Japan

Monetary policy: let's give it another try

■ **In order to boost inflation expectations and inflation, the Bank of Japan has made two changes to its monetary policy.**

■ **By introducing yield targeting, it creates more flexibility than would a QE policy.**

■ **Importantly, it has committed to overshoot its inflation target. However, judging by the reaction of the USDJPY exchange rate, the market was not impressed.**

Central bank credibility is a necessary condition for monetary policy to be successful in achieving its objectives. It refers to the authority (independence) of the central bank to act when circumstances require and to its willingness and ability to take the appropriate measures. A credible central bank will succeed in influencing behaviour of households and companies in such a way that its inflation goal (along with other goals, if any, as well) is met and is expected to be met also in the future: inflation expectations are well anchored. If progress towards reaching the objective(s) is too slow, doubts about the effectiveness may creep in, inflation expectations may become unanchored and the central bank might lose some of its credibility, rendering its monetary policy less effective. This risk is all the more real if financial markets are under the impression that time is running out, i.e., that there is a risk of running out of ammunition.

Bank of Japan introduces yield targeting

The decisions taken by the Bank of Japan (BoJ) last Wednesday need to be seen against this background. The introduction of "yield curve control", including targeting the 10-year yield on Japanese government bonds (JGBs), reflects multiple concerns: 1. inflation is still too low compared with the objective, and inflation expectations have declined, 2. a volume-based monetary policy (buying a certain amount of JGBs or other instruments per month) would become increasingly difficult to maintain as the remaining stock of JGBs declines, 3. in a traditional QE policy, the market determines the shape of the yield curve, and an excessively flat curve would end up having a detrimental impact on banks and insurers, 4. related to this, should the BoJ eventually decide to lower the negative rate further on policy-rate balances in current accounts held by financial institutions at the BoJ, a policy of targeting the 10-year yield would make it possible to soften the impact on the financial sector by maintaining a sufficiently steep curve and 5. finally, creating more flexibility with respect to the volume target (although surprisingly the BoJ refrained from dropping this target altogether) could increase the market impact of its operations by exploiting the surprise factor.

This is reminiscent of foreign exchange market interventions where a surprise move can also have a considerable impact. The real question is of course how lasting this impact will be. Is bond yield targeting the equivalent of "drawing a line in the sand", the metaphor often used in currency markets, in which case the decisiveness will be tested? How can foreign (US) influences that could push up JGB yields beyond the target level set by the BoJ be dealt with? On what basis will the target be changed? Lack of clarity on these matters and on the successful stabilisation of yields could increase bond yield volatility and have detrimental effects on the real economy. In this respect, chart 1 illustrates the extreme steepening of the yield curve during the summer months when the market started to anticipate that a change in policy was coming. In an economy where the central bank is running QE, the steepening was sharp to say the least.

■ **Japan's rate curve**

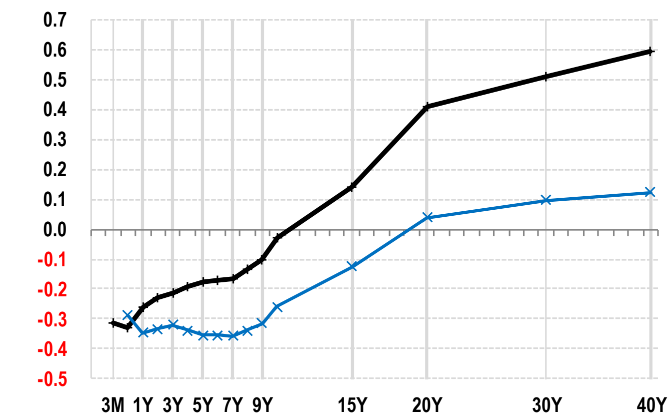

Chart 1 Sources: Bloomberg, BNP Paribas

■ **Exchange rate-intraday***

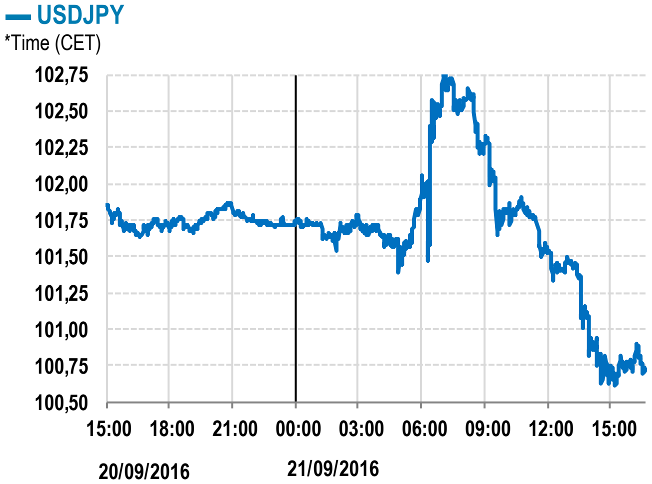

Chart 2 Sources: Bloomberg, BNP Paribas

Committing to overshoot the inflation target

The second decision raises even more questions. The BoJ "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"[1]. The rationale goes as follows: if one seeks to hit the 2% inflation objective without accepting an overshoot, markets will anticipate an early policy tightening. This would cause a tightening of financial conditions (appreciation of the currency, higher bond yields, rising corporate bond spreads and a weaker equity market) and make it very difficult to hit the inflation target. This argument is made in a recent research paper by Fernando Duarte, a Federal Reserve Bank of New York economist (see box). In addition, the BoJ defines its inflation objective as an average over the business cycle so in consideration of the fact that inflation is currently running below target, policy should seek to bring inflation above target. In so doing, the BoJ also tries to change the mechanism of inflation expectation formation of households and companies. It is of the view that at present expectations are formed in an adaptive way by "looking in the rear-view mirror": recent and historical inflation experience drives the expectations for the future. This implies that expected real interest rates are too high (because the adaptive inflation expectations are too low and adjust very slowly), which weighs on the transmission of monetary policy. In order to push the private sector to adopt a more forward-looking process of inflation expectation formation, the BoJ has now committed to overshoot its inflation target, thereby insisting it wants to engineer an increase in inflation at the earliest possible time.

On paper, a policy to accept a prolonged overshooting of the inflation target is very aggressive. Expected real interest rates drop (at least if inflation expectations are formed in a forward looking way), and this should support debt-financed spending provided that households and/or companies are confident about their future ability to pay back the debt and are convinced that inflation will indeed overshoot. The currency should also weaken, thereby boosting growth and inflation. However, if the central bank is not credible, nothing will work. Chart 2 reminds us that the BoJ has some work to do. The intraday evolution of the USDJPY exchange rate before and after the announcement of the new monetary policy clearly shows that the currency market is not yet convinced that this new policy will work. If the announcement had been credible, the yen would have seen a step-change weakening rather than a jump followed by a downward drift.

The BoJ seems to be aware of the credibility challenge because its policy announcement includes reference to "possible options for additional easing": cut the short-term interest rate policy and the target level of the long-term interest rate, expand asset purchases and accelerate the expansion of the monetary base. One would hope that mentioning these tools would enhance the credibility of the central bank and help it to achieve its new objective of inflation overshooting. However, it would also bring us closer to a new and even greater challenge: how to normalize monetary policy without causing market disruption (bonds, equities, the yen) when the influence of the central bank on asset prices has been huge (via QE and yield targeting) and the inflation target has at long last been overshot.

Box: ***How to escape a liquidity trap with interest rate rules, Fernando Duarte, Federal Reserve Bank of New York***

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This paper offers the theoretical underpinning for the BoJ decision[2]. It uses a three-equation model with an output gap equation driven by the difference between the real interest rate and the real natural rate of interest, an inflation expectations equation (which depends on the output) and a nominal interest rate equation (nominal rate with a zero lower bound (ZLB)). This theoretical model is used to run simulations to assess whether stable solutions can be reached. A key conclusion is that by stimulating future output and inflation, a longer span of interest rates pegged at zero guarantees that by the time the central bank reverts to a Taylor rule, the economy will no longer be constrained by the ZLB. However, "promising to be tough on inflation outside the ZLB prevents the future boom in inflation and output that is necessary to arrest the deflationary expectations while at the ZLB." Committing to overshoot the inflation target would kill any expectations of a pre-mature tightening.

However, the model does not have equations explaining the dynamics of financial markets. It remains to be seen to what extent this influences the policy recommendations. When inflation is picking up and ready to overshoot the central bank target, bond yields may very well increase significantly, which could weigh on the stock market and cause volatility in the real economy, making it more difficult to keep inflation high enough.

[1] Source: New Framework for Strengthening Monetary Easing: "Quantitative and Qualitative Monetary Easing with Yield Curve Control", Bank of Japan press release, 21 September 2016

[2] Of course we don't know whether this paper has influenced the BoJ decision.