HOUSE OF LORDS

Select Committee on Economic Affairs

Corrected oral evidence: Quantitative easing

Tuesday 20 April 2021

3 pm

Watch the meeting: https://parliamentlive.tv/event/index/767da91f-5a93-4fe7-9038-8c63b9708184

Members present: Lord Forsyth of Drumlean (The Chair); Lord Bridges of Headley; Viscount Chandos; Lord Fox; Lord Haskel; Lord King of Lothbury; Baroness Kingsmill; Baroness Kramer; Lord Livingston of Parkhead; Lord Monks; Lord Skidelsky; Lord Stern of Brentford.

Evidence Session No. 15 Virtual Proceeding Questions 148 - 156

Witness

I: Masaaki Shirakawa, former Governor of the Bank of Japan (2008-13).

USE OF THE TRANSCRIPT

1. This is a corrected transcript of evidence taken in public and webcast on www.parliamentlive.tv.

2. Any public use of, or reference to, the contents should make clear that neither Members nor witnesses have had the opportunity to correct the record. If in doubt as to the propriety of using the transcript, please contact the Clerk of the Committee.

3. Members and witnesses are asked to send corrections to the Clerk of the Committee within 14 days of receipt.

Examination of witness

Masaaki Shirakawa.

Q148 **The Chair:** Welcome to the Economic Affairs Committee. We are very privileged to have as the witness for our first session today Masaaki Shirakawa, a former governor of the Bank of Japan from 2008 to 2013.

Mr Shirakawa, why do you think the use of QE has not sparked inflation in Japan?

Masaaki Shirakawa: Thank you, Chair. First, it is my great honour to be invited to the Economic Affairs Committee of the House of Lords.

You framed the question of QE's failing to spark inflation in terms of the Japanese experience, but central banks in many advanced economies are now more or less in the same situation. The inflation rate continued to undershoot the 2% target, despite the fact that many central banks have been deploying massive QE for an extended period of time. In that sense, your question is not confined to Japan; it is a universally relevant question.

The reason I refer to this fact at the outset of answering your question is that just focusing on unique Japanese factors is not sufficient to understand the deep issue that you raise.

I have to explain factors unique to Japan as well as factors that are globally common, which is a vastly complicated task. The explanation that we hear most often nowadays as a reason for QE's failing to spark inflation in Japan is the following. Inflation expectation is adaptive, meaning that inflation expectation is predominantly formed by actual inflation development in the past, which is very low. If so, then the next question naturally comes: why on earth is the past inflation rate so low? The argument goes, it is because monetary policy in the past was not aggressive enough.

I am not convinced by this line of argument. First, inflation expectation is more or less adaptive in many countries. Secondly, and more importantly, exactly the same logic applies to inflation rates that the Bank of Japan was faced with in the past as well.

The past inflation rate was low because inflation expectation was low, due to the low inflation rate in the distant past. That is somewhat circular. In any event, it is true that the Japanese inflation rate has been low, but we have to note that this is not a recent phenomenon. Japan's average inflation rate in the 1980s was 2.5%, the lowest among G7 countries. For your reference, corresponding inflation rates for the US and the UK were 5.4% and 6.4% respectively. Furthermore, the average inflation rate in Japan in the latter half of the 1980s, which was characterised by a massive bubble, was already as low as below 1%.

Bearing these numbers in mind, I must explain both the direction and the average level of Japan's inflation rate since the 1980s in answering your question.

On the level question, I have to admit that I do not have a fully convincing explanation for why the inflation rate was low, not only in recent decades but in the 1980s, when Japanese economic growth performance was stellar. The only thing I can say is that it is history-dependent—although I recognise that this is not a complete explanation.

On the question of the direction—a downward movement of the inflation rate—I would point to two factors: a global economic factor, and a uniquely Japanese factor. The global economic factor is the positive supply shocks that have taken place, such as globalisation due to the entry of former socialist economies into market economies, and the technological progress typified by the IT revolution. This universal trend brought about disinflation in many parts of the world, including Japan.

The inflation rate in each country declined in a parallel manner from their respective positions. The difference in current inflation rates reflects a difference in the initial level of the inflation rate in each country to some extent. Japan recorded a slightly negative inflation rate, partly because its initial inflation rate was already so low. The percentage point decline in the consumer price inflation rate from 1989 to 2019 is 1.8% for Japan and 3.5% for the UK.

A uniquely Japanese factor causing this inflation was lifetime employment practices. Its importance decreased compared with decades ago, but it is still prevalent, especially among big companies and the public sector. In the face of a severe negative demand shock due to, say, a financial crisis, corporate management has prioritised employment. In return, employees have accepted a lower wage or even an absolute decline in wages.

This practice was rational for management and employees alike. If the shock hitting the economy was temporary, the flip-side was mild deflation. That is one of the most important reasons why we are seeing a combination of a very low unemployment rate in international comparisons and subdued wage and inflation rates in Japan.

Your direct question is why monetary policy or QE could not change such an inflationary development. As you know, in Japan, massive reserves are being piled up beyond already huge levels of reserves. The ratio of the size of central bank balance sheets to GDP was about 20% at the start of 2000; now, it stands at 114%.

This does not have power in itself. Reserves are just financial institution deposits at a central bank. It is a decline in interest rates induced by increases in reserves that stimulates spending, and that could raise the inflation rate. Short-term interest rates in Japan have already been practically zero since the mid-1990s. A 10-year government bond yielded 1.4% in the event of the collapse of Lehman, and 0.5% when I left the Bank of Japan in March 2013. Now, it is at 0.1%.

It is not surprising that the QE first adopted in 2001 did not bring about inflation, simply because of the very limited room for interest rate decline. However, some people argue that a determined posture of a central bank directly affects inflation expectation, and thus the actual inflation rate. We often heard the mantra that deflation is always a monetary phenomenon, but do you really believe in that kind of story?

Actual experience is most telling. As Larry Summers recently said, "the utter failure of the Bank of Japan's extensive efforts to raise inflation suggest that what was previously treated as axiomatic is in fact false: central banks cannot always set inflation rates through monetary policy".

We have to take this experience seriously and go back to the basics of monetary policy. The effectiveness of monetary easing essentially derives from bringing forward future demand to the present by lowering interest rates and boosting asset prices, or shifting demand back home, away from foreign countries, by depreciating its own currency.

The former mechanism could work if the shock hitting the economy is temporary. If not, it could not work. After all, Japan has deployed monetary easing for more than 30 years, and its effect inevitably diminishes, just because the room for front-loading future demand naturally diminishes.

As for the second mechanism, the Bank of Japan was not equipped with instruments to counter currency appreciation pressure, due to aggressive monetary easing abroad at the time of the collapse of Lehman Brothers, simply because, back then, Japan's yield curve was much lower than that of other developed economies, as I explained some minutes ago.

I am sorry for my long speech.

The Chair: Thank you for that very comprehensive answer. I hope that we will get through eight questions in the next hour, but that was a very good introduction, for which we are very grateful.

Q149 **Lord Bridges of Headley:** Looking ahead a bit, if we may, during the pandemic we have seen Governments around the world undertaking enormous budgetary responses to the pandemic, not least in the US. We have also seen enormous amounts of saving in certain economies. Yesterday, for example, the *FT* reported that there is a $5.4 trillion stockpile of savings, potentially, for what it calls "post-Covid spending".

How significant a risk is there of a sustained spike in inflation—and I stress "sustained"—across the globe, not just in Japan but in the US and, in particular, in Europe following this expansionary monetary and fiscal policy?

Masaaki Shirakawa: My short answer is that this kind of risk is somewhat overblown. Yes, year on year, the inflation rate likely exceeds 2%, partly due to the base effect of last year's decline and partly due to narrowing output gap, but the issue, as you have pointed out, is sustainability. I suspect that it is not sustainable, because two oft-cited

factors narrowing output gap are essentially one-off in nature. One of those is the rollout of the vaccination. This is of course important, but it just means that the economy will go back to the pre-Covid era.

On the other factor, fiscal policy, it is hard for us to count on continued fiscal stimulus on this scale. Eventually, we will be faced with a fiscal cliff. If narrowing output gap is as such, the issue is whether there is a convincing reason why we can believe the flattening Phillips curve has now changed. At this juncture, there seems to be no convincing evidence that we can assume the factors behind flattening this curve—globalisation and technological change—have finally changed.

In this environment, my concern is not inflation but low growth—in particular, decreasing productivity growth. Low growth is partly caused by various real factors, such as heightened uncertainty following the global financial crisis, unfavourable demographics and growing inequalities, among others. These are all important, but I do not think that this is the full story. I am concerned about declining productivity growth induced by prolonged monetary easing, coupled with aggressive fiscal policy responses.

Let me explain the logic. As I said, the effectiveness of monetary easing derives from front-loading future demand to the present by increasing debt, through reducing savings or by increasing borrowing. This strategy works if the shock hitting the economy is temporary. What Japan experienced over the past 20 years and what other developed economies have experienced over the past 10 years or so was not just such short-term shocks.

Nonetheless, if monetary easing is prolonged, front-loaded demand will inevitably decline. Further, since investment is undertaken according to the expectation of profitability, the proportion of productive investment will decline over time, thus reducing productivity growth, and the credit spread will be suppressed by aggressive monetary easing, which could lead to lower productivity growth by reducing the efficiency of credit markets.

Finally, so-called zombie firms will be kept alive, which decreases productivity growth.

All those factors will depress demand for private borrowing over time. If that is the case, government can continue smoothly to borrow money without paying higher interest rates. If government engages with productive infrastructure investment, it could raise productivity, but its political feasibility is at this stage uncertain.

My prediction may be wrong. If inflation pressure increases, what would happen? Central banks seem to be confident about the containment of inflationary pressure on the grounds that they know what to do. I am not fully convinced by this argument. The problem is not whether central banks are equipped with tools. Surely they have tools. The problem is that, if central banks tighten monetary policies significantly, their

response to a sign of inflation pressure could affect financial institutions and government finance. On the other hand, if they hesitate to do so for concern over financial stability, this will invite higher inflation. Price stability and financial stability are just two faces of the same coin.

My short answer, as I said, is that the sustained inflation risk is overblown. Rather, we have to be concerned about declining productivity induced by the current policy mix.

Q150 **Viscount Chandos:** Mr Shirakawa, what would you describe the main purpose of QE to have been in Japan? Did it change through the different phases, moving from QE to QQE, for instance?

Masaaki Shirakawa: Before answering the question, allow me to explain the brief history of QE in Japan. The Bank of Japan adopted QE in March 2001. It was the first of its kind in the history of monetary policy. At that time, global economic conditions were deteriorating rapidly, following the bursting of the dotcom bubble in the US. Short-term interest rates were 0.15%, so the Bank of Japan did not have any meaningful room for a decline in interest rates. Against this background, QE was adopted as a measure to counter weakening of the economy.

QE is an ambiguous concept, so identifying the QE period is somewhat arbitrary and is a business of a kind of semantics. Here, I would define a QE period as a period when central bank balance sheets enormously expanded. According to this definition, I would say that, since 2001, QE has almost always been deployed in Japan, except during a very short period. The level and increase of the Bank of Japan's balance sheet was extraordinary, but it increased more dramatically after 2013, which was sometimes called QQE. The ratio of the central bank balance sheet to GDP is now 114%, which is much higher than that of the Federal Reserve, the ECB and the Bank of England.

On your question about the purpose of QE, I would say it is in the eye of the beholder. Its overarching purpose was stabilising the economy. Under this purpose, there were several considerations. Which considerations the Bank of Japan thought were important were somewhat different across board members and across time. At least four aspects were considered: avoiding financial system instability, stimulating economic activity, preventing deflation and preventing the yen's appreciation.

As for understanding a mechanism of how QE works, board members, staff and economists have different interpretations. A natural connotation of QE is the size of central bank balance sheets does matter, but I do not believe that huge balance sheets themselves stimulate the economy, even when the Bank of Japan started QE. As I said some minutes ago, QE was effective as a measure to stabilise the financial system, although I am not sure whether it is appropriate to call a lender-of-last-resort operation QE.

The effect on GDP was rather modest. The reason for the modest effect on GDP in Japan was very simple. As I said previously, first, the room for

interest rate decline was limited; and, secondly, various structural factors, especially demographic change, were at play.

Incidentally, my observation of the modest effect on GDP does apply to QE in other advanced economies. It is interesting to compare the path of GDP in the post-bubble period relative to the cyclical peak in the bubble period. The cyclical peak was 1991 in the case of Japan and 2006 in the case of the US and Europe, but there is no material difference in terms of GDP between Japan and the US/Europe, even though QE was adopted in the latter period.

I am not saying QE—or, to be more precise, unconventional monetary policy in Japan was meaningless. To try and deploy QE was meaningful in the following senses. One is the philosophical ground. The central bank does not exist in a vacuum; it exists in a democratic society. Given that so many academics and economists supported and urged the adoption of QE, and that the condition of Japanese economic conditions was severe, it is justified that central banks experimented with monetary policy that had never been tested before.

The other is the ground of economics. As I said, the size of a central bank's balance sheet itself does not affect the economy, but what assets central banks purchase and what kinds of lending central banks do are important. Where the financial system is fragile, both actions by the central bank are crucial.

The Bank of Japan took various bold measures such as the purchase of asset-backed commercial papers, asset-backed securities, stocks held by commercial banks, ETFs and REITs. I support central banks taking these measures in a highly critical situation, but my support is predicated on an extremely important condition: these measures should be deployed only in emergency situations. If this condition is not met, the side-effects could become larger and larger. If QE is with us for a long time, central banks become the only game in town. As my friend Lord King is reported to have said, "I would like to get out of that town". In that sense, the political will to address fundamental economic challenges is critical.

The Chair: Lord King will ask you a question later; he may want to come back on that point.

Q151 **Lord Fox:** You have already given a very good comparison of the differences in starting place on inflation, but how closely do the economic and monetary policy environments across advanced economies in Europe and the US resemble the situation in Japan since the 1990s? Are there warning signs that we should be heeding, which you have already seen in the Japanese economy?

Masaaki Shirakawa: That is one of my favourite questions. My short answer is very clear: the economic and monetary policy environment is quite similar. Many advanced economies seem to be following what Japan experienced 15 years earlier.

I would point to four similarities. First, there is a bubble, followed by a financial crisis. Japan had experienced extremely benign economic performance: high growth, coupled with a low and stable inflation rate in the late 1980s, which turned out to be a bubble on a scale never seen in modern global economic history. Believe it or not, in terms of market capitalisation, seven of the best 10 companies in the world were Japanese companies at the end of 1989. Ultimately, the bubble brought about a very severe financial crisis, which culminated in the 1997 to 1998 crisis. Western economies went through exactly the same phenomenon with a lag of 15 years or so. Good economic performance was coined a "great moderation". This benign period was followed by the severe global financial crisis of 2007 to 2009.

The second similarity is protracted low growth and low inflation after the acute phase of the financial crisis was over. Borrowing from words by Mark Carney, the UK also experienced the "lost decade" that had been used to describe the Japanese economy since the 1990s. You may say that a declining growth rate is common, but the UK never experienced deflation, whereas Japan suffered from it. Yes, as I said, Japan experienced a mild deflation, but even in the bubble economy period the average inflation rate was below 1%. What happened was a parallel shift of inflation rates in both countries.

The third similarity is monetary policy responses after the outbreak of the financial crisis: the very low interest rate, quantitative easing, a huge expansion of the central bank balance sheet, the purchase of private assets such as corporate bonds and forward guidance, among others. Even the funding-for-lending scheme that the Bank of England adopted in July 2012 has a counterpart: the Bank of Japan's scheme is called the growth-supporting funding facility, which was adopted in June 2010, two years earlier.

The fourth similarity is overreliance on monetary easing, and very slow progress in implementing reform measures to address a problem of a structural nature.

In the case of Japan, the challenges lay in the adjustment of an economy and a society to a changing environment. One of them has been demographic change, characterised by rapid ageing and a declining population due to low birth rate. The other is declining productivity growth, due to our inflexible labour practices, against the backdrop of globalisation and IT revolution.

These are difficult challenges. The result is overreliance on monetarism.

Q152 **Lord Haskel:** Mr Shirakawa, Japan introduced QE early to help to overcome deflation but, as there were no easily derived concrete effects, QQE was introduced in 2013. As a result, as you have told us, it enormously increased the balance sheet of the Bank of Japan. Does this experience of Japanese monetary policy suggest that QE is likely to become a long-term or even a permanent fixture of monetary policy not only in Japan but in other advanced countries?

Masaaki Shirakawa: First, your observation is right. Nowadays, we often hear the expression "Japanification", although I dislike this terminology. As this term shows, the US and Europe are more or less following the same path as the Japanese one. The zero interest rate and QE have been with Japan for 26 years and 20 years respectively. Now, more than 10 years have passed since the US and Europe adopted QE. Interest rates have been so low.

Your question is whether this monetary environment could be a permanent fixture. How should we explain this fact? A standard explanation by economists is that the policy rate is low just because the natural rate of interest, which equates saving and investment at full employment, is low. I do not deny that the natural rate has declined for various structural factors, but I do not think this is a full explanation.

Once again, we have to note that the mechanism of monetary easing is essentially borrowing tomorrow's demand for the present, but tomorrow becomes today. If we continue to try to create demand through this channel, we will have to lower interest rates further and further. We cannot rely on this mechanism indefinitely. Furthermore, if prolonged low interest rates allow inefficient firms to keep alive, potential growth rates and, for that matter, the natural rate of interest itself will decline. This will aggravate the situation.

Your question is whether QE is likely to become a long-term or even permanent fixture of monetary policy in advanced countries. There is no denying that perpetual low interest rates reflect various changes in the global economy, but low interest rates are in part a natural consequence of current monetary policy strategy.

To the extent that you expect current monetary policy strategy to continue, it will be a permanent fixture. In this respect, I am of the view that we must seriously reconsider the current macroeconomics.

As for real factors pushing down the natural rate of interest, I see a potential momentum for pushing it up. In particular, measures to address inequalities might play some role.

Q153 **Lord King of Lothbury:** Masaaki, good evening: it is very nice to see you again. When we used to meet in Basel with the other central bank governors we would often talk about the challenges of the relationship between governors and finance ministers. In your experience, did the use of QE require greater co-ordination between the Bank of Japan and the finance ministry?

Masaaki Shirakawa: First of all, I am very glad to see you, even virtually.

That is a very difficult question. Sometimes, the question you raise is framed in terms of co-ordination between the Ministry of Finance and the Bank of Japan. This was often debated in Japan. By answering this question, I will try to answer your question.

I do not know the subtle nuances of the English word "co-ordination", but, if the ex ante co-ordination mechanism between the Ministry of Finance and the Bank of Japan is implied, I feel some unease with such a concept. I do not think that such co-ordination is necessary.

To explain why, I go back to the basic argument. First, the Ministry of Finance sets fiscal policy. Given this, the Bank of Japan assesses macroeconomic conditions and then sets monetary policy. This works perfectly. Of course, communication between the two is quite important. However, this is nothing more than a candid exchange of views between two institutions.

Secondly, the well-designed division of labour between the two is quite important. That is related to your question. This is particularly so when a central bank acts as a lender of last resort or when a central bank purchases private risk assets. In these cases, the central bank might lose money, which means a tax burden on national citizens, and/or it might intervene in resource allocations significantly in the market economy. In other words, QE has an element of fiscal policy. In this sense, central banks need some legitimacy in a democratic society. It should be clear who is responsible for the decisions: namely, the central bank or the Government, or both. The exact design depends on the constitutional order in each jurisdiction.

I understand that the UK has set up an asset purchase facility, to which the Bank of England provides liquidity, while any profit or loss accrues to the Treasury, which is quite sensible in the UK context, in my view.

Thirdly, the right understanding of the economy is crucial for both the Government and the central bank when they deploy macroeconomic policy. It is understandable, and natural to some extent, that the Government or the Ministry of Finance pin their hopes on the effect of QE by the Bank of Japan, given that so many economists argue that those measures are effective and that structural reforms are difficult to implement and take a considerable time for their effects to be visible. Experience of QE has now been accumulated.

Once we recognise what is and what is not delivered by QE, we should redouble efforts to address the fundamental challenge for the Japanese economy. In that sense, what is needed on the part of government is more straightforward to implement various measures of a structural nature, as I explained earlier.

That is my reading of the subtle relationship between government and central banks in terms of QE.

The Chair: Do you want to come back on that at all, Lord King?

Lord King of Lothbury: No, I am happy to move on. Thank you for the answer.

Q154 **Baroness Kingsmill:** Good afternoon, Governor. Is there any evidence to suggest that the use of QE in Japan has had significant distributional

effects? For example, has it exacerbated inequalities of wealth? Has it involved inflated asset prices? What have been those other effects of QE on the real economy?

Masaaki Shirakawa: In answering your question in the Japanese context, we need to have rigorous empirical studies. As you can imagine, this task is inherently difficult. The difficulty lies with the simple fact that the timeframe for discussing the immediate impact on the macroeconomy is much shorter than the timeframe to verify the impact on inequality.

As far as I know, there are only two empirical studies examining Japanese data. I would say that evidence to strongly support a significant distribution effect from QE is lacking, but evidence to strongly refute this effect is also lacking, so the only thing we can do is carefully observe the facts and make an educated guess about the implication of QE on the distributional aspect.

In this spirit, I would like to briefly explain my reading of the current distribution situation in Japan, before responding to your question.

First, compared with other advanced countries, Japanese society is relatively egalitarian, judging from the Gini coefficient or the share of income and wealth of the top 1% and the top 10%.

Secondly, if we look at the change in the past 10 years or 20 years, like in the rest of the world, we are seeing increasing inequality. On the link between QE and inequality, the debate is not yet settled. One school of thought says that if QE had not been deployed many workers would have been unemployed, which means more inequality. I think that this argument is somewhat misleading. If central banks had not acted as lenders of last resort, the consequence would have been a massive increase in unemployment, which obviously increases inequalities. As I said some minutes ago, however, this is essentially the lender of last resort, not QE. In any event, once the economy passes such a critical point, the impact of QE on the macroeconomy is rather modest. Nonetheless, if QE is prolonged, its distributional effect could become larger through elevated asset prices.

When it comes to thinking of distributional issues, we probably need to take a longer-term perspective. In this regard, we have to seriously take a defining feature of advanced economies over the past decades, characterised by the following four features.

The first is the simultaneous presence of rising debt and a declining interest rate. Secondly, the rising debt has been driven by borrowing by households and Governments. Thirdly, this rising debt is accompanied by rising income inequality. Fourthly, there has been a secular decline of investment and productivity growth.

These four factors are very complex phenomena, but they are interrelated. We seriously have to think about whether indebted demand is really sustainable. If not, we have to think about whether prolonged monetary easing creates some role in this unsustainable process. As I

have said repeatedly, monetary easing stimulates the economy by bringing future demand to the present through lowering interest rates and thus increasing debt. However, if monetary easing is prolonged, the economy will inevitably be faced with less demand, which calls for further monetary easing and debt. In this process, savers are wealthy people and borrowers are relatively low-income households. The saving rate of wealthy people is high, while that of low-income households is low, which means a decline in the natural rate of interest and, for that matter, policy interest rates. This further aggravates income and asset inequality.

Since investment is undertaken in the order of profitability, it is inevitable that productive growth will decline as monetary easing is prolonged. This is really an odd equilibrium. My argument is that indebted demand is not sustainable, but accepting this view means a radical departure from the prevailing policy thinking in past decades, which would shock the economy and financial markets significantly. The economy gets stuck in a debt-driven liquidity trap.

My basic argument is quite simple, in a sense. Monetary policy, be it QE or a more standard one, of course has a distributional effect, but in a normal case the duration of monetary easing and tightening is relatively short. Looking at the full cycle, we can reasonably say that the distributional effect of monetary policy can be dismissed. However, if monetary easing is prolonged, as we are now seeing, we can no longer safely say that monetary easing does not have any distributional effect.

Baroness Kingsmill: Thank you; that was very helpful.

Q155 **Baroness Kramer:** May I ask about structural forces, notably demographic trends and their impact on low growth and low inflation? You mentioned the low birth rate. Of course, Japan has very low immigration rates, and therefore a declining working-age population. What is the linkage as you see it? We have heard from some economists that wealthy older people could push inflation up, because they would have an instinct to spend. How do you see those two things together?

Masaaki Shirakawa: First, demographic change is hugely important in accounting for the low growth of Japan. The best way to explain this point is probably by doing an international comparison of growth of GDP and GDP per working-age population of G7 countries. Japan's growth rate is the lowest in terms of GDP but the highest in terms of GDP per working-age population. This gap is explained by the shrinking Japanese workforce, which is due to rapid ageing. The decline of the working-age population in Japan started from 1996. Initially, the pace of decline was very mild, but, entering into the 2010s, it was accelerating. At its peak, annual decline was elevated to 1%, which was a huge headwind.

Nonetheless, popular policy discourse among economists almost always focused on deflation. That is why I always stress that the demographics are important. In this environment, I emphasised that the policy challenge for Japan was, first, how to boost the workforce by increasing labour participation by the elderly and female populations and, secondly,

how to raise productivity. At the end of the day, people were asking for higher real income, job security and a happy retirement life, among other things. These problems are not solved by achieving 2% inflation growth.

Your question is about the linkage between demographics and inflation. Charles Goodhart's recent book is of some relevance. When I explained the impact of rapid ageing, many economists said, "No. In this environment, you should worry about inflation, because of the shrinkage of labour supply". However, this argument looks only at workers as labour, but the working-age population is not only workers; it is also the core age cohort of consumption and housing investment. The decline of the working-age population means a decline both in labour supply and in demand for goods and services. To the extent that people expect a decline in the working-age population in future, this is translated into current expenditure, which lowers prices. Through that kind of mechanism, the shrinkage in the working-age population has tended to lower the inflation rate.

The second thing that we have to note is that we have to distinguish two developments that are regarded as demographic change. One is rapid ageing, which many people argue. The second is the decline in the population itself. I was born in 1949. In that year, the number of new babies, including me, was 2.7 million. Last year, the number of new babies was 0.7 million. That is quite a decline.

Even so, society needs basic infrastructure. In a local community, the minimum amount of public expenditure is needed. Eventually, it is very hard for us to maintain such public expenses. Eventually, we have to shift resources from less populous areas to populous areas. As you can imagine, that takes time and, through that period, productivity growth will decline. This also affects growth and price development.

What I am saying is that the dynamics that are created by rapid ageing and the declining population are quite complex, which is not well captured by current macroeconomics.

Baroness Kramer: That was really helpful; thank you.

Q156 **Lord Livingston of Parkhead:** Mr Shirakawa, right at the beginning of our discussions, you mentioned the issue of central banks not hitting the inflation target. With that in mind, do you think that a single inflation target is the right thing for banks to be aiming for? It is obviously a government decision, largely. Should we be averaging? Indeed, is 2% the right number going forward?

Masaaki Shirakawa: I am not a big fan of revising the 2% inflation target at this juncture. This is neither because I believe that 2% is a right and sacrosanct number nor because it can be achieved if we continue with current monetary easing in earnest. In fact, if I was in a position to set an inflation target from scratch, I would not prefer the 2% target.

The reason I do not support revising the 2% target inflation target at this juncture is partly that it has already been with us for many years; more

importantly, it is because we do not know what the right number is or, more precisely, we do not know how we should treat the inflation number in formulating monetary policy.

Let me elaborate. The conventional rationale for a 2% inflation target is twofold. One point is that the measured inflation rate has an upward bias. That means that, if we try to achieve a 0% inflation rate in a true sense, we should target a small positive number for the inflation rate that is measured. The other factor is the need to have a buffer for lowering interest rates in the face of a negative demand shock.

That need is further increased in the presence of a zero lower band of interest rates. That is a standard argument. I have reservations about that argument, however. As for the measurement bias, I do not know whether the bias is positive or negative. Conceptually, the price index is supposed to be compiled based on prices, adjusting for change in quality, but measuring quality change is a really daunting task. Do we really believe that we can measure the quality change of a smartphone every month? Aside from this issue, how can we identify the price of each item in the age of prevalent use of dynamic pricing or free-price services?

It is hard to justify a 2% target; equally, it is hard to justify, say, a 1% target or a 3% target. The honest answer is that the business of measuring the inflation rate is not an exact science to the extent that is assumed in standard policy discourse.

As for the second rationale, the need for a policy buffer, I am also sceptical. Suppose we do not have a zero lower-band interest rate, say, due to the introduction of central bank digital cash. In this hypothetical case, we can lower the interest rate to deep negative, say, minus 5% or minus 10%. Does this solve the problem? I think that it just shifts the timing of expenditure, but it does not shift the amount of total expenditure.

The more fundamental issue is whether inflation development could serve as a reasonable guide for central banks to steer monetary policy. Almost three years ago, Fed chair J Powell said, "Whatever the cause, in the run-up to the past two recessions, destabilising excesses appeared mainly in financial markets rather than in inflation. Thus, risk management suggests looking beyond inflation for signs of excesses". I entirely agree with his observation. I am not saying that price stability is not the objective of monetary policy. It should be. The point is that, if we fixated on achieving a specific inflation number in a short timeframe, such as two or three years, we would lose sight of the holistic picture of what is happening in the economy and in the financial market, which could lead to greater macroeconomic instability in the long run.

In this spirit, what is important is how to operationalise such thinking in a concrete policy framework, rather than tinkering with the 2% target or introducing a sort of average inflation targeting.

Lord Livingston of Parkhead: Thank you very much. That was very

helpful.

The Chair: We just have time to squeeze in a quick question from Lord Skidelsky.

Lord Skidelsky: Mr Shirakawa, at various points you have been quite critical of the advice that central bankers were getting from the economics profession. Does that suggest to you that the standard macro models are seriously in need of revision or seriously flawed, perhaps in the direction of increased modesty?

Masaaki Shirakawa: First of all, I was a student of Milton Friedman many years ago. I am a strong believer in economics; I believe in the strength of economics. At the same time, as you have said, the economists and policymakers have to be humble. Our knowledge is quite limited. That is my recollection of my 39 years at a central bank.

In that sense, the macroeconomics must be constantly updated. I am always saying that macroeconomic textbooks are very important, but we need some additional chapters. Central bankers have to work hard for academics to revise or incorporate some new chapters in macroeconomic texts. That will be a great asset for the policy community.

Lord Skidelsky: Thank you very much.

The Chair: On that note, Mr Shirakawa, I thank you for what has been a tour de force. I am looking forward to reading the transcript, because your answers were so packed full of important points. We are extremely grateful to you for giving your time, your experience and your knowledge of what has happened in Japan and elsewhere in the world, which will be invaluable to our inquiry. Thank you so much.

Masaaki Shirakawa: Thanks so much.

The Chair: It has been great to have you.