

APIR Commentary

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BOJ Reform towards an Exit from Mild but Stubborn Deflation; its Independence and Accountability

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BOJ's monetary policy became a focus in the national election. In the election campaign, LDP leader Abe made a series of statement calling for the more expansionary monetary policy in order to get out of the mild deflation in Japan. These led to active controversy related to the independence of BOJ, since some considered those were inappropriate intrusion against its legitimate independence. This situation reminds us of an event in the US history in the late 19th century, when the choice between the gold standard and the bimetal standard became a focus in the presidential election and *Wizard of OZ* was written perhaps as an allegory of the event. Mr. Brian lost then in the U.S. but Mr. Abe won this time and became a Prime Minister in Japan.

Central Bank Independence

What is the “central bank independence”? The notion of “independence” has many facets and thus is intriguing. However, in this context, it means that an “independent” central bank can be free from influences of the governments *to a certain extent*..

You can find many miserable experiences in the human history, where value of money fluctuated dramatically. Even the modern advanced economies, in 1970s when the international monetary system was modified in the unprepared way and the OPEC embargo shocked them, could not avoid double-digit inflation. Japan was among the first few to get out of the high inflation, then. Several others like UK, who failed in doing so, finally chose to change the monetary policy framework. They gave “independence” to their central banks in order to block the political influence onto their policy-making and, at the same time, gave 2-3% inflation rate as a policy target to be attained in the certain time period. This policy framework, inflation targeting, was a big success at least in stabilizing inflation at low level and became a standard policy framework worldwide.

You might have noticed that central bank independence is all about how they attain the given policy goal. This is an important point. Independent central banks shall be free to choose instruments. Thus, this type of central bank independence is called as “instrument independence”. In a democratic society, appropriate policy goals shall be chosen by the society and then central banks shall be delegated as professionals how to attain them. However, there is another notion, “goal independence”, which is close to “instrument independence” but to be clearly separated from it. When central banks can determine the policy goals themselves, they

have “goal independence”. “Instrument independence” shall be assured but “goal independence” can be harmful. It is natural, if you let central banks to choose their goals to be attained themselves, that they tend to choose the easier goals.

Then, which independence is given to BOJ? Let’s examine the BOJ’s monetary policy operations in order to find out the answer. The Japanese economy has been suffered from the mild but stubborn deflation for almost two decades. BOJ tried to avoid its acceleration by implementing a series of unorthodox monetary policy procedures, ZIRP(zero interest rate policy), commitments to keep ZIRP until the end of deflation, Quantity Easing, and etc. These policy procedures became precious former examples for the central banks of other advanced economies after the world financial crisis. However, the Japanese economy could not exit from the mild deflation. Nowadays, the youth in Japan do not know inflation. Perhaps corresponding to those situations, BOJ top officials tend to state the limit of the monetary policy; “ the monetary policy is not a cure-all policy”; “we trespass into the region of the fiscal policy, if we are to do more”; “What else we can do?” All sounds logical and plausible.

BOJ’s effective goal independence

I still think that we can stop deflation with monetary policy. I do respect many talented economists working for BOJ and the innovative policy procedures they framed up so far. However, I come to think that BOJ’s monetary policy operations failed to exercise their full power since BOJ set a wrong policy goal. The wrong goal was introduced when BOJ shaped the ambiguous notion of “price stability”, which was set as its policy goal in the BOJ Act, into a concrete one. I cannot explain the detail here but, in essence, the BOJ top officials decided to interpret “price stability” as consumer price inflation rate between 0 and 2%; inflation rate within 1% point band around the central rate of 1%. However, they did not set any time frame to realize this price stability nor they commit to attain it.

This policy framework resulted in the policy operations, which the financial market came to consider that the BOJ actually accepted inflation rate between -1% and +1% centered around zero percent. In short, BOJ was not expected to move significantly even though inflation rate became negative, below its “price stability” band, as long as deflation did not become serious by going beyond -1%. I think these means that BOJ did own “goal independence” effectively. And, as its result, mild deflation has become the norm for the Japanese economy for two decades. If the current BOJ Act gives this goal independence to BOJ, we should reconsider it.

After a while, corresponding to criticisms against these policy operations, BOJ announced that it did not accept the negative inflation rate. However, many think that there had been no substantial changes in the actual policy operations until the introduction of inflation goal in February 2012. We can safely summarize that the BOJ’s policy strategy had been to avoid the acceleration of the deflation but not to realize the price stability as inflation rate around 1% until then. Financial markets welcomed the inflation goal and the Japanese yen depreciated significantly. But, BOJ did not followed up this announcement with changes in policy actions. Moreover, BOJ emphasized that this goal is different from the normal inflation targets,

suggesting its commitment is weaker than inflation targeting central banks. Naturally, people started to doubt its significance and its impacts on the financial markets faded away.

Central bank accountability

When central banks were given independence, it was emphasized not only that it means the instrument independence, but also that they have to fulfill the accountability. In this context, accountability basically means that central banks must explain the monetary policy, which they implemented, to the people who delegated it to do so. We have to be clear that it is not limited to the responsibility to explain but means to take a responsibility for policy performances. In the early period of the inflation targeting history, the latter was emphasized highly.

For example, in NZ where the inflation targeting was first introduced, the central bank governor were to resign when he/she failed in attain the specified target within the certain period. Recently, the inflation targeting itself evolved into more flexible policy framework so that resignation is not required anymore anywhere. But, it is still common for central bank governors, if he/she missed the target, to write special letter in order to explain the reasons of failure. This type of accountability clause is missing in the current BOJ act.

Towards an exit from mild but stubborn deflation

Mild but stubborn deflation led to reductions in sales and/or incomes that have worsened performances of business and welfare of families. Combined with population decreases, deflation has made the story almost for sure that we cannot expect the significant growth in nominal GDP in Japan. Financial markets cannot expect the sustainable growth in the Japanese stock price in general so that the Tokyo market is losing its central position in Asia. Many firms have faced the vicious circle between the deflation and high yen. As the mild but stubborn deflation has exercised adversary influences onto the Japanese economy, BOJ shall implement the monetary policy to combat against it.

In order to have that, we should reform the BOJ act. Firstly, we should set the inflation target well above the zero so that we can delete the ambiguity in the definition of the policy goal, which has generated the de-facto goal independence. Second, we should clearly assure the instrument independence and delegate the policy operations to the talented economists in BOJ. Off course, we should strengthen the accountability. In addition, we shall include the clause which promises any loss of BOJ caused in the fight against the deflation to be compensated automatically by MOF. This will free BOJ from concerns about the turf battle with MOF.

Once this reform gets implemented, BOJ will change the monetary policy operations by looking for the chances to realize the inflation target so that it is not going to miss the timing for easing acts. There would be no need for government to intrude against its instrument independence. This will influence the expectations in financial markets, so that exchange rates

and share prices will also move. It may well lead to an exit from the vicious cycle between the high yen and deflation.

Noda administration legislated the consumption-tax hike with high cost of losing the general election badly. Monetary policy operations based on the corrected policy framework shall support the economy so that this tax hike brings the recovery of government financial conditions. Otherwise, populist demagogues, who are calling for unrealistic tax cut, might gain more popularity; they might intrude seriously against even the instrument independence. That is a straight road to the serious crisis. Though we might avoid it now, if we fail in controlling the government debt growth in future, its credibility will be lost and the massive capital freight will lead to dramatic depreciation. Japan will face the hyper inflation regardless of the BOJ independence, then. It will result in the serious declines of the living standards of the general public. It is no use to keep the excessive independence for BOJ when the Nation's economy collapses down.

Notice

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