The Bank of Japan must explain its inflation toolbox
By Anil Kashyap
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Last week the Bank of Japan declared it had slain deflation and was therefore moving towards a new approach to monetary policy. Based on what it has said so far, the bank intends to hold interest rates at zero and re-evaluate how it can achieve its mandate of delivering sound development of the economy through price stability.

But lost in the details of the BoJ’s ?Introduction of a New Framework for the Conduct of Monetary Policy? is a stunning assertion. The bank is now on record saying that ?in the case of Japan, the average rate of inflation over the last few decades is lower than major overseas economies. Japan has also experienced a prolonged period of low rates of inflation since the 1990s. Consequently, the rate of inflation at which households and firms perceive price stability seems to be low, and economic decisions may be guided by such a low inflation environment. The conduct of monetary policy must take account of such possibilities.? That is a scary statement. It implies that the BoJ bears little responsibility for the low levels of inflation during its lost decade. Instead, it is claimed that inflation is inherently lower in Japan. This is like concluding that potential output growth in the US in the wake of the Great Depression was low or that Argentina should target triple-digit inflation since people there are used to high inflation. To disavow responsibility for the past deflation suggests that the BoJ is still seriously confused.

The conventional analysis of the bank’s decision has largely ignored this amazing assertion and has instead focused on two other issues. One is that the old policy of ?quantitative easing? (under which the BoJ flooded banks with extra reserves) had little theoretical underpinning. Part of quantitative easing involved pinning interest rates at zero and a commitment to keep rates at zero for an extended period. Standard economic theory explains why this kind of commitment drives longer-term rates down. The BoJ always had trouble spelling out how the availability of additional reserves accomplished anything (other than perhaps signalling that zero interest rates would persist). Therefore, the thinking goes that so long as the bank promises to keep rates near zero, jettisoning the extra reserves will make no difference.

The second perspective focuses on the communications problem now confronting the bank. The bank had repeatedly signalled that it would not adjust policy until deflation was overcome. The end of quantitative easing obliges the bank to come up with some new language and strategy for signalling its future intentions. Most observers have argued that the obvious way to fill this void is to announce an inflation target and move towards the framework adopted by inflation-targeting central banks around the world.

There is truth in both perspectives. Quantitative easing was successful precisely because of the extended commitment to zero short-term rates, and not because of the excess reserves supplied to banks. Likewise, the BoJ does have a serious communications challenge. But these observations distract from the fundamental problem that the bank seems confused about how its actions affect the economy, so neither making half-hearted statements that give a range for the preferred rate of inflation, nor adopting inflation targeting or any other framework will matter.

What should the bank do? First, it must settle on how it believes the monetary transmission mechanism operates in Japan. If it cannot explain how the tools at its disposal affect the rate of inflation and output growth any communications strategy will unravel.

Monetary economists believe that the bank’s commitment to zero interest rates has been critical and that if it maintains this policy the economy can continue to recover. More important, inflation will continue to rise. Nothing prevents the BoJ from pushing inflation to 3 per cent or higher if it wants to. Likewise, the bank could lead people to expect any non-zero inflation rate of its choice if it made a commitment to deliver it. If the BoJ disagrees with this diagnosis it should say so and explain why everyone else is wrong.

Second, it must organise its communications strategy to be consistent with its view of the transmission mechanism. An inflation-targeting strategy can succeed only if the bank explains its control over inflation. Successful inflation-targeting central banks set up a whole apparatus, usually with a regular inflation report, that aligns the bank’s words and actions. Clearly, if the BoJ thinks that it must take inflation expectations as given, it is nowhere near ready to go down this route.

Until the bank confronts these fundamental problems, no fine-tuning of language will make a difference.

The writer is professor of economics and finance at the University of Chicago Graduate School of Business, and author with Takeo Hoshi of Corporate Financing and Governance in Japan (MIT Press)