

**Topic** “Unconventional” Monetary Policy

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### Issues for discussion

- (1) Current conditions of financial markets
- (2) Challenges for central banks
- (3) Policy instrument selection and effectiveness
- (4) “Unconventional” policy and risks

### Summary of comments

#### 1. Introduction by Secretary

##### Inoue <Secretary> :

- Under the current financial crisis, the FRB and the BOE as well as the BOJ have already launched “unconventional” monetary policy with virtually zero policy rates, in order to battle against mal-functioning financial markets and deteriorating economies. Therefore, we chose the effectiveness and risks of such policy measures as the topic of the first meeting of Financial Markets Panel.
- Major issue for discussion would be the optimal selection of policy instruments under the conditions of economy and financial markets, based on proper understandings of purposes of respective instruments. Furthermore, risks accompanied by these measures and their managements deserve discussion. While we could utilize the experiences of our financial crisis, we should take account of the possibilities that such discussion may be affected by specific features of economy, financial markets and financial system during those years. Regarding our discussion on risks of “unconventional” policy, there are important issues such as sharing loss between central bank and government or conducting exit policy.
- (Secretary briefly reviewed conditions of financial markets, policy measures and their explanation given by the BOJ and the FRB, balance-sheets of the BOJ and the FRB and literature of studies on “unconventional” monetary policy.)

#### 2. Discussion

##### (1) Current conditions of financial markets

##### Mr. Kato :

- Commercial paper yields rose and issuance fell towards the end of 2008 as large companies issued paper to boost cash reserves and banks, worried about stock market declines, scaled back purchases of CP. Issuance subsequently recovered and yields dropped below those on TB of the same maturity as the BOJ and Development Bank of Japan (DBJ) announced to begin buying CP. This policy has been extremely effective, with some issuances in the market being foregone on the back of expectation of purchases by these authorities.
- In repo market, Treasury Bill supply pressures and a dearth of market makers continue to exert upward pressure on yields. The BOJ is conducting term repo operations to keep interest rates in check, because such pressure on yields is likely to gain momentum due to inventory financing by dealers.
- The current accounts balance at the BOJ has hovered between ¥10trn and ¥13trn during this period. Although the BOJ does not indicated any numerical target, they are effectively operating Quantitative Easing because its purchases of CP and corporate bonds and expanded operations in term-funds markets result in the creation of substantial excess reserves. Although banks’ aggressive participation in the BOJ’s dollar supply operations to meet their own and customers’ need for foreign currency led to a

temporary collateral shortage, those problems diminished when the BOJ launched operations to facilitate corporate fundraising.

**Mr. Takata:**

- The move by companies to offset reduced CP and corporate bond issuance with bank loans towards the end of 2008 was convenient for banks in that loans need not be marked to market. Further, widening market spreads discouraged pension funds—the largest buyers of corporate bonds—and bank departments responsible for CP underwriting from buying such securities, regardless of credit quality.

**Mr. Miyao:**

- The sharp deterioration in world economies means there is now an increasing risk of global deflation.

**Mr. Watanabe:**

- In the securitization market, the epicenter of the financial crisis, companies underestimated both default (“rare event”) probabilities and default correlation risk.
- As CDS and other risk distribution instruments see increasingly widespread use, central banks must go beyond their traditional role of monitoring commercial lenders. A more robust market will require the adoption of central counterparty clearing or other risk-reducing infrastructure.

**(2) Challenges for central banks**

**Mr. Kato :**

- A key reason why the FRB is boldly implementing “unconventional” monetary policy is that the US has no institution authorized to use government funds to engage in policy finance on a nationwide level. The BOJ’s emphasis on maintaining market functions is understandable given the degree to which Japanese markets have been affected by developments in the US and Europe. However, it needs to consider how it would respond in the event the sharp decline in Japan’s exports took a further toll on the real economy and bank asset quality.
- ECB Governor Jean-Claude Trichet said in a speech at a recent European Parliament meeting that while short-term measures are needed to deal with the financial crisis and economic downturn, longer-term structural issues must also be considered. Central banks must move beyond an emergency response and think about the future and how they will pass the baton to the government when the time comes.

**Mr. Takata:**

- In Japan’s last financial crisis, a strong perceived risk of deflation meant that the amount of funds supplied by the BOJ was a critical factor. In the current crisis the lack of market liquidity is more important, and as such it is understandable

why the BOJ has focused on easing credit. But amid fears of rising deflationary risks, the BOJ needs to conduct an empirical study of the significance of Quantitative Easing.

- Inasmuch as the US faces a more severe crisis than Japan in the 1990s, the FRB has focused its efforts on putting out fires and adopted one “unconventional” measure after the other. That, in turn, has forced US academics to come up with after-the-fact justifications for the FRB’s credit easing measures and other policies.

**Mr. Fukuda:**

- Despite the significant risk of deflation in both the US and Japan, US academics who proposed ways of boosting inflation or inflationary expectations during Japan’s crisis have been notable for their silence. Have they subsequently concluded that inflation targets and the portfolio rebalancing effect were meaningless?
- Although the policy decisions are made at the FRB in Washington DC, its market-friendly brand of “unconventional” monetary policy hints at the influence of the FRBNY, which is in daily contact with the markets.
- Even if the stabilization of the financial system is the priority, the central bank should limit its actions to curbing systemic risk; the rescue of individual financial institutions and efforts to ward off a credit crunch should be implemented by regulatory authorities with government money. While it can be difficult in practice to draw a line between these two approaches, the central bank should quickly seek an exit if it finds itself in a gray area

**Mr. Yanagawa:**

- As the current crisis originated in the US, it would be difficult for Japan to adopt policies opposite to those of the FRB. However, the financial crises in Japan and the US are different, as are the associated political pressures, and it is important that the BOJ maintain a flexible approach to policy conducts. Another important issue for Japan is how to coordinate its fiscal policy with that of the US and other advanced economies.

**Inoue <Secretary>:**

- The message communicated by US academics during Japan’s last financial crisis was that central banks need to become “irresponsible” with respect to inflation if they hope to foster inflationary expectations.
- While consumer price deflation during that crisis was modest, the severe damage incurred by bank and corporate balance sheets focused attention on the risk of a deflationary spiral. If such a risk also exists today, a proper understanding of the underlying causes would lead to the adoption of appropriate policies.

**(3) Policy instrument selection and effectiveness****Mr. Kato :**

- FRB paper titled “Alternative Instruments for Open Market and Discount Window Operations” (2002) presented the standard understanding of “conventional” monetary policy in recent years. Basic principles included maintaining the neutrality of resource allocation in central bank operations and not leaving a bill for taxpayers. This approach stands in sharp contrast to the FRB’s recent purchases of large quantities of MBS and ABS.
- The only assets that should be purchased via “unconventional” monetary policy are those for which fair value cannot be ascertained because of dysfunctional markets. Like FRB Chairman Bernanke, I question the FRB’s decision to purchase US Treasury notes for which there is still a functioning market in an attempt to force medium- and long-term interest rates lower.
- In the US there is a tendency (according to Bernanke and Reinhart) to label as “Quantitative Easing” any policy that leads to expansion of the central bank balance sheet. The FRB has issued some of the same objections to Quantitative Easing under a (near) zero interest rate regime that the BOJ did during Japan’s crisis—namely, that it is meaningless to exchange reserve funds for Treasury Bills, and that Quantitative Easing cannot work when damage to the financial system has lowered the credit multiplier.

**Mr. Takata :**

- BOJ officials say they cannot confirm any stimulus effect for Quantitative Easing during Japan’s crisis. But the ineffectiveness of one drug does not necessarily justify administering another. Nor is there any reason why Japan should have to take a specific medicine simply because the US did. The effectiveness of Quantitative Easing and other “unconventional” monetary policy measures should be reviewed before they are adopted.
- While central banks have traditionally been averse to the purchase of government debt, they have been more willing to take on substantial amounts of credit risk. A central bank without governance functions that purchases corporate bonds acquires absolute power over individual businesses’ ability to raise funds, and by doing so it risks creating zombie companies. If corporate bonds are to be purchased, they should be bought by public financial institutions with credit management and corporate restructuring functions. The BOJ’s previous acquisition of securitized assets had limited effect because it was undertaken after markets had normalized.
- While government intervention to jump-start the credit markets is acceptable, in Japan the banks must first be revitalized. The recent BOJ’s policy of buying stocks from banks’ equity

portfolios was difficult to execute because it forced institutions to realize losses on their holdings. However, the provision of subordinated loans is likely to work. Other effective measures would include securing a stable long/short interest rate spread for banks through the outright purchase of JGB and adding floating-rate JGB to the list of assets eligible for purchase.

- If collapse of export demand is a serious problem, a zero-interest-rate policy is desirable for its likely impact on exchange rates. Quantitative Easing served to depress the value of the yen in the previous crisis via outward capital flows.

**Mr. Fukuda:**

- Of the various policy responses to the previous crisis, Quantitative Easing was largely ineffective in combating deflation, but it was not entirely meaningless. The BOJ’s Commitment Policy had the effect of keeping interest rates in check fairly far out on the curve. And the BOJ’s purchases of equities and ABS, while limited in scale, represented a kind of credit easing.
- Few banks have responded to the BOJ’s offer to buy stocks from their securities portfolios in the current crisis, suggesting that central bank purchases of risky assets are not always effective. The absence of a penalty rate in the BOJ’s operations to stabilize the corporate finance market is also inconsistent with its Lombard lending facility, and these operations may be taken advantage of by institutions that are not in need of assistance.

**Mr. Miyao:**

- I disagree with those who argue that the world’s central banks should follow the FRB’s lead simply because the current crisis originated in the US. For example, the FRB’s dual mandate provides justification for growth-oriented policies and makes it easy for the central bank to ask the government to bear associated losses, but the same cannot be said for the BOJ or the ECB. If such policies are to be adopted as an emergency measure, central banks should at the very least have an exit strategy.
- The market remains skeptical about the portfolio rebalancing effect of Quantitative Easing. However, it has not been adequately addressed that Quantitative Easing could curb real interest rates by lifting inflation expectations, thereby stimulate economic activity. Amid a rising risk of deflation, we may see resumed discussion of this issue and the related question of inflation targeting.

**Mr. Yanagawa:**

- The FRB has appeared to implement its credit easing measures in an ad hoc manner as the financial crisis has unfolded. From an academic perspective, we need to (1) study the various options and mechanisms available under

the rubric of credit easing, (2) identify the conditions needed to justify credit easing, and (3) study the relationship of credit easing with “unconventional” monetary policy. Regarding the third need, the impairment of market functions by credit easing may diminish the impact of “unconventional” monetary policy as well.

- If the original goal of Quantitative Easing was to stabilize the financial system, there is no requirement that it ease deflationary pressures as long as it helps reduce liquidity risk. The question is whether the goal of monetary policy is simply to stabilize the financial system or rather to provide economic stimulus via the stabilization of the financial system.

#### **Inoue<Secretary> :**

- Because the Japanese financial system centers on bank lending, policies to prop up the financial system chiefly targeted the banks. Their first priority was to deal with problems in the banking system, which tended to force the government to take on substantial credit risk. The purchase of securitized assets was probably undertaken as part of efforts to revitalize the credit markets with a view to introduce a “multiple-pillar” financial system over time.
- It is a regret that debate on Quantitative Easing in the US and Europe in part seems to assume that the central bank is capable of controlling the money supply directly.

#### **(4) “Unconventional” policy and risks**

##### **Mr. Kato :**

- Chairman Bernanke argues that it does not make sense to focus exclusively on the central bank’s balance sheet. His view on this subject has been consistent over time, and the FRB has in fact acquired a variety of assets. In his most recent speech, the Chairman argued repeatedly that the expansion of the FRB’s balance sheet posed no problems. He noted that (1) many of the assets acquired by the FRB carry government guarantees, (2) securities acquired in open-market operations must meet collateral and ratings requirements, and (3) financial institutions are choosing to leave their excess reserves on deposit with the FRB. Nonetheless, market participants seem concerned: not only is the US government increasingly dependent on foreign investors to buy its debt, but many are skeptical as to whether the US can continue to run such large fiscal deficits.
- The FRB also leaves itself open to accusations of arbitrariness in conducts of “unconventional” monetary policy. Even if we ignore last year’s investment bank rescues, the FRB should not have the power to choose which institutions will be rescued. While an undercapitalized banking sector would incidentally cripple the BOJ’s operations to support corporate finance because those operations require banks to assume

credit risk, such operations have successfully provided large amount of funds to banks so far. Yields in the BOJ’s CP buying operations are only slightly higher than normal, whereas in the FRB’s TALF program participants are paying a significant penalty, with a typical spread of 200bp over OIS.

##### **Mr. Takata :**

- In Japan’s last crisis the BOJ extended substantial credit to the Deposit Insurance Corporation. This seemed an inevitable action for a central bank because the loans were guaranteed by the government and credit easing activities were mostly limited to purchases of shares from bank equity portfolios. This time, however, there has been no debate over why Japan should engage in credit easing. The central bank is granted independence because professional expertise is required for it to achieve price stability. It is difficult to understand why the BOJ would give up its independence so easily after guarding it so closely in the last crisis, when conditions were more severe. Functions of bank supervision give the BOJ a good understanding of conditions at individual banks. The BOJ has the wherewithal to engage in credit easing activities based on this information, and it could do so under an explicit agreement with the government.
- The FRB’s credit easing measures are constrained by the requirement that assets acquired under the program carry a certain credit rating. However, there are a number of practical issues in terms of risk management, including uncertainties about the reliability of the ratings themselves. Purchases through the credit easing program should be limited to assets that can no longer be priced because of market dysfunctions.

##### **Mr. Fukuda:**

- Central banks’ inability to resuscitate troubled companies prevents them from showing companies how to run their businesses better. Similarly, policy lenders are unsuited to the provision of liquidity because they lack settlement functions. Any central bank engaging in credit easing should exit as soon as the problems are resolved. Loans extended by a central bank as LOLA has the highest priority. Quantitative Easing can mitigate liquidity risk but also have the side-effect of propping up entities that should no longer be in the market.
- Japan is characterized by heavy political opposition to fiscal outlays and higher taxes, while central bank funds tend to be freely used. In the previous financial crisis, the BOJ not only extended credit to the Deposit Insurance Corporation but also lent to a handful of banks. The biggest question is how to maintain discipline.

##### **Mr. Yanagawa :**

- From a public standpoint, it may be that there is little sense in worrying about holes in the central bank’s balance sheet as long as the government will eventually fill them. Calling on the

central bank to manage its balance sheet properly is meaningful in the sense of instilling discipline. However, an excessive focus on balance sheet health during times of crisis can prevent the central bank from administering necessary policies, which in turn can take a heavy toll on the economy. Of course it is difficult to achieve a balance between discipline under ordinary circumstances and flexibility during emergencies. Various problems remain, including the establishment of decision-making criteria for crises and the question of how far to depart from ordinary standards at such times.

**Inoue <Secretary> :**

- The BOJ took the unusual step of injecting capital into individual financial institutions during earlier period in the last crisis largely because the legal framework for handling financial institution bankruptcies was immature. The US has faced a similar problem in the current crisis.
- In its credit easing operations, the FRB seems to be to some extent engaged in careful risk management via the establishment of penalty rates of interest and ratings requirements for assets to be purchased.
- Market participants are particularly concerned about the relationship between the central bank's balance sheet and its independence, and the ability of a central bank to provide a convincing explanation will be important going forward.

### 3. Adjournment

**Inoue <Secretary> :**

- It is all the more significant to discuss "conventional" monetary policy when it takes time to restore stability of financial system and fundamental economy is to deteriorate further. We need to continue our discussion of this topic from new perspectives, taking account of some interesting issues presented today such as revaluation of Quantitative Easing and governance over a central bank's policy actions.

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