Quo Vadis, Central Banks? Monetary Policy in the COVID-19 Crisis and Beyond

Kiyohiko G. Nishimura

2020-11-09

National Graduate Institute for Policy Studies (GRIPS)
Former Deputy Governor, Bank of Japan
Advisor, Ministry of Internal Affairs and Communication

A (Former) Bank of Japan Policy Maker's Viewpoint (1) *de facto* "Weak" Dual Mandate

- Bank of Japan Act: Article 2　Currency and monetary control by the Bank of Japan shall be aimed at

- achieving price stability,

- thereby contributing to the sound development of the national economy.

- kind of a "weak" dual mandate: price stability as prerequisite of the sound development of national economy (implicit emphasis on the latter)

A (Former) Bank of Japan Policy Maker’s Viewpoint (2) 2% Target as a Long-Run Goal or “Equilibrium”

- 2013 Jan 22. *The “Price Stability Target” under the Framework for the Conduct of Monetary Policy*.

- **The "price stability target" at 2 percent** in terms of the year-on-year rate of change in the consumer price index (CPI)

- (is) the inflation rate consistent with price stability on a sustainable basis

- as efforts by **a wide range of entities (especially the Government) toward strengthening competitiveness and growth potential (and sustainable fiscal structure**) of Japan's economy make progress.

Policy Issues: Covid-19 Crisis and Thereafter

- Are there a sufficient number of measures?
- Are they immediately effective (especially with respect to financial stability)?
- Are they sustainable after the Covid Crisis ends or fades?
- Are there long-run problems that the Bank of Japan faces after Covid 19 Crisis?

Remarkably Large Number of Instruments

- Twenty-One even before Covid-19 crisis. *

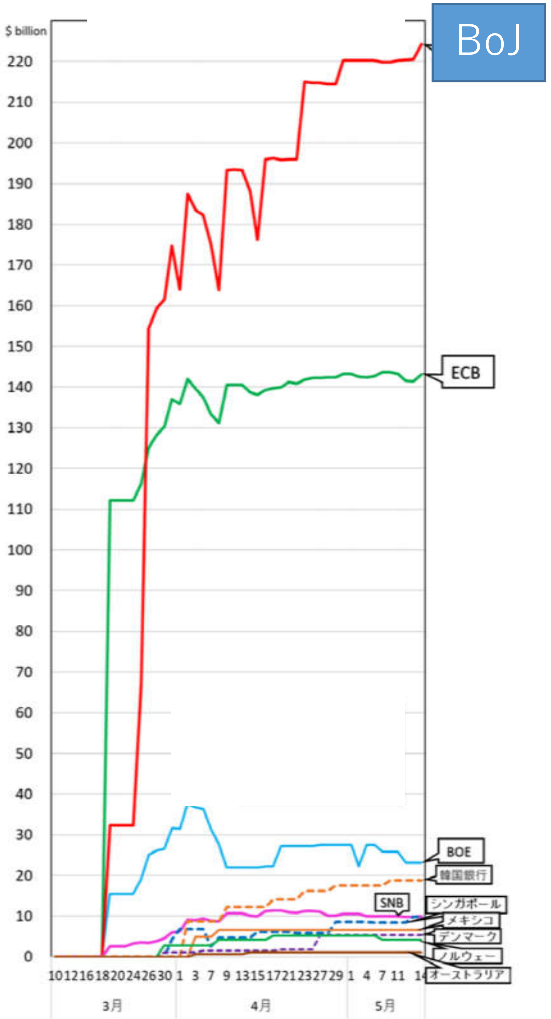
  * Heckel and Nishimura, "Unconventional Monetary Policy through Open Market Operations: A Principal Component Analysis" mimeo., September 2020

- New Covid 19 instruments are mostly to expand existing facilities … (though massively)
- Asset Purchase Programs – Increasingly Direct Interventions in Resource Allocation (ETF, J-REIT)
- Ample Liquidity Provision Beyond the Border (dollar swaps)
- Lending Support Facilities

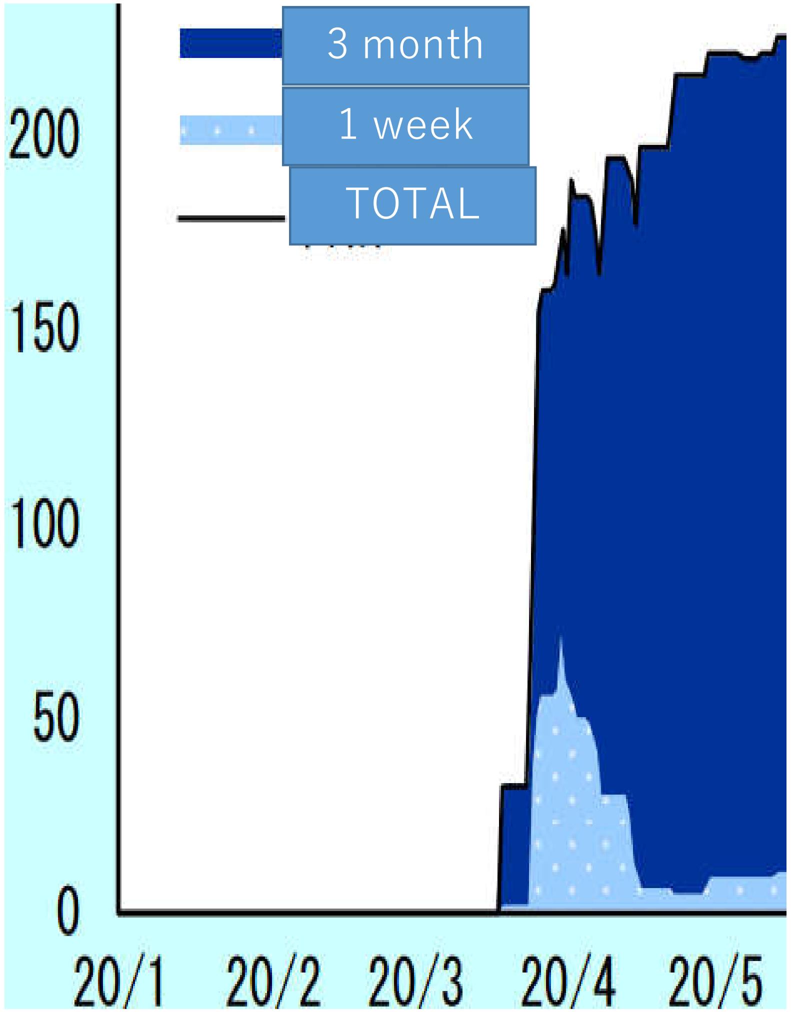
- Those (except for some lending support facilities for Covid 19) are mostly for large corporations and banks, whose effects are trickled down to small enterprises and non-wealthy households

An Example: Rescuing US Bond Markets

FRB Currency Swap



Bank of Japan Dollar-Supply Operation

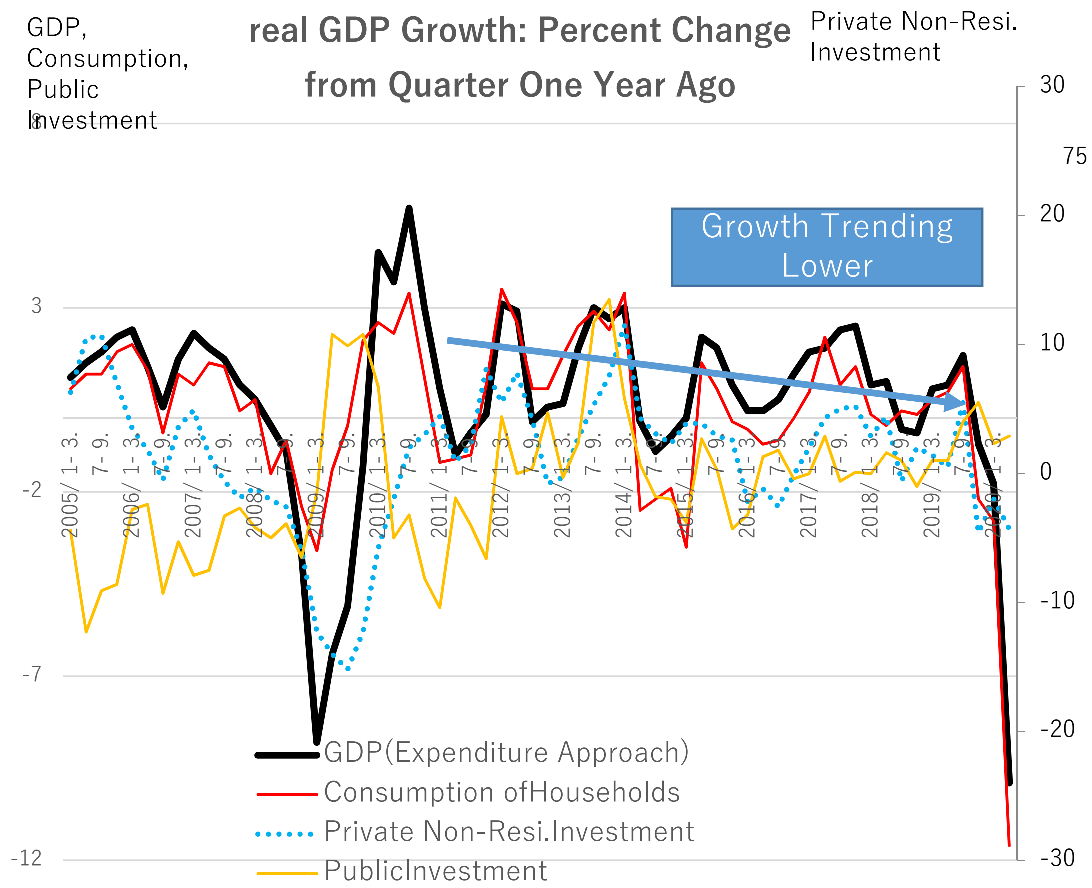


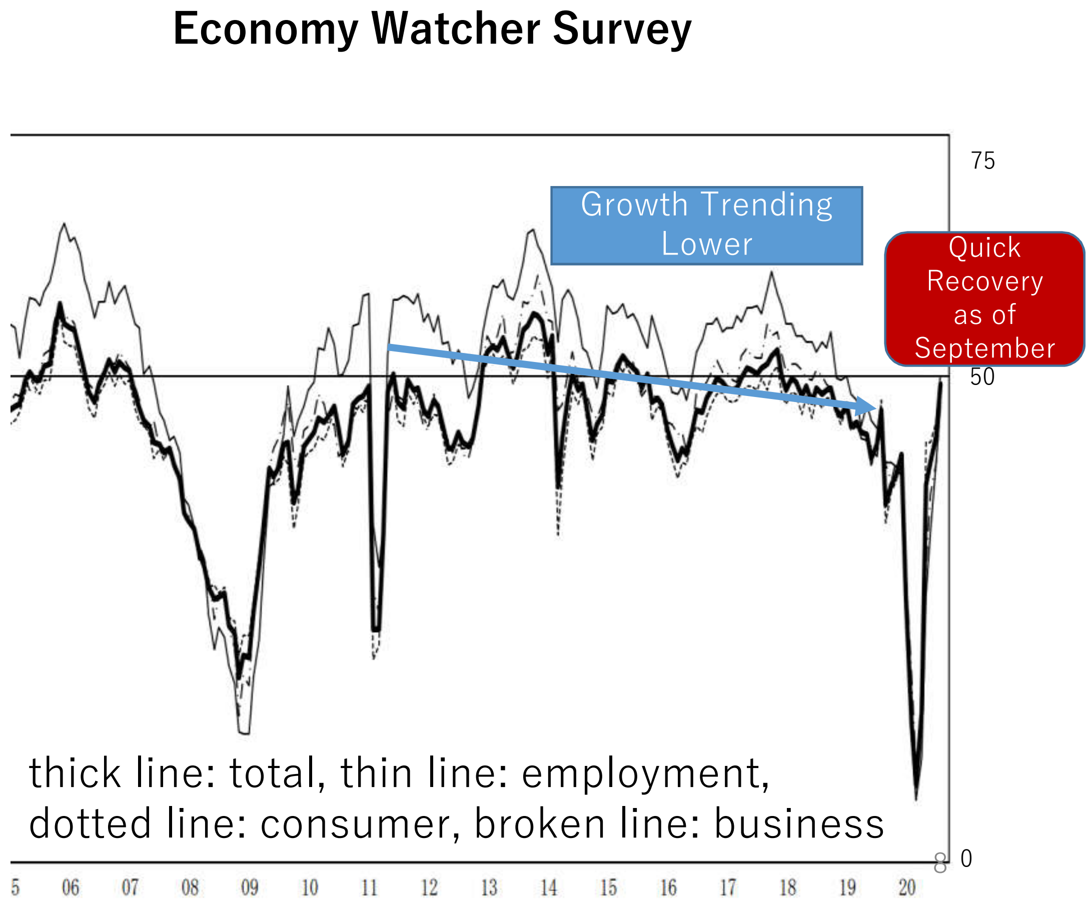
Where are we now?: Success, so far, with respect to "sound development of the national economy".

- Sharp Dip from Declining Growth Trend before Covid-19 but Surprisingly Quick Recovery Except for Services

- However, the issue of "Declining Growth Trend before Covid-19" is not solved and may even be worsened with the effect of Covid-19 crisis.

Sharp Decline and
A Surprisingly Quick Recovery (Except Services)





Where are we now? Challenging, so far, to restore "price stability“ in the short run.

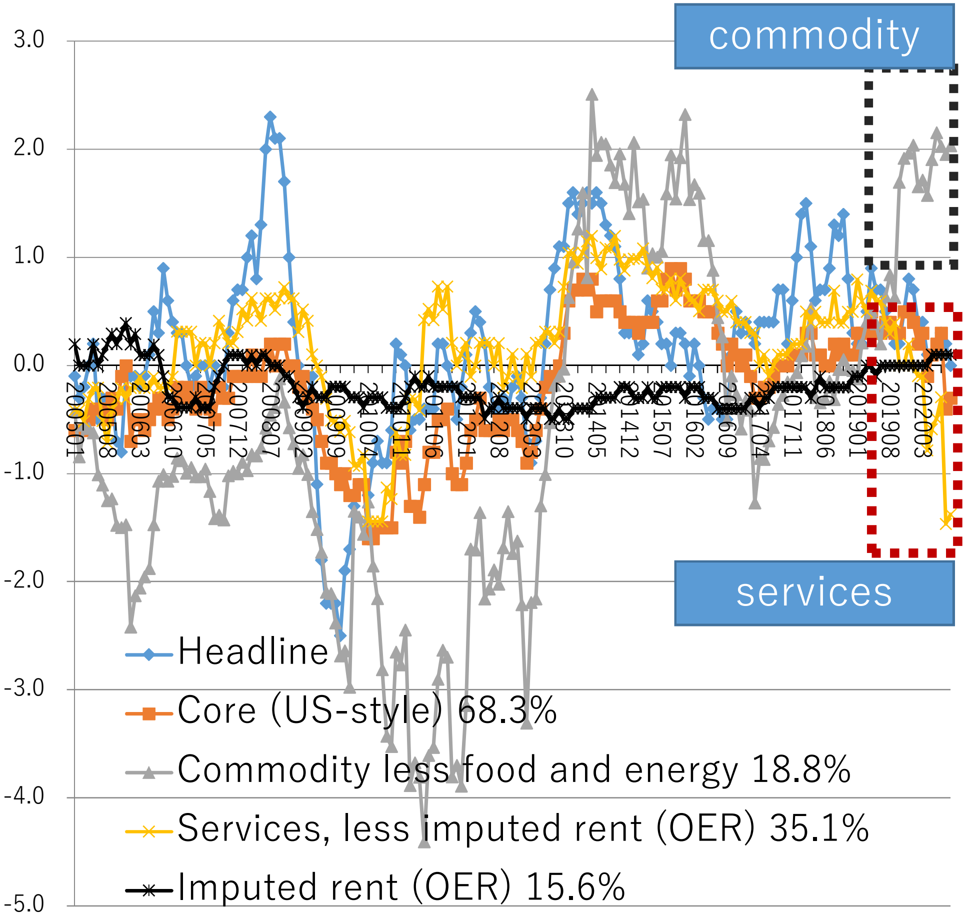
- First, Initially Deflation Dominates.

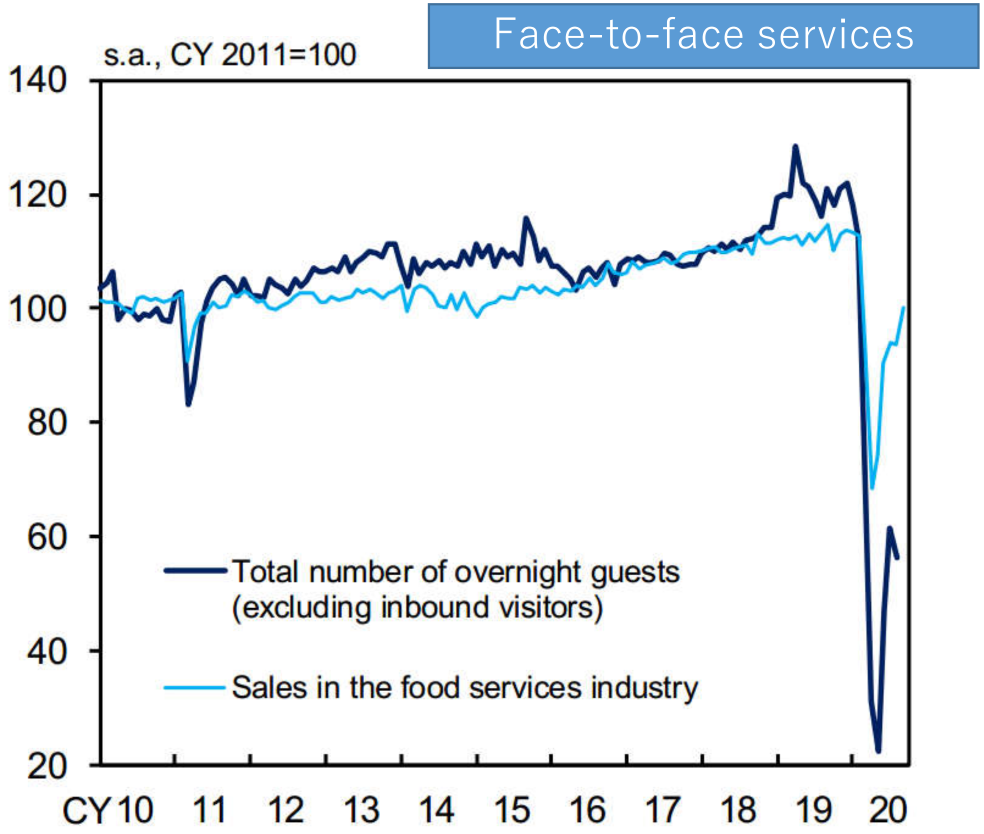
  Secondly, conflicting forces about price stability

- For face-to-face, services sectors (employing poor to lower-middle-class people), employment is lost, wages and their permanent income are down, and thus deflationary.

- In manufacturing, ITC, and digital sectors (employing upper-middle-class and owned by wealthy people), there are huge forced savings which is strongly inflationary when dissaving starts.

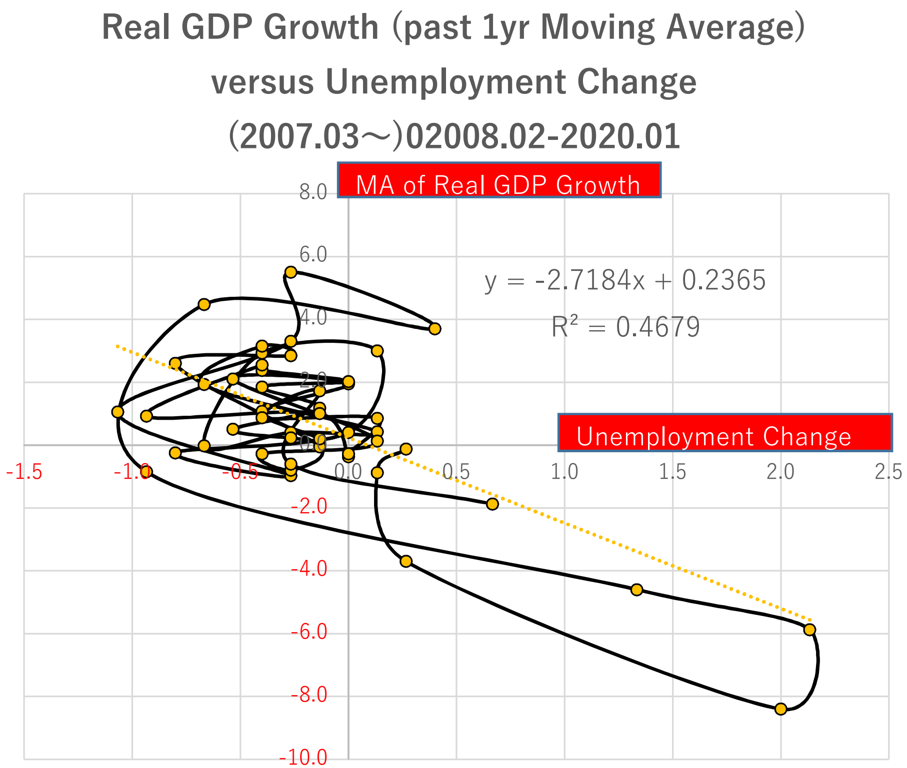
Commodity Less Food and Energy: A Sharp Increase
Services less Imputed Rent: A Sharp Decline



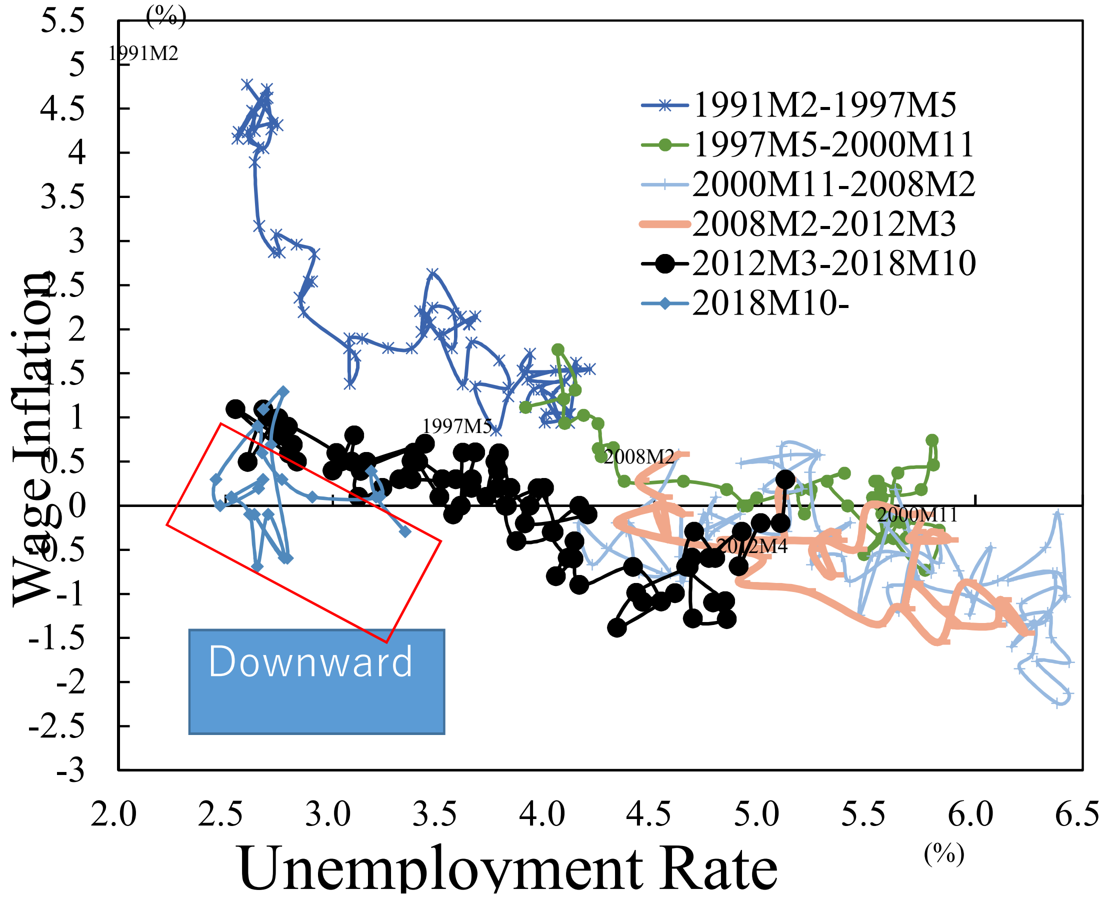


Prolonged Slow Services Growth ↓ ➔Unemployment Rate ↑ ➔Wages (Permanent Income) ↓ ➔ Deflation ↓

"Long-lagged" Okun's Law

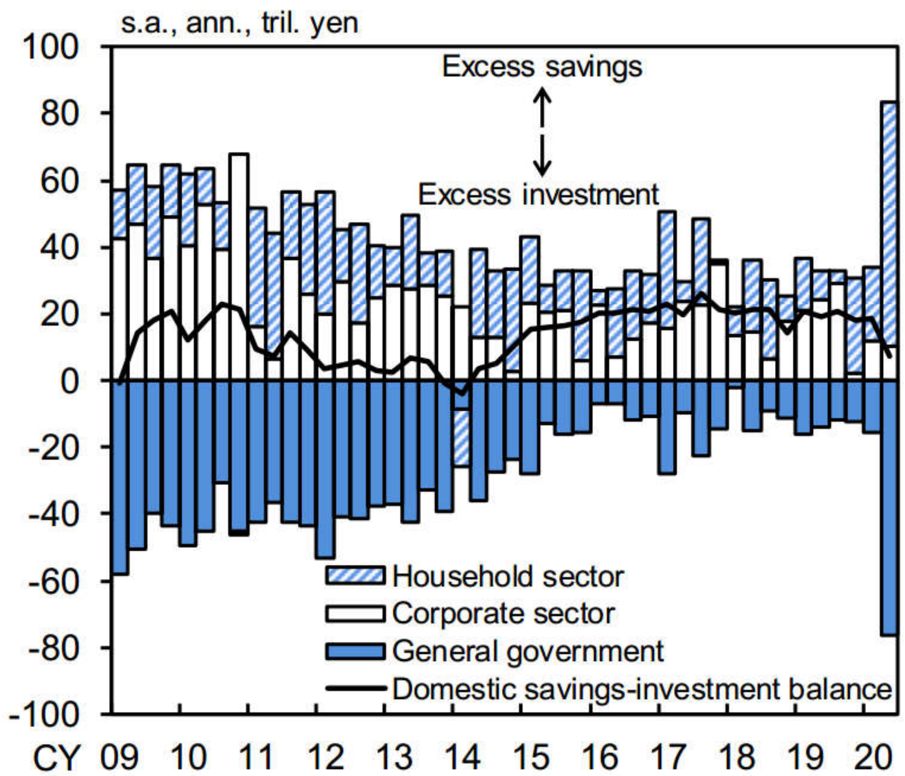


Wage Phillips Curve



Forced-Saving, Pent-up Demand ➔ Inflation

Generous Income Transfer: Huge "Forced" Household Savings



Source: Bank of Japan.

When and How Are They Turned to Demand, and Become Inflationary?

- If behavioral restraints are temporary, then inflation comes back soon.
  - Generous consumption stimulus such as Go-to-travel, Go-to-eat, etc.
- If precautionary saving rates are up because of future health cost increases even for upper-middle to wealthy people, it ends up with not-so-strong demand.

- **If the former dominates, a substantial inflationary pressure.** If the latter does, inflationary pressure is subdued.

Tag of War:

- For **“price stability”** in the medium run

- the deflationary face-to-face service sector effects should be minimized, while

- the inflationary dissaving effects should be maximized.

To Achieve "Price Stability"

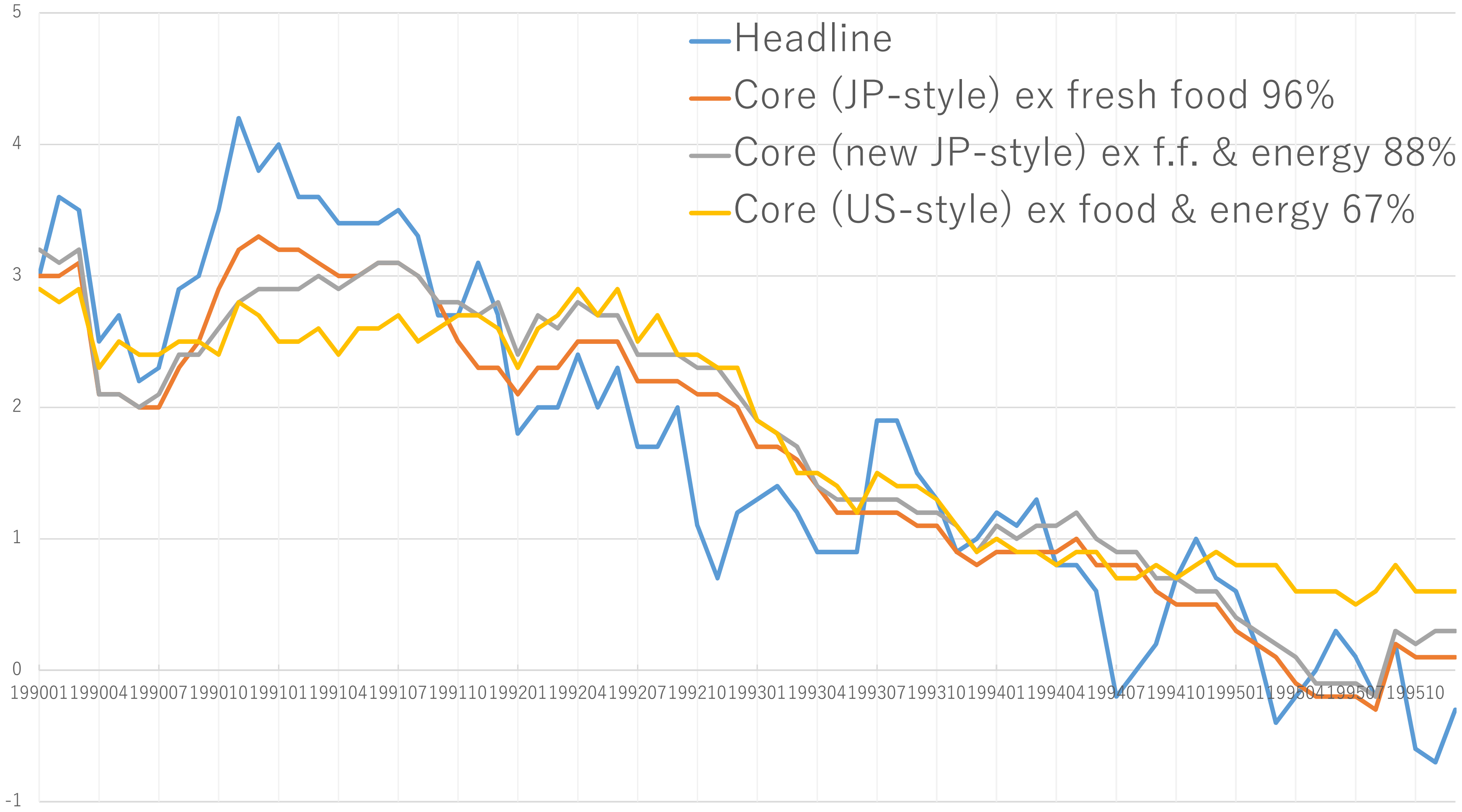
- Coordination / mutual commitment between Fiscal and Monetary Authorities Are Desirable
- Fiscal-side commitment
- The commitment or agreement is desirable with the fiscal authorities about how long and in what conditions the stimulus continues. This is especially important to minimize deflationary effects on face-to-face service sector effects, including medical and nursing care sectors.

Government's Policies Determine Inflation

Lessons from the Failure in Japan in the1990s: Deflationary Pressure Overlooked

- Not only monetary policy easing was behind the curve,
- But also fiscal policies were consistently tight to ensure there should be no more property bubble (e.g. land value taxes, and strong opposition to capital injection to troubled financial institutions.)
  - The Ministry of Construction refused the assessment that land prices were undervalued of the regulatory reform committee even in the late 1990s.
- Stagnation of the 1990s caused "price destruction" (disinflation-deflation). However, the government did not consider it problematic since it was regarded as correction of "higher domestic-foreign price differentials" (i.e., domestic prices were considerably higher than foreign ones) and thus even welcomed.

CPI Inflation: Four Indexes – 1990.01-1995.12



To Achieve “Price Stability”

- Coordination / mutual commitment between Fiscal and Monetary Authorities Are Desirable
- Monetary-side commitment
- If necessary, additional asset purchases in targeted sectors are appropriate to supplement and/or kick-start particular sectors, although this means a direct intervention in resource allocation.
  - example: TFP-enhancing sectors, climate-change sectors, etc.

Relevancy of Recent Debates about “2% Flexible Average Inflation Target”

- In principle, in the long run, central banks’ inflation targeting should be aligned properly.

- If otherwise, expectations about exchange rates (and thus exchange rates themselves) differ substantially from each other. This is disruptive, although such changes are hard to predict.

- This is the essential purpose of setting “2% target” in the long run of the Bank of Japan announced on Jan 22, 2013, though not directly stated.

- Thus, we do not have to change 2% at all at this juncture.

Problems about “2%” in the medium run

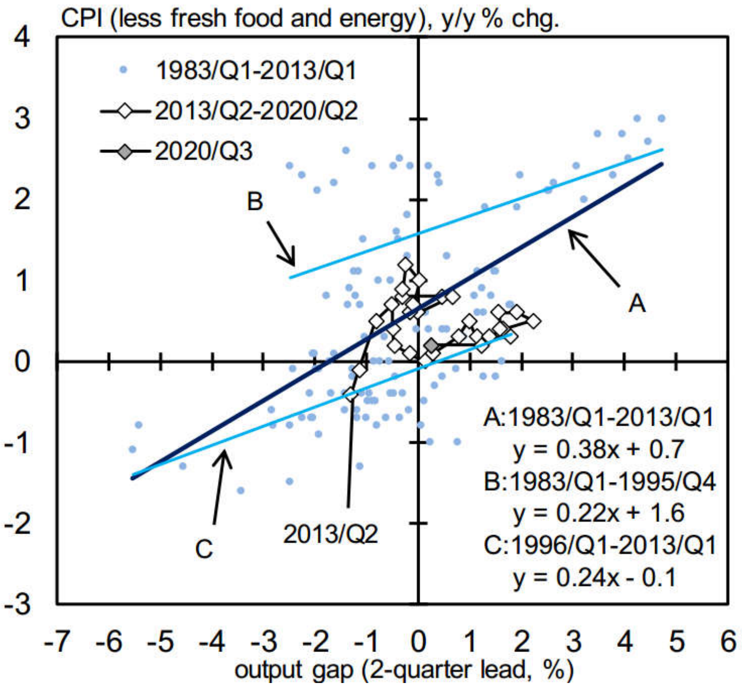
Inflation Expectations are stable around 1% and well below 2%

- The Phillips Curve is describing relationship between inflation (CPI inflation) and Output Gap (“slack” in the economy) . Zero slack (no output gap) inflation is the sustainable (long-run) inflation expectations.
- Fact 1. Long-run inflation expectations (implied by the Phillips curve) was already substantially below the 2% target between 1983-1995.
- Fact 2. From 2005, surveys of long-run inflation expectations have been stubbornly stable around 1%, and far below 2% target.
-
- Fact 3. From 2019, surveys of long-run inflation expectations move downward.
- **This unique feature prevents “2% target” from being fulfilled in almost 30 years.**

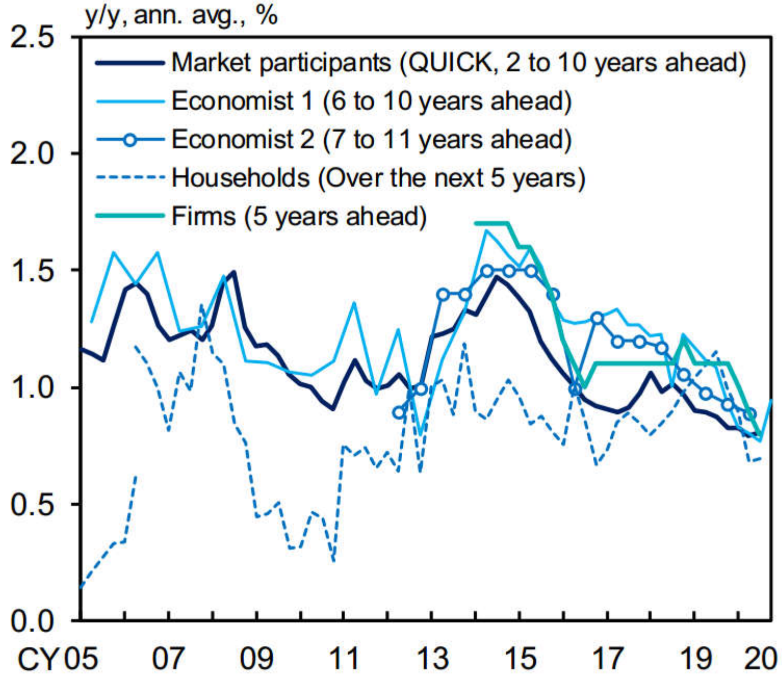
Inflation Expectations as Anchor in the "GAP" Price Phillips Curve (CPI Inflation vs. Output Gap)

Price Phillips Curve 1983 – 2020

Inflation at zero gap = (sustainable) long-run inflation expectations



Surveys of long-run inflation expectations 2005-2020



Can the Covid-19 Inflationary Stimulus Effects Change “1% Stability of Inflation Expectations”?

- Covid-19 fiscal stimulus effects with huge forced savings may be strongly inflationary after Covid 19 crisis is over.
- They may change inflationary expectations.
- Changes in inflationary expectations (and thus actual inflations) are sometimes drastic and happen in a short period time of only three years. (for example: 5%➔23%➔8% during 1973-1975)
- So be prepared in case.
- However, most observers think they do change “1% stability of inflation expectations.”
- If this is the case, we then stick to already-explained **Coordination with Fiscal Authorities for “Price Stability” as guidance to follow.**