# Challenges for Central Bankers

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I am honored to be invited to the Bank of Mexico's conference on the occasion of the 20th anniversary of gaining central bank independence, and am delighted to serve as a panelist together with my former colleagues in the central banking community.

When we look back at the evolution of central banks with respect to their independence, the situation has changed significantly. Forty years ago, an independent central bank was the exception rather than the rule. Twenty years ago, the movement toward giving independence to central bank had already started. Ten years ago, an independent central bank had become the rule rather than the exception. Public understanding of the importance of central bank independence has advanced significantly, and in retrospect, culminated prior to the Great Financial Crisis. But now that we have gone through the Great Credit Bubble, the Great Financial Crisis, and the Great Recession, the situation surrounding central banks has become much more complicated.

In the next fifteen minutes, I will explain my current thinking on central bank independence based upon the experience in Japan as well as my reading of the situation faced by other central banks.

The 1990s was a decade characterized by changes in central bank law and practice. The three key ingredients were central bank independence, inflation targeting, and separation of supervision and regulation from the central bank. In the interest of time, I will focus mainly on the first. The Bank of Japan gained legal independence in 1998 through the amendment of the Bank of Japan Law that was originally enacted during wartime period. The same is true for the European Central Bank, the Bank of England and many central banks in emerging market economies including the Bank of Mexico.

The fact that changes in central bank law were made in a synchronized manner can be explained, for the most part, by the progress of financial globalization. Financial globalization is probably a necessary condition, but not a sufficient condition. Since a significant amount of political energy is consumed in amending a basic law such as the central bank law, a momentum driver is needed. Speaking of the amendment of the Bank of Japan law in 1998, it was a more of a response to public anger toward the asset bubble and its aftermath. However, its timing was not particularly favorable for the Bank of Japan, since Japan was already in the situation in which the effectiveness of monetary policy was significantly constrained due to the following factors.

- First, Japan was in the very process of balance-sheet adjustment following the collapse of huge bubble, which was further aggravated by the delay in making the political decision to cope with the massive non-performing loan problem.
- Second, Japan was already constrained by the zero-lower bound of interest rates. Overnight interbank lending rate became 0.4% in the middle of 1995 and, since 1999 became 0%, except for a very brief period.
- Third, Japan was faced with rapid aging which is unprecedented in terms of its speed in modern times. The Working-age population started to decline in 1998.

All of this was a truly strong headwind. In order to bring the Japanese economy onto a sustainable growth path, the Bank of Japan deployed all sorts of unconventional monetary policy measures. When I was first involved in implementing these unconventional monetary policy measures, I never once thought of a situation where central banks in other major advanced economies might someday be also implementing the same sort of policy measures. These efforts notwithstanding, there is no denying that such monetary policy was not powerful enough to offset the strong headwinds. On top of that, the intellectual climate fostered during the period of the Great Moderation, which I would call the “omnipotent central bank view”, was unfavorable for the Bank of Japan which was struggling against headwinds.

However, the global financial crisis and the ensuing Great Recession has changed this global landscape and put central banks in US, Euro-area and UK in more or less the same situation as Japan. The current situation surrounding central banks urges us to think through more deeply the meaning of central bank independence.

Central bank independence is understood essentially as an arrangement to deal with inter-temporal tradeoffs. The attempt at supposedly smoothing the short-term fluctuations of the economy activity conflicts, at times, with ensuring the long-term sustainability and stability of the economy. In the years after the Second World War, we have already mismanaged such tradeoffs at least twice. The first instance was in the 1970s. The ill-placed faith of governments and central banks in their ability for short-run smoothing let loose the inflation genie out of the bottle, resulting in the combination of high inflation and high unemployment, namely, stagflation.

In order to avoid such an outcome, policy makers had to pay closer attention to monetary aggregates and implement less discretionary policy. One of the concepts that gained wide acceptance was flexible inflation targeting. It was seen as an effective monetary policy framework for meeting the challenges of reducing the volatility of inflation and output by anchoring long-term inflation expectations. The result was hailed as the Great Moderation. However, it turned out that financial imbalances were allowed to be built-up in this period, which was eventually corrected violently by the Great Financial Crisis. This was the second instance of mismanaging inter-temporal tradeoffs.

Although both failures are common in that an excessive focus on short-run aspects resulted in long term instability, there is a subtle difference. In the former case, disequilibrium took the form of inflation. Tensions conceived were between governments and central banks. In the latter case, disequilibrium took the form of financial imbalances. The identification of the financial imbalances was much harder for central banks. Pressures came mainly from markets rather than politics.

My concern at this moment is that central banks may be facing another difficult situation in judging inter-temporal tradeoffs. When conditions in the real economy fall short of expectations, all eyes are on the central bank to do something. Today, central banks are rolling out every conceivable measure within their powers in order to achieve maximum employment, exit from deflation, etc., in other words, aiming at stabilizing the economy in the short run. In fact, the political establishment and more broadly the society at large are expecting more and more out of the central bank. As many people put it, the central bank is now becoming “the only game in town”.

Short term stabilization policies are meaningful and needed, if the problem we face is a temporary shortfall in demand. Even if that is the case, however, since the effect of monetary easing is, in essence, to bring forward demand from the future, there is a limit and effects would inevitably taper off at some point. On top of that, if our problem is more of a structural or supply-side nature, monetary easing cannot be the answer.

Central banks’ attempts to be accountable to such demands in this context may sometimes carry risks. If the central bank places too much emphasis on meeting demands to achieve today's stability, it might be jeopardizing tomorrow's stability. This can be called a kind of paradox of independence and accountability. The conventional rationale for central bank independence and accountability rests with reasonable correspondence between the goal, measurement of its attainment, instruments used and the body of monetary policy execution. The fundamental difficulty which we are now faced with lies in the following three points.

- First, price stability is a long-run concept which is rather hard to verify within a conventionally understood time frame.
- Second, achieving price stability calls for the efforts by other entities as well. Maintaining fiscal sustainability is crucially important. Without this, borrowing the word of Sargent and Wallace, an “unpleasant monetarist arithmetic” works. Conducting good supervision and regulation of financial institutions and executing macro-prudential policy are equally important. A central bank could be the entity for supervision and regulation and/or macro-prudential policy depending on an institutional setting in each country, but of course cannot be the entity for government finance.
- Third, unconventional monetary policy, which is a natural response on the part of central banks in the face of the zero lower bound, makes the distinction between monetary policy and fiscal policy somewhat blurred. It could undermine the perception of neutrality of central banks. Such a

situation can ultimately erode the credibility of central banks as a basis for successful monetary policy. Entering into the realm of fiscal policy could create some subtle problems of democratic accountability.

- Fourth, as Sir John Hicks once said, central banks might no longer be central to the market and become just national or local banks, as financial markets are integrated across borders. In this environment, the influence of global financial conditions, which are determined by the collective action of central banks, becomes more important. But it is inherently difficult for an individual central bank to "internalize" the spill-over and feed-back effects of its policy actions.

Bearing these difficulties in my mind, I cannot present the model of central bank independence for all seasons. Nonetheless, at least, I would like to emphasize four points which I think are important.

First, central bank independence is a sort of "capital" which society has given to central banks in order to achieve the long-run stability of the economy. Of course, it is not a blank check. The "capital" has to be utilized in an area where actions by central banks are most effective and indispensable. I think there are two such areas. One is to act as a lender of last resort in a systemic crisis. The other is to fight inflation. As for unconventional monetary policies, to what extent a central bank should deploy them in a situation without systemic instability requires careful cost-benefit analysis.

Second, deliberate efforts to incorporate financial analysis in the formulation of monetary policy are needed for central banks to be accountable in its conduct. The ultimate objective of a central bank is to best contribute to economic growth by providing and maintaining stable financial conditions. Price stability and financial stability are two facets of stable money or stable financial conditions and interrelated in a complicated manner. Central banks are already heading in this direction. Five years ago, central banks which explicitly referred to risks of financial instability in formulating monetary policy were rather few. Notable exceptions were the ECB's two-pillar approach and the BOJ's two-perspective approach. But now, both the Federal Reserve and Bank of England are respectively mentioning financial stability considerations in explaining the conditions for the exit from unconventional monetary policies.

Third, some kind of coordination mechanism for performing the lender of the last function during a crisis must be put in place. In a crisis, the distinction between liquidity and solvency is quite difficult. But, if central banks should procrastinate about acting as a lender of last resort in a systemic crisis for this reason, it would be quite detrimental to financial stability and eventually price stability. Decisive action by central banks is quite important and I think this is the most important condition for avoiding deflation. Case in point is the Bank of Japan's decision to provide unlimited liquidity to the Yamaichi Securities after massive off-balance sheet losses were revealed at the brokerage in the fall of 1997. Yamaichi, which had assets of 3.7 trillion yen or 30 billion US dollars at that time, could be regarded as the Japanese equivalent to Lehman Brothers in 2008. Yamaichi also had a sizeable presence internationally, especially in European capital markets. At that time, Japan did not have a bankruptcy law that enabled an orderly resolution of securities companies. Given such circumstances, the Bank of Japan decided to provide unlimited liquidity to the firm. This measure essentially enabled an orderly resolution of the firm, by effectively replacing all exposures of domestic and overseas market participants against Yamaichi with exposures against the Bank of Japan. The materialization of systemic risk was thus prevented. The decision to provide unlimited liquidity to Yamaichi was an extremely tough one for the Bank of Japan. It was made without knowing whether the institution was solvent or insolvent. While the Bank of Japan eventually suffered some losses, I would say that the benefits of preventing the systemic risk from materializing far exceeded these costs: in contrast to the global economy after the collapse of Lehman Brothers, Japan did not experience a sharp and significant plunge in economic activity. If the Bank of Japan had been hesitant about acting as a lender of last resort, Japan would have suffered from a deflation analogous to that observed in the US in the 1930s. The Bank of Japan's decision was made possible by our own judgment as to systemic instability and government approval. When the Bank of Japan law was amended, this treatment was refined. According to the new law, either the Bank of Japan or the government can initiate the process, but both parties need the agreement of the other. The exact mechanism for making such a decision has to be carefully designed in each country. What is crucial is the existence of timely but accountable execution of the lender of the last function in a crisis.

Fourth, cooperation among central banks in the area of banking operations is crucial. In an ideal world, international monetary policy coordination could work. But in the real world where each central bank is governed by the central bank law of its jurisdiction that focuses on “domestic stability”, the odds of success arelow and sometimes could become counterproductive. In contrast, cooperation in the area of banking operations is positive-sum game. Case in point is the US dollar swap arrangement between Federal Reserve and major central banks. The establishment of CLS with the support of major central banks is another example. In the area of banking operations, I think there is further room for advancing global cooperation.

I do not think that the four points I have just explained, address all of the difficult issues surrounding central bank independence which has become evident after the global financial crisis erupted, but I believe these are among the important elements of central bank independence in the decades to come.

Thank you for your attention.