Masaaki Shirakawa: Evolution of the Bank of Japan's policies and operations – looking back on fifty years of history

Remarks by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the Introductory Program on Bank of Japan Policies and Operations on the occasion of 2012 Annual Meetings of the IMF/World Bank Group, Tokyo, 9 October 2012.

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Good morning, honorable ministers, honorable governors, and distinguished delegates to the 2012 Annual Meetings of the IMF/World Bank Group. I am truly delighted to welcome you to the Bank of Japan today. Before I begin my remarks, please allow me to take this opportunity to express my sincere gratitude for the warm support we received from you and many other friends around the world when we were hit by the devastating tremor of the Great East Japan Earthquake last year.

This is the second time Tokyo has hosted the Annual Meetings of the IMF/World Bank Group. The last time was in 1964 when Japan was at the zenith of a high-growth period and still one of the "emerging market economies". Comparing the size of economy at that time to that of the United States, nominal GDP was 12% and per capita nominal GDP was 24% of that of the U.S. That roughly corresponds to Russia or Brazil today. Japan went through a reconstruction period after World War II, and from the mid-1950s to early 1970s, it enjoyed high economic growth that marked an annual rate of 10%. Among the conditions that contributed to this high growth, I believe the most important ones were, first, the migration of the labor force from rural areas to the cities and from the agricultural to the manufacturing sector, which resulted in higher productivity, second, the high level of education, and third, the benefits of the free trade system. However, no economy can maintain high growth indefinitely. From a certain point, the potential growth rate starts to decline gradually. The most important task for policy makers is to achieve a smooth transition from high growth to stable growth. Yet, it is by no means easy to identify in real-time the change in potential growth rate. The attempt to maintain high growth beyond its potential may cause various imbalances. Let me take the case of Japan as an example. Japan suffered from high inflation in the first half of the 1970s, amplified by the first oil shock. Later, the country tried hard to make its industrial structure energy efficient, and monetary policy was focused on price stability. Against such a backdrop, the Japanese economy achieved the best economic performance among major developed economies in terms of price and growth rate. This situation, albeit good in itself, fomented excessive optimism about Japan's higher potential growth and, together with the influence of prolonged easy monetary policy, contributed to the creation of economic bubbles of unprecedented scale in the latter half of the 1980s. In the 1990s, Japan suffered from deleveraging of excess debt, the aftermath of the bursting of the bubbles. And, since the early 2000s, the Japanese economy has gradually come to face a different issue from that in most of your countries. The challenge here is the rapid ageing of the population dragging down the potential growth rate. Since the beginning of the 2000s, the growth rate itself has remained low, while the growth rate per working-age population in Japan has been 1.5% per annum, the highest among the major developed economies, along with Germany.

It is impossible for me to go through the fifty years' history of Japanese economy in just a few minutes. What I would like to stress is that we need to identify the new issues that always emerge at different stages of economic and financial development, and find the appropriate policy responses in a timely manner.

In any case, changes in the economic environment require a constant review of a central bank's policies and operations.

Let me start with the exchange rate system. Japan currently uses a floating exchange rate system. Fifty years ago, we had a fixed exchange rate system. Cross-border capital transactions were still quite regulated in those days, despite Japan's acceptance of IMF Article VIII obligations. These restrictions were gradually removed and cross-border capital transactions increased dramatically.

There was also a sea change in the financial system during the same period. In the 1960s, interest rates were strictly regulated and the capital market was underdeveloped. The major tool for the Bank of Japan's monetary operations at that time was the allotment of central bank loans with a below-market interest rate, and the role of open market operations was limited. Today, the major monetary operation tools have been shifted to the open market operations to control money market interest rates. Incidentally, the Bank of Japan has been deploying various non-traditional policies over the past 15 years, given that we are faced with short-term interest rates that are currently practically zero.

In the area of payment and settlement systems, the development of computer systems and information technology brought major changes in the way funds and securities were settled. Fifty years ago, settlement was conducted by deferred netting. Today, the BOJ NET system settles the funds among the counterparty financial institutions on-line and on a real-time gross basis (RTGS).

The evolution of the Bank of Japan's policies and operations reflects the different stages of development in the Japanese economy and the changes in the domestic and external financial environment. In addition, the systems specific to Japan and its historical background are also reflected in the Bank of Japan's operations. Here I would like to pick up two examples from different areas.

One is the inclusion of securities companies or investment banks among the counterparties of the Bank of Japan. Following the bankruptcy of Lehman Brothers, investment banks in the United States became bank holding companies and gained access to the central bank's facilities. For more than seventy years, the Bank of Japan has allowed securities companies to open BOJ current accounts. And it has conducted on-site examination of those account-holding securities companies. This treatment of securities companies made it possible for the Bank of Japan to swiftly provide liquidity, as the lender of last resort, when the financial crisis triggered by the unprecedented scale of the bursting of its bubbles forced the collapse of Yamaichi Securities, then one of the biggest securities companies. I believe that was one of the reasons why Japan was able to avoid becoming the epicenter of a global financial crisis at that time.

Another example from a different field is the business survey known as the *TANKAN*. The Bank of Japan has been sending a special quarterly questionnaire to Japanese companies since 1957. The survey currently covers about ten thousand medium-sized to large companies, in both manufacturing and non-manufacturing industries. As such, the *TANKAN* provides information valuable to gaining an understanding of the state of the economy.

Central banks must strive to provide the operations best suited to their own environment. I believe this is also true for the central banks of African countries, represented by many of the governors here today. A few years ago, I attended a conference held by the BIS with the governors of African central banks. There, I learned that banking services provided through mobile phones are widely used in Africa. Although I was initially surprised to hear this, I quickly realized that it is indeed quite a natural development given the geographical environment of Africa, and is something which may have bearing on the operations that African central banks are endeavoring to provide.

I referred earlier to the evolution of central bank monetary policies and operations over the past fifty years by taking the experience of the Bank of Japan as an example. In considering these changes, I have realized once again the difficulty of reaching a universal definition for such a unique organization as a central bank. Today, instead of trying further to precisely define the central bank, I would like to talk about the three points I always highlight regarding the roles of a central bank.

First, the most important role of a central bank is to provide a stable financial environment. Sustainable economic growth tends to be achieved in a stable financial environment, even if that is not always the case.

Second, a central bank is an organization that plays its role through banking services. The specialized knowledge required of a central bank is not only knowledge of macroeconomics, but the wisdom to cover a wide range of activities. What is especially important for central banks is practical knowledge related to the details of the circulation of money. Borrowing the phrase of one central banker I respect, this kind of knowledge is akin to the knowledge required by a good plumber.

Third, a central bank is an organization that needs to learn constantly from the changes in the world. Earlier, I referred to a stable financial environment. The specific elements from which a stable financial environment is constructed also change with time. When price stability is achieved, many economic entities gain the confidence to take more risk. And, as a result, the stability of the financial system is compromised. This paradox of price stability is a good example of the need for the central banks to stay vigilant and keep learning in a changing environment.

The staff members from the Bank of Japan will now explain the current central bank policies and operations of the Bank. We would also like to take this valuable opportunity to learn from your experience and to deepen the ties of cooperation with you.

Thank you for your attention.