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featuring

Masaaki Shirakawa

Governor of the Bank of Japan

"Society, Economy and the Central Bank"

Introduction

Even as the world is practically getting smaller, with the remarkable advances in transportation and communications technologies, and with all the resulting increases in interaction among peoples and economies, foreign policy is, unfortunately, something that is all too often put on the back burner by people busy with their daily lives. This is why the activities of the Foreign Policy Association are so invaluable. Since its foundation in 1918, for nearly a century, the Association has served as a catalyst for developing awareness, understanding of, and providing informed opinions on global issues. I am honored, therefore, this evening, to receive the FPA Medal, whose past recipients include many people I respect very much.

Today, I will offer my views on the recent Global Financial Crisis, which, from the viewpoint of central banks, was the most important international development of the past few years. In doing so, I will not comment on the Crisis itself, on which a lot of ink has been spilt already, but on the issues that the Crisis has raised concerning the role of central banks in relation to the well-being of the society at large. As the Crisis is bound to leave indelible marks on the global economy, it would probably affect how central banks would conduct their business in the future.

In this Crisis, as I will later explain, central banks have succeeded in deflecting the destructive forces in the acute phase, by injecting unprecedented amounts of liquidity into the financial system and by rolling out massive monetary easing. Now, the Crisis has moved into the chronic phase, characterized by low growth and persistent unemployment. In this regard, many more challenges certainly lie ahead, before we can even take back the lost ground and make further advances from there.

One reminder that prosperity is quite fragile can be found in *The Economic Consequences of the Peace*, by John Maynard Keynes.[1] I believe it is rather fitting to quote his writing today, considering that FPA was founded to promote the "Just Peace," advocated by President Wilson, who led the U.S. delegation to Versailles, and that the collective failure of the international community to achieve that goal at Versailles prompted Lord Keynes to write the book. Lord Keynes describes the world before the First World War as "economic Eldorado" or "economic Utopia," where a middle-class Londoner could easily "order by telephone...the various product of the whole earth," "adventure his wealth...in any quarter of the world," and "secure...cheap and comfortable means of transit to any country." Furthermore, this state of affairs was regarded "as normal, certain and permanent, except in the direction of further improvement." Whenever I read this passage, I am always struck

1 Keynes, John Maynard, *The Economic Consequences of the Peace*, 1919.

by the power of globalization in bringing about economic prosperity, the ephemeral quality of such achievement in the light of the two World Wars, and the parallel with our experiences leading to the Great Financial Crisis.

I. The Changing Economy and Central Banking

In our current discourse on economic policy, or more broadly the whole economy, no one would doubt the critical stabilizing role played by central banks. Nevertheless, economic history after the Second World War reveals that such a view is quite a recent product. The enhanced role of central banks came into being on the back of three important changes.

Firstly, there is now a clear division of labor between monetary and fiscal policies. To our eyes, such an arrangement seems too obvious, but during the War, in many countries including the United States and Japan, monetary policy was subordinated to fiscal policy. Central banks were doing all they could to finance the war effort, and there was no room for independent monetary policy. In fact, monetary policy continued to be constrained for some time after the War. For example, in the United States, the Fed was freed, in 1951, from the obligation to maintain long-term interest rates below a level set by the Treasury, after arriving at the so-called "Accord" between the Treasury and the Fed.[2]

Secondly, there is no longer any doubt about the role of monetary policy. It is widely accepted that monetary policy should be an important stabilizing force for the macro-economy. During the 1960s and as late as the first half of 1970s, an influential school of

[2] Bernanke, Ben S., "Lecture 2: The Federal Reserve after World War II," The Federal Reserve and the Financial Crisis, Chairman Bernanke's College Lecture Series, March 22, 2012. http://www.federalreserve.gov/newsevents/lectures/about.htm

thought, now more or less discredited, held that a slightly higher inflation was a necessary evil for achieving stronger growth and fuller employment. As monetary conditions were relaxed and tightened discretionarily with such a bias over a number of business cycles, inflation, both actual and expected, began to creep up quite noticeably. It became evident that higher inflation was not contributing to higher growth or employment. Furthermore, the distortions in the savings and investment decisions of economic agents and in resource allocation resulting from higher inflation became a drag on growth. This was how stagflation of the late 1970s came into being. This unpleasant experience taught us that economic growth could only be sustained with price stability, and price stability should be the goal of monetary policy.

Finally, against the backdrop of the first two changes, central banks are nowadays granted formal independence. If central banks are to pursue price stability, they should be able to conduct monetary policy from a medium to long-term perspective, away from short-term concerns. This is legally secured by recognizing the independence of central banks in national laws. Looking back, there were not many central banks that had statutory independence in the 1980s. The situation changed markedly during the 1990s, when many countries, including Japan, revised their central bank laws. The new laws clearly stipulated the independence of the central banks in conducting monetary policy.

These changes were the basis of the new institutional framework for the conduct of monetary policy, which emerged from the second half of 1980s and into 1990s. At the core of the new framework was the linkage between independence and the mandate to ensure price stability. In other words, central banks are held strongly accountable for achieving price stability, in return for being granted independence. The increasing adoption of inflation targeting from the second half of 1980s and into 1990s symbolizes this development. In the context of this transformation, there was also a slight shift in the traditional mandate granted to central banks regarding the regulation and supervision of financial institutions. Under the view that price stability and financial stability are two distinct objectives, and in order to avoid concentrating too much power in one institution, at some central banks, for example at the Bank of England, regulatory and supervisory functions were carved out and transferred to another organization, thereby letting central banks to focus solely on monetary policy.

As this new framework of monetary policy was being accepted over the 1990s, many developed economies experienced a prolonged period of both relatively high growth and stable prices. The age of Great Moderation had come. The phrase, which seemed to have appeared shortly after the turn of the century, quickly gained popularity, capturing the optimistic mood of the times, and central banks were praised for their substantial role in bringing about prosperity. In a sense, the 1990s and 2000s, up until the Crisis, were, in fact, the heyday of central banking.

One exception, however, was Japan, which experienced a prolonged period of sub-par growth and modest but persistent deflation. Actually, Japan was experiencing profound changes in the economy ahead of other developed economies. While Japan had suffered severe stagflation at the time of the first Oil Crisis of the 1970s, its subsequent economic performance was superior compared with other developed economies, reflecting the restraint in wage increases and appropriate monetary policy. The bubble years of the second half of 1980s were, in this vein, the culmination of all that was good about the Japanese economy. The bubble burst in the 1990s, and Japan has since been suffering from its lingering effects.

It is quite remarkable that economies in North America and Europe are now experiencing the same changes that Japan has experienced from the 1990s onwards. Since 2006, the

United States has experienced a drawn-out period of declining house prices. This was only the beginning. Financial strains quickly spread around the world engulfing many venerable names both in the United States and Europe, and leading to, but not ending with the demise of Lehman Brothers. As governments and central banks intervened aggressively, the global financial system and the economy subsequently gained a respite, but it was short-lived. Beginning from the spring of 2010, cascading problems within the euro area weighed on global economic activity and heightened uncertainties. Consequently, output in the developed economies is only 4 percent above the pre-crisis peak, and average growth since 2007 is a paltry 0.8 percent.

What went wrong? What can central banks do to prevent the development of another disruptive bubble? Policy makers are certainly in the midst of soul-searching, regarding the conduct of monetary policy and the regulation and supervision of financial institutions in the years leading to and during the crisis. Today, I will just stress one point, considering that I have already explained my thinking on another occasion.[3] The key issue is that price stability and financial stability are intricately intertwined. In an environment of price stability, economic agents may come to expect ever more strongly that a prolonged period of low interest rates would be sustained. This could exacerbate financial imbalances, such as increasing asset prices or leverage. Taken too far, such imbalances would destabilize the

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[3] For lessons of asset bubbles and financial crisis, see the following.
Masaaki Shirakawa, "Revisiting the Philosophy behind Central Bank Policy," Speech at the Economic Club of New York, April 22, 2010.
http://www.boj.or.jp/en/announcements/press/koen_2010/ko1004e.htm
Masaaki Shirakawa, "Deleveraging and Growth: Is the Developed World Following Japan's Long and Winding Road?" Lecture at the London School of Economics and Political Science (Co-hosted by the Asia Research Centre and STICERD, LSE), January 10, 2012.
http://www.boj.or.jp/en/announcements/press/koen_2012/ko120111a.htm
Masaaki Shirakawa, "Central Banking: Before, During, and After the Crisis," Remarks at A Conference Sponsored by the Federal Reserve Board and the International Journal of Central Banking, March 24, 2012.
http://www.boj.or.jp/en/announcements/press/koen_2012/ko120326a.htm

financial system, which would then lead to unacceptably large fluctuations of real economic activity and ultimately prices. In this vein, monetary policy must take account not only of inflation but also of financial imbalances, and it must attempt to look beyond the conventionally accepted time horizon. At the same time, it has also become clear that it is not appropriate to purge non-monetary policy functions from central banks, and that central banks must maintain at least some regulatory and supervisory functions over financial institutions.

Apart from these somewhat abstract challenges of tomorrow, today, central banks are still confronted with numerous challenges, resulting from the recent global economic and financial turmoil. What can central banks do in this difficult environment? The answers are inevitably unique to each central bank, but let me identify some common emerging themes.

II. Central Banking Today

Currently, many central banks are implementing measures that were unthinkable only a few years ago. As interest rates are cut to almost zero, there is no longer any room for conducting monetary policy in the traditional sense. Consequently, central banks are now conducting so-called unconventional monetary policy. This fact is reflected in the most significant increases in the size of central bank balance sheets. The composition of balance sheets has also changed considerably. In the case of the Bank of Japan, over the last ten years, it has purchased commercial paper (CPs), corporate bonds, equities, exchange-traded funds (ETFs), and real estate investment trusts (REITs). Looking at the Fed, it has purchased various risk assets, such as mortgage-backed securities. Meanwhile, at the end of last year and in February this year, the European Central Bank (ECB) supplied an unlimited amount of three-year loans to banks. Furthermore, on interest rate developments, the Bank of Japan has made clear its commitment and the Fed has announced its guidance. Unfortunately, notwithstanding these efforts, growth in the developed economies remains anemic, as I noted a few minutes ago.

When conducting monetary policy in such an environment, central banks must be aware of three socioeconomic trends.

Firstly, in many developed economies, there are heightened expectations on what central banks could deliver.[4] In this regard, one of the most symbolic discussions touched upon the measures that could be unleashed by the ECB in the context of the euro-area financial crisis. As an analogy to the lender of the last resort function to banks, which is an important and established function of central banks, some have forcefully argued for increasing the Bank's supply of liquidity through a novel and untested function -- a lender of last resort to governments.

There are probably several reasons for the elevated expectations. Probably, the most important one is the prolonged period of low growth and high unemployment. Another factor is the increasing constraints on the conduct of fiscal policy, reflecting the dire straits of government finances in most developed economies. In fact, the outstanding amount of government debt relative to the size of the economy in G7 countries is fast approaching levels not seen since the end of the Second World War.[5] Furthermore, one could also point out that central banks can act quickly -- they can put up a huge wall of money almost instantaneously. This could be most relevant given the differences in the speed demanded by markets for results and the amount of time that is necessary for the democratic process to agree on and implement fiscal and structural policies.

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4 See Hannoun, H., "Monetary Policy in the Crisis: Testing the Limits of Monetary Policy," Speech at the 47th SEACEN Governors' Conference, 13-14 February 2012.

However one interprets what is happening now, there is a potentially toxic mix of heightened expectations regarding central banks on the one hand and what central banks could actually deliver on the other. If central banks cannot deliver, public confidence in the institution will be eroded. This, to which I will come back later, will impact the efficacy of central bank policies.

Turning to the second issue, I would like to draw your attention to the blurring of the line between monetary and fiscal policies. As I have just explained, unconventional monetary policy of central banks involves the purchases of substantial amounts of long-term government bonds and/or risk assets. The value of these assets, in the long run, may fall, and when that happens, losses incurred by the central bank will have to be passed on to taxpayers in the form of reduced profit distribution from the central bank to the government.

Additionally, these purchases will inevitably influence micro-level resource allocation. In these respects, unconventional monetary policy is getting closer to fiscal policy. Considering that, in a democracy, the delegation of the power to issue unlimited amounts of legal tender to an independent central bank can only be justified by the tacit understanding that it will not overstep into the realm of fiscal policy, the adoption of measures bordering on fiscal policy could ultimately undermine the legitimacy of central bank independence and public trust in the institution.

The third and final issue is a corollary to the first two issues. Reflecting the fact that central banks are introducing heretofore untested measures, public opinion is beginning to diverge widely on the desirable course of action by central banks. One example is the policy proposal for ECB that I have noted a few minutes ago. In the United States, monetary easing

[5] See Haldane, Andrew G., "Risk Off," August 18, 2011.

by the Fed is criticized by those who fear the consequence of inflation, while there are many economists who believe additional easing is warranted in view of the slightly falling but still stubbornly high unemployment. Also in Japan, there is a heated discussion on monetary policy and fiscal consolidation.

III. The Capacity and Limits of Central Banking

Up till now, I have explained the significant economic and social changes evident in the operating environment for central banks. The role of central banks, whether it should or should not change, needs to be carefully deliberated in the context of these changes. If I may jump to the conclusions first, it is dangerous to both over- and underestimate what central banks could achieve. Central banks must act correctly.

What Central Banks Can Do

One thing that central banks can always do is to stamp out inflation. No matter how severe inflation is, conceptually, it can be contained by monetary tightening. In the history of mankind, severe inflation has never been defeated without tightening. Nevertheless, it should also be noted that conceptual possibility and practicality is not the same. Statutory independence is not sufficient. Timely and appropriate policy requires something more. Central banks should not waver in the face of unpopularity and the society at large must be ready to acquiesce.

Another important thing that central banks can achieve is to prevent the meltdown of the financial system through its lender of the last resort function to banks. This is the most important role in view of preventing the economy from falling into a severe deflation. Reflecting on the Japan's financial crisis of the late 1990s and the recent Financial Crisis, missteps in policy could have resulted in a much worse outcome, perhaps akin to the Great

Depression of 1930s. The most important difference was that central banks acted as the lenders of the last resort. Shocks could be dampened through central bank actions that mitigated the loss of trust among private economic agents, which hindered the use and acceptance of privately created money. The central bank could stand between two private counterparties and provide its money, which would be unconditionally accepted. The central bank is the only institution that could play this important role in a financial crisis. Furthermore, in a crisis environment, it also becomes imperative to maintain the efficient and uninterrupted functioning of the systems and arrangements through which money and other financial instruments flow. The working of what one might call the plumbing of the financial system requires constant attention, and central banks have, over the last two decades, made various efforts to improve its resilience, for example, promoting real-time gross settlement (RTGS), ensuring delivery versus payment of securities (DVP), and introducing simultaneous settlement of foreign exchange claims. Such exercises are not glamorous but central bank veterans are pleased to reflect on their achievements, which probably contributed considerably in preventing chaos after the recent collapse of Lehman Brothers.

What Central Banks Cannot Deliver

While central banks can achieve a lot, we should not have the illusion that there are no limits to the power of central banks. Central banks cannot reasonably deliver solutions to structural issues.

Let me take the current problems in the euro area as an example. The situation in the euro area, whose troubles became evident around the end of 2009, significantly deteriorated since the summer of last year. The fire sales in the government bond markets of the so-called periphery countries led to a vicious cycle of worsening fiscal balance, increasing tensions in the domestic banking system, and dampening of real economic activity. With a view to arresting and hopefully reversing this destructive momentum, ECB has conducted two operations, once at the end of last year and another at the end of this February, supplying an unlimited amount of three-year funds. The subsequent return of relative calm to global financial markets demonstrates that central bank liquidity can play an important role. At the same time, it must also be impressed that liquidity provision has only bought time. One must not lose sight of the fundamental issues, one of which is the current account imbalances within the euro area. When the euro was introduced in 1999, interest rates for all member economies converged on one low level. This led to credit expansion in the periphery, which, at the same time, lost competitiveness because of increases in wages and prices. Now, policies must be put in place to address the root causes of the problem. Structural reforms must be implemented within the breathing space provided by the provision of central bank liquidity. If complacency sets in because of the improvements in market sentiment, we could be headed for a worse outcome. Time bought can equally be usefully spent or wasted.

Structural issues are everywhere in the developed economies. Japan is no exception. The Japanese economy has stagnated and the rate of growth is sub-par among the major economies. Given that the ten-year average per capita GDP growth is comparable to other developed economies and per worker growth is the highest among its peers, the challenges facing Japan is not demography per se, but adapting to the rapidly changing demography, which no other country has so far experienced. The low aggregate growth and the huge fiscal hole are both largely the symptoms of the failure to adapt to the demographic reality. The modest deflation is, in turn, largely attributable to the lower growth outlook impacting expected future income and hence current spending.

Monetary policy influences economic activity and hence prices in two stages. Firstly, the central bank influences the financial conditions, and secondly, the resulting financial conditions influence the spending decisions of firms and households. Considering that the Japanese financial conditions are probably the most expansionary among developed economies, the failure of Japan to shake off modest deflation can mostly be explained by its deteriorating growth potential. In this sense, if the Japanese economy is to extricate itself from deflation and return to a path of sustainable growth under price stability, it requires both policies aimed at enhancing growth potential and supporting monetary stimuli. This is why the Bank of Japan is fully committed to continuing powerful monetary easing through various measures, including maintaining the policy interest rate at practically zero and purchasing financial assets, until the current goal of year on year CPI inflation at 1 percent is deemed to be achievable.

IV. Realizing the Full Potential of Central Banking

The ultimate objective for central banks is to realize stable and sustainable growth. Operationally, this is going to be achieved through the stability of prices and the financial system. Having said that, it must also be stressed that this goal is not pursued in a vacuum. Such growth can only materialize through the intricate interaction among various economic agents -- households, firms, financial institutions and the government -- each dynamically pursuing their own goals. While the central bank is probably the actor most responsible for ensuing price stability in a steadily expanding economy, some conditions must be met before the central bank could make the most of its potential. Those conditions have not always been appreciated, but our experiences after the recent global financial turmoil have brought them back in focus.

The first condition is ensuring the sustainability of public finances.[6] When doubts arise over

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[6] See Masaaki Shirakawa, "Sustainability of government debt: preconditions for stability in the financial system and prices," Banque de France, *Financial Stability Review*, No. 16, April 2012, forthcoming.

fiscal sustainability, serious efforts are required to regain confidence. If this is unsuccessful, the only plausibly available options are either inflation or outright default. The operational objectives of the central bank, price stability in the first instance and financial stability in the second will be compromised, with dire consequences for economic activity and the welfare of the people. In this sense, the sustainability of public finances is an essential condition for the central bank to realize its ultimate objective.

The second condition is maintaining the credibility of the central bank among the general public. Economic agents can be savers or borrowers, exporters or importers, and while some may benefit from the actions of the central bank, others may lose out. The pain in the short term could be considerable. As a result, it is most important that the general public truly believes that the central bank is acting to maximize the medium- to long-term potential of the whole economy. To begin with, if the central bank is not credible, it may even end up not being able to implement measures that it deems necessary. Furthermore, the effectiveness of the measures heavily depends on expectations formed against the background of credibility. The time-honored reluctance of central banks to enter into quasi-fiscal measures is based on the deference of neutrality, i.e., the need to be seen as not meddling with the allocation of scarce resources, which is crucial for maintaining independence. In this context, the unconventional policies currently implemented by central banks of the major developed economies will truly be tested when central banks deem that the policies are no longer necessary. The appropriateness of the policies will inevitably be judged by how quickly and smoothly such policies could be unwound. The tricky issue is that expectations and credibility are not necessarily malleable or may not behave predictably. While central banks must be bold in times of crisis, they need to be most vigilant at the same time.

The third condition is upholding the public support for the market economy. While this goes beyond central bank policies, it is most relevant because all the policies adopted by the central bank presuppose the existence of a competitive market economy. Such support can easily be eroded when the public at large comes to believe that the decks are stacked against them. The increase in unemployment following the recent financial crisis, the widening of the wage gap between skilled and unskilled workers due to deepening globalization, and the antipathy against banks and bankers rescued by taxpayer money, could all result in the weakening of support for a competitive market economy. In the long run, this could pave the way for the adoption of policies that are detrimental to the efficient functioning of the economy. One of the lessons learned from the interwar years in the first half of the twentieth century was that crisis response begets the next crisis, then epitomized by the spread of protectionism and beggar-thy-neighbor competitive devaluation. Policy makers, including central bankers must not forget such lessons of history.

V. Concluding Remarks

In his recent book, the influential author Robert Shiller notes that "Central banks are an invention that served its purpose at a certain time in history, in a certain kind of environment," and goes on to say that their time may have passed.[7] Central banks could not prevent the bubble and the following Crisis. Nevertheless, as I have explained today, the role of central banks has evolved over the years and that process is continuing or has even accelerated after the Great Financial Crisis.

Our economic system, while bringing us unprecedented prosperity, is an inherently unstable creature because of its dynamism. If the peoples of the world are to maintain, let alone further improve, their current lifestyles, policy makers, including central banks, must not let

[7] See Shiller, Robert J., *Finance and the Good Society*, Princeton University Press, 2012.

the various currents unleashed by the Crisis threaten the foundations of an affluent society. In an ideal world, if we could understand and model why you decided to have latte instead of espresso this morning, it could be possible to design an automatic stabilizing mechanism for the economy, and central banks would become only a chapter in economic history books. Nevertheless, being a complex system that involves people and their emotions, managing the economy will probably remain an art rather than a science, where human actors, who can learn from the past and adapt accordingly, have to play a leading role. Automatic stabilizers and mechanical rules would not work. Continuing this process of learning and adapting, I believe, is at the core of the challenges facing central banks at this juncture, and if central banks can meet those challenges, central banks will still be able to fully serve the good society.

Thank you very much.