Toshihiko Fukui: Incentive mechanisms for economic policy makers

Opening speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at the 12th International Conference hosted by the Institute for Monetary and Economic Studies, Bank of Japan, 30 May 2005.

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Introduction

Good morning, ladies and gentlemen.

I am very pleased to address the 12th international conference hosted by the Institute for Monetary and Economic Studies.

On behalf of my colleagues at the Bank of Japan, I welcome participants from all over the world.

Over the last twenty-four years, we were fortunate to have the best minds from the academia and central banks come together at previous Conferences to discuss current issues in central banking.

I would like to thank everyone who has been involved, because the positive reviews we received are reflections of all the commitments in time and efforts of the people attending the Conferences.

From this year, the Institute will hold the Conference every year, not every other year. This should enable us to cover a wider range of monetary and economic issues in a more timely manner.

The new annual Conference format should offer more opportunities for candid exchanges of views between central bankers and scholars.

I hope that you would extend to us your continued support for our future Conferences.

Theme of this year's conference

This year, we discuss how to design incentive mechanisms for economic policy makers.

Institutions and the incentive mechanisms they engender collectively influence economic performance. Some institutions create incentives to induce efficient behavior, and others do not.

Take two of the broadest of institutions, a market economy and a centrally planned economy.

In a market economy, the market price signals any excess demand or supply, and creates incentives for producers. When the market price is higher than the equilibrium price, a producer has an incentive to increase his or her production and increase sales. On the other hand, a producer also has an incentive to cut back on his or her production when the market price is lower than the equilibrium price. Meanwhile, increased supply will let the market price fall and vice versa, until the market is cleared at the equilibrium price. Such an incentive mechanism achieves efficient resource allocation in a market economy.

In a centrally planned economy, the track record of central planning agencies is dismal. They generally failed to structure incentives for a producer to autonomously respond to excess demand and excess supply. At the same time, central planning agencies themselves lacked proper incentives to identify changes in demand, and consequently, often failed to instruct producers to produce according to changes in demand. Efficient resource allocation was not achieved.

It is no wonder then that centrally planned economies collapsed around the world by the 1990's. Institutions and their incentive mechanisms play a key role in determining economic performance.

Failure of incentive mechanisms in a market economy

The market price is not the only source of incentives in a market economy. Some incentive mechanisms, however, fail to induce efficient behavior.

For example, incentives influenced the course taken by Japanese banks in dealing with the problem of non-performing loans. Until the late 1990's, the Japanese regulatory and institutional environment did not motivate banks to take prompt actions that would have prevented their balance sheets from deteriorating further. For example, the latitude banks had in the disclosure of non-performing assets enabled banks to withhold information, perfectly legally, on the full extent of their problems.

As a result, market discipline could only play a limited role. At the same time, measures available to regulators and supervisors were rather limited.

A bigger stick would surely have helped the authorities to persuade banks to take more decisive actions.

Finally, in the late 1990's and early 2000's, various policy measures were introduced to better align the incentives of banks. They included the introduction of more precise standards for disclosure and prompt corrective actions by the FSA. The functions of the Deposit Insurance Corporation were strengthened as well. The Bank of Japan encouraged Japanese banks to make an appropriate evaluation of their loans by using discounted cash flow method.

These measures finally generated proper incentives for Japanese banks to put their houses in order. The recent removal of the blanket guarantee of deposits was a symbolic event in this regard.

This example suggests that incentive mechanisms could affect the stability of the financial system. The central bank has a vested interest in the design of such incentive mechanisms.

Incentive mechanisms for a central bank

Central banks are not free from incentives created by their institutional settings.

For example, in the past, governments in the industrialized economies tended to regard that there was a trade-off between high growth and moderate inflation. This created an environment where central banks would acquiesce inflation resulting from above-potential economic growth. The stagflation in the 1970's could be regarded as a consequence of such misguided institutional incentives.

Fortunately, we have learned from history. From the late 1980's onwards, there seems to be a growing recognition among governments in the industrialized economies that central banks should aim for price stability, which is a precondition for governments to achieve sustainable growth.

Accordingly, many central banks today are conducting monetary policy under a more favorable mix of incentives. The key ingredients are independence from the government and accountability in decision making.

The specific mandate for price stability varies from a central bank to a central bank. Some central banks are required to hit specific numerical targets, and others do not.

An example of a rather specific target is the policy target agreement 2002 between the Minister of Finance and the Governor of the Reserve Bank of New Zealand. The agreement says that "the policy target shall be to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term."

Another example, which is less specific, can be found in Article 2 of the Bank of Japan Law. It says: "Currency and monetary control shall be aimed at, through the pursuit of price stability, contributing to the sound development of the national economy."

From my point of view, and I believe my central bank colleagues would agree, the most important outcome is not hitting a specific numerical target. The achievement of price stability today in terms of a particular price index does not always guarantee sustainable growth in the future. It is, therefore, important to design and put in place an institutional setting that would create incentives for a central bank to pursue a price path consistent with sustainable growth.

Incentive mechanisms for a monetary policy committee

Incentives matter to central banks, not only at the level of macroeconomic targets, but also at the micro-level of day-to-day decision making. In other words, if the people decide that delegating price stability to the central bank leads to the achievement of price stability, how should the central bank make its decisions?

In the growing number of cases, including the Bank of Japan, committees formulate monetary policy. Though there is an old saying that a camel is a horse designed by a committee, I feel that there are advantages in monetary policy by committees. At a minimum, it enables a thorough discussion of issues reflecting the diverse background of committee members. On the other hand, the very fact that a monetary policy committee consists of different people with different opinions could create conflicting incentives within the committee.

The chair of the monetary policy committee that consists of different people with different opinions must, therefore, take care in aligning the incentives of members and hopefully arrive at a consensus. I remember, in a recent publication, Professor Alan Blinder describing Chairman Greenspan as leading the FOMC "with a velvet glove, not with an iron fist." This shows the delicate task of the chair in dealing with diverse if not diverging incentives.

As to myself, I keep a few points in mind as chair of the Board of the Bank of Japan. First, I welcome counter arguments or minority opinions, which contribute to a better decision in the end. Secondly, I refrain from actions that might result in undue influences over the discussions.

If I might give you a glimpse of the inner workings of the Board, instead of making an opening statement, I always ask other members to identify issues and express their opinions.

Final words

Designing institutions and policies that incorporate appropriate incentive mechanisms plays a crucial role in determining the economic performance of an economy. Policy makers, including the central bank governor, still have a lot to learn in this respect.

Through the next two days, I am looking forward to hearing from experts in this field, from both academic circles and central banks, their analyses and views on the designs of various incentive mechanisms in various institutions.

It would be our utmost pleasure if every one of you could take home some insights from these discussions.

Thank you very much.