

COMMENTS ON PAUL TUCKER'S REMARKS

*(" THE POLITICAL ECONOMY OF CENTRAL BANK
BALANCE SHEET MANAGEMENT ")*

Masaaki Shirakawa

Aoyama Gakuin University

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Paul Tucker's remarks

- Very rich and thoughtful. I learned a lot.
- I strongly agree with the central message: to have a set of principles for delegation to unelected power in a democratic society is extremely important in the context of monetary policy or more broadly central bank policy.
- Monetary policy implementation sounds more technical than monetary policy but in reality, issues surrounding the former are much deeper, in a situation where central bank has been pushed to deploy various unconventional monetary policy with serious fiscal implications for extended period of time.
- Actually, issues that Paul Tucker raised were quite at the heart of the policy debate in Japan in the past 20 years! So, I would like to reflect on BOJ's experience in light of issues raise by Paul Tucker.

BOJ adopted various unconventional measures with significant fiscal and/or allocative implications

Under the old BOJ Act (until March 1998)

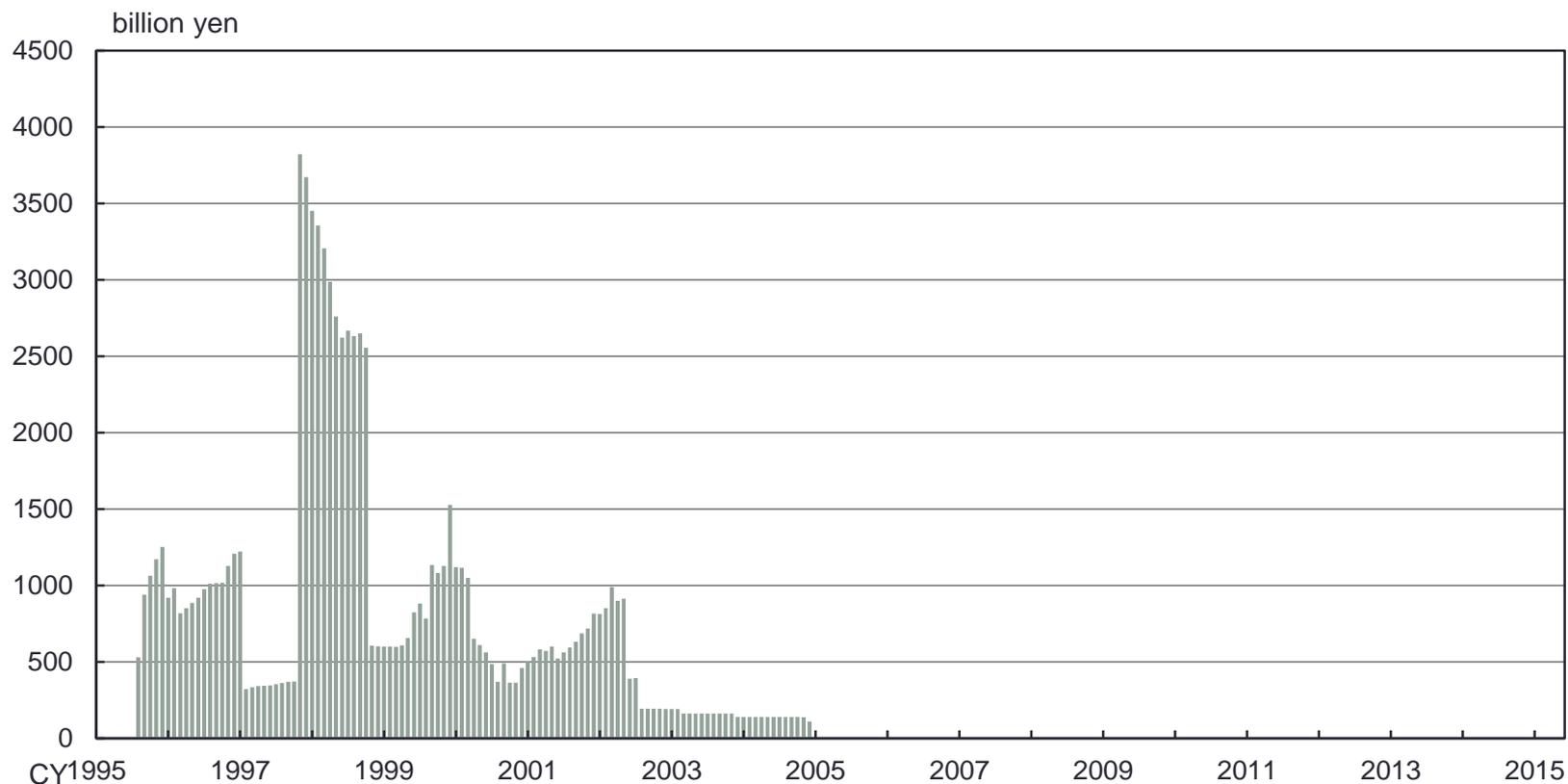
- Commitment to provide unlimited amount of liquidity to Yamaichi Securities to facilitate its orderly resolution (1997)

Under the new BOJ Act (since April 1998)

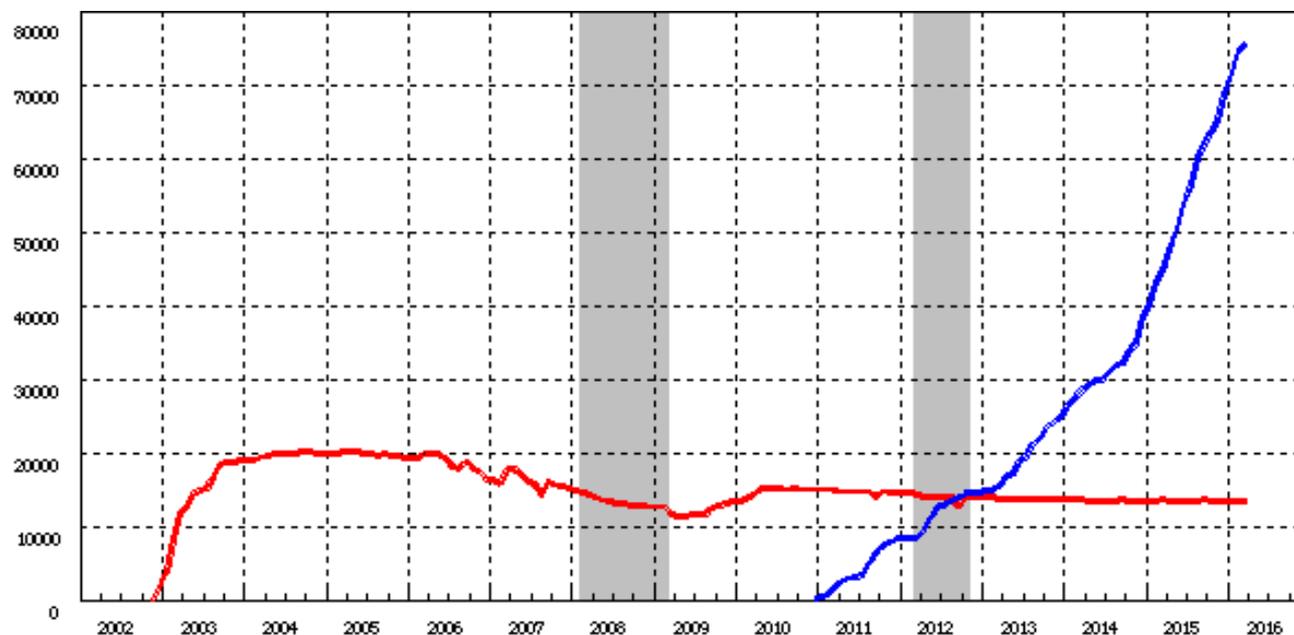
- Purchase of stocks held by financial institutions (2002-2004, 2009-2010)
- Purchase of ABCP and ABS (2003-2005)
- Purchase of CP and corporate bond (2009)
- Purchase of CP, corporate bond, ETF and REIT (2010-)
- Aggressive purchase of JGB

Bank of Japan's "special loan" outstanding

Loans Pursuant to Article 38 of the Bank of Japan Act (Article 25 of the old Bank of Japan Act)

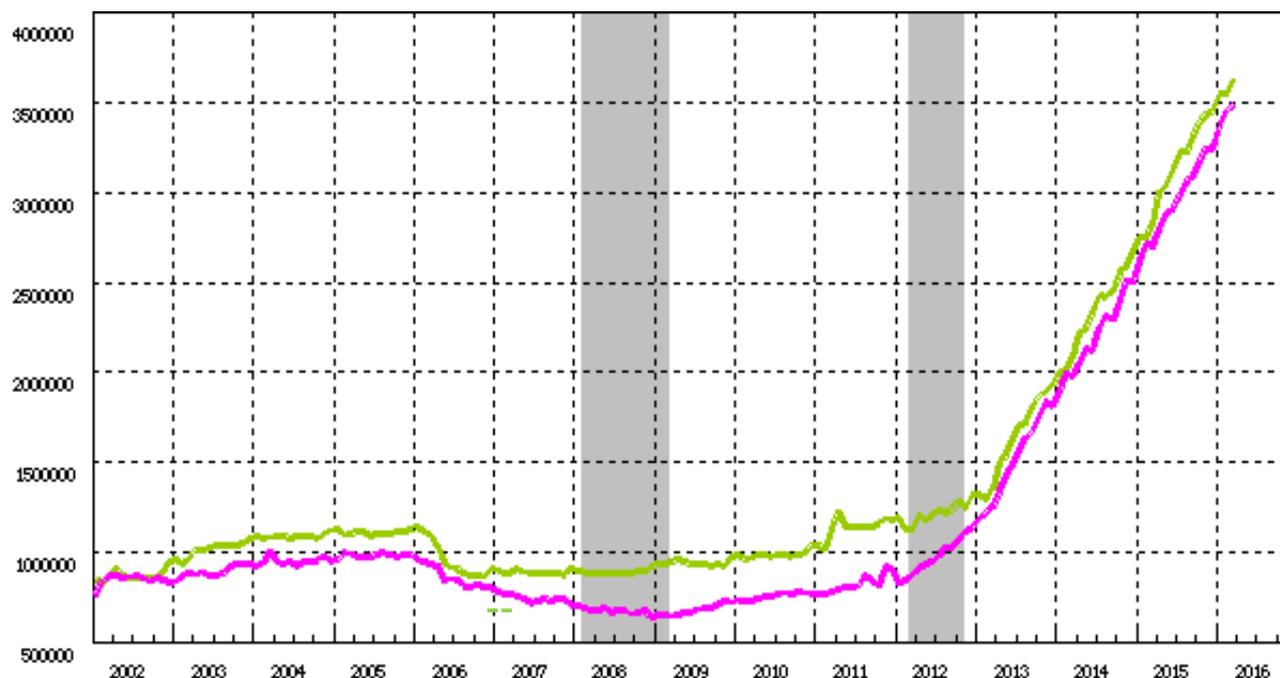


BOJ's purchase of stocks held by banks and ETF



-- **stocks** 1.3 trillion yen (as of March, 2016)
-- **ETF** 7.6 trillion yen (as of March, 2016)

BOJ's purchase of JGB and expansion of monetary base



monetary base 362 trillion yen (as of March, 2016)

-- JGB 349 trillion yen (as of March, 2016) . 69.1% of nominal GDP

There issues that BOJ had to consider in deciding on such unconventional measures

1. Does BOJ Act allow such measures?
2. Are they effective in terms of stated goal (avoiding collapse of financial system, maintaining credit intermediation functioning, achieving price stability etc.)?
3. Given significant fiscal and/or allocative implications, what kind of institutional arrangements are necessary and desirable in a democratic society?
 - Predetermined demarcation between the government and central bank?
 - Some sort of government backing?
 - indemnity by the government?

#1. Legality: Pre-crisis legislation or post-crisis legislation?

- The new BOJ Act was enacted in April 1998.
- Japan was already faced with severe financial crisis at the time of the change of law which made BOJ Act somewhat different from typical central bank act enacted in the same period (ECB, BOE, etc.).
 - Explicit recognition of financial system stability as the purpose of central bank
 - Explicit stipulation of the process of enabling extraordinary measures (special lending to financial institutions with insufficient collateral, the purchase of instruments not stipulated in BOJ Act etc.)

New BOJ Act

- The purpose of the Bank of Japan, or the central bank of Japan, is to issue banknotes and to carry out currency and monetary control. (Article 1(1))
- In addition to what is prescribed in the preceding paragraph, the Bank of Japan's purpose is to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of stability of the financial system. (Article 1(2))
- “Buying and selling of commercial bills and other negotiable instruments (including those drawn by the Bank of Japan in this item), national government securities and other bonds, or electronically recorded claims” (Article 33 (1) (iii))
- The Bank of Japan may not conduct any business other than that specified by this Act as the business of the Bank, provided, however, that this shall not apply to the case where such business is necessary to achieve the Bank’s purpose specified by this Act and the Bank has obtained authorization from the Minister of Finance and Prime minister. (Article 43 (1))

2. Effectiveness: It depends on situation that central bank wants to solve

- Measures of LLR nature in a crisis situation were quite effective
 - Commitment to provide unlimited amount of liquidity to Yamaichi to facilitate its orderly resolution (1997)
 - Purchase of stocks held by financial institutions (2002-2004, 2009-2010)
 - Purchase of CP (2009)
- On the other hand, the effectiveness of monetary policy in a more normal period seems to be rather modest, though it is hard to know “counter-factual.”
 - The essential mechanism of monetary easing is to bring forward future demand to the present. Therefore, as more aggressive and prolonged monetary easing is, its effectiveness tends to be diminishing.

3-1. Institutional arrangements: Predetermined rule of demarcation

- Writing meaningfully “complete contract” in advance is not so easy. We had reasonably good predetermined rules, in that BOJ Act is relatively “complete”.

Purchase of instruments not stipulated in the BOJ Act

- Consistency with the purpose of BOJ stipulated in BOJ Act
- Government’s approval

Special lending

- Consistency with the purpose of BOJ stipulated in BOJ Act
- BOJ can initiate such measure with the approval of the government. Or government can request BOJ to do such measure, on the condition that it is approved by BOJ’s Policy Board.

#3-2. Institutional arrangements: BOJ did not seek indemnity by the government under new BOJ Act.

- BOJ had opted to get some sort of government backing but did not seek indemnity by the government.
- BOJ purchased stocks held by banks and ETF, REIT with the formal approval of government by resorting to aforementioned Article 43 of BOJ Act which gave legitimacy to BOJ by making government's support clear in the eye of general public.

Purchase of corporate debt immediately after collapse of Lehman

Comparing four CBs, there no uniform response.

	BOJ	FRB	ECB	BOE
Purchase	○	○	--	○
Instrument	CP, corporate bond	CP	--	CP, corporate bond, syndicate loans, ABS
Indemnity by the government	--	○	--	○
The main entity to bear loss	CB	government	--	government
The form of taking on credit risk	Outright purchase	Non-recourse loan to SVP		Loan to the fund (subsidiary of BOE)

Indemnity by the government might be a double-edged sword

- When BOJ decided on purchasing CP and corporate bond after the collapse of Lehman, we were faced with the following tradeoff;
 - Indemnity gives BOJ financial backing as well as political backing.
 - But, if BOJ were to avoid critical judgement about credit worthiness of borrower/product just because it is insulated from financial losses, joint responsibility of BOJ and government could have a bias of being too generous.
- In this regard, non- indemnity might create incentive for BOJ to carefully strike the balance, as long as BOJ has reasonably strong capital cushion.

Capital of central banks

- Capital cushion of CB gives some room for CB to act on its own, although it is so divergent across countries.
- Optimum level of capital cannot be discussed in isolation.
 - Societal understanding of the role of CB that is historically formed
 - Assessment of the speed of reaching needed political consensus
 - Trust toward technical competence of CB to cope with crisis

One last issue on demarcation. Some argued for “Accord” between BOJ and the government.

- “BOJ commits to conducting aggressive purchase of JGB to achieve inflation target”
- “The government commits to implementing economic and fiscal reform.”
- Who is the “government” to be credibly able to sign such Accord?
 - cabinet and/or parliament
 - What about future government? Six prime ministers and ten finance ministers in five year time and two changes in ruling political party.
 - Hung parliament
- Who is central bank to be credibly able to sign such Accord?
 - Governor or committee
 - What about future governor or committee member? Average remaining term of committee member is 2.5 years.