Japan-U.S. Symposium on Building the Financial System of the 21st Century

Is inflation a problem?

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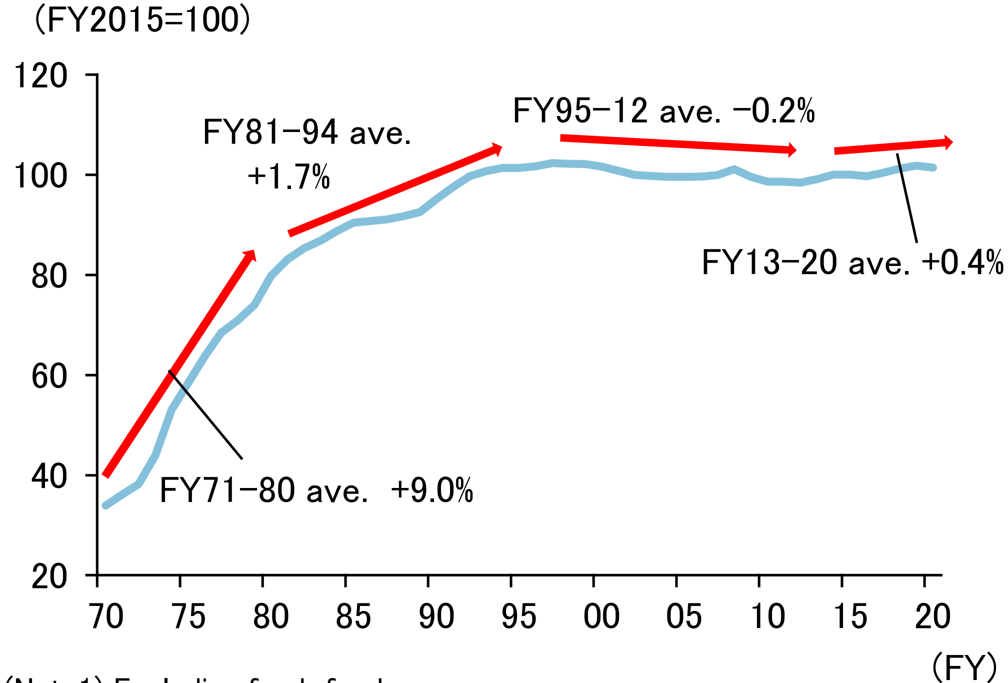
General observations about inflation and monetary policies

1. Cost-push inflation is emerging almost everywhere in the world, due to pandemic related supply-chain disruptions and rises in commodity prices.
2. As for the US, strong demand, importantly induced by fiscal expansion, also plays a significant role.
3. While the US inflation is expected to decline substantially around mid-2022, continued impact of excess savings and potentially prolonged labor supply constraint are among major sources of uncertainty.
4. In Japan, higher costs are unlikely to translate into a full-fledged inflation. Much more relevant concern is that an ongoing deterioration in terms of trade may weigh on the economic recovery.

Japan’s “zero inflation” regime is extremely durable.

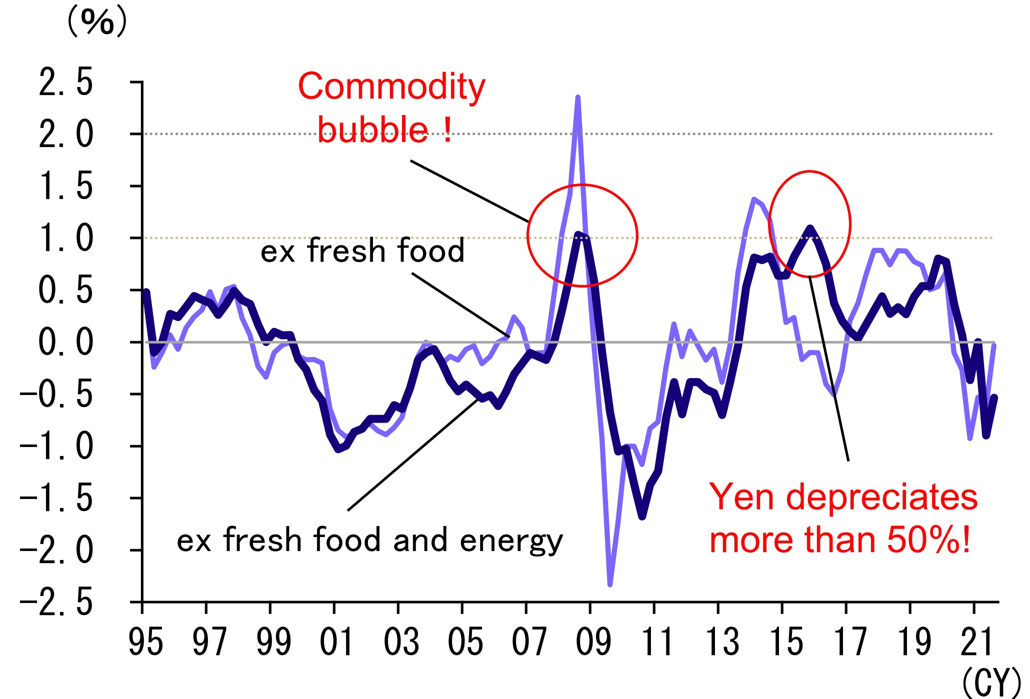
- Prices have been literally stable since the mid-1990s. “Deflation" is a bit exaggerated characterization of what exactly happened.
- 2% inflation is unrealistic. Even 1% inflation (CPI ex fresh food and energy) has not occurred for more than 25 years, with only two temporary exceptions.

【 CPI: long-term trend 】



(Note1) Excluding fresh food.
(Note2) Adjusted for impacts of consumption tax hikes in 1997 and 2014.
(Source) Ministry of Internal Affairs and Communications.

【 CPI: year-to-year change 】



(Note) Adjusted for impacts of consumption tax hikes in 1997 and 2014.
(Source) Ministry of Internal Affairs and Communications

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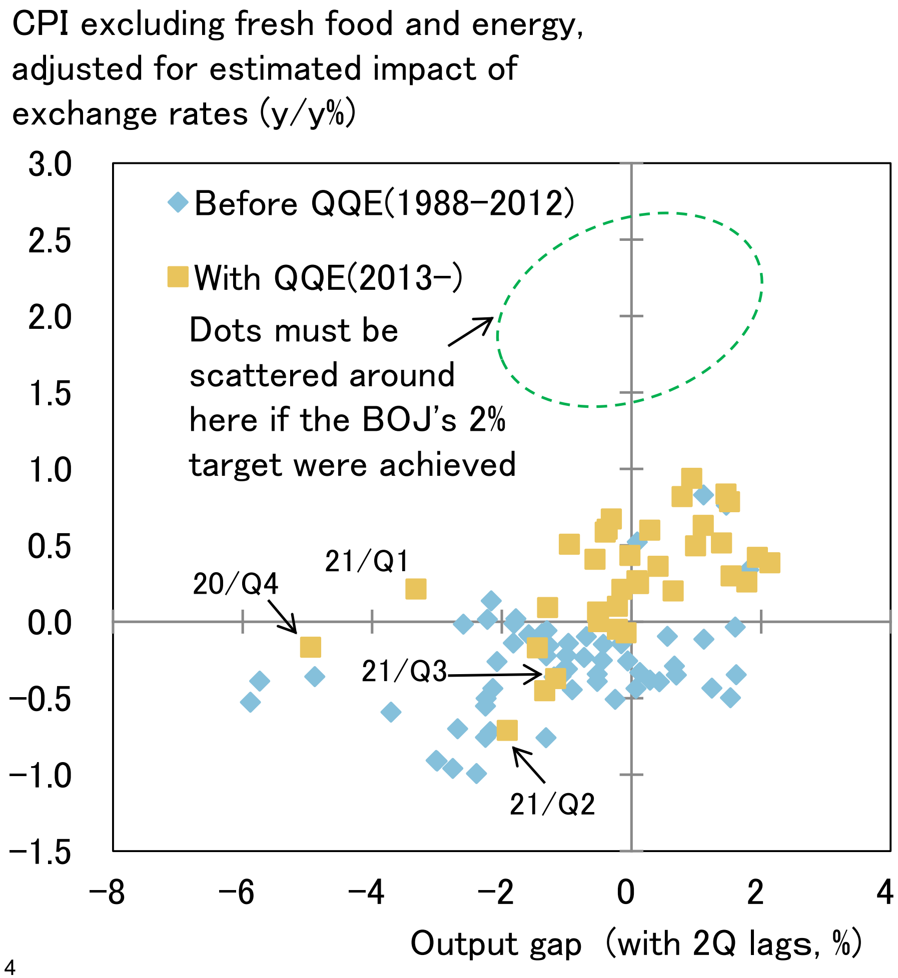
The BOJ's "QQE" for eight and a half years has not changed price dynamics.

- No "regime change" has been observed in the Phillips Curve.
- Possibility of even a temporary 2% looks remote, let alone "through-the-cycle 2%".

【 Phillips Curve adjusted for exchange rate 】



(Note 1) Exchange rate impact is derived from the following regression.

$$CPI = -0.041 - \underset{(6.0)}{0.151} \times \text{Output gap} - \underset{(8.3)}{0.047} \times \text{Exchange rate}$$

R^2 (adjusted)=0.65

Note 2) "Output gap" is estimated by the BOJ, with 2Q lag

(Note 3) "Exchange rate" is the real effective rate of the yen, with 3Q-8Q lags

(Sources) MOIAC, BOJ, BIS, calculation by author

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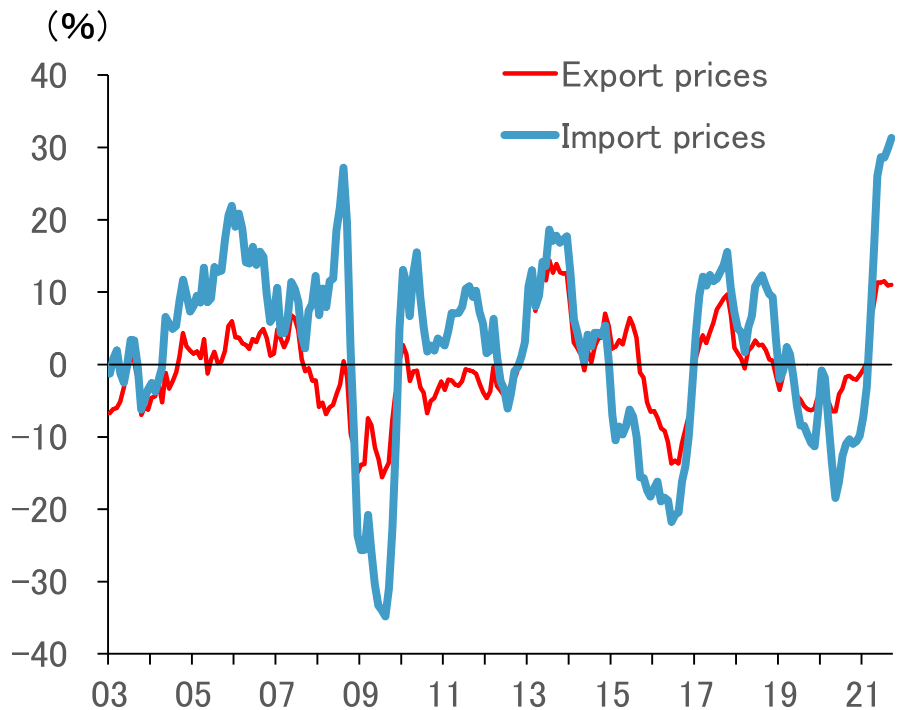
Deterioration in terms of trade is becoming a problem.

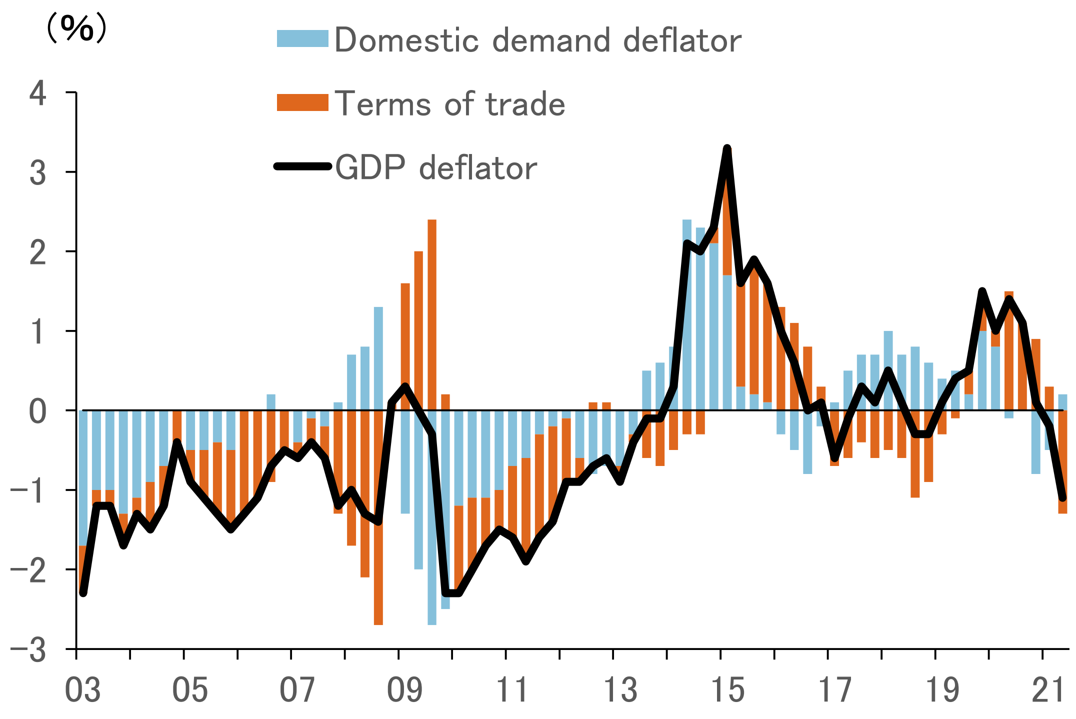
- Import prices rose 31% in September, the largest increase for 41 years.
- While year-to-year CPI is likely to move higher, it is not an inflation but a deterioration in terms of trade that really matters, as reflected in negative GDP deflator.

【 Export and import prices 】



(Source) BOJ

【 GDP deflator 】



(Note) Terms of trade = GDP deflator − Domestic demand deflator
(Source) Cabinet Office

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Issues going forward

1. While the Fed's communication and policy strategies have been successful thus far, an upside surprise in the US inflation could still cause market turbulence going forward.

2. At the same time, it is still plausible that a below-the-target inflation will return over the medium term even in the US.

3. A fundamental question appears to be raised: Is inflation a monetary phenomenon or a fiscal one?

4. *Greenflation* will possibly be a daunting challenge in terms of both energy and monetary policies.