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NEWS ANALYSIS
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Will Japan Target Inflation in 2006?

The Bank of Japan may well adopt a formal target figure to guide monetary policy after easing interest rates

As the Bank of Japan prepares to finish quantitative easing of interest rates, an important issue will be how it defines its post-reflationary monetary policy framework. Despite its previous opposition, the Bank of Japan is now likely to find merit in the adoption of a formal inflation target, possibly in conjunction with the government.

The Bank of Japan has a statutory "price stability" mandate, but has never formally defined what this means in terms of specific inflation outcomes. The bank has typically defined price stability in the same way as Alan Greenspan: a rate of inflation that does not distort economic decision-making, without seeking to formulate this in terms of a numerical target to guide policy.

Under the zero interest-rate policy (ZIRP, lasting from 1999 to 2000) and quantitative easing (QE, from March, 2001, to present), the Bank of Japan has nonetheless resorted to ad hoc inflation commitments designed to guide policy and influence market expectations in relation to interest rates. ZIRP was maintained to dispel deflationary concerns. However, QE has been maintained depending on a return to a positive annual rate in the core consumer price index, along with the requirement that the central tendency of the policy board's inflation forecast also be positive.

While these are only necessary, rather than sufficient, conditions for an end to QE, it's likely that the Bank of Japan will end quantitative easing and return to ZIRP in the second quarter of 2006, before proceeding to raise the nominal overnight call rate later in the year.

DEFLATION AND REFLATION. With the termination of QE, the Bank of Japan will no longer have an inflation commitment guiding policy. This is an undesirable situation, since it leaves Japanese monetary policy without any formal policy guidance, and gives the market and the public nothing on which to condition expectations for the future path of interest rates, potentially impairing the effective transmission of monetary policy. Indeed, the lack of a nominal anchor for policy facilitated Japan's slide into deflation from the mid-1990s.

The Bank of Japan has been skeptical of the value of formal inflation targets, particularly as a solution to deflation. The Bank of Japan has always doubted its ability to influence inflation expectations, and feared that its credibility would suffer if an inflation target were set but not realized. Of course, this could easily become a self-fulfilling prophesy if the bank makes no attempt to influence inflation expectations.

The Bank of Japan's other concern has been that positive inflation expectations, once generated, might be difficult to contain. Advocacy of inflation targeting in Japan has been associated with some of the more irresponsible schemes to "spring" Japan from its "liquidity trap" and the Liberal Democratic Party's (LDP) old guard, who sought to substitute reflation for structural reform of the Japanese economy.

Formal inflation targets have usually been adopted by countries with poor inflation records, often as part of an explicit disinflation process. The Bank of Japan has thus questioned the relevance of inflation targeting to Japan, even though Japan's experience of deflation and attempts at reflation are in some respects just the mirror image of the problems faced by other inflation-targeting countries.

HAWKISH POLICY BOARD. The Bank of Japan has also been influenced by the "Nike," or "Just Do It," approach of the U.S. Federal Reserve. The Bank of Japan sees the Fed's approach as more relevant to its situation than, for example, dollar-bloc economies like Canada, Australia, and New Zealand, which adopted inflation targets from the early 1990s. With incoming Fed Chairman Ben Bernanke sympathetic to inflation targeting, however, this is likely to spark a reassessment on the part of the Bank of Japan. If the Fed moved to adopt an inflation target, the Bank of Japan would not want to be an outlier in terms of G3 practice. The Bank of Japan is now likely to see an inflation target as a useful way of containing long-term inflation expectations as the Japanese economy recovers.

A key issue is whether the Bank of Japan will adopt an inflation target unilaterally, in conjunction with the government, or have one imposed on it by the government. We think any move to inflation targeting is more likely to be done in conjunction with the government. This approach has the advantage of conferring democratic legitimacy on the chosen target, and protects the Bank of Japan from future criticism from the government, since it would then be a party to the agreed inflation target. The Japanese Cabinet Office, the Ministry of Finance, and the LDP have been very sympathetic to the idea of an inflation target, mainly because they see this as a way of placing a greater macro-policy burden on monetary policy, offering them more flexibility in terms of fiscal policy.

An LDP committee is currently studying the issue of government-Bank of Japan cooperation, with an interim report -- likely to recommend some form of inflation or nominal income targeting -- due in March. The government also will have to make two new appointments to the Bank of Japan policy board during the first quarter. The government has a track record of appointing hawks to the policy board, which makes its complaints about a lack of cooperation from the Bank of Japan more than a little ironic.

PHASED APPROACH? If the government is serious about having the Bank of Japan adopt an inflation target, then it could appoint those sympathetic to the idea to the policy board, adding to the existing minority support among the deputy governors. The Bank of Japan might see some advantage in taking the initiative and unilaterally adopting an inflation target. This would allow the Bank of Japan to set its own agenda, but would lack the advantages of a target determined jointly with the government.

This leaves the issue of what form an inflation target should take. The Bank of Japan will be very resistant to adopting an ambitious inflation target that it might not be able to reach. When New Zealand adopted inflation targeting in the early 1990s, it took a phased approach, with a gradually declining target that the central bank of New Zealand, the RBNZ, could credibly realize as it disinflated.

A similar phased approach could be adopted by the Bank of Japan. This could involve an initial target specified in terms of some measure of underlying inflation of between zero and 1%, with the target then raised to zero to 2% after one or more years. A zero-to-2% target range would give a midpoint consistent with the average inflation rate in Japan since the early 1980s, and would effectively signal that policy will seek to preempt the reemergence of deflation. It would also be consistent with the European Central Bank's approach, although the Bank of Japan will aspire to greater success than the ECB in actually meeting the target.

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