Japan really starts to fight deflation

4 April 2013

Japan has been stuck in deflation for about 15 years. Finally, the BoJ is at least trying to escape from this crisis. The first moves of the new BoJ president were rather spectacular, and there is almost certainly more to come. Whether this massive monetary experiment will work remains to be seen.

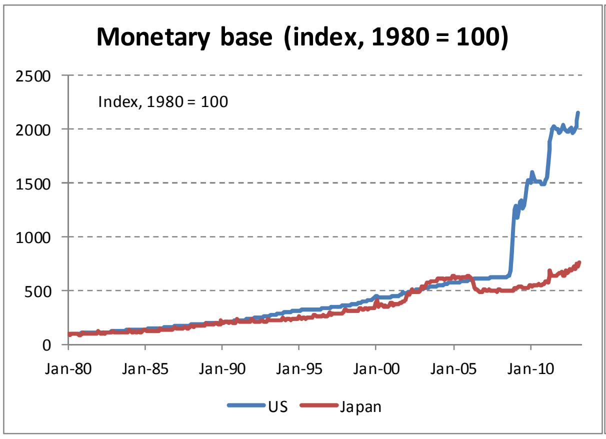
In recent months the BoJ had already announced an explicit inflation target (initially of 1%), doubled that target and announced an open-ended asset purchase program to start in 2014. At his first meeting new BoJ president Kuroda (quite rightly) decided there was no reason to wait until 2014 by announcing massive monetary easing to start basically right away.

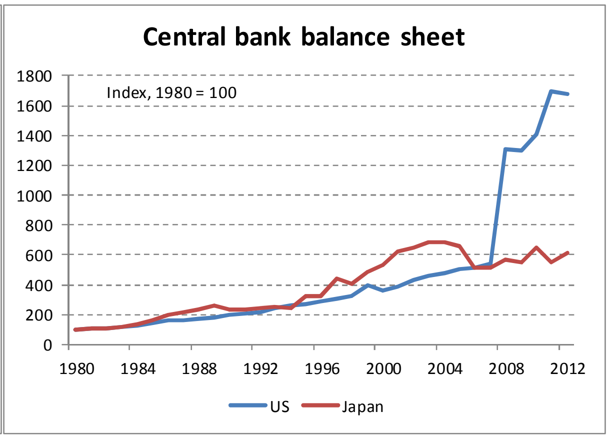
Before the end of 2014, the BoJ aims to:

- Double its monetary base (from 138 trn yen to 270)
- Double its holding of government bonds (JGBs) (from 89 trn yen to 190), making all maturities eligible for purchase (earlier plan were aimed at short term debt). This implies monthly JGB purchases of 7 trn (versus 4 trn currently)
- Purchase other assets: 2 trn of ETFs and 60 bn of real estate investment trusts (REITs)

In all, the BoJ wants to reach its 2% inflation target at the earliest possible time. It will continue monetary easing as long as necessary to maintain that target in a stable manner.

With these moves the BoJ rather convincingly shows that it is finally ready to really start fighting deflation. The new easing measures announce a spectacular change from earlier BoJ policy, which was remarkably tame in the face of long-lasting deflation. The BoJ has never tried anything like this. However, the Fed already has. By doubling its monetary base and overall balance sheet, the BoJ is only following what the Fed has already done in recent years. In light of the difficulties/limited success the Fed has had in its efforts to generate higher inflation and economic growth, and adding to that Japan's starting position with firmly established deflation is worse than the that of the US, it is highly likely that the new measures will not be sufficient to establish inflation at 2%.





There are still further options for monetary easing for the BoJ, and Kuroda seems inclined to try them: a higher pace of purchases, increased purchases of private assets, and maybe even the 'helicopter drop' (direct monetary financing of public spending) could eventually be tried. In any case, more monetary easing should be expected in the next two years.

Whether this will generate 2% inflation remains to be seen. Theoretically aggressive enough monetary policy (in tandem with fiscal policy) should be able to end deflation. In the past, the BoJ just hasn't tried hard enough, it now finally seems willing to do so. It will be interesting to see whether this monetary experiment works.

Other implications are likely to be:

- Additional downward pressure on the yen
- Continued downward pressure on JGB yields
- Positive impact on the Japanese export sector (whether this will have an important impact on global growth will depend on whether the positive impact will feed through in the domestic economy in Japan, which remains uncertain)