Japan's futile quest for inflation

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The art of common sense

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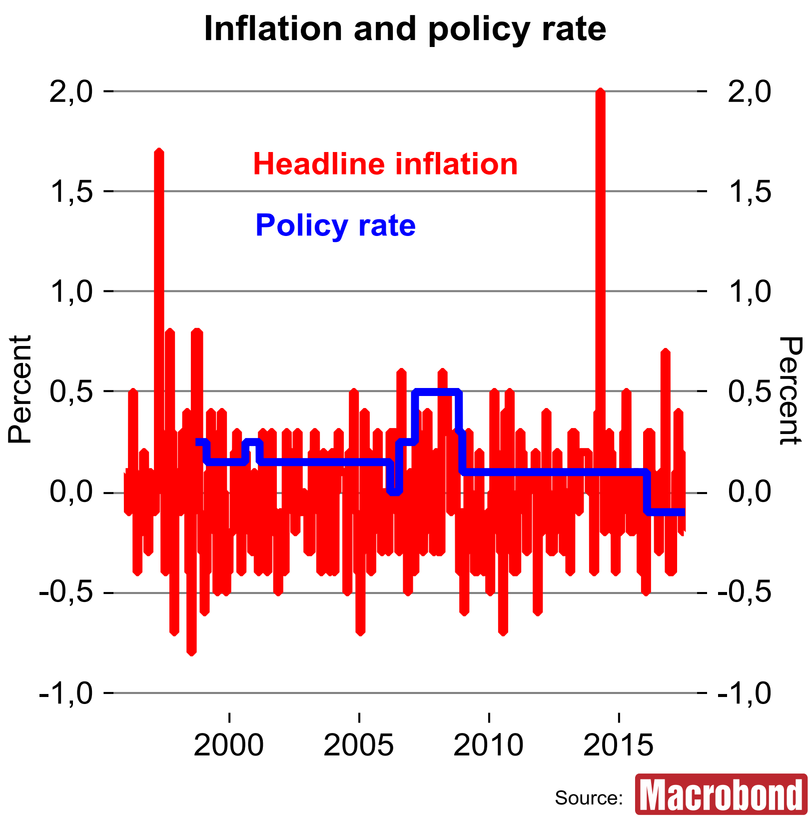
Almost 22 years of "easy money" – success or failure?

- The Bank of Japan's policy rate has been at or below 0.5% since December 1995.
- The central bank innovated and currently engages in massive "quantitative easing".
- Stripping out the occasional direct effect of sales tax legislation, consumer prices have been amazingly stable over the past 21 and a half years.
- Since December 1995 the average rate of inflation has been slightly less than 0.1% per year.
- If the Bank of Japan had strived for price stability, its policies would have been a remarkable success.
- However, the central bank targets 2% inflation so judging by its ability to generate inflation, its policies have been an abject failure.



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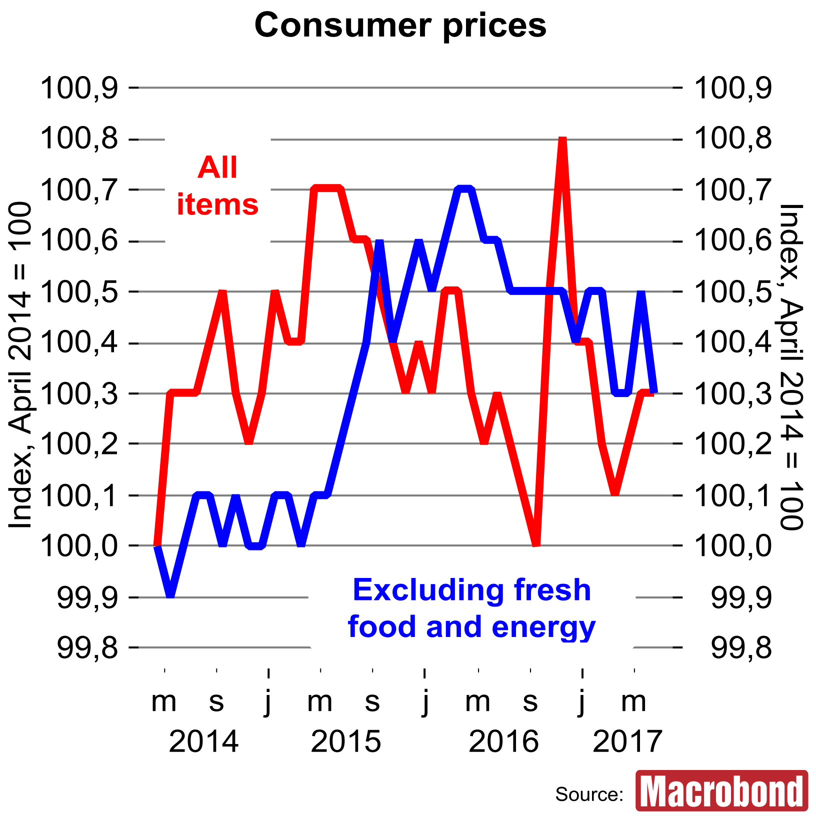
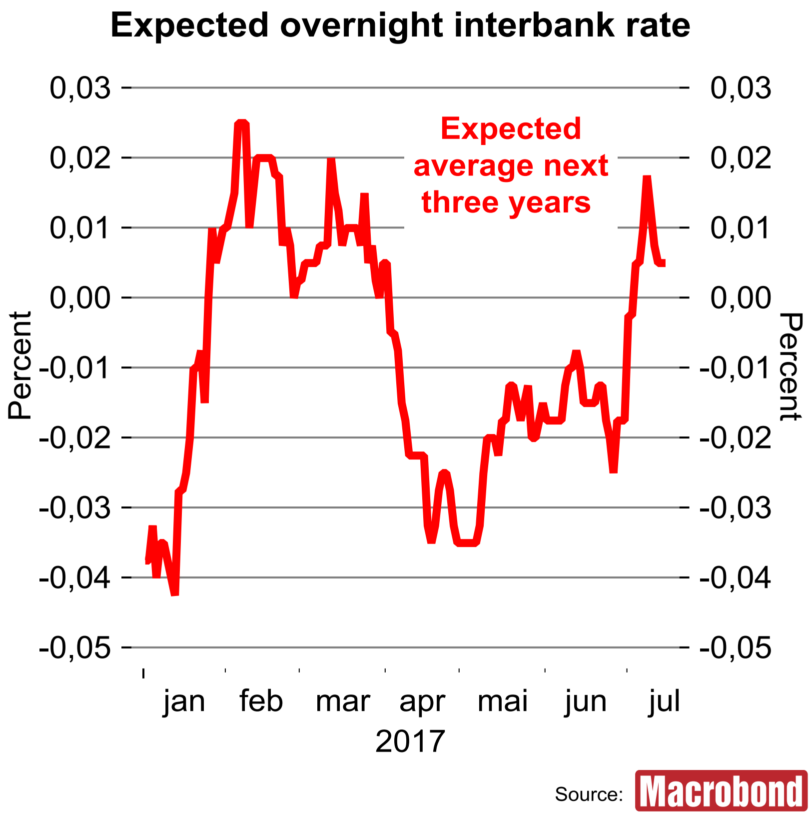
Recent inflation does not differ from post-95 average

- The sales tax was last adjusted in March 2014, causing the CPI to jump slightly.
- Since that time, the CPI has returned to foetal position.
- From April 2014 to June 2017 consumer prices rose 0.3%, i.e. less than 0.1% per year.
- NB: *I use the consumer price index for Ku area of Tokyo. It tracks the national index closely, but is updated faster than the national index.*



More “easy money” is anticipated; expect zero inflation

- The market expects that the overnight interest rate in the interbank market will be zero for the next three years.
- Experience indicates that if the policy remains close to zero, inflation too will hover around zero.
- If Japan’s trading partners on average have higher inflation, then the yen will gradually appreciate in nominal terms. But this has no implications on the yen’s value in real terms.
- If other large economies also achieve the kind of nominal stability that Japan has had, the yen will not appreciate nominally over time.
- And this might turn out to be the case. The policy rate has been close to zero since 2009 in most advanced economies.



Price stability has not precluded economic growth

- Adjusted for demographics GDP growth has not been different from the growth rate of most other developed economies.
- Since 1995 the annual growth rate per person aged 20-65 has been 0.1 pp less than in France, for example.
- There are policies that hamper growth in Japan, as in other developed countries,
- However, it is difficult to substantiate the claim that price stability has had a negative effect on real economic activity.
- The evidence from Japan suggests that it is good to be "trapped" in a "zero-zero regime".
- An economy can enjoy decent growth with a zero policy rate and an annual rate of inflation that is close to zero.