

Communication, Credibility, and Price Stability: Lessons Learned from Japan

Owen F. Humpage

Over the past couple of decades, central banks have been taking steps to increase the transparency of their monetary policies through clearer communications with the public. While there are many differences between the economic challenges Japan has been struggling with in the past decade and those facing U.S. and European central bankers now, we can learn a great deal about combating deflation from Japan's experiences.

In mid-February, the Bank of Japan took steps to clarify and strengthen its commitment to price stability and to improve its credibility for monetary policy. It announced specific numerical goals for inflation, both in the immediate and medium-to-long term, and expanded its asset-purchase program.

The Bank's efforts to clearly communicate an inflation objective are not unique. Over the past couple of decades, many central banks have been taking steps to increase the transparency of their monetary policies through clearer communications with the public. Doing so not only increases their accountability to the public—especially important given most central banks' political independence—it can actually enhance the effectiveness of their monetary policies.

But while the recent Japanese announcement is clearly a step in the right direction, the Bank of Japan's experience illustrates the struggle that central banks can face in communicating an inflation objective in a deflationary environment. The Bank of Japan entered the fray with a strong reputation as an inflation hawk but found that it had to revise its message in order to clarify its inflation goal as Japanese price levels fell.

When interest rates approach zero and deflation is a recurring problem, as has been the case in Japan, monetary policy primarily affects economic activity by creating expectations of future inflation. A clear, credible statement of an inflation objective can enhance the expectations effects of monetary policy. Economists and policymakers can learn a great deal about this monetary-policy expectations channel from the Japanese efforts to communicate a credible inflation objective when prices are falling.

Communication at the Zero Bound

When short-term interest rates come close to zero, the effectiveness of monetary policy wanes because bank reserves, which earn very little interest, and short-term securities, which now also earn very little interest, become near-perfect substitutes on banks' balance sheets. In this situation, standard monetary-policy operations, which substitute reserves for short-term government securities, are not likely to affect short-term interest rates and to spur much bank lending and economic activity. If, in addition, prices are falling, households and businesses will postpone borrowing and spending. If goods are cheaper tomorrow, why not wait?



In such deflationary situations, monetary policy can still work by creating expectations that the central bank will keep monetary policy easy—that is, keep short-term interest rates very low—as long as it takes to generate price increases. Central banks operating in this vein buy long-term securities in order to drive down their interest rates. To the extent that long-term interest rates embody expectations of future short-term rates, such operations are only effective if the central bank’s actions successfully alter expectations. In times when economic activity is weak and current short-term interest rates are near their zero bound, this expectations channel is likely to exert a bigger force on economic decisions than the direct impacts of adding reserves to the banking system.

A willingness to talk openly about the intended objectives and methods of such operations can only reduce the public’s uncertainty about future monetary policy. Less uncertainty must surely enhance how expectations respond to such monetary-policy developments. If completely transparent and perfectly credible, communications about future operations conceivably should affect financial variables today.

Defining Price Stability

Many central banks are now trying to enhance this expectations channel through clearer communications. The Bank of Japan is no exception in this regard. Its efforts began shortly after it gained independence, but initially the Bank referred to its price objective qualitatively and in terms of an outlook for inflation rather than its actual experience. Unfortunately, the outlook often failed to materialize. Eventually, the Bank shifted to a quantitative price objective—one often stated in terms of outcomes rather than an outlook.

In June 1997, a newly revised Bank of Japan Act made the Bank independent of the Japanese government. The Act requires the Bank to focus monetary policy on achieving price stability as a means of contributing to the nation’s economic development. Conceptually, price stability refers to an inflation rate that does not affect households’ and businesses’ economic decisions. Operationally, the term applies to persistent price trends rather than high-frequency price movements.

While this general concept of price stability finds wide acceptance, opinions can differ substantially on how to give this notion of price stability precise numerical content. The Act offered no guidance on specific inflation rates consistent with price stability, but Japan had a strong reputation for being a low-inflation country, and policymakers in Japan seemed to believe that the Japanese public regarded an inflation rate lower than in most other countries as consistent with price stability. Irrespective of the definitional imprecision, if a price objective is to leave the private sector’s economic decisions unaffected, it must be credible—clearly communicated, understood, and frequently achieved.

In February 1999, the Bank of Japan undertook its zero-interest-rate policy to combat recession and deflation. This

was the Bank’s first attempt to link a specific policy action directly to a price outcome. The Bank drove its overnight call-money interest rate effectively to zero and promised to maintain it there until “deflationary concerns” had dissipated. The Bank, however, did not clearly define what “deflationary concerns” meant conceptually or how it might empirically identify such a state. In the end, the Bank judged this condition as having been met when economic activity—notably corporate profits and business investment—picked up, and when economic growth promised to move toward potential.

The Bank intended to abandon its zero-interest-rate policy when it anticipated inflation, not when it observed inflation. To the Bank, real economic growth implied that the public’s deflationary fears had dissipated. To be sure, households and businesses tend to postpone expenditures when they anticipate lower prices in the immediate future. But since inflation lags economic activity and since the Bank had a history of being hawkish on inflation, this generally defined trigger did not seem a strong commitment to a positive future inflation rate. In August 2000, the Bank of Japan ended its zero-interest-rate policy and raised its call-money-rate target. The announcement noted that downward pressure on prices had “markedly receded,” but deflation persisted at the time of the announcement.

Japan slipped back into recession in 2001, and the Bank of Japan first instituted its well-known quantitative easing policy in March of that year. Now the Bank focused policy on achieving a target for bank reserves and expanded its asset purchases to encompass a wider range of securities—mostly long-term Japanese government bonds. The objective was to flood banks with excess reserves, many more than was needed just to keep the overnight call-money rate at zero. Hence, quantitative easing was a more profound and visible course of action than the zero-interest-rate policy. Over the next few years, the Bank increased its reserve target frequently and substantially.

The new policy seemed to have had its biggest impact after late 2002. At this point, economic recovery seemed to be building. Before the quantitative easing policy, the Bank of Japan would have responded to such incoming information by tightening in anticipation of inflation. This time, however, the Bank of Japan focused on actual inflation, not its expectation.

The Bank promised to maintain its quantitative easing policy until inflation, as measured by the core CPI, was “stably above zero.” Empirically, this meant that on a year-over-year basis, the price index would no longer be falling. Initially, the objective did not specify a time frame. Would the Bank terminate the policy if inflation reached zero on a year-over-year basis for a single month?

Given the Bank of Japan’s strong anti-inflation tradition, this interpretation was not unreasonable. In October 2003, therefore, the Bank of Japan strengthened its inflation target by making its time frame more explicit and by adding an

expectations component. The quantitative easing policy would continue until core-CPI inflation measured on a year-over-year basis was zero or positive for a few months and most members of the Bank's Policy Board expected it to remain positive over the foreseeable future. The new emphasis on observed, rather than anticipated, inflation marked an important communications improvement over the zero-interest-rate policy.

The quantitative easing policy ended in March 2006, when the core CPI—and the overall CPI—had indeed fulfilled the objective. Yet, the end quickly proved premature. Shortly after the program ended, deflation returned to Japan.

Coinciding with the end of its quantitative easing policy, the Bank of Japan offered an extended term-lending program to Japanese banks, which were still struggling to improve their balance sheets. The Bank also attempted to clarify its empirical definition of price stability. The Bank of Japan began asking its Policy Board members for their empirical “understanding” of medium-to-long-term price stability. A range of 0–2 percent, which encompassed their individual understandings, emerged from the exercise.

At the same time as it offered its “understanding,” the Bank emphasized—as it had done in 2000—that under normal circumstances, it regarded zero inflation as the definition of price stability in Japan. The Bank, however, could accept a small, positive rate of inflation as insurance against the difficulties of conducting monetary policy when interest rates were at zero.

This price objective would seem perfectly fine if the risks to the outlook and inflation had been evenly distributed to the upside and the downside. When, as was the case in Japan, deflation is a recent—and persistent—problem, and the risks of deflation remain significant, a zero or very low inflation objective can be self-defeating. The public may continue to anticipate that deflation is the most likely outcome under such a policy regime, since the Bank now suggests that it will offset all but tiny positive-inflation impulses, it has recently failed to offset deflationary trends, and negative price shocks still seem highly likely.

In such a case, a central bank might want an unusually high inflation objective, implying a much easier policy that will accommodate a greater number of positive—and bigger—inflation impulses. In such an environment, households and businesses are more likely to anticipate future inflation, and they are prone to spend today. Intended or not, the presentation of a low 0 percent to 2 percent range, given the Bank's hawkish history and the current deflation environment, may not have had a strong impact on inflation expectations in Japan.

In October 2010, economic activity in Japan was picking up, but deflation remained a problem. The Bank of Japan instituted its comprehensive monetary easing policy. This program offered a second round of quantitative easing, but it gave more emphasis to a wider range of securities than long-term government bonds. The Bank promised to maintain the

comprehensive monetary easing policy until price stability was in sight. Once again a forecast of future inflation—not actual inflation—seemed to govern the conduct of monetary policy. The forecast objective relied on the Policy Board's “understanding” of price stability—0 percent to 2 percent, year-over-year in the CPI—but now with the Bank of Japan offering 1 percent as the central tendency of the distribution. The Bank of Japan has yet to achieve that understanding.

In February 2012, the Bank of Japan elected to expand its asset-purchase program by ¥10 trillion to encourage Japan's flat economic activity. The Bank now sets a medium-to-long-term inflation “goal” of 0 percent to 2 percent as measured by the overall CPI on a year-over-year basis, with 1 percent as an immediate goal. The Bank promised to maintain its powerful monetary expansion until it “judges that the 1 percent goal is in sight.” Again, the Bank seems to emphasize an expectation of inflation, rather than an outcome.

While the term “goal” seems a communications improvement over “understanding,” the Bank made it clear that an inflation “goal” was not an inflation “target.” The Bank chose the word goal over target because the latter was too rigid; it did not allow enough flexibility given the economic uncertainties—including structural changes—that could affect economic growth and inflation down the road. But if monetary policy operates through the expectation of future inflation, flexibility may limit the effectiveness of the policy.

A Last Lesson

Since 1994, the inflation rate in Japan has seldom exceeded its 1 percent goal, although inflation in Japan is currently moving toward that objective. The Bank maintains that monetary policy has been sufficiently expansionary to accommodate inflation, as evidenced by a buildup in the monetary base and broad money. The Bank tends to attribute falling prices to such structural phenomena as deregulation and improvements in the supply chain, to Japanese workers' willingness to accept wage cuts when economic activity slackens, and to the yen's persistent appreciation.

This may be the case; myriad events beyond the control of Japanese monetary authorities may have had an important influence on aggregate price patterns in Japan over the past couple of decades. Still—purely as a communications strategy—when the Bank of Japan downplays its own ability to affect price patterns through monetary policy, it can become more difficult for the public to expect the Bank to deliver on its inflation goal. In this case, the expectations channel of monetary policy must narrow.

Central banks today realize that clear communications are an important component of efficient central bank operations, particularly when policy rates are at their zero bound and deflation remains a persistent problem. They are still struggling to improve and fine tune their communications policies. The Bank of Japan's experience with communicating a price objective when policy rates are near zero and deflation is a persistent problem offers lessons worth learning.



Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101

PRSRT STD
U.S. Postage Paid
Cleveland, OH
Permit No. 385

Return Service Requested:
Please send corrected mailing label to the
above address.

Material may be reprinted if the source is
credited. Please send copies of reprinted
material to the editor at the address above.

References and Recommended Reading

“On the Current Monetary Policy,” Bank of Japan, 1999
(21 September).

“Change of the Guideline for Monetary Market Operations,”
Bank of Japan, 2000 (11 August).

“On Price Stability,” Bank of Japan, 2000 (October).

“New Procedures for Money Market Operations and Monetary
Easing,” Bank of Japan, 2003 (19 March).

“The Bank’s Thinking on Price Stability,” Bank of Japan, 2006
(10 March).

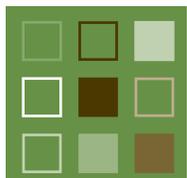
“Enhancement of Monetary Policy,” Bank of Japan, 2012 (14
February).

“The Price Stability Goal in the Medium to Long Run,”
Bank of Japan, 2012. (14 February).

“Liquidity Trap,” Gauti B. Eggertsson, 2008. In *The New Palgrave
Dictionary of Economics Second Edition*, edited by S.N. Durlauf, and
L.E. Blume.

“Inflation Targeting and Japan: Why Has the Bank of Japan Not
Adopted Inflation Targeting?” Takatoshi Ito, 2004. NBER work-
ing paper no. 10818.

“The Bank of Japan’s Efforts toward Overcoming Deflation,”
Masaaki Shirakawa, 2012. Speech at the Japan National Press
Club in Tokyo (17 February).



Owen F. Humpage is a senior economic advisor at the Federal Reserve Bank of Cleveland. The views he expresses here are his and not necessarily those of the Federal Reserve Bank of Cleveland, the Board of Governors of the Federal Reserve System, or Board staff.

Economic Commentary is published by the Research Department of the Federal Reserve Bank of Cleveland. To receive copies or be placed on the mailing list, e-mail your request to 4d.subscriptions@clev.frb.org or fax it to 216.579.3050. *Economic Commentary* is also available on the Cleveland Fed’s Web site at www.clevelandfed.org/research.