Masaaki Shirakawa: Unconventional monetary policy – central banks: facing the challenges and learning the lessons

Remarks by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the Conference co-hosted by the People's Bank of China and the Bank for International Settlements, Shanghai, 8 August 2009.

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Introduction

Currently, major central banks have introduced "unconventional monetary policy measures" to deal with the economic and financial crisis that materialized in the aftermath of the bursting of the global credit bubble. In this regard, the Bank of Japan has clearly been a forerunner since the latter half of the 1990s. Today, I would like to talk about some of the issues surrounding unconventional monetary policy, while reflecting upon the experiences of the Bank of Japan during the latter half of the 1990s and the earlier part of this decade.

Bank of Japan's monetary policy since the latter half of the 1990s

In order to refresh the memories of conference participants, I will begin by listing the innovative elements of Bank of Japan's monetary policy since the latter half of the 1990s, including those which were not necessarily considered to be innovative by outside observers at that time.

First, the overnight interbank rate was brought down to truly zero, to be precise 0.001%. Second, we introduced "quantitative easing" by setting the outstanding amount of reserves at the central bank as an operational target and by raising it to levels well beyond the required amount. At its peak, the excess reserves were 29 trillion yen or 5.8% of nominal GDP. This compares with 6.2% for the Federal Reserve and 3.5% for the European Central Bank during the current global crisis. Third, we extended the maturity of funds-supplying operations. In 2005, during the final phase of quantitative easing, the average maturity of funds-supplying operations was over six months and the longest operation extended up to eleven months. Fourth, we made commitments on the duration of zero interest rates and quantitative easing. Fifth, we commenced what is now called "credit easing" by purchasing ABCP and ABS. Sixth, although not necessarily part of monetary policy, the Bank of Japan purchased stocks from banks' equity portfolios in order to help reduce the market risk associated with their shareholdings, which was a significant destabilizing factor for the Japanese financial system.

In a nutshell, the Bank of Japan had, in previous years, adopted many of the innovative measures which are now being introduced on a global scale.

Challenges for the Japanese economy and the Bank of Japan

Though needless to say, such unconventional monetary policy measures were initiated to deal with the difficulties that the Japanese economy confronted at that time. Each crisis is different. But overall, there are many common elements with the challenges that the economies and central banks in Europe and North America are now facing. Specifically, I can raise five points.

First, the risk taking capacity of various economic entities was severely damaged, and, as a result, the effectiveness of conventional monetary policy was seriously hampered.

Second, in such an environment, the overnight interest rate dropped down to zero, limiting the room for additional easing through conventional monetary policy measures. In Japan's case, the overnight rate fell to 0.5% five years after real estate prices peaked in 1990. In the US, policy actions were faster, but still three years had passed after the residential real estate prices peaked in 2006, before overnight rates came down to levels seen in Japan.

Third, it took time to recapitalize the banking system, which was most effective and vital in revitalizing the economy. The injection of public capital into weakened financial institutions was indispensable in stabilizing the financial system, but was politically unpopular. In the current crisis, European and US authorities have deployed such measures much faster than the Japanese case. But more than a year passed after the initial shock which occurred in the summer of 2007, before such measures were initiated.

Fourth, reflecting the situation I have just mentioned, uncertainty regarding the transmission mechanism of monetary policy is much larger than in normal times. Therefore, regardless of whether experimental types of monetary policy measures were introduced or not, explaining the intentions of monetary policy decisions to markets and to the public at large, or in other words, fulfilling their accountability obligations became a key challenge for central banks.

Fifth, when central banks try to create "productive" policy measures, in an environment where the effectiveness of traditional monetary policy is constrained, they naturally come close to the area of fiscal policy. As a result, the policymakers need to face up to the issue of who should be responsible for such policy actions in a democratic society.

The challenges for central banks

How should central banks deal with such issues? The answer depends on multiple factors. They include, among others, the economic and financial environment which each central bank faces, and the laws which set out the responsibilities of each central bank and the policy tools at its disposal. There is no single universal answer which transcends both borders and the passage of time. I would like to explain my perspectives on unconventional monetary policy, building upon the experiences from both the last Japanese crisis and the current global crisis.

First, the most essential point in dealing with a financial crisis is to maintain the stability of financial markets and the financial system. Central banks need to exert maximum effort in this area. After all, in times of crisis, that is what central banking is all about. In this regard, the Bank of Japan introduced quantitative easing, credit easing, and stock purchases. With respect to Japan's quantitative easing, although the stimulative effects on economic activity through monetarist channels seemed to be self-evident in the eyes of quite a number of economists, the financial system perspective was not fully appreciated. However, looking back, the most important benefit of quantitative easing was its contribution to financial market and financial system stability through the provision of abundant liquidity.[1] In the current crisis, major central banks have expanded their balance sheets, but excluding the Bank of England, they have not characterized their measures to loosen monetary policy as quantitative easing. This certainly is understandable when we look back on the Japanese experience, where the effectiveness of quantitative easing on real economic activities has not been confirmed.

Second, as I mentioned, in order to stabilize the financial system, the injection of capital into the banking system together with the provision of liquidity is indispensable. This alleviates pressure on the financial intermediation process, but it is not sufficient to resolve the fundamental problem which had lead to the crisis.

This raises the third point. The unwinding of various excesses which have built up in the non-banking private sector is just as critical. We must not forget that the injection of public funds as capital into the banking sector as well as the provision of abundant liquidity through, for

[1] As for the effect of quantitative easing, see Bank of Japan (2005), Shirakawa (2004, 2005), Ugai (2007).

example, quantitative easing do not alleviate the need for the unwinding process in the non-banking sector. It must be recognized that some time is necessary before excesses are unwound and the economy can return to a sustainable growth path. The length of time necessary will depend on the size of the imbalances which build up during the bubble period, and the severity of the negative feedback effect magnified by the loss of confidence during the crisis that follows. In any case, it will not be brief.[2]

The fourth issue is the fine line between monetary policy and fiscal policy. Measures to take on individual credit risk such as corporate debt are extraordinary steps for a central bank since they come close to the area of fiscal policy which deals with resource allocation at the micro level. I believe such measures are only justified when we are facing a situation where, if left untouched, there is a substantial risk that credit market functions will deteriorate and the resulting weakening of the financial conditions can seriously damage the economy. It must also be compatible with the legal framework provided in each country's central banking law. When such measures are introduced, in order to avoid constraining market functioning where market participants become reliant on such extraordinary measures, it would be important to have an appropriate built-in exit mechanism which reduces the incentive to use the facility as market functioning recovers. Additionally, since it is in essence close to the realm of fiscal policy, a clear understanding of which authorities are taking on the risks involved is indispensable. This is also important from the perspective of maintaining public confidence in the financial strength of the central bank. If the central bank's financial strength is perceived to be weakened, concerns may arise, subtly through various channels, with regard to its ability to effectively fulfill its monetary policy mandate.

Fifth is communication with the markets. Without public trust in the organization, a central bank cannot effectively conduct monetary policy. Words and deeds have to match. There is much uncertainty with regard to the effectiveness of unconventional monetary policy and extraordinary measures may be pushing the boundary of monetary policy. Because of these two aspects, thorough communication with markets and the public becomes all the more important. Careful explanations while continuously evaluating both the positive and adverse effects of the steps taken become critical. Even during times of a crisis, if central banks take time-inconsistent policy measures, this could rather have negative effects on confidence in the central bank, and as a result reduce the effectiveness of monetary policy. At the end of the day, the central bank needs to communicate its aims and strategies in response to the characteristics of the problem the economy faces, and also needs to take policy measures which are consistent with the communication. I would like to emphasize once again that, especially in a crisis situation, the central banks must make clear their commitment to the stability of financial markets and the financial system, and take decisive policy actions to achieve such goals.

Concluding remarks

The five issues I raised today were those which the Bank of Japan struggled to solve when it last embarked on unconventional monetary policy. The difference between now and then is that the practical difficulties in dealing with such issues were not fully appreciated by many economists at that time. I am sure many of you can recall the various policy recommendations that were made toward Japan's policymakers by economists, both domestically and from abroad, as well as from international organizations since the latter half

[2] Ahearne *et al.* (2002) analyzed the Bank of Japan's monetary policy conducted during the 1990s, and showed the simulation result that deflation could have been avoided if the Bank of Japan had cut its policy rate to a great extent immediately after the bursting of the asset price bubble. There have been cases where an optimistic view has been expressed, partly based on such analysis, that a recession after the bursting of a bubble could be dealt with by aggressive monetary easing. For instance, Mishkin (2007) noted that, as long as a central bank timely responds to the bursting bubble, its harmful effect can be kept to a manageable level.

of the 1990s. Recommendations, some of which were quite bold, were made to the Bank of Japan. Typical recommendations were: "all that the Bank of Japan needs to do is to set a high inflation rate target and purchase all types of assets including physical assets to achieve that target", and "the Bank of Japan should monetize the government's budget deficit". One of the most famous was, "the central bank should credibly promise to be irresponsible".[3] Interestingly, in the current crisis, in spite of the sharp contraction of the economy, very few similar bold recommendations are being made by economists, and such radical measures are not being implemented. As we experience first time challenges, the discussion surrounding policy measures tends to swing between the extremes. Such discussions become truly practical once people actually face the challenge of dealing with a crisis. Viewing such changes, I believe that the learning process, the process of moving forward while learning the lessons from past experiences, is working effectively. What is important is to fulfill our basic responsibilities as a central bank. In this regard, an important challenge for us central bankers is to continue to humbly work to increase our understanding of changes in the economy and financial system and enriching our knowledge regarding the workings of the economy and the art of central banking.

Thank you.

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[3] See Krugman (1998).