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Why It Matters for Prices and the Yen

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Abstract

For decades, Japanese inflation expectations were anchored near zero, helping stabilize prices but also making it harder for the Bank of Japan to escape deflation. That zero-percent anchor has now largely disappeared. Yet a new anchor at the BOJ’s 2 percent target has not taken its place. Japan is therefore caught between inflation anchors, leaving expectations—and potentially prices and the yen—more vulnerable to shocks. Establishing a credible 2 percent anchor is now a key challenge for monetary policy.

What Is a Nominal Anchor?

Money has little practical value in and of itself. For its value to remain stable, it therefore needs to be tied, in one way or another, to some reference point. Economists call such a reference point a nominal anchor.

Under the gold standard, the value of money was stabilized by fixing its exchange rate to gold. The Bretton Woods system, established after World War II, was based on the same principle: the dollar was pegged to gold, while other currencies were pegged to the dollar.

After the move to floating exchange rates and the high inflation of the 1970s, many countries adopted a new nominal anchor: inflation targeting. A central bank announces an inflation target—say, 2 percent—and tightens monetary policy when inflation rises above the target and eases it when inflation falls below. Over time, this builds confidence that inflation will eventually return to the target. That confidence itself helps stabilize inflation.

Japan adopted its 2 percent price stability target only recently, in January 2013. Does that mean Japan had no nominal anchor before then? Probably not.

Zero Percent Was the De Facto Anchor

Figure 1 shows the distribution of Japanese households' inflation expectations in April 2012, estimated from the Cabinet Office's Consumer Confidence Survey. Many respondents expected prices to rise by 2–3 percent over the following year. But an even more striking feature is the large concentration at zero: respondents who expected prices to remain unchanged. Zero percent formed a distinct and prominent peak in the distribution.

This suggests that household inflation expectations at the time were strongly anchored at zero. The Bank of Japan (BOJ) had never explicitly promised zero inflation. Yet after years of largely unchanged prices beginning in the mid-1990s, the belief that "prices do not rise" had become deeply embedded in the mindset of households and firms.

This zero-percent anchor appears to have served as a nominal anchor, helping stabilize prices. Suppose, for example, that Japan was hit by an external inflationary shock. If households' and firms' inflation expectations remained close to zero, the shock would be less likely to feed into wage- and price-setting behavior. The risk that a temporary shock would turn into persistent inflation would therefore be reduced.

The Zero-Percent Anchor Survived Unconventional Monetary Easing

What happened after the introduction of inflation targeting? Figure 2 shows the distribution in April 2013, when the new inflation target was in place and the BOJ, under Governor Haruhiko Kuroda, launched its unprecedented monetary easing program.

The concentration at zero was clearly smaller than a year earlier. This suggests that Kuroda's strong commitment to ending deflation, combined with aggressive quantitative easing, may have shifted household inflation expectations. But the zero-percent anchor did not continue to weaken steadily thereafter.

Figure 3 measures the excess probability mass at zero at each point in time. Specifically, it quantifies how much the observed probability at zero exceeds the probability implied by the estimated distribution in the neighborhood around zero.

The measure fell sharply in the spring of 2013, but subsequently rose again. It never returned to its pre-inflation-targeting level, yet the belief that “prices do not rise” clearly remained deeply entrenched even under the BOJ’s unconventional easing.

When Kuroda stepped down in 2023, he reflected that Japan’s long experience with deflation had left deeply rooted “norms”—ways of thinking and practices based on the assumption that wages and prices would not rise—and that these had prevented the BOJ from achieving its 2 percent target in a sustainable and stable manner. These “norms” overlap substantially with what I call the zero-percent anchor.

As noted above, the zero-percent anchor contributed to price stability. But once the BOJ sought to end deflation, the same anchor became an obstacle to monetary policy. The very feature that made inflation expectations resistant to external inflationary pressures also made them resistant to the BOJ’s attempts to raise them through monetary easing.

Normally, if a central bank credibly commits to maintaining monetary accommodation into the future, people may come to expect higher inflation. That change in expectations can in turn raise inflation today.

But under a strong zero-percent anchor, people continue to believe that, ultimately, prices will not rise. In that environment, even a commitment to prolonged monetary easing may fail to raise inflation expectations sufficiently. The resulting effect on current inflation will also be weaker.

Since 2022, the Zero-Percent Anchor Has Largely Disappeared

The situation began to change markedly after 2021. As Figure 3 shows, the concentration at zero initially increased after the onset of the pandemic. It began to decline in the spring of 2021 and, from the spring of 2022 onward, has remained at very low levels.

The spring of 2022 also marked when Japan entered its current inflationary phase, and firms began passing higher costs through to prices across a broad range of goods and services. This greater willingness to raise prices reflected not only higher input costs but also a shift in firms’ perceptions: they increasingly believed that consumers would accept price increases.

Figure 4 shows the distribution of inflation expectations in February 2026, immediately before the outbreak of the Iran war. The striking peak at zero observed in 2012 has almost disappeared. This suggests that de-anchoring from zero is now well advanced.

The concentration at zero has not entirely disappeared, however. By age group, younger households remain more likely to expect zero inflation. Having spent their formative years during Japan's long period of deflation, younger generations may still be more strongly influenced by the deflationary mindset than older generations.

The Problem Is That Expectations Are Not Anchored at 2 Percent

The weakening of the zero-percent anchor is broadly consistent with what the BOJ had long sought to achieve. However, in a September 2013 speech, Kuroda emphasized that breaking the zero-percent anchor was only one part of the task. The next challenge was to re-anchor inflation expectations at 2 percent. Governor Kazuo Ueda expressed a similar view in a May 2025 speech.

How much progress has Japan made toward re-anchoring expectations at 2 percent?

Returning to Figure 4, re-anchoring at 2 percent would mean a greater concentration of probability around 2 percent. In February 2026, the peak of the distribution was between 3 and 4 percent—not too far from 2 percent.

But should we regard this as evidence that expectations have been re-anchored at 2 percent? To examine this question, Figure 5 plots the estimated mode of the distribution—the peak of the distribution excluding the mass at zero—for each month.

The mode stood at 3.1 percent in February 2026. It rose to 4.1 percent in March and 4.4 percent in April. The Iran war broke out during this period and likely contributed to the shift. In just two months, from immediately before the outbreak of the war to April, the mode increased by 1.3 percentage points.

What does the sensitivity of the mode to an external shock tell us? Even with a strong anchor, one-year-ahead inflation expectations can move in response to shocks. But the response should be limited, with the distribution remaining tightly concentrated around the target.

That is not what happened. The most likely point in the distribution itself shifted by more than one percentage point in a very short period. This suggests that 2 percent has not yet become a sufficiently well-established reference point in households' expectations.

Building an Anchor Requires a Track Record

Why has re-anchoring to 2 percent made so little progress?

The institutional framework is already in place: the BOJ has maintained a 2 percent price stability target since 2013. What is missing is a policy track record.

When inflation rises above target, a central bank tightens monetary policy, which brings inflation back toward 2 percent. As this pattern repeats, people learn that even if a shock temporarily pushes inflation above target, it will eventually return to 2 percent.

Major central banks in the United States and Europe did precisely this in response to the surge in inflation after 2021, raising interest rates quickly and bringing inflation down. By contrast, the BOJ has little experience bringing excessively high inflation back to 2 percent.

During Kuroda's ten years as governor, the challenge was to raise inflation to 2 percent in the first place, so there was no occasion for monetary tightening. Under Ueda, the BOJ has raised interest rates, but the central aim of policy has still been to nurture inflation that had long been too low, rather than to act as an inflation fighter determined to suppress excessive inflation.

From the perspective of households, the question remains unanswered by actual policy experience: If inflation rises substantially, will the BOJ really bring it back to 2 percent? Without confidence in the answer, it will be difficult to establish a credible 2 percent anchor.

A Missing Nominal Anchor Makes Prices and the Yen More Vulnerable

The implication is that Japan is currently in an interregnum between nominal anchors. The old zero-percent anchor has largely disappeared, while a new 2 percent anchor has yet to take hold.

In general, an economy without a credible nominal anchor is more vulnerable to shocks—such as surges in oil prices, geopolitical disruptions, and natural disasters. Such shocks can cause larger swings in inflation expectations and, in turn, greater volatility in actual inflation. The resulting instability is sometimes likened to a kite whose string has been cut.

The same logic applies to exchange rates. When people lack a firm view of the future value of money, exchange rates can become excessively sensitive to shocks. History offers many episodes in which the loss of confidence in a nominal anchor has been accompanied by severe instability in a currency's value.

What about Japan today? Whether Japanese inflation has already become a “kite without a string” is open to debate. The yen, however, has depreciated substantially against the dollar since 2021, when the zero-percent anchor began to weaken. Of course, the weakening of the anchor cannot explain all of the yen’s depreciation. But uncertainty about future inflation and the BOJ’s policy response may be one factor affecting the exchange rate.

One possible factor behind the weak yen is a view among overseas investors that Japanese inflation has further to rise and that the BOJ may not respond forcefully enough. Whether that view will prove correct remains to be seen. But financial markets are clearly paying attention to the risk that inflation in Japan could become substantially less stable.

There is also a more immediate issue. The BOJ expects underlying inflation to continue rising and to reach 2 percent in the second half of fiscal 2026.

In an ideal world where inflation expectations are firmly anchored at 2 percent, the behavior of households and firms itself creates forces that pull inflation back toward 2 percent. The central bank can take advantage of those stabilizing forces.

But without such an anchor, there is no guarantee that inflation will stabilize on its own once it reaches 2 percent. It may simply pass through 2 percent and continue to rise. If that happens, keeping inflation close to 2 percent will depend more heavily than ever on the BOJ’s policy response.

That is why Japan urgently needs to turn 2 percent from a policy target on paper into a genuine anchor for people’s expectations.

Figure 1: Distribution of Inflation Expectations, April 2012

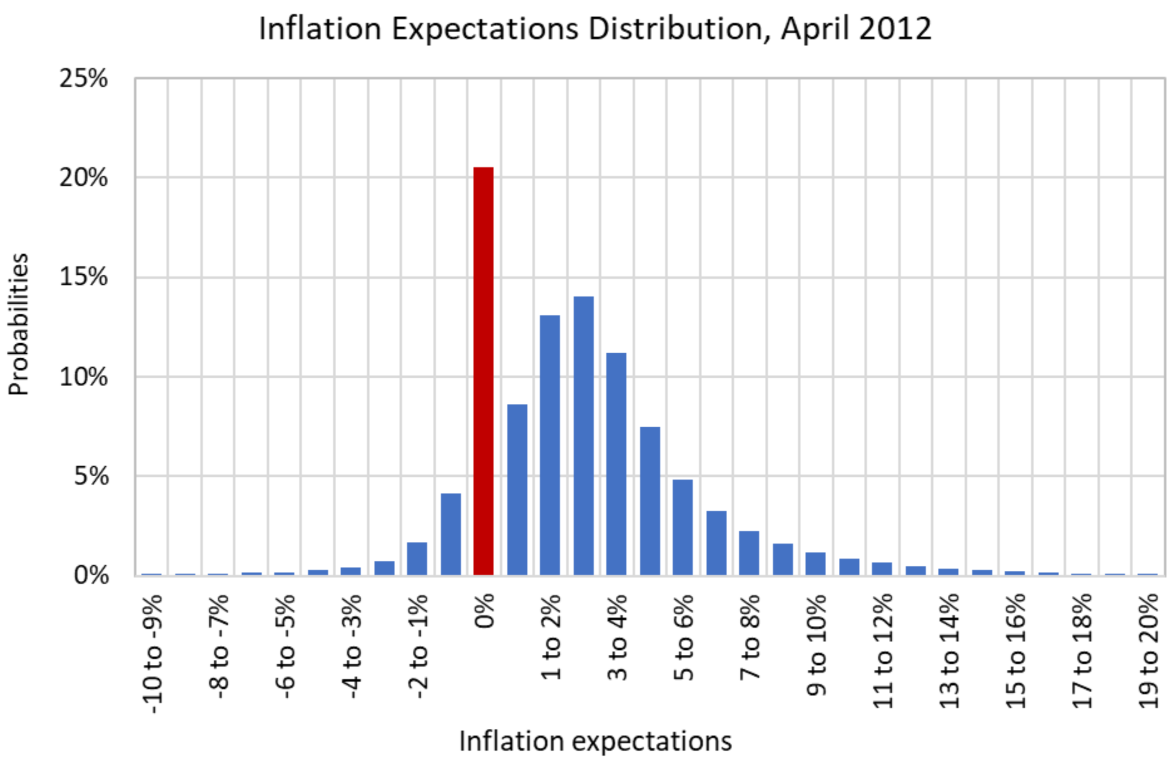


Figure 1: Distribution of Inflation Expectations, April 2013

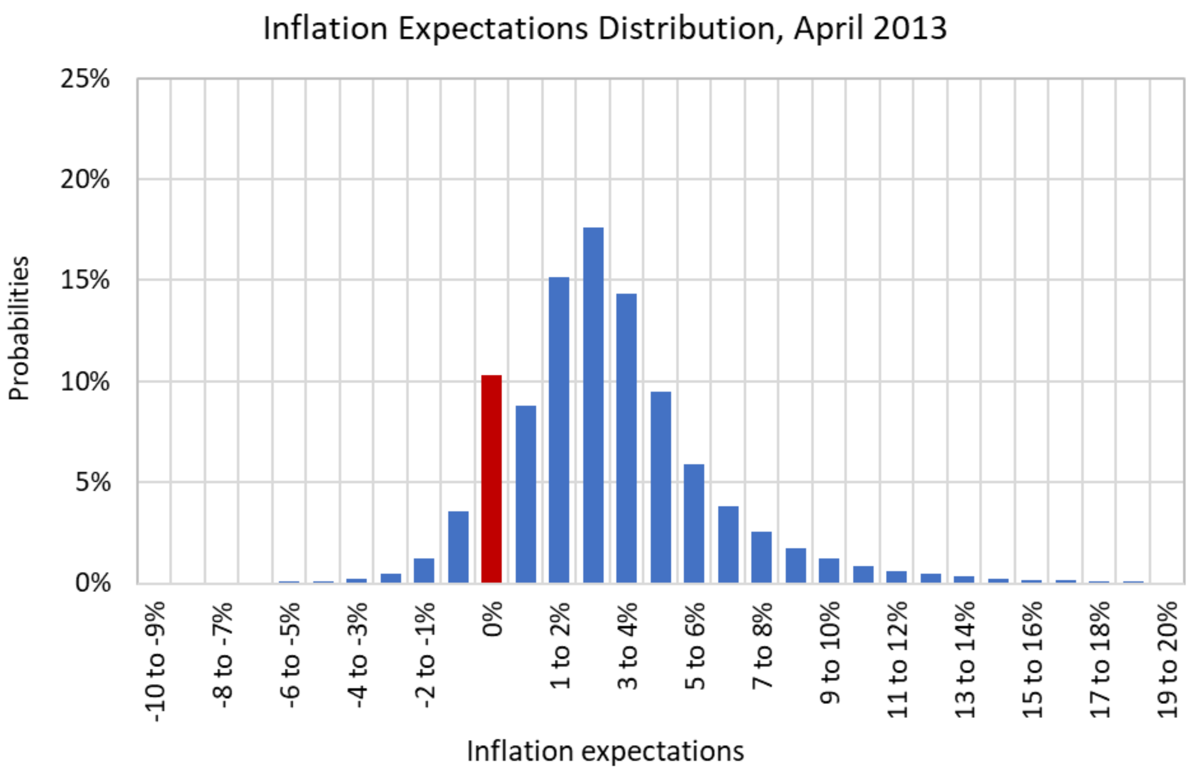
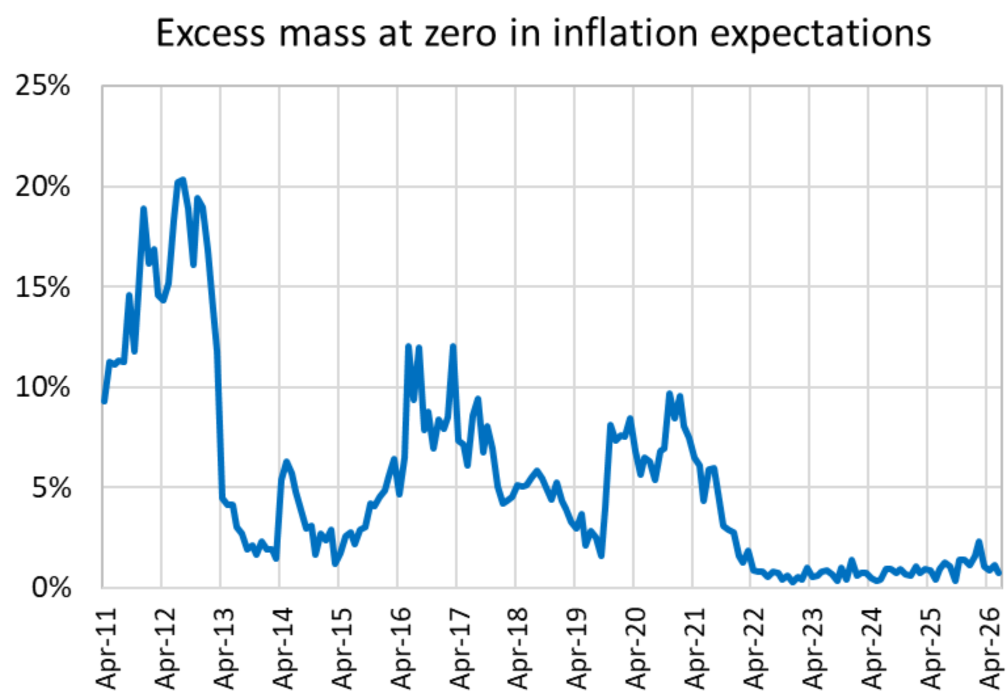


Figure 3: Excess Probability Mass at Zero Percent



Note: This measures the excess probability mass at zero relative to the probability implied by the estimated distribution around zero.

Figure 4: Distribution of Inflation Expectations, February 2026

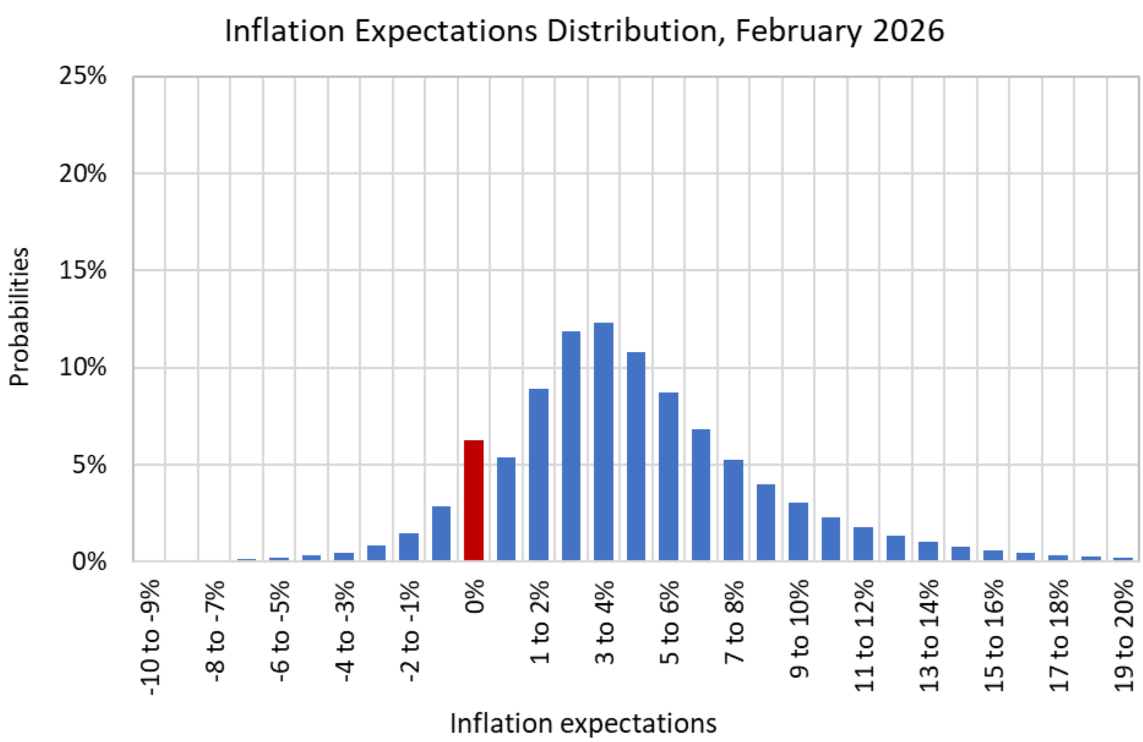
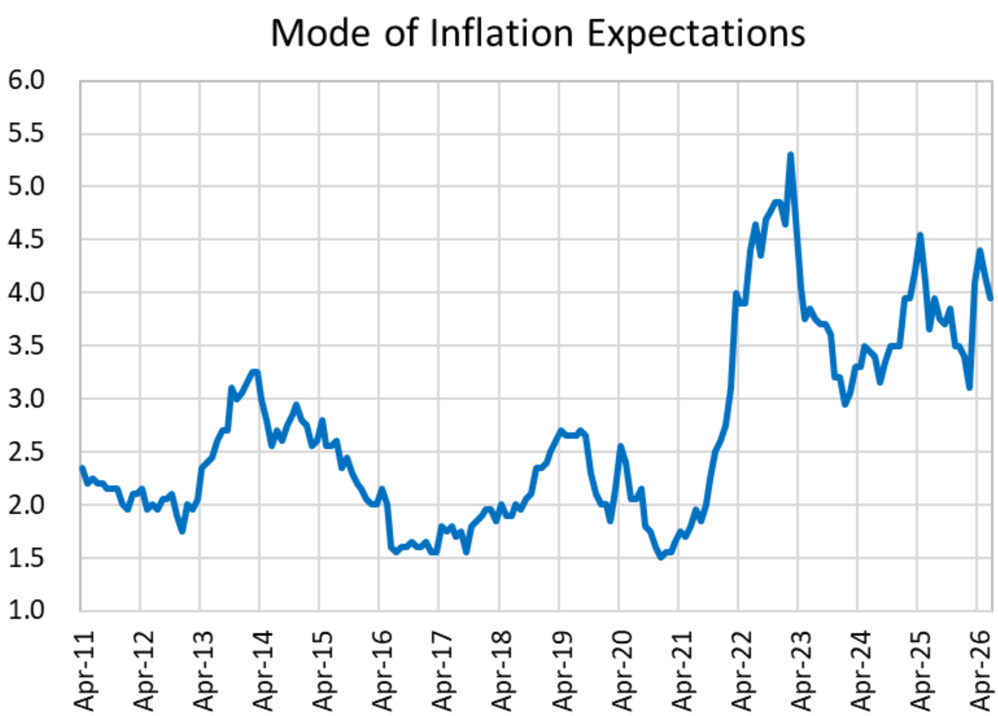


Figure 5: Mode of the Inflation Expectations Distributions



Note: The mode is estimated from the continuous component of the distribution, excluding the point mass at zero.