

**JAPAN'S DEFLATION, MONETARY POLICY
AND ISSUES AHEAD**

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Executive Summary

1. Since the later half of the 1990s through 2012, the Japanese economy suffered from mild but persistent deflation that had eroded its economic vitality. By the end of 2012, prices were lower than they were in 1998, an outcome that is unique among the advanced economies.
2. At the end of 2012, Shinzo Abe became prime minister on a platform that included overcoming deflation as one its top priorities. He appointed new leadership to the monetary policymaking board of the BOJ, notably the vocal reflationist Haruhiko Kuroda as governor.
3. The BOJ then shifted to embrace bolder monetary measures – including large-scale unconventional policies such as quantitative easing and negative interest rates – to reflate the economy and achieve a new inflation target of two per cent. These policies largely remain in place even today.
4. The economy is currently experiencing its second longest expansion since the end of World War II. Economic analyses have suggested that the BOJ's monetary policies have had positive effects on growth, inflation and a number of other economic variables.
5. Nevertheless, these monetary policies remain somewhat controversial. The inflation target has not been achieved; many citizens do not feel the tangible benefits of economic growth and critics urge that the unconventional monetary policy of the BOJ may have a number of potential negative side effects like unsustainability of asset purchases and investors' excessive risk taking.
6. In the coming years, it is likely that in Japan as well as other regions, such as the eurozone, deflation will continue to pose a challenge. If deflation returns, central banks may need to maintain and possibly expand their unconventional monetary policies.

7. In the Japanese context, current policies may be less effective in stimulating growth. There is a limit to how low interest rates can go as the BOJ's policies have already lowered 10-year interest rates to near-zero per cent. There are other monetary policies that the BOJ can try, though.
8. One approach known as "helicopter money" would involve the BOJ creating new money that the government transfer to citizens through tax cuts, for instance. Such a policy would blur the line between monetary and fiscal policies, and could potentially require legislative changes. This approach is highly controversial in Japan and the Abe administration does not seem inclined to support such a move.
9. Future monetary policy will be determined by the BOJ's Policy Board, which for the foreseeable future will continue to reflect Prime Minister Abe's policy preferences. Abe has appointed every member of the Policy Board and he is likely to stay in power for several more years.