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ABSTRACT

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Abstract

For most of the time since 1995, the Japanese price level has declined – despite zero interest rates and dramatic increase in excess reserves. In the era of low inflation rates worldwide, concern has risen about the ability of monetary policy to control deflation. It is, therefore, worth studying what chances monetary policy – and in our case, the European Central Bank especially – has in pushing the economy out of deflation.

This paper explores the means of monetary policy in ending deflation after the conventional instrument – the official interest rate – has reached the zero bound. The paper looks into the Japanese experience in the light of different theories of monetary transmission and analyses to what extent the operations suggested in recent economic discussion are feasible within the Eurosystem.

The study takes a view that a liquidity trap arises rather from an incapability of conducting successful monetary policy than from a theoretic idea that the public would prefer money to all other assets. According to the theory, money supply affects the price level even if the reaching of the zero bound makes the conventional monetary policy instrument irrelevant.

The central bank can expand its balance sheet and thereby raise the money supply by exceeding the amount needed to keep the overnight interest rate at zero. By changing the composition of the balance sheet and targeting the expansion to specified asset classes, the central bank can affect the supplies of these assets and thereby decrease the market yields. Even if the nominal interest rate is zero, real interest rates remain high in a deflationary economy. In order to decrease the high real interest rates, monetary policy has to induce expectations of future inflation. An effective way to influence the expectations is to purchase assets, whose degree of substitutability to money is low. The strategy gains credibility from the commitment to purchase these assets to whatever amount is necessary to achieve the explicit target set on money growth or exchange rate.

The Treaty on European Union complicates the implementation of an excessive monetary expansion by restricting the purchasing of government debt. However, the Eurosystem is fairly independent in operating with foreign exchange in the name of price stability. Finally, the paper concludes that it is possible to fight deflation successfully by committing to a credible monetary policy and that the Eurosystem has the means to implement it through the foreign exchange operations.

Key words	deflation, monetary policy, liquidity trap, Japan
Further information	