Common Issues Central Banks Face on Unconventional Monetary Policies

Wataru Takahashi
Osaka University of Economics
& Kobe University

"Japan and the EU in the Global Economy—Challenges and Opportunities"
Bruegel-Graduate School of Economics, Kobe University,
Foundation France-Japon de I'EHESS
7 October 2013,
Bruegel, rue de la Charité 33, 1210 Brussels, Belgium

This work was supported by JSPS KAKENHI Grant Numbers 24243024 and 25285100.

Main Points

- With the Bank of Japan (BOJ) as a typical case, central banks face an "institutional crisis" in policymaking (policy rules, communication) and independence.
  - ✓Trade-offs among mandates have reemerged: price stability, financial stability, and fiscal stability."
  - ✓Since unconventional monetary policies (UMPs) (e.g., quantitative easing) are *ad hoc* and discretional, the absence of policy rules causes problems of accountability and independence.
  - ✓This requires strong communications. Central bank governors must be "skilled performers."
- The new environment following the financial crisis is challenging.
  - ✓Central bank independence might come under attack.
- The time has come to reconsider the model of central banks in the new environment.

1) Brief review of UMPs

Taxonomy of UMPs

- UMPs are categorized as quantitative easing (QE) / credit easing (CE) and forward guidance (FG).
  - QE/CE are essentially tools for liquidity control / management of the financial market / sector.
    - With QE/CE, the central bank essentially serves as a lender of last resort (LLR) to the market as a whole (it shouldn’t serve as an LLR to an individual bank).
  - FG is regarded as effective for lowering the long-term yield. But it doesn't necessarily boost investment and consumption.
  - Since QE/CE have proven less effective with respect to supporting economic recoveries, FG has become the main policy tool of UMPs.
    - But FG is controversial as to whether it’s correct for monetary policy to manipulate expectations.
      - It led to the yen “carry trade” during the QE period in Japan.

2) UMP achievements

- UMPs are effective for restoring financial stability, but comparatively less effective for boosting economic activities such as investment and consumption.
- With respect to accountability, UMPs are criticized as less accountable, since they can't set a clear policy rule such as the Taylor rule.
    - But practically speaking, it's difficult to set a linear relation between the size of a central bank's balance sheet and key economic variables such as inflation and the output gap.
- Since they're *ad hoc* and discretional, UMPs require good communication.
- Communication becomes particularly important for the exit from UMPs.
    - Unfortunately, the BOJ wasn't successful in this respect.
    - Similar situations exist now in the United States due to the lack of a clear future rule for the base path of the exit.

3) Lessons for the BOJ 1

Two major criticisms of the UMPs of the BOJ:

1. Exit from the QE in March 2006 was too early.
    - The exit condition for CPI inflation (“the current rate of change in consumer prices moves up above zero”) was too low.
    - As theory (New Keynesian Theory) suggests, a view of “historical dependence” was needed. The exit must be set to lag behind the optimal timing.
    - In terms of communication: The BOJ was required to set specific conditions to stop the QE in March 2006. Although the BOJ repeatedly announced the continuation of the zero interest policy (ZIP) after exit from the QE, this wasn’t understood by the market.

3) Lessons for the BOJ 2

2. Communication with government and markets was unsuccessful during the comprehensive easing period (2010-2013).
   - Markets had the impression that (1) the policies were too little, too late, and (2) central bank independence was weak against the government and political concerns.
   - The BOJ’s strategy to avoid political conflicts didn’t succeed.
   - In terms of relations with Prime Minister Shinzo Abe, the BOJ lost some credibility in independent policymaking, e.g., (1) the abrupt adoption of 2% inflation targeting in January and (2) anonymous approval of the new Governor’s policy at the BOJ’s Monetary Policy Meeting in April.

4) The challenging environment for central bank independence 1

- The “good times” are over.
  - Although communications and independence are important, recent experiences show it is very difficult to achieve them when situations for central banks turn unfavorable.
- Following the global financial crisis, the mandate became threefold: (1) price stability, (2) financial stability, and (3) fiscal stability.
  - Under the Great Moderation, a single mandate of (1) price stability was assigned.
  - Fiscal dominance has become a primary concern, and the fiscal theory of the price level (FTPL) suggests that central banks would lose control of inflation.

4) The challenging environment for central bank independence 2

- It's time to reestablish central bank independence.
  - The "conservative central banker (inflation fighter)" approach failed.
  - Rules and accountability are needed to establish independence.
  - A question is whether central banks can maintain independence even when conducting bank supervision for financial stability.
  - The Bank of England attained independence while it gave bank supervision to the new Financial Stability Authority.]
  - The constitutional framework (separation of powers) should be considered.

5) Quantitative and qualitative monetary easing (QQE) by the BOJ

- A new monetary policy has been adopted by new BOJ Governor Haruhiko Kuroda (as the first "arrow" of Abenomics).
  - Inflation targeting of 2% CPI inflation has been adopted with a time horizon of about two years.
  - Doubling of the monetary base and active purchase of Japanese government bonds of longer maturity
  - To support Abenomics, in particular, the focus is on public finances (the second "arrow" of Abenomics).
- The prudent style of monetary policy has been abandoned, but the impact on expectations is strong.

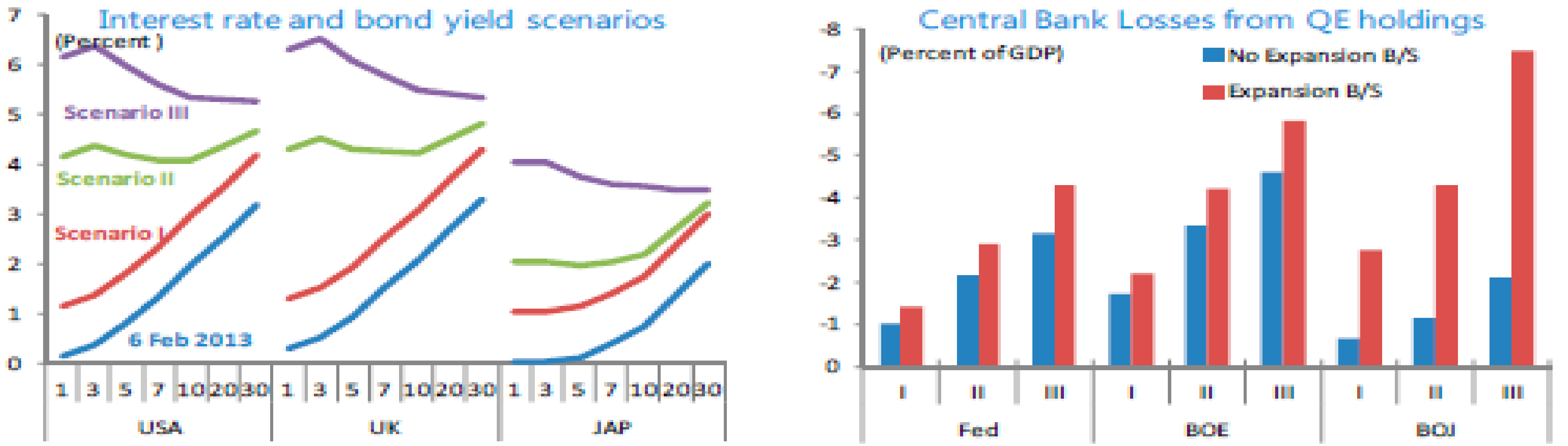
Achievements:

- Strong impact on asset prices (depreciation of the yen, higher stock prices)
- Signs of modest recovery (two consecutive quarters of positive GDP growth)
- However, there are potential risks (see the next panel).

6) Tasks for the exit by the BOJ

1. Fiscal dominance (Chart 1)
   - Despite increasing government debt, interest payments have remained low due to a decline in the interest rate thus far.
   - A rise in interest rates would increase government payments.
2. Deterioration in the BOJ's financial soundness (Chart 2)
   - Central banks make higher interest payments on reserves and record losses from selling assets to shrink their balance sheets.
   - Political interference could increase as central bank profit transfers to the government diminish or disappear during the tightening cycle.

Figure 1. Possible Central Bank Losses in Different Scenarios

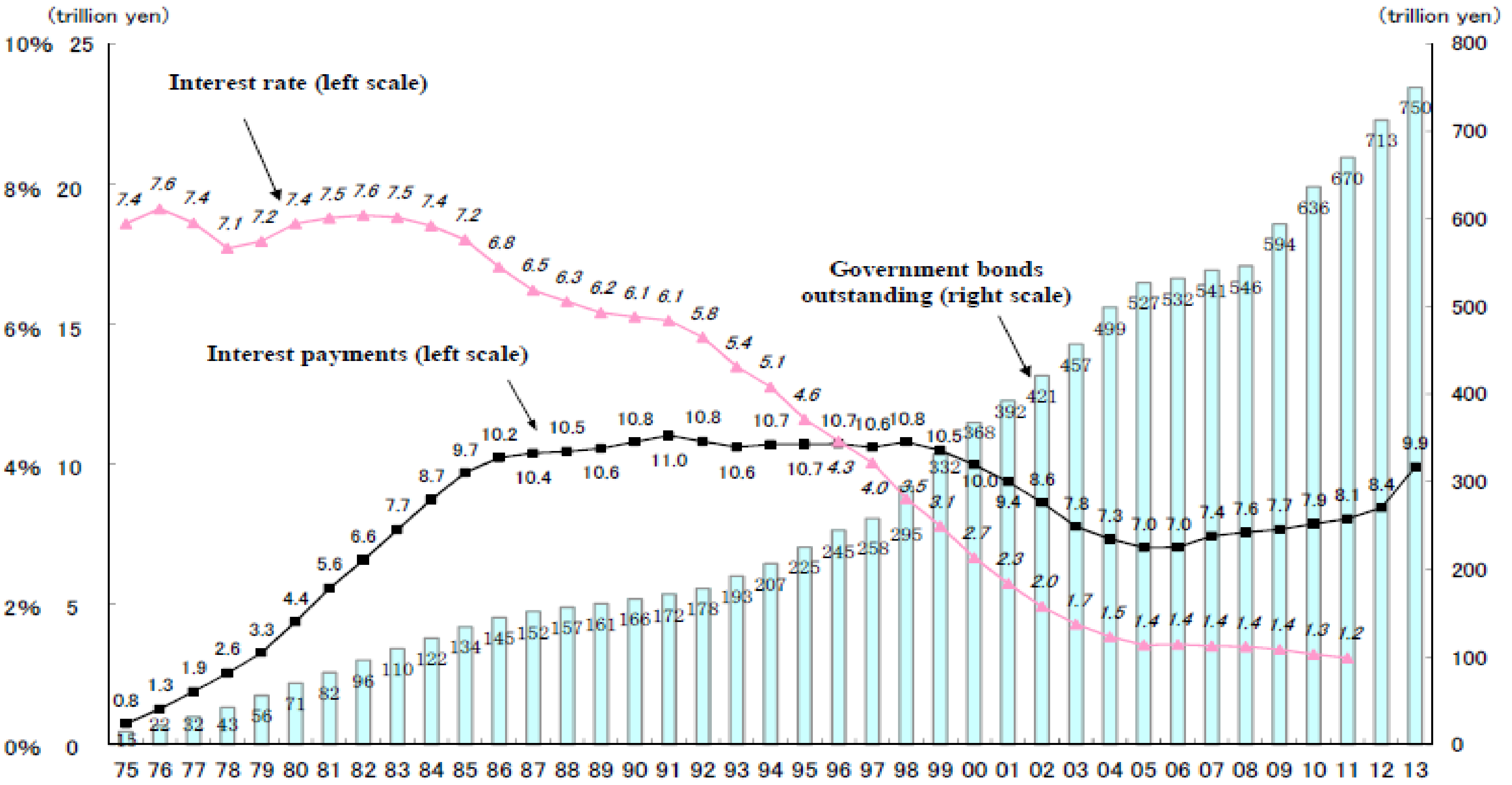


Sources: Federal Reserve Bank of New York System of Open Market Accounts; Bank of England; Bank of Japan; J.P. Morgan; U.S. Treasury; UK Debt Management Office; Japan's Ministry of Finance; and Staff computations

Notes: Central Bank losses from asset purchases are based on bond valuations as of February 6, 2013 using price sensitivity to interest rate changes, multiplied by the central banks' balance sheet exposure, and expressed as a percent of 2012 GDP. Price sensitivity is computed as ½ $C\Delta i^2$ - $D\Delta i$, where Δi denotes changes in yields, C convexity and D modified duration. Losses follow three scenarios: I. parallel shift +100 bps in yields, II. +400bps in short-term and up to +225bps in long term yields (Japan +200 and +125bps, respectively) and III. +600bps in short term and up to +375bps in long run yields (Japan +400bps and +167bps). 'No expansion B/S' assumes a static balance sheet (B/S). The Fed B/S expansion assumes purchases of UST and MBS until end-2013 of $85bn per month. The BOE B/S expansion assumes an addition of £75bn to its Asset Purchase Facility in the long range (+7 years) segment. The BOJ B/S expansion accounts for the April 4, 2013 announcement of qualitative and quantitative easing of ¥100 trillion JGB purchases in 2013-14 at a longer maturity (going from slightly below 3 years to about 7 years).

Source: IMF, "Unconventional Monetary Policy-Recent Experience and Prospects-Background Paper," April 18, 2003

(6) Trends in Interest Payments and Interest Rate



(Note1)Interest Payments for FY1975-2011: Settlemnt; FY2012: Supplementary budget; FY2013: Draft budget
(Note2)Government bonds outstanding for FY1975-2011: Actual; FY2012: Estimates; FY2013: Draft budget
(Note3)Government Bonds Outstanding includes reconstruction bonds issued in FY2011, FY2012 and FY2013(FY2011: 10.7 trillion yen, FY2012: 11.2 trillion yen, FY2013: 12.2 trillion yen). Measures and projects for reconstruction from the Great East Japan Earthquake would be financed by reconstruction bonds, which are used as a temporary means until when the financial resources are secured by the revenues including the special tax for reconstruction.

6

Source: MOF, "Japan's Fiscal Condition," January 2013

7) Conclusion

- Central banks face a difficult situation:
  - Independence becomes weak when policy rules are absent and central banks face the issue of “fiscal dominance.”
  - A clear future path is required for the exit from UMPs.
  - Fiscal “repression” (a financing budget deficit) is required for monetary policy.
- There’s no simple, good solution. However:
  - At a minimum, communication has become more important.
  - Central banks must be skilled political actors.
    - It isn’t possible to be “nonpolitical” as an independent political institution.
  - To maintain independence, an active role by central banks is expected to require fiscal discipline by the government.