Kazumasa Iwata: Transparency and communication policy in Japan

Summary of a speech given by Mr Kazumasa Iwata, Deputy Governor of the Bank of Japan, at the Panel Session "Recent and Prospective Developments in Monetary Policy Transparency and Communications: A Global Perspective," at the Allied Social Science Associations Annual Meeting, New Orleans, 5 January 2008.

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Introduction

1. Following the introduction of the new Bank of Japan Law in 1998, the Bank's de-jure independence has been significantly strengthened. The Board members can be confident of making decisions independent of interference from outside the Bank, although the rationale, the process and the consequences of those decisions are exposed to the critical eye of the media, the BOJ-watchers and the politicians.

The independence, together with the long-term tenure, allows the decision making of the BOJ a longer time horizon. This should enable the BOJ to carry out its tasks with both transparency and flexibility. At the same time, in a democratic society, the responsibility to fulfill the mandate of policy objectives is increased; that is to say, this independence is accompanied by accountability. A lack of transparency in the decision-making process may easily lead to a deficit of accountability.

In addition to the clarification of monetary policy objectives, central banks provide the framework for communication about the justification for their decision. Moreover, to gain the benefits of providing an anchor for expectations regarding the future inflation rate, some central banks are even willing to clarify the future course of monetary policy based on their economic forecast. Transparency is needed not only for achieving accountability, but also to make the effect of monetary policy more efficient through market expectation channels. The communication policy, if it is managed successfully, serves to enhance transparency.

Objectives

2. For today's panel discussion, let me take up some issues of transparency and communication policy in the light of recent experience in Japan. While the issues cover several aspects including (1) objectives, (2) procedures, (3) economic analyses, (4) actions and (5) policy instruments, I will focus on two of them, namely, the objectives and instruments.

3. The new Bank of Japan Law states that, "currency and monetary control shall be aimed at, through the pursuit of price stability, contributing to the sound development of the national economy" (Article 2). The dual mandate of sustainable growth under price stability is similar to the "maximum employment and price stability" mandate of the Federal Reserve. It is different from the hierarchical or lexicographic ranking of the ECB which attaches overriding importance to maintaining price stability (Papademos(2006)).

Quantitative easing policy

4. Despite the dual mandate, under the quantitative easing policy regime of the period covering March 2001 to February 2006, the primary objective was focused on the restoration of price stability or the exit from the deflation which had persisted since late 1998. The other important objective was to stabilize the financial system.

The Bank of Japan made a commitment to continue the zero interest rate policy unless the rate of change in consumer prices moved above zero in a stable manner. More precisely, the

Monetary Policy Committee in October 2003 made the conditions for exit more transparent. Namely, the following three conditions must be satisfied before ending the quantitative easing policy: (1) the current rate of change in consumer prices moves up above zero (2) the rate of change in consumer prices does not return to negative territory, (3) there may be a case that the BOJ will judge it appropriate to continue the zero interest rate policy, even though the first two conditions are satisfied.

The explicit commitment on the duration of zero interest rate policy worked to lower longer-term interest rates. Increasing bank reserve targets strengthened the "time duration effect" which relied solely on market expectations of future developments in policy rates in the absence of any actual change in policy rates (Iwata(2005)).

New policy framework

5. After confirming the development of an above-zero inflation rate, the BOJ exited from the quantitative easing policy in March 2006. At the time of the exit, the Bank announced a new policy framework. In this framework we provided the "understanding of medium- to long-term price stability" in a numerical form conceived by the Board members. It ranges from 0% to 2% with the distribution above and below the median value of 1%. This longer-run price stability concept can be regarded as a natural consequence arising from the second condition under the quantitative easing policy.

This "understanding of medium- to long-term price stability" is common knowledge among the Board members. It is not only shared knowledge, but also everybody knows that the others know it. Provision of common knowledge serves as a focal point to coordinate human action.

6. Thomas Schelling (1960) illustrated the role of focal points using the following situation as a whimsical example: "When husband and wife, separated in a department store, gaily traipse off to the "Lost and Found". Likewise, if we can correctly communicate the Board members' common knowledge to market participants and the general public, then we might expect that it can be also shared among market participants, and thus as a result, we can presume that market expectations will converge on the longer-run price stability.

7. If we look at the fan chart, we can see that our "understanding" is different from the "inflation target" adopted by the Bank of England, which seems to aim at achieving a 2% target after 8 quarters. We have no specific time horizon attached to our "understanding".

Furthermore our "understanding" is also different from the ECB's numerical definition of price stability over the medium-term ("below 2%, but close to it") in the sense that the Board members' opinions determine the numerical range. If there is a change in the membership of the Board, then the range also changes. Further, it is also possible that our "understanding" changes to reflect changes in the structure of the economy. Within our framework it is possible to revise the numerical range regularly. So far there has not been any change in the numerical range of our "understanding", despite routine changes in Board membership.

Two perspectives approach

8. The new policy framework is entitled the "two perspectives approach", in contrast to the "two pillars approach" advocated by the ECB. The first perspective examines whether the outlook deemed most likely by the BOJ follows a path of sustainable growth under price stability within the forecast period, while the second provides an assessment of various risks, including low-probability events which can cause serious damage to the economy beyond

the forecast time horizon. The latter perspective shares features in common with the "risk management approach" urged by former Federal Reserve Chairman Alan Greenspan[1].

Transparency and flexibility

9. Keeping in mind the "understanding of medium- to long-term price stability", we make policy decisions by examining the plausibility of our scenario presented in the semi-annual outlook and by assessing the various risks and the uncertainty ahead for our economy. As the plausibility of forecasts and the examination of risks play a key role, the new policy framework can be broadly described as a "forecast-based policy" which is inherently forward-looking (Bernanke(2004)). The publishing of projections, and the related explanations and reasoning, contributes to enhancing the transparency of decision procedures.

By adopting the new policy framework we have restored the flexibility of monetary policy management, while enhancing the transparency both of policy objectives and decision procedures. Under the quantitative easing policy regime, the flexible management of monetary policy was seriously undermined; developments in real economic activity mattered only to the extent that they cause upward/downward pressure on prices. There was also the risk of financial imbalance and resource misallocation due to the mounting market expectation of permanently low interest rates.

10. Given the institutional framework of consensus formation at the Monetary Policy Meeting, our "understanding", which reflects the opinions of the Board members, is suitable for maintaining democratic order and supporting individual accountability. In addition, the longer-run time horizon of price stability allows more flexibility in monetary policy management. On the other hand, this practice may raise the issue of dynamic (inter-temporal) inconsistency or self-consistency. If the communication policy fails to achieve its role of transmitting the Board members' common knowledge correctly to market participants and the general public, the role of transparency may be significantly eroded.

Before discussing the role of communication policy, I would like to take up the issue of transparency of policy instruments, namely the announcement of the future development of policy rates, because this practice is presumed to enhance transparency significantly, and several countries have adopted it, for instance, New Zealand, Norway and Sweden.

Instruments: policy rate projections

11. Under the quantitative easing policy regime, transparency in regard to policy instruments was extremely high, as was expressed by the above-mentioned three conditions. Moreover, the assumption of the constant policy interest rate in providing forecast could be easily justified, as long as the inflation rate was expected to remain below zero.

12. But the assumption of the constant policy rate is no longer adequate since exiting the quantitative easing policy. We have added the footnote to the Forecast Table, as of April 2006, that we take into account market expectations on future policy rates. In other words, we have adopted the approach that each individual Board member assumes the appropriate path of future policy interest rates in providing the figures for forecast (real GDP, core CPI and CGPI over a two-year time horizon), thereby taking into account market expectations on the future development of policy rates.

It seems reasonable to pay due attention to market expectations, because current asset prices reflect market expectations on the future development of policy rates. In my understanding, the decision at the Monetary Policy Committee is made when the majority

[1] On the relation between the asset price bubble and the second perspective, see Iwata (2007).

view is formed on the appropriate timing of policy interest rate changes after examining the plausibility of the scenario embodied in the forecast and assessing the various risks both in the short- and longer-run. Whether it is desirable or not to publish the appropriate path of future policy rates in achieving the goals of the mandate depends on judgments regarding noise in public information, the limits of transparency, the possibility of distorted communication and our limited knowledge about structural changes in the economy.

Communication policy

13. Monetary policy becomes more effective, if the communication policy succeeds in coordinating market expectations by providing the public information as a signal. Yet, it is possible that the public information is imperfect and contains noise.

Take the example of focal points illustrated by Schelling. If the focal point is unique, then it is easy to bring expectations into convergence. But if there are several focal points, it may not be easy to stabilize market expectations[2]. In addition, there may be cases where market participants find it difficult to delineate the consensus view and the minority view which is expressed to demonstrate individual accountability.

Furthermore, if the common knowledge shared by Board members or the public information is imprecise, as compared with the private information, the signaling by the central bank can have an adverse effect on welfare. There may be a limit to transparency, if the provision of public information can cause an overreaction in market participants (Morris and Shin(2002)). It is also possible that the public information contains noise or the precision of public information is significantly lower than the private information[3]. Nobody would recommend broadcasting Monetary Policy Meeting discussions.

14. Deputy Governor of the Swedish Riksbank, Lars Svensson (2007) proposed the announcement of the loss function of central banks and making voting on the relative weight attached to two objectives; namely the deviation of the inflation rate and the GDP gap on the future path of economic development. He recommends preannouncement of the path of policy rates to minimize the present value of the loss function. Yet it seems to be premature to put preannouncement into practice at the present time in conducting Japanese monetary policy.

First of all, there are doubts as to whether communication with the general public can be carried out in an undistorted way[4]; specifically, it may not be easy to convince market participants that the announced path of policy rates is conditional, and is not a promise.

Second, there is a measurement problem. In addition to the GDP gap, there is uncertainty over the measurement of the relevant parameters. There are two critical parameters for minimizing future loss; namely, the relative weight in the loss function and the sensitivity of price changes to changes in the GDP gap. The ratio of these parameters is equal to the marginal rate of transformation between the two objectives (inflation rate and the GDP gap)

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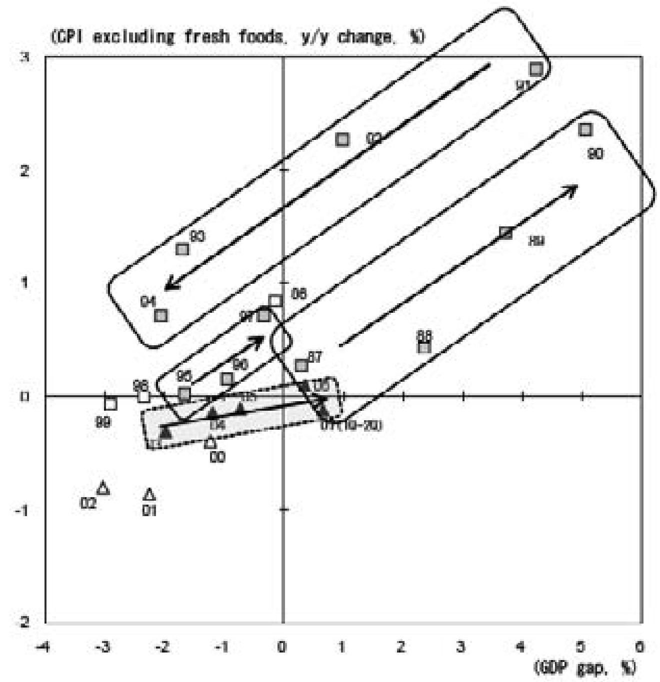
[2] For instance, we could mention the entrance of the department store through which husband and wife passed. Or there may be several "Lost and Found" offices. Then the power to bring expectations into convergence weakens. If some market participants perceive that the desired inflation rate set by the BOJ is the lower limit of the price stability range, namely 0%, while others regards the upper limit as the desired one, then the signal to stabilize expectations may be muted.

[3] Svensson (2006), commenting on Morris and Shin's paper, argued that the provision of public information diminishes welfare only if the precision of public information is eight times lower than the private information, or the amount of noise is more than eight times the amount of noise in the private information. Otherwise, more transparency increases the welfare.

[4] Habermas (1992) argued that the validity of the political decision-making process can be secured by democratic discourse under circumstances facilitating "undistorted communication" among voters.

on the policy possibility frontier. The value of the former parameter is determined by voting, while the value of the latter parameter can be gauged from the instantaneous sacrifice ratio, by which I mean the inverse of the slope of the aggregate supply function in the macroeconomic analysis. One of the problems is the fact that the slope of the aggregate supply curve can change, partly reflecting the effect of globalization, as shown in Figure 1[5].

(Figure 1) GDP Gap and CPI



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An alternative way to derive the ratio is to estimate the elasticity of demand faced by monopolistically competitive producers, as pointed out by Woodford (2007)[6]. Yet the values obtained from the two approaches, macro- and micro-economic analysis, can differ widely. Given the limited knowledge about the key parameters and the uncertainty of measurement, I would hesitate to preannounce the path of future policy rates, although I do not deny the usefulness of examining the intertemporal consistency and the robustness of policy decisions by employing different parameters.

15. Finally, communication can be made through action. The power of action can be stronger than words in persuading market participants. Schelling once noted that "to communicate a commitment requires more than the communication of words...One has to communicate

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5 Borio and Filardo (2007) argue that the changes in GDP gap in foreign countries make the slope of the aggregate supply function flatter, while a study by staff of the Federal Reserve does not support the evidence on the effect of globalization (Ihrig, Kamin, Lindner, Marquez(2007)).

6 We need to collect more microeconomic empirical evidence in assessing the price setting behavior of Japanese firms, including the issue as to whether Calvo-type or Taylor-type staggered price adjustments are made.

evidence that commitment exits". It is important to implement monetary actions in a consistent manner based on the fundamental framework notably under the circumstances of imperfect public information.

Conclusion

16. The new policy framework of the BOJ has improved both transparency and flexibility. There is room for further improvement in transparency and communication policy. Yet, we should be mindful of the limits of our knowledge and of transparency, as well as of the liability to distortion of communication in the process of consensus formation on decision making.

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