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# A "global standard" for central banks

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## BOJ adopts "global standard" inflation target…

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With the Kuroda BOJ's announcement of unprecedented easing measures, it is perhaps easy to forget the significance of the Bank's adoption of an inflation target already in January, given the long years of debate that led up to that event.

When Shinzo Abe revived the subject of an inflation target last autumn, proponents argued that both the Fed and the ECB had adopted flexible inflation targets (as had the BOE in practice, even though it was officially a hard target), and that this sort of framework had become a global standard of sorts. The Shirakawa BOJ ultimately adopted this view and was able to justify an inflation target.

Proponents' views are based on a proper understanding of the western monetary policy framework, and there is in fact a global standard in the sense that central banks in nearly all the developed economies have introduced similar frameworks—assuming we ignore the differences in economic structure underlying the 2% target and the fact that western central banks' inflation targets are not binding at least for the time being.

Since the financial crisis, however, western central banks have established another "global standard"—namely, a greatly expanded role for themselves in maintaining financial stability. The Fed traditionally served as the primary supervisory authority for certain types of financial institutions, but that role has now been broadened to include all systemically important institutions. The Financial Stability Oversight Council (FSOC), which is responsible for macro-prudential regulation in the US, has come to play a leading role along with the Department of the Treasury. The ECB houses the secretariat for the European Systemic Risk Board (ESRB), which plays a central role in macro-prudential supervision in the Euro-area and will be responsible for regulating individual financial institutions under the so-called "Banking Union". Meanwhile, the Bank of England will be officially responsible for supervising individual financial institutions—previously the role of the FSA—via its "subsidiary," the Prudential Regulation Authority (PRA), and will also play a primary role in implementing macro-prudential policy via the Financial Policy Committee (FPC).

In light of the above, the BOJ—at least outwardly—would appear to be strongly biased in favor of price stability: not only has it adopted an inflation target, but it has mobilized all the tools at its disposal in an attempt to achieve that target. Yet its role in ensuring financial stability diverges significantly from the emerging global standard.

## But remains an outlier on financial stability

While perhaps it goes without saying, western central banks’ expanding role in ensuring financial system stability is not due entirely to growing public sector intervention in economic activity following the financial crisis. To a certain extent it has been driven by central banks’ reflection on their role in the financial crisis, as it was a pursuit of price stability to the exclusion of other factors that led them to overlook or at least underestimate financial imbalances, thereby contributing to the crisis. It therefore comes as some concern that the BOJ has chosen not to adopt the global standard on this issue and is instead more of an outlier.

Although central banks in the developed economies share the same basic objectives and functions, the decision of which objectives to prioritize should be made by national authorities internally based on local financial and economic conditions. Japan, for example, was not at the epicenter of the global financial crisis and did not experience major damage to its financial system, and it therefore makes sense for the BOJ to focus on tackling the deflationary tendencies that have been an issue for so many years.

However, it is possible and appropriate for the central bank to focus on deflation only if price stability and financial system stability can be dealt with separately, as Masaaki Shirakawa once emphasized in a speech. If a trade-off exists between price stability and financial system stability—even if we do not go to the textbook extremes of the “Great Moderation” prior to the crisis—the central bank cannot target price stability exclusively.

How should economic and financial conditions in Japan be viewed on this point? A look at the financial markets since 4 April suggests that the financial system destabilized as soon as the BOJ began pursuing its inflation target in earnest. However, much of the recent increase in volatility is probably attributable to supply/demand imbalances and sudden swings in liquidity in specific market segments, perhaps most notably in some areas in the JGB market—i.e., it is the result of financial market dysfunction. If so, it should be possible for the BOJ to address the problem to some extent by entering into a close dialogue with market participants and fine-tuning its asset purchases. Worries about a potential trade-off between price stability and financial system stability based on recent developments may therefore be somewhat exaggerated.

## BOJ targeting price stability “from below”

That said, we cannot simply assume there is no cause for concern here. One worry is that the price stability being targeted by the BOJ involves the transformation of deflation into a desirable level of inflation—i.e., price stability from below. The Bank’s policy prescription for achieving price stability is so aggressive that in the past it would have been presumed to be a typographical error.

When price stability is targeted with monetary tightening, which entails higher interest rates, it has the potential to depress financial institution earnings and thereby destabilize the financial system. Monetary accommodation, on the other hand, tends to boost financial institution earnings and risk-taking capability and can lead to asset price bubbles that subsequently collapse and destabilize the financial system. The concerns noted above may be warranted inasmuch as this is precisely what happened in the recent financial crisis.

The traditional thinking is that even in such a case, rising inflation would automatically bring accommodative policy to an end thanks to inflation targeting, thereby arresting the bubble’s development at some point. However, inflation rates did not increase significantly during either the Great Moderation or Japan’s Heisei bubble, and that left central banks reluctant to tighten policy. It is not easy to show why inflation did not accelerate, but if this kind of structure has become entrenched in the developed economies it is necessary to consider the possibility that this pattern will repeat itself and also to devise some kind of braking mechanism other than inflation.

## Dynamic inconsistency

For the moment, at least, the BOJ is unlikely to lend an ear to concerns about the trade-off between price stability and financial stability or to ways of addressing that trade-off. Paradoxically, this is because the BOJ itself understands the problem. The governor and his two deputies may be freshly appointed, but nearly all the

Bank’s executives are holdovers from the Shirakawa era who are well versed in the debates and analysis of that period. It therefore makes sense to presume that the BOJ has, after due consideration of potential costs and risks, decided that achieving the price target should be its first and exclusive priority.

Easing policy (with the aim of achieving a price target) while carefully monitoring potential stresses on the financial system would signify a return to the approach of Mr. Shirakawa. The Bank would need to be cautious about enacting policy measures and would have to ensure it had a solid grasp of attendant costs and risks. Such an approach would be incompatible with the BOJ’s aggressive new easing regime and would make it more difficult for the Bank to carry out its basic strategy of eradicating deflation expectations and fostering inflation expectations. Such concerns are therefore unlikely to receive an audience at the Kuroda BOJ.

One interesting question is whether the BOJ would return to the “global standard” of assuming responsibility for financial stability as well as price stability if the estimated costs and risks to the financial system were to increase over time. Unfortunately, recent trends in Japan’s fiscal position, the current accounts balance, and domestic savings suggest this scenario warrants some consideration.

In the event of real concerns about financial stability, the BOJ would clearly be responsible for restoring stability after the fact. At the very least, it could not ignore signs of instability in the financial system (despite its stated exclusive focus on price stability), since the Bank of Japan Act requires it to pursue both price stability and financial stability. This signifies a state of broadly defined dynamic inconsistency.

Is there some way by which the BOJ could avoid being caught up in such a situation in spite of its efforts to boost inflation? If problems with the potential to upset the financial system would be difficult to address after the fact, the only option for the Bank is to nip them in the bud. Some of them, unfortunately, are not under the BOJ’s control. Others might include asset purchases, closely monitored to ensure they did not cause the financial markets to overheat, as can be surmised from the debate over an exit from the Fed’s QE3. In terms of the impact of monetary easing, such advance measures would be difficult to implement if the Bank seeks to realize asset prices that are inconsistent with the realization of the inflation target.

The objective of the BOJ’s recently announced “enhanced dialogue” with the market is to prevent market dysfunction from undermining the effectiveness of its policy. Confirming whether asset prices appropriately reflect the impact of monetary easing may therefore play a surprisingly important role in maintaining financial stability.

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