Financial System and Monetary Policy Implementation: Long and Winding Evolution in the Way of Thinking

Opening Speech

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Good morning. I am very pleased to address the Bank of Japan international conference. On behalf of my colleagues at the Bank of Japan, I welcome all the participants from central banks, international organizations, and academia.

I. Interaction between the Financial System and Monetary Policy

This year's conference focuses on the theme of "Financial System and Monetary Policy Implementation." The two things in the theme are closely interacted. That interaction has been consistently posing important policy challenges to the Bank of Japan since the late 1980s, when the bubble emerged. That seems to be increasingly the case for central banks in other countries as well. In fact, the interaction has gradually but steadily attracted both policymakers and academics, and has become a popular theme for research conferences. We have certainly benefited from such developments. For this conference, leading economists have contributed six stimulating papers. Distinguished policymakers are getting together to discuss the current policy challenges at the policy panel session.

I look back, with somewhat mixed feelings, on the past discussions on the policy responses to the bubble and its bursting. Several points come to mind immediately: 20 years ago, when Japan's bubble was at its peak. Ten years ago, when Japan's financial crisis was at its peak. Several years ago, when the global economy was in the era of "great moderation." Two years ago, when the global credit bubble came to the surface as the U.S. subprime mortgage problem. And even more recently just at this time last year. I see long and winding evolution taking place in the way of thinking over time.

Up until the mid-2000s, Japanese participants in international conferences, including myself, often felt frustrated both at home and abroad: on the one hand, the delay in necessary actions at home such as injection of public capital, and, on the other hand, the difficulty in sharing the economic reality in Japan under the malfunctioning financial system after the bursting of the bubble.[1] The delay in policy actions was in part due to the political difficulty of persuasion. One factor behind this seems to be the fact that financial institutions were unpopular, as always. But, most fundamentally, we were not equipped with economic theory to fully address the core of the problem.

In those days, we made the most of academic wisdom, but we often encountered situations that were not well captured by the existing economic theory. For example, financial imbalances were built up under benign economic conditions, through sharp credit expansion, outsized leverage, and soaring asset prices.[2] After the bursting of the bubble, market participants suddenly lost their confidence and reduced their risk-taking capacity. As a result, the effectiveness of monetary policy was severely constrained. Further monetary policy responses with unorthodox measures were adopted. The effectiveness of monetary policy measures crucially depends on the central bank's credibility, which is partly affected by the soundness of the central bank balance sheet and the central bank's neutrality perceived by the public at large. All in all, those experiences seem to show that textbooks on macro and monetary economics need some new chapters on the interaction between the financial system and monetary policy.

The way of thinking about monetary policy management has certainly changed since the outbreak of global financial market turmoil in the summer of 2007. In particular, since the collapse of Lehman Brothers in September last year, the policy discussions have changed further with the first-hand experiences of the downward spiral in both the financial and real sectors of the economy. It has turned out that Japan's experience is no longer unique.

II. Adoption of Unprecedented Policy Measures: Japan's Experiences

I will provide a basis for discussion by reviewing the Bank of Japan's policy implementation during the financial crisis after the bursting of the bubble, especially since the late 1990s. Of course, various measures were taken in the fields of central banking. Here my focus is on monetary policy.

The Bank of Japan's policy responses can be summarized into five points. First, the Bank lowered overnight interest rates in the interbank market down to virtually zero, eventually just one-10th of a basis point (0.001 percent). Second, the Bank provided ample excess reserves by using various tools for monetary operations, including an increase in the outright purchase of long-term government bonds. For the smooth provision of ample liquidity, the maturity of monetary operations lengthened, running for 10 months in bill-purchase operations at the final stage of the quantitative easing policy. "Quantitative easing" is often used in a rather vague manner, but the policy action we adopted can be regarded as a pure form of "quantitative easing." Third, the

1. Japan's 1990s is often referred to as the "lost decade." For the appropriateness of such characterization and policy responses, see Shirakawa (2009a).
2. Among the papers contributed to the conference, Hattori, Shin, and Takahashi (2009) revisit Japan's bubble in the 1980s by shedding light on the changes in money flow behind the expansion of the bubble.

Bank adopted “credit easing” in the current terminology. The assets purchased included asset-backed securities (ABSs) and asset-backed commercial paper (ABCP). Fourth, the Bank made a commitment to continuing with the zero interest rate policy and the quantitative easing policy. The conditions for commitment were expressed as “until deflationary concerns are dispelled” at the time of the zero interest rate policy and “until core CPI inflation becomes stably zero or above” at the time of the quantitative easing policy. Fifth, the Bank took unprecedented measures to secure the stability of the financial system, including purchases of stocks held by financial institutions.

You may find striking similarities between the policy measures formerly taken by the Bank of Japan and those currently taken by central banks in major countries. I never imagined that a host of unconventional measures taken by the Bank of Japan would be adopted by other central banks just a few years later. I also guess that my colleagues at central banks in other countries never imagined employing such policy measures. Of course, such measures are not perfectly identical, reflecting the differences in the structure of financial intermediation and severity of stress in financial markets, as well as the differences in legal and social restrictions on policy measures available for central banks. Notwithstanding such differences, the aforementioned striking similarities stand out. It is quite natural that a central bank facing a financial crisis takes similar measures, because a central bank, after all, pursues the same objectives with the same capacity, that is, the capacity to adjust the amount of liquidity in the economy.[3]

III. Importance of Liquidity

This leads me to discussing liquidity, which, I think, is the most important concept in understanding the current financial crisis, though it is hardly possible to sort out a single factor. During the expansion period of the credit bubble, complacency based on unfounded expectations about the unlimited availability of liquidity was behind the aggressive risk-taking attitude. By contrast, during the period of bubble bursting, it was fear of the exhaustion of liquidity that caused an extraordinary contraction of economic activity. In addition, liquidity conditions significantly changed the valuation of financial assets, thereby influencing the capital positions of financial institutions.

Here, I use the term of “liquidity” as the concept incorporating both funding liquidity and market liquidity. But I have to admit that “liquidity” is hardly defined precisely and measured exactly in a quantitative manner, and thus it remains somewhat elusive. Nevertheless, anybody can surely assess “liquidity” to a certain extent. After all, liquidity is the core concept in understanding interdependence between the real and financial sectors of the economy from the beginning of central banking. The principal function of central banks has been and will be the guardian of liquidity.

From the standpoint I just mentioned, it is crucially important for a central bank to adequately control the aggregate amount of liquidity in the economy. Please note, however, that the concept of liquidity here does not necessarily correspond just to the terms of broad monetary aggregates or reserves. In fact, the reversed correlations

3. Among the papers contributed to the conference, Goodfriend (2009) argues central banking under financial turmoil by classifying central bank initiatives into monetary policy, credit policy, and interest rate policy.

between money stock and economic activity are almost consistently observed in recent years in Japan: money stocks increase when economic activity weakens, while they decrease when economic activity expands. The money multiplier is also quite unstable.

IV. Challenges for Central Banks

If this is the case, what does it mean practically to say liquidity is important? I will touch briefly upon some issues and challenges for central banks, based upon the recent experiences.

First of all, I want to draw your attention to a fine line between liquidity provision and capital provision. Currently, central banks are faced with an imminent challenge of implementing unorthodox policy measures. The traditional role of a central bank is in providing liquidity. In times of crisis, a central bank attempts to provide liquidity aggressively sometimes with taking some credit risk. The relaxation of collateral eligibility is a case in point. In a dysfunctional market where prices are not "discovered," it is not so certain that a central bank is protected from credit risk, even if central bank lending is "collateralized." That makes it difficult to distinguish liquidity provision from capital provision. Outright purchases of credit instruments imply that a central bank shoulders credit risk in a more straightforward manner. In that regard, monetary policy approaches the region of fiscal policy. Under such circumstances, a central bank should be cautious about the risks of undermining its credibility, which is prerequisite for any policy implementation. The issues such as deterioration in financial soundness and massive intervention for resource allocation at an individual level are now recognized. Central banks in major countries manage to strike a balance between the ultimate responsibility of maintaining price and financial stability on the one hand and the accountability in a democratic society on the other hand. Although there is no clear-cut answer holding true universally, the public needs to understand the role of central banks correctly.

Second, central banks are supposed to work hard as a "plumber" in facilitating the smooth and efficient flow of funds.[4] An important area is the payment and settlement system and our own procedure of monetary operation. Taking an example of the cross-border collateral arrangement, the Bank of Japan decided last week to expand its eligible collateral to foreign government bonds denominated in foreign currencies as a temporary measure. That arrangement enables financial institutions to use foreign currency denominated foreign bonds as collateral for yen-fund provision operations by the Bank.

Third, redesigning financial regulation and supervision, jointly with other relevant authorities, is called for.[5] In view of the current crisis, not only credit risk but also market and funding liquidity risk need to be addressed. Specifically, the problem of pro-cyclicality should be addressed by establishing proper incentive structures for rules and market practices to control the incentives at both micro- and macro-levels.

4. See Tucker (2009).
5. See also Shirakawa (2009b).

Last but not least, I will draw your attention to how monetary policy should be conducted, once we fully recognize the importance of liquidity. Here, research activity at central banks is crucial. For example, the current financial crisis sheds light on the risk-taking channel of monetary policy, stemming from the changes in liquidity conditions. The risk-taking channel works in the nexus between monetary policy and behavior of financial institutions.[6] The prolonged low interest rates under benign financial and economic conditions tend to create overconfidence and thus boost asset prices and collateral values as well as incomes and profits, thereby leading to affecting risk perception as well as enhancing risk tolerance. As a result, aggressive risk-taking behavior in the financial system surges, while a resultant build-up of financial imbalances is likely to be left unchecked. Such financial imbalances come to the surface only once the economic environment starts deteriorating.

Considering the complicated transmission channel and the behavioral aspect of various economic agents, how to frame monetary policy is quite a challenge. For instance, in its explanation, the time horizon for monetary policy needs to be extended, compared with the standard time horizon generally assumed in the formal inflation targeting. In this case, another important policy challenge is posed as to how to ensure the transparency of monetary policy.

V. Closing Remarks

Let me conclude now. In response to the current financial crisis, the policy discussions are continuing about wide-ranging issues on not only monetary policy management but also financial regulation and supervision. Dialogue between academics and policymakers plays a crucial role in discussing and formulating necessary actions in both short- and medium- to long-term perspectives. In that regard, I am convinced that this year's conference will produce further insights into more effective central bank policymaking.

Thank you.

6. See Borio and Zhu (2008).

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