

In contrast to the previous “understanding,” “goal” implies the BOJ’s intention to hit a target. Whether it leads to formal inflation targeting will depend on such conditions as the public consensus on a desirable inflation rate, the operational independence of the central bank, and the consensus on the causes and costs of inflation/deflation. Moreover, an emphasis on the substantive actions of the BOJ could undermine the significance of collective decisions at the MPM. As an initial step under the new “goal,” an increase in JGB purchases may be a signal of policy commitment and/or a message to the forex market.

Price stability goal in the medium to long term

The Bank of Japan replaced its “understanding of medium- to long-term price stability” with a “price stability goal in the medium to long term.” The action itself was mostly expected in the markets, as it had been discussed in numerous press reports in the US and Europe as well as in Japan.

Few would argue that the word “understanding” as used by the BOJ was easy to understand. That is all the more true when we consider that monetary policy in pursuit of price stability should be conducted for the general public rather than for experts in the markets and academia. In this note I will first discuss the rhetoric of the new “goal” in laymen’s terms and then discuss its practice.

Rhetoric (1)

“Understanding,” “Goal” and “Target”

In the context of the previous “understanding of medium- to long-term price stability,” the word “understanding” refers to the identification of some level of inflation as being desirable. In contrast, the word “goal” in the “price stability goal in the medium to long term” could be interpreted as meaning the central bank will take actions to achieve some desirable level of inflation.

The difference is easier to see in the following example. Imagine speaking with subordinates about their mandates for the coming fiscal year. You would criticize them if they only talked about their “understanding” of the mandate because that would make it seem as though they were dealing with someone else’s mandate. In contrast, you would give them credit if they declared they were going to work towards achieving a specific “goal.” Above all, you would feel encouraged to see them express some initiative.

As is apparent from this example, the word “goal” in the context of the “price stability goal in the medium to long term” is nearly identical to the word “target” in laymen’s terms. Moreover, it would be true from the point of view of the general public that the BOJ has finally introduced an inflation target.

Even in laymen’s language, however, a “target” usually requires additional concreteness. If the subordinates in the example above declared they were going to try to hit a specific target, you would ask them to present a deadline. Moreover, their performances could be evaluated in light of the pre-determined target. These, needless to say, are important elements of a formal inflation target (although not in the US or the eurozone).

From a medium- or long-term perspective, it is natural that the key focus of the monetary policy framework is on whether to introduce this full-fledged inflation targeting.

I would like to insist that several conditions be satisfied before making such an important decision. First, the specific

target should be chosen based on a consensus among the general public, because price stability is a common good for broad-based economic activities. Some experts in the markets and in academia in Japan claim that the 1% “goal” is too low in light of global “standards.” In my view, however, we are not justified in assuming that the desirable rate of inflation converges across all nations.

Second, the operational independence of the central bank should be established. Under an inflation targeting framework, the central bank is given full discretion in administering policy measures. We might need to go back to 1998, when the Bank of Japan Act was modified. In addition to such legislation, it would be necessary to share the “spirit” of this independence with the general public.

Last, but not least, we need a consensus on deflation. Despite long years of debate, there is no shared understanding of the major causes of deflation, and by extension of the effectiveness of the policy measures mobilized to combat it. It is also unfortunate that experts in the markets and academia have tired of—and grown increasingly dismissive of—such debate.

With regard to this point, the cost of inflation/deflation should be an important issue. In the “price stability goal in the medium to long term,” the BOJ reiterated its conceptual definition of price stability as the state “where economic agents such as households and firms may make decisions regarding economic activities without being concerned about the fluctuations in the general price level.” But it could be argued that economic agents will be able to optimize their actions as long as the rate of inflation/deflation is stable. Of course, we could suffer from welfare losses if the pace of inflation/deflation accelerates or if there are some frictions due to price adjustments. In any case, further detailed discussion would be warranted if and when the BOJ sets a formal inflation target.

Evidently these conditions are not satisfied in Japan at present, and their fulfillment should be a key issue in the public debate over whether to introduce a formal inflation target.

Rhetoric (2)

Reference of the goal

The “understanding of medium- to long-term price stability” and the “price stability goal in the medium to long term” are identical in the sense that both refer to 1 percent inflation as the year-on-year rate of change in the consumer price index (CPI). This was one reason for the market’s muted initial reaction.

Nevertheless, there is a clear difference between the expressions “the mid points of most Policy Board members’ ‘understanding’ are around 1 percent” and “set a goal at 1 percent.” Here we can see the benefits of choosing the word “target.” Rather than an objective description of the fact that

the majority of board members understand 1 percent inflation to represent price stability, we can sense the BOJ's intention to achieve the goal of 1 percent inflation.

Also noteworthy is the phrase "for the time being" in reference to the "price stability goal in the medium to long term." Because it refers to "a positive range of 2 percent or lower" as the ultimate goal, it could be understood to signify that the BOJ will pursue 1 percent inflation as the initial step, then make further efforts to achieve a positive level of 2 percent or lower.

Another point of interest in this new goal is the choice of subject (my apologies if this line of discussion deviates from laymen's terms...). In the former "understandings," the subject was the members of the Policy Board. But the new "goal" was announced by the BOJ. Under the Bank of Japan Act, monetary policy decisions are made by the Policy Board and are based on a majority vote. Therefore, there is no meaningful difference between a Policy Board majority and the Bank of Japan in this respect, and it might not make sense to highlight the choice of subject as noted above.

Nevertheless, there could still be differences between the two terms when the BOJ is explaining them. Under the previous regime, the BOJ could say that 1 percent inflation represented the view of Policy Board members. But in the current regime, the BOJ will have to present this as its own goal. The implications of this seemingly trivial difference can be understood clearly if we imagine a situation in which the BOJ needs to elicit support from people who typically are critical of its monetary policy.

There is an interesting contrast here with the Fed's ongoing initiative. It is well known that Chairman Bernanke has been making efforts to "institutionalize" monetary policy decisions because he is mindful of the risk of over-influence by a specific member of the FOMC. For example, he explained that this view is one reason why it was decided to announce FOMC members' expected path of policy rates. The reason for such caution is not so clear to outsiders like myself. The authors of *Banking on the Future* (Howard Davies and David Green, Princeton University Press, 2010) suggested that Chairman Bernanke may not like a dominant approach to managing discussion at FOMC meetings and would prefer to establish a more democratic approach as his legacy for the Fed.

While there is less risk of a dominant figure being appointed BOJ governor, the change of subject discussed above could raise some issues for the BOJ. By changing the subject from the members of the Policy Board to the BOJ, the Bank clarifies its policy intention and achieves a higher standard of accountability. Nevertheless, there is an emerging risk that the significance of divergence in Policy Board opinions will be undermined. I think the expression of this goal should evolve naturally and deserves further discussion.

Practice

On the day the "goal" was introduced, the BOJ also decided to increase the scale of the Asset Purchase Program by ¥10tn and to allocate the entire amount to JGB purchases.

From an outsider's point of view, the reasons for such additional monetary easing are unclear. While the BOJ maintains a cautious outlook on Japan's economy (largely because of developments overseas), it did not make any

downward adjustments to its main scenario. Moreover, the outlook for inflation is largely unchanged, although there is little confidence in purported "improvements" in inflation. This led many overseas market participants to declare that the additional stimulus came as a surprise.

During the last week there has been frequent speculation on the factors that may have prompted the BOJ's action. One possible and seemingly powerful argument is that the BOJ may seek to emphasize its commitment to the new "goal" with the concrete action. Another likely candidate is that the BOJ would like to ease upward pressure on JPY. Retrospectively, the BOJ's monetary easing actions during these two years coincided with foreign exchange intervention by the MOF. Heated discussion at the current session of the Diet before the BOJ's decision suggested that politicians were concerned about—and frustrated by—deflation and the strong yen.

The latter story relates to another interesting aspect of the "price stability goal in the medium to long term." The word "goal" is the BOJ's translation of the Japanese word "medo." In Japan, however, both the general public and market experts might be slightly uncomfortable with this translation. While the word "goal" can be found in the dictionary entry for "medo," the Japanese term also carries nuances of prospect and/or outlook. It may be that the BOJ is seeking to converge its monetary policy framework with that of the Fed in consideration of possible reactions from the FX market (please note that what the FRB announced on January 25 were "longer-run goals").

Lastly, the choice of concrete action warrants our attention. When the BOJ decides to expand its asset purchases, additional purchases of JGBs are indeed a natural choice. As the discussion at the nineteenth meeting of our Financial Markets Panel clearly showed, it was both difficult and undesirable for the BOJ to increase the scale of "credit easing." We observed distortions in the yields of CPs and TBs and signs of under-subscription in CB purchases. Still, the ¥10tn outright increase in JGB purchases, which represents the initial step towards achieving the new "goal," may be the chief reason for the renewed attention being (unexpectedly) devoted to the BOJ's policy framework at present. And it reminds us that operational independence is a necessary condition of formal inflation targeting.

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