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Looking back on the first pillar of Abenomics

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Executive Summary

The first of the three cornerstones of Abenomics, "aggressive monetary accommodation" focused on achieving the inflation target. As a result, it succeeded in identifying the structural aspects of Japan's low inflation and thus helped to assure the independence of monetary policy. The Bank of Japan's large-scale JGB purchases and control of medium- and long-term interest rates were in a sense made possible by the nation's structurally low inflation.

First pillar of Abenomics

The announcement of Prime Minister Abe's retirement has prompted many to offer fresh appraisals of Abenomics. While the prevailing view is that the new administration will make no major changes to the first pillar of the policy framework—bold monetary easing—a review of its significance would be worthwhile given its many innovative aspects.

Significance of inflation target

Although Governor Kuroda declared at the outset that achieving the inflation target would be his first priority, inflation has yet to consistently exceed the 2% target level. This has prompted a great deal of debate regarding the inflation target, with the possibility of a review.

The price target was clearly important in a number of respects. First, it made it clear that Japan's anemic inflation was not due solely to a shortfall of aggregate demand and that it would be difficult to engineer a substantial increase in prices using monetary policy alone.

Monetary easing has certainly boosted aggregate demand, although some of the gains were probably attributable to an upturn in overseas economies. Before the coronavirus struck, the macroeconomic shortage of demand had disappeared and the output gap was positive. That the corresponding pick-up in inflation was so modest forces us to recognize—as the BOJ has also acknowledged—that there was substantial downward pressure on prices from structural factors.

These included the globalization of the economy, IT innovations, the stickiness of rents and public charges, and the decline in expected growth rates as Japan's population ages. The fact that the BOJ and other policy authorities were able to establish a shared understanding of the situation with financial market participants should prove a useful legacy when setting a course for future monetary policy.

Second, the Bank succeeded in protecting its independence by steadfastly maintaining the inflation target. Some may question this independence inasmuch as "bold monetary easing" formed the first pillar of the government's economic policy platform. However, whatever influence the BOJ may have felt is a far cry from the heavy political pressure that the Fed—whose mandate includes both price stability and maximum employment—and the ECB—which is charged with keeping risks from member nations' fiscal deficits in check—are experiencing at a time of severe economic and financial stresses from the coronavirus.

To the extent that the BOJ focuses exclusively on its mission of price stability (as specified in the Bank of Japan Act) and conducts monetary policy accordingly, it is naturally accountable for the resulting outcomes. Nevertheless, this has helped it to avoid becoming overly involved in issues—such as employment and economic disparities—that have heavy political overtones and are not conducive to a direct monetary policy response.

Significance of policy tools

The BOJ's focus on the inflation target was also significant for policy tools in a number of ways. First of all, the unprecedented scale of the Bank's purchases of government bonds, carried out mostly before the "comprehensive assessment" in 2016, did not lead to the kinds of side effects that had long been feared.

Perhaps we should not have expected a pick-up in inflation given the central role of structural factors in keeping Japanese prices under pressure, but many warned about such outcomes as asset price bubbles and a loss of confidence in the currency. Yet none of them came to pass, in part because the supervisory and fiscal authorities acted appropriately.

Depending on future developments in fiscal conditions—including the impact of the huge economic stimulus administered in response to the coronavirus—the central bank's massive bond purchases may still undermine confidence in the nation's finances at some point in the future. However, the timing of these actions was probably fortuitous in that the authorities were able to confirm both the benefits and costs of this experiment with massive bond purchases at a time when Japan's fiscal position was relatively stable.

Under the subsequent policy of yield curve control, the BOJ was able to maintain an accommodative financial environment while scaling back its bond purchases by setting a variety of constraints on the remaining maturity of the bonds it bought.

But we should not forget that the inflation target has played a key role in the Bank's ability to control medium- and long-term interest rates, something that would ordinarily be quite difficult from a technical standpoint. By steadfastly maintaining its price target and convincing market participants that Japan's low inflation is attributable to structural factors, the BOJ can generate expectations of prolonged easing. That, in turn, lowers the anticipated future path of policy rates and helps to keep yields anchored at low levels across the curve. In other words, the Bank's conduct of policy has served as a form of "automatic" forward guidance.

Viewed from the opposite perspective, it could be argued that low inflation was what made it possible for the Bank to engage in its massive bond purchases and control medium- and long-term interest rates with relative ease. An issue shared by so-called unconventional monetary policies is that if these measures turn out to be highly effective and inflation actually picks up, there is no guarantee that the central bank will find it easy to keep asset prices stable and maintain confidence in the currency. Another thorny issue concerns the impact that a destabilization of long-term interest rates might have on the nation's finances.

The fact that the ECB and the Fed seem to hold different views on the possible application of the BOJ's policies in their own economies probably has something to do with their divergent views on the upside risks to inflation going forward.

Looking ahead

In summary, severe side effects are unlikely to materialize immediately even if monetary accommodation continues for an extended period. Yet these policies, coupled with swelling fiscal expenditures, could enable inefficient businesses to obtain low-interest loans and expand their operations. That has the potential to depress long-term productivity growth and entrench low inflation fueled by excessive competition.

To minimize the side effects of accommodative monetary policy, the BOJ needs to prevent the creation of a vicious cycle in which easing policies that were enhanced in response to a crisis become the starting point for the next crisis and need to be expanded even further. In that sense—although it may seem paradoxical—the central bank must coordinate its crisis response with the government and ensure that both their measures are wound down at the same time.

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