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Japanese and US monetary policy: convergent frameworks, divergent motivation

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Executive Summary

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The BOJ and Fed's monetary policy frameworks have converged as both central banks have adopted de facto inflation targets and committed to maintaining ultra-low interest rate policies. However, the Fed and BOJ had different motivations in adopting such a framework. The former was motivated by criticism of its large-scale asset purchases; the latter, by pressure to adopt an inflation target to supply liquidity more aggressively. For markets and governments, differences in how the BOJ and Fed communicate regarding monetary policy have various implications in terms of policy effectiveness and risks.

Convergence of monetary policy frameworks

Japanese and US monetary policy frameworks have recently become very similar.

In January, the Fed publicly announced its first-ever inflation and employment targets in the form of specific "goals" to be achieved over the medium to long term. At the same time, it began publicly disclosing the policy rate forecasts of members of its policy-setting body, the Federal Open Market Committee (FOMC). These measures are primarily intended to make monetary policy more predictable for market participants and the general public. In fact, Fed Chairman Ben Bernanke has explicitly said that he believes that to achieve its inflation and employment targets, the Fed must maintain its existing ultra-low interest rate policy until 2014, in line with FOMC members' forecast.

In Japan, the BOJ newly adopted a medium- to long-term price stability "goal" in February. The BOJ had previously been publicly disclosing its Monetary Policy Board members' “understanding” of price stability, but the implications of their views were somewhat nebulous. The recently adopted price-stability goal can be construed as a target that the BOJ aims to achieve over the medium to long term. In April, when the BOJ released its updated semiannual Outlook Report, the report's fiscal 2013 CPI inflation forecast fell short of the goal, implying that the BOJ will maintain its existing ultra-low interest rate policy until fiscal 2014.

Different circumstances behind similar policy frameworks

However, the circumstances that led to the adoption of such a monetary policy framework in Japan and the US differ substantially between the two countries.

In the US, the Fed's post-crisis policy response, excluding emergency provision of liquidity in the crisis's immediate aftermath, has predominantly revolved around large-scale asset purchases. However, the Fed's "QE2" Treasury bond purchase program that ended last June was blamed for stoking commodity (particularly crude oil) price inflation to the detriment of US consumers. It was also criticized by the US Republican Party, which is opposed to excessive government intervention in markets.

Given such a political environment, it made sense for the Fed to switch to a new policy that aims to achieve clearly defined objectives by lowering long-term interest rates, not least from the standpoint of promoting housing market recovery, a key policy priority. When faced with an economic slowdown in mid-2011, the Fed's policy response was the maturity extension program, dubed as “Operation Twist”, which involves selling short-term bonds and purchasing long-term bonds. Primary objective of this new operation is lowering long-term interest rates without supplying additional liquidity. The Fed's aforementioned new policy framework likewise has the effect of suppressing shorter-end of the yield curve, through a commitment to maintain an ultra-low policy rate.

The BOJ, by contrast, adopted its new policy framework in response to mounting pressure to become more proactive in supplying liquidity. Such pressure stemmed from recognition that halting deflation is a key policy priority for Japan. Meanwhile, some observers cited the relative dearth of liquidity supplied by the BOJ as a factor contributing to the yen's appreciation and asserted that the BOJ must supply liquidity more aggressively to halt yen appreciation. Given that yen appreciation has a deflationary impact on domestic prices, these criticisms can be regarded as two sides of the same coin.

The BOJ's critics demanded that the BOJ adopt an inflation target to ensure that it supplies ample liquidity. The BOJ's current monetary policy framework is very similar, except with respect to accountability, to “formal” inflation targeting as practiced by other central banks, most notably the Bank of England. Significantly, the BOJ simultaneously adopted a monetary policy framework similar to the Fed's in the aim of curbing yen appreciation and, like the Fed, has implicitly committed to maintaining an ultra-low interest rate policy until 2014.

Communication differences and their implications

A widely cited difference between Japanese and US monetary policy is communication style. This difference is commonly attributed to the personalities of the two central banks' chief executives.

Fed Chairman Bernanke has an image of being always proactive, confident in his explanations of monetary policies' effects, and emphatic that the Fed still has effective policy tools that it stands ready to utilize if financial or economic conditions worsen. In contrast, BOJ Governor Masaaki Shirakawa has an image of being always cautious and having a strong tendency to emphasize monetary policies' unintended consequences. He is also seen as having a frequent habit of hinting that the BOJ has few remaining policy tools and being hesitant to utilize them, even when financial or economic conditions deteriorate.

Whether such perceptions are accurate is a matter for readers to decide for themselves, but they have important implications from two standpoints.

From the standpoint of a central bank's relationship with financial markets, entrenched perceptions such as those mentioned above with respect to the BOJ are clearly undesirable in terms of policy effectiveness. With nominal policy rates at the zero bound, both the BOJ and Fed undeniably have few remaining policy tools. Under such circumstances, it becomes more important for a central bank to maintain markets' confidence in the effectiveness of its policies. This point is clearly evident from the fact that the effectiveness of a central bank's commitment to maintain an ultra-low interest rate policy depends on whether financial market participants consider the commitment to be credible. If a central bank emphasizes the unintended consequences of its policies, markets have to be cognizant of the risk of the bank scaling down its policy response or shifting from one policy to another in a manner that detracts from the policies' effectiveness.

From the standpoint of a central bank's relationship with the government, entrenched perceptions like those described above with respect to the Fed pose a risk of reducing the government's incentive to expeditiously take necessary policy actions. Both Japan and the US face a common long-term challenge of fiscal consolidation. Moreover, the US, the epicenter of the recent financial crisis, still faces severe problems in its housing and job markets. Although the Fed can ameliorate these problems to some extent through such means as suppressing long-term interest rates, the main player in terms of policy response is the government. The Fed's monetary policies basically buy time until the government acts. Yet, if a central bank emphasizes that it is practically omnipotent and willing to continue to flexibly pursue a variety of policy measures one after another, the government will feel little urgency to swiftly adopt appropriate policies while the central bank is buying time.

The best option for both the BOJ and Fed is to speak soothingly to the markets while calling upon their respective governments to do what is necessary. Whether central banks can be induced to adopt such a split personality is debatable, but now that they have lost their conventional policy tool of lowering policy rates while there governments confront various policy dilemmas, the BOJ and Fed must attempt to walk such a tightrope.

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