2, stock prices are rising. Long-term interest rates, while once faced with increased volatility, have been almost flat recently despite a rise in interest rates overseas. Also, in

Chart 1
Monetary Base and JGB Holdings



Source: Bank of Japan.

Chart 2
Stock Prices and Long-Term Interest Rates



Source: Bloomberg.

terms of corporate finance, growth in bank lending has gradually been increasing and lending rates have been at historical lows.

Second, there has been a favorable turn in the public's expectations. Consumer sentiment and business sentiment have improved markedly. Many indicators suggest that inflation expectations have been picking up in the market, as well as among firms and households. Chart 3 shows a recent development in one such indicator. This development, together with low and stable nominal interest rates, has been effective in lowering real interest rates.

The third favorable turn is in economic activity and prices, as shown in Chart 4. Private consumption remains resilient on the back of improved household sentiment and the wealth effect from the stock market rally. Business fixed investment is showing signs of picking up, in line with improved business sentiment and corporate profits. The year-on-year rate of change in the CPI has turned positive, reflecting both improvement in the economy and the yen's depreciation.

II. Unconventional Monetary Policy, Real Interest Rates and Natural Rate of Interest

In this way, the Bank's QQE has already started to gradually exert effects. Now, let me next look at the transmission mechanism of the policy effects from the two perspectives of real interest rates and the natural rate of interest.

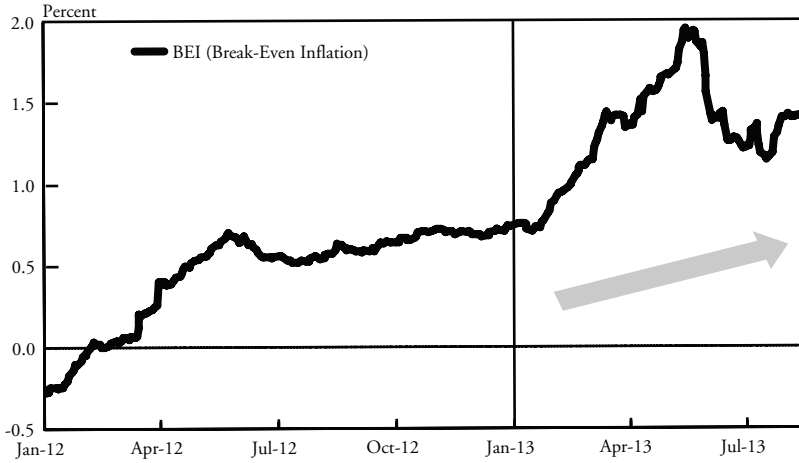
Needless to say, the effects of monetary policy will be determined by the difference between real interest rates and the natural rate of interest. Thus, there are two ways for monetary easing to be effective: First, lower real interest rates, given that the natural rate of interest is unchanged, or, second, increase the natural rate of interest, given that real interest rates are unchanged.

The Bank of Japan's QQE seems to have started to exert effects both in terms of lowering real interest rates and an increase in the natural rate of interest. Let me explain this in order.

II.i Lowering Real Interest Rates

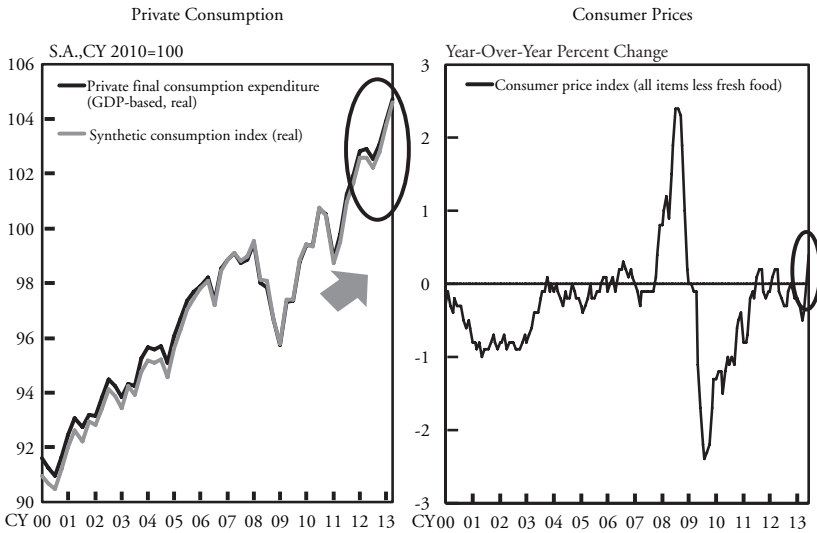
First, let me consider the effect of lowering real interest rates.

Chart 3
Inflation Expectations of Market Participants



Note: BEI is the yield spread between fixed-rate coupon-bearing JGBs and inflation-indexed JGBs. Figures are calculated using yield data for the inflation-indexed JGBs with the longest maturity at each period that corresponds to five years recently. Source: Bloomberg.

Chart 4
Private Consumption and Prices



Sources: Cabinet Office; Ministry of Internal Affairs and Communications.

When lowering real interest rates as a policy, a central bank normally lowers nominal interest rates. Of course, to utilize such a policy, there should be sufficiently large room for reduction in nominal interest rates. For example, in the United States, based on the assumption that inflation expectations were anchored, it can be interpreted that real interest rates have been lowered as a result of reducing nominal interest rates.

In Japan, as nominal interest rates were already at low levels, there was limited room to lower real interest rates by reducing nominal interest rates. Another way was needed to lower real interest rates—namely, an increase in inflation expectations. While the purpose of lowering real interest rates itself was the same as in the United States, there was a stark contrast in terms of a strategy to achieve that purpose.

The Bank aims to achieve the 2 percent price stability target with a time horizon of about two years and implement measures toward achieving the target, which would be effective in overcoming the policy constraints. With the implementation of the QQE, inflation expectations have actually been edging up, as I mentioned earlier, and thus the Bank's policy has started to exert its intended effects.

II.ii An Increase in the Natural Rate of Interest

As the second issue for discussion, let me consider the relationship between unconventional monetary policy and the natural rate of interest. This issue has been little discussed, and thus might be controversial to some extent.

To begin with, the natural rate of interest corresponds to expected returns from firms' capital investment. The Bank's QQE aims at conquering the "deflationary sentiment" that has been entrenched among the public and restoring what had been the intrinsic dynamism of Japan's economy. As a consequence of the policy, if Japan's growth potential recovers, investment opportunities will increase and the natural rate of interest will rise.

As an unconventional monetary policy that contributes to strengthening growth potential, the Bank has established a facility called the "Loan Support Program." The facility is composed of two measures.

One is the fund provision for economic growth, which provides funds for financial institutions' loans and investment that contribute to Japan's economic growth. The second is the fund provision to stimulate lending, which provides long-term funds at low interest rates for financial institutions' incremental lending and supports their efforts to increase lending. The facility aims to promote financial institutions' initiatives toward finding demand for funds in high-growth firms and business fields.

I would like to add one point here. Maintaining the natural rate of interest at a high level is also important as a means of increasing the resilience of the economy against various shocks. In that regard, when the natural rate of interest increases sufficiently, the possibility that the policy rate will hit the zero lower bound again declines and the resilience of Japan's economy is likely to increase.

III. Unconventional Monetary Policy and Global Financial Markets

Lastly, as already discussed in this symposium, let me touch on issues that relate to global liquidity and cross-border capital flows. Given the wide spectrum of important issues within this set of topics, let me focus on two such issues, taking into account my own experience.

III.i Unconventional Monetary Policy and Cross-Border Capital Flows

First, the relationship between unconventional monetary policy and cross-border capital flows is quite complicated.

While this is not new to central banks and related parties, almost all base money provided through monetary policy will be accumulated in the form of deposits with a central bank. Even if a country eases monetary conditions, this does not necessarily mean that money being provided directly "spills over overseas."

Starting from such accumulated base money and changes in demand-supply conditions in asset markets in which the Bank conducts purchase operations, the issue is how financial market participants' expectations and transactions change and how that affects cross-border capital flows.

This process is fairly complicated, and monetary easing does not necessarily lead to cross-border capital outflows. For example, if growth expectations rise due to monetary easing, there might be capital inflows in search of a high natural rate of interest.

III.ii Importance of International Coordination Among Central Banks

Second, I would like to point out that—also in international coordination among central banks—“unconventional” initiatives have indeed been reinforced.

In tandem with progress in financial globalization, the speed and magnitude of systemic risk contagion among countries have increased, and due vigilance is called for regarding the possibility that destabilization in the global financial markets will be a drag on the global economy.

Following the Lehman shock, the Bank of Japan, in coordination with other central banks, has endeavored to maintain the stability of the global financial system through initiatives such as making currency swap arrangements, improving the framework of cross-border collateral and enhancing regional financial infrastructures, including fostering Asian bond markets.

As a person who has been involved in international finance in various positions, I would like to emphasize that it is increasingly important to have international coordination with regard to the prevention and management of a financial crisis.

Concluding Remarks

The QQE aims to overcome deflation that has continued for 15 years and to rejuvenate Japan's economy. While maintaining real interest rates at low levels through increasing inflation expectations, the policy will exert its maximum effects by working also on the natural rate of interest rates together with the government's growth strategy. The Bank of Japan will pursue proper policy conduct to achieve the price stability target, while continuing to make efforts to maintain the stability of the global financial system.