Inflation Targeting in a Zero-Interest Rate Environment
— *Ineffective Measures Could Reduce the BOJ's Credibility*

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Since last year, there has been considerable debate in anticipation of additional monetary policies to stimulate the economy. This paper examines one of the proposed measures, inflation targeting.

1. Inflation Targeting as a Monetary Policy

To enhance the effect of monetary policy, the central bank has been shifting away from its conventional stance of taking action without elaborating reasons, to a new stance of conveying its policy intentions to financial markets. In the interest of a more efficient dialogue with the market, the transparency and accountability of monetary policy must be improved. In line with this thinking, there have been calls for the bank to introduce inflation targeting.

With inflation targeting, the central bank would announce medium-term inflation rate targets, and give these targets top priority in monetary policy, while at the same time being accountable for explaining the current status of its policies. Because the bank would announce targets and release information pertaining to implementation measures and policy evaluations, its policies would be accessible to the public.

A number of countries introduced inflation targeting during the 1990s. New Zealand was first to do so in 1990, followed by Canada and Israel in 1991, England in 1992, and the rest (Figure 1).

Figure 1 Countries That Have Introduced Inflation Targeting

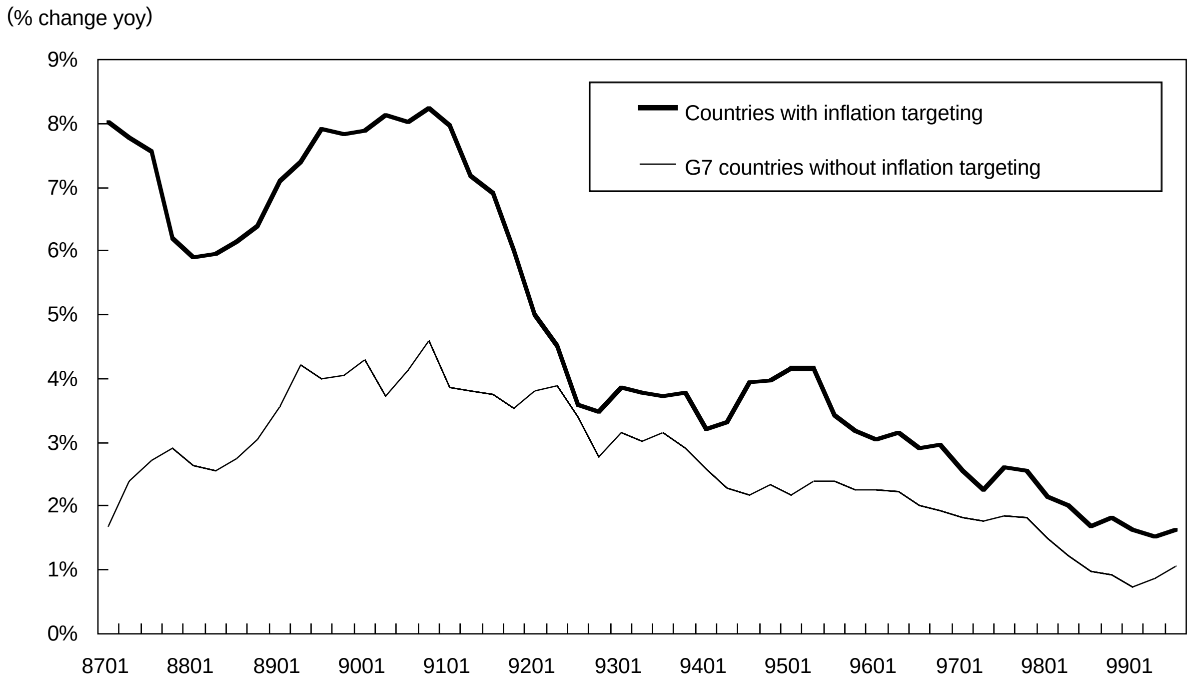
	New Zealand	Canada	Israel	England	Sweden	Finland	Austria	Spain
Introduced	Mar. 90	Feb . 91	Dec. 91	Oct. 92	Jan. 93	Feb. 93	Apr. 93	Jan. 95
Recent target	0-3%	1-3%	8-11%	Below 2.5%	2%	2%	2-3%	Below 3%
Targeted index	Core CPI	CPI	CPI	Retail price index excl. mortgage rates	CPI	Core CPI	Core CPI	CPI
Items excluded	Interest expense, indirect taxes, taxes collected by govt., large change in exports/ imports	None (core CPI sometimes used)	None	Mortgage rate	None	Mortgage rate, indirect taxes, govt. subsidies, housing prices	Mortgage rate, indirect taxes, other factors causing fluctuations	None
Target announcement	Agreement between treasury secretary and president of central bank	Agreement between treasury secretary and president of central bank	Unknown	Finance minister	Central bank	Central bank	Reserve bank	Central bank
Frequency of reporting	Quarterly since Mar. 90	Semi-annually from May 95	Unknown	Quarterly since Feb. 93	Quarterly since Oct. 93	None	None	Semi-annually
Inflation rate prediction	Released	Not released	Unknown	Released	Not released	Not released	Not released	Not released

Sources: Bernanke and Mishkin (1997); Guy Debelle (1997).

In most countries, inflation targets have been set to achieve a consumer price inflation rate of around 3%. None of the countries has targeted an inflation rate of zero. This can be attributed to the fact that most of them have suffered from high inflation rates in the past, and to the view that an inflation rate near zero is undesirable.

Due to its short history, the general effectiveness of inflation targeting has yet to be verified quantitatively. However, results from the eight countries show that inflation rates of around 10% in the 1980s have subsided following the introduction of inflation targeting. Even allowing for the existence of other factors, we can surmise that targeting has helped constrain inflation to some extent.

Figure 2 Inflation Trends



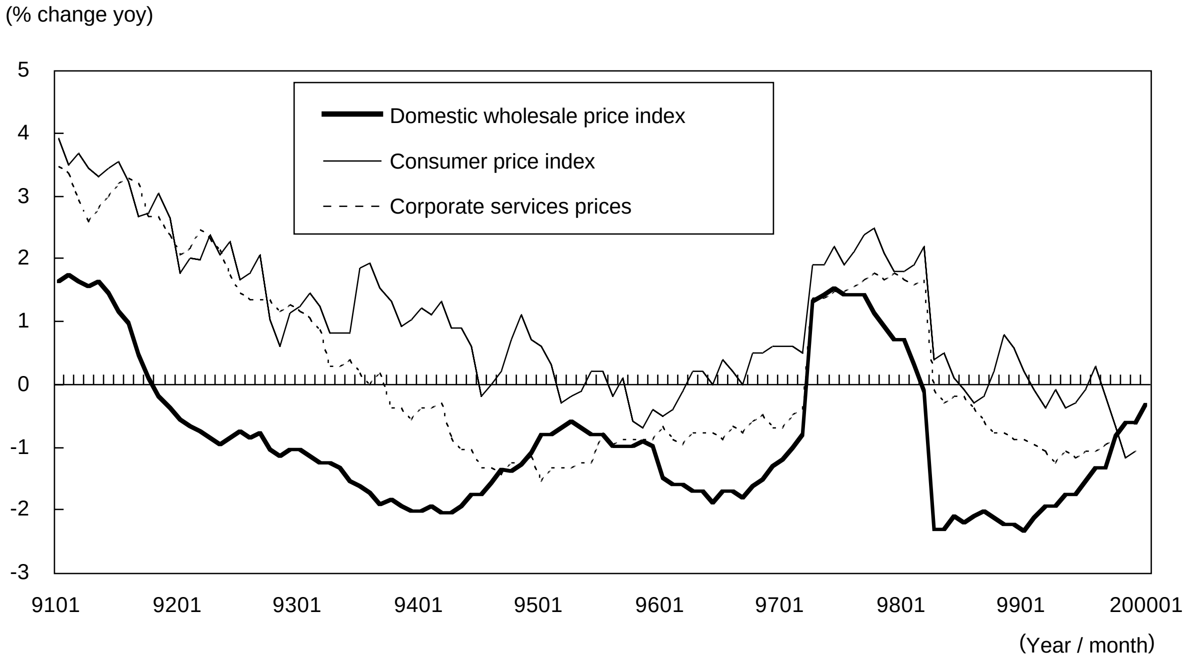
Note: For countries with inflation targeting, graph shows simple average of consumer price indexes of eight countries from Figure 1.
Source: IFS

2. Japan's Unique Argument for Introducing Targets

While other countries have introduced inflation targeting to combat inflation, the argument for introducing inflation targeting in Japan is unique — to overcome deflation.

This argument is informed by two perspectives: first, to provide guidelines that will promote further monetary easing, and second, to stimulate the economy by setting slightly high inflation targets and thus increasing inflationary expectations of companies and households.

Figure 3 Price Index Trends



Sources: MACA, *Consumer Price Index*; BOJ, *Wholesale Price Index,* and *Price Index of Business Services*.

3. Dissimilarity from Krugman's Inflation Argument

Due to striking similarities, the inflation targeting policy described above is apt to be confused with Professor Paul Krugman’s argument that Japan should inflate its way out of its problems. However, we must emphasize that the two arguments are based on completely different approaches.

Krugman advocates inflation targeting as a policy for Japan to overcome its present economic difficulties. To create inflationary expectations, he argues, the BOJ should set inflation targets at 4% or higher, which is far above the 0-2% range deemed appropriate by the BOJ. He then advocates that the BOJ commit not to tighten its policy even if inflation rates rise in the future.

While this argument may make sense for overcoming something close to a deflationary spiral, it is equivalent to telling the BOJ to disregard price stability, which is obviously repulsive to the BOJ in its role as inflation watchdog.

As a monetary policy, inflation targeting was originally intended to achieve appropriate inflation levels, not higher inflation rates. Thus while the two arguments may appear similar in form, their approaches are completely different.

4. The Money Supply Growth Problem

Even if inflation targeting were introduced in Japan today, there would remain the question of whether it would function effectively.

First, since the introduction of inflation targeting in a deflationary situation is unprecedented in the world, there is no assurance of its effectiveness as a monetary easing policy. Next, even if it does work, there is no assurance that it can cause moderate inflation without triggering hyperinflation. But perhaps the most critical problem is whether, under near-zero interest rates, there remain any viable means to achieve targeted inflation rates. Considering the negative undertone of consumer price inflation at present, to achieve the target inflation rate range of 0-2%, the BOJ will need to pursue policies to increase inflation. However, because of the long-term relationship between inflation and the money supply, raising the inflation rate requires that the money supply growth rate be increased.

However, since despite the near-zero interest rate policy pursued since February 1999, money supply growth has remained consistently low, recently declining to 2%.

The short-term capital markets remain consistently flooded with excess funds. In the BOJ's open-market operations, offerings have consistently been undersubscribed. Thus further quantitative easing will be difficult using conventional measures in short-term capital markets.

5. Obstacles to Quantitative Easing

Since conventional monetary easing measures do not work, the only option available for quantitative easing is the formerly prohibited means of ultra-easing. This involves expanding open-market purchases of government bonds above the current ¥400 billion per month, as well as the unprecedented measure of buying risk-bearing assets such as stocks and land. Additionally, the BOJ could itself issue deficit-financing bonds.

Even if open-market purchases are expanded in scale and scope to include risky assets, the resulting increase in supply of high-powered money to the banking sector is not certain to increase private sector credit in the form of loans. Since the corporate sector is undergoing balance sheet adjustments to reduce debt, while banks have a powerful incentive to reduce risky assets, credit creation and hence money supply growth cannot be anticipated.

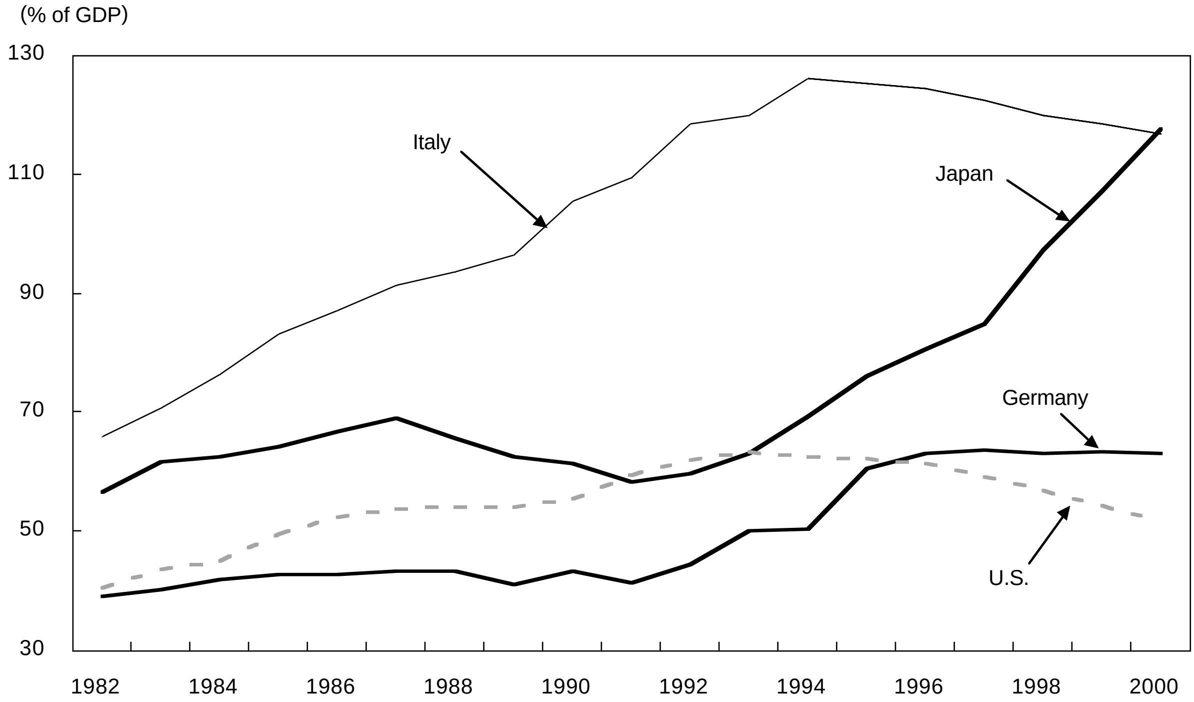
If the BOJ goes ahead and monetizes the government debt, the money supply will certainly grow as funds flow to the private sector. However, a substantial amount would have to be monetized if it also fails to stimulate credit creation, making this alternative nonviable.

The adoption of ultra-easing policies, combined with the global attention on Japan's perilous fiscal situation, could create uncertainty regarding government bonds and the Japanese economy itself. In the worst case scenario, Japan would experience a capital flight, causing long-term interest rates to surge and stock prices to plunge.

Thus resorting to previously prohibited measures for an ultra-easing policy will not necessarily increase money supply growth, which is the required condition for causing inflation.

Without the necessary means to realize an inflation targeting policy, its introduction will ultimately only reduce confidence in the BOJ, and in the long term risk reducing the effectiveness of monetary policy.

Figure 4 Outstanding Government Debt as Ratio to GDP



Source: OECD, *Economic Outlook 65 / June 1999*. Values for 1999 and 2000 are predictions.