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Monetary policy in 2020

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Executive Summary

Missing part of the announcement of‘ the third arrow” of Abenomics is the vision where the policy initiative is heading. Lacking the vision is a shared problem with the monetary policy in the major economies. While some still believes that the policy strategy should return to the pre-crisis‘ normality”, it would not be straightforward if the fundamental economic and financial structures have changed in irreversible manner.

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The third "arrow"

Previous round of announcement of policy agenda in June, known as "the third arrow" of Abenomics, was greeted by disappointment both by domestic and overseas markets. Unfortunately, it set the tone of the yen and Japanese equities markets with relatively high volatilities, which was apparently reinforced by the growing discussion on "tapering" the QE3 and the concerns about its potential impacts on global financial markets. I am still sympathetic with the administration, however. The measures contained in the government's growth strategy were largely predictable from a Japanese standpoint, and I suspect few would object to the individual issues addressed by the growth strategy. Given that there had been no major changes in the structural problems facing Japan's economy over the last six months, I think the strategy would have contained similar policies even if another administration had been in office.

What is missing in my view is the clear communication regarding the anticipated impact of the third element of Abenomics on Japan's economy, or even better, a sort of vision the Abe government had in mind for the economy when it drew up the growth strategy. I am aware that the administration tried to communicate that message in Prime Minister's three key policy speeches in earlier months. Nevertheless, the impression created for the general public and the markets would have been very different if, when announcing the strategy, the government had prefaced the detailed information about policy issues, responses, and timeframes with just a few pages laying out Prime Minister's vision for the future of Japan's economy. That not only would have reassured overseas investors and prevented disarray in Japan's financial markets but could also, more importantly, have helped show the Japanese people where Abenomics is heading.

Of course political considerations probably played a role, and it may have been difficult to discuss on the eve of the major election the specific sectors and agents of the economy that would have to change under the proposed structural reforms. With this respect, the administration now has another chance of revising the strategy after the land-slide victory in the election. Moreover, both the domestic and overseas markets appear to maintain interests in a renewed growth strategy. In any case, the discussion on this important initiative toward this autumn deserves attention.

Normalization of unconventional monetary policy

However, the absence of a clear vision is a problem shared by virtually all central banks in the developed economies, and the lack of a consensus on this issue is an even more serious problem.

Although it may have been largely forgotten, when the major central banks began implementing unconventional monetary policies in response to the financial crisis—or rather, from a Japanese perspective, when they began following in Japan's footsteps—it was considered self-evident that monetary policy could and should be restored to its pre-crisis state as soon as the time needed for the policies to work had passed.

Although the US and the European economies initially managed to restore a sense of calm and unwind the measures carried out in response to the crisis, de-leveraging throughout the broader economy coupled with constraints on the flexible application of fiscal policy—a result of widening fiscal deficits—then prompted central banks to take on the task of resuscitating the economy even though they were operating under the zero bound constraint. The policy tools mobilized by Japan and other developed economies generally involved the use of the central bank's balance sheet—although there were some differences in terms of substance and degree. As the term "quantitative and qualitative easing" used by Mr. Kuroda clearly implies, this went beyond a mere expansion of scale and included asset purchases that were qualitatively different from past policy. Specifically, not only the FRB under Chairman Bernanke but also the BOJ under Governor Kuroda and the BOE under Governor King sought to acquire and hold longer-term assets with the goal of keeping long-term interest rates in check. Given the outlook for the euro-area economy and financial sector, the ECB is also likely to eventually adopt policies similar to those of Japan and the US. The euro-area, after all, seems more likely than the US to undergo “Japanization” given the de-leveraging of its banking sector and the impairment of its credit creation function, persistent disinflation, and the bogging down of fiscal consolidation efforts.

In light of this hard reality, it is no longer self-evident that—and in fact has become increasingly questionable whether—the central banks of Japan and the west will return to their pre-crisis selves and restore the kind of policy framework that existed prior to the financial crisis.

The FRB’s normalization strategy

In the interest of discussing this point in more concrete terms, I think it would be useful to take a look at the FRB, which is declared to be closest to “normalizing” policy among the central banks of the developed economies.

At a press conference following the FOMC meeting in June, Chairman Bernanke made it clear that when reviewing the “exit strategy”—the basic plan for normalizing QE3 and other unconventional monetary policies that was first revealed in the minutes of the June 2011 FOMC meeting and endorsed in the minutes of the May 2013 FOMC meeting—a majority of FOMC members felt the FRB should hold its MBS until maturity. The implications of this are significant. Until now, inasmuch as long-term interest rates were being held in check partly by QE3, MBS were being redeemed before maturity even without any sales by the FRB as households refinanced their mortgages. But now it will become increasingly difficult to keep long-term rates in check to the extent that any review of QE3, as Chairman Bernanke notes, will be predicated on a recovery in the US economy. That means further “natural declines” in the MBS holdings by the FRB are unlikely.

Even if conditions in the US economy and financial sector improve enough to enable the FRB to sell its assets on the market, that would not solve the problem. A review of the exit strategy noted above suggests it will take three to five years for the FRB to return its holdings of Treasury securities and MBS to their original levels without creating undue stresses in the US financial market. If the FRB embarks on this difficult process after the zero-interest-rate policy is ended in 2015 (as the Fed claims), the process will not conclude until around 2020. Moreover, this period exceeds the average duration of the US business cycle, something noted and discussed by the Financial Markets Panel chaired by the author. Consequently, the US economy could fall back into recession and force the next round of easing before the FRB's holdings of Treasury securities and MBS are brought back to normal levels.

The FRB, naturally, is arguing that it will be technically possible to raise the policy rate in response to an economic expansion even if it still holds large quantities of Treasury securities and MBS. As noted in the exit strategy, it plans to use such tools as reverse repos and interest-bearing term deposits, and the FRB New York has in fact been engaged in frequent test deals of this nature. If the FRB can raise the policy rate, that means it will be possible to lower the rate when the next recession hits, restoring the conventional monetary policy framework of making adjustments to the policy rate—even if a substantial volume of Treasury securities and MBS remain on the FRB's balance sheet. This would be a very favorable development from the perspective of those who believe policy can and should be returned to its pre-financial crisis state.

Still, there are a number of points that need to be considered here.

First is the question of whether the FRB can raise the policy rate as planned. Following Chairman Bernanke's press conference in June, many in the financial markets in the US and elsewhere have questioned why the FRB would try to "normalize" monetary policy using the official exit strategy when the real economy is still sending out mixed signals. I naturally suspect that there is a substantial desire within the FRB to enable the use of "traditional" policy tools—i.e., cuts to the policy rate—the next time the US faces a recession. That appears to be a lesson learned from the struggles of the BOJ, which after ending ZIRP and quantitative easing was forced to address the next recession without traditional policy tools in its arsenal. In other words, it would seem that the BOJ's experience taught the FRB that time commitments and other unconventional monetary policy tools should be ended in a backward-looking manner, while the subsequent "normalization" of policy should be carried out relatively quickly.

But it has yet to be seen whether this kind of strategy will be successful. Not only is the real economy in the US characterized by a variety of problems in the labor market, but there could also be an adverse impact from developments in Europe or the global financial system. Inasmuch as investment in the emerging economies was supported by the FRB's large-scale monetary accommodation, the stresses resulting from a normalization of policy could at the very least affect the flexibility of FRB policy administration from a political-economic standpoint.

At the same time, it remains to be seen whether rate hikes carried out when the FRB is still holding substantial assets would have the same effect on the US economy as they used to. Under these conditions, for example, the excess reserves held by financial institutions at the FRB would simply be frozen or sterilized, and there is no precedent to confirm that that would serve to rein in economic activity and asset prices. In that case, a substantial hike in the policy rate aimed at achieving certain results in the US could lead to increased stresses in the global financial system.

Second, even if the FRB is able to return to an orthodox monetary policy framework based on the policy rate, we must not forget that the market value of its massive holdings of Treasury securities and MBS will fluctuate sharply along with changes in interest rates. Although the impact on the FRB's balance sheet would be positive if the economy entered a recession and interest rates fell, the FRB would face massive capital losses if the economy expanded and rates rose. Ignoring for now the question of how those losses would be treated from an accounting perspective, we can use our detailed information on the Treasury securities held by the FRB to determine with relatively high accuracy the quality of the FRB's assets.

There has been a great deal of debate already on the likely impact of deterioration in central bank balance sheet quality. There is no guarantee that the experiences of emerging or developing economies, which are often referenced in this context, apply to the developed economies, and thus far, at least, we have not seen any major problems even though the central banks of Japan, the US, and the UK do face significant risks. You may like to add China to this list, since the PBOC holds extremely large amount of foreign exchange reserves. In any case, no one can say with certainty what will happen if a rise interest rates causes a significant impairment of the central bank's balance sheet. Nor do we know how monetary policy independence would be affected if a government effectively compensated the central bank for its losses with taxpayer money. We could discover that policy independence has already been lost just as an expanding economy creates an urgent need for such independence.

A "normal" economy and financial sector

Even if the central bank itself strives to overcome these problems and return to "normality" according to the standards before the crisis, such efforts may be inappropriate if the fundamental structure of the economy and financial sector has changed as a result of the crisis. That is probably the situation faced by the BOJ after it ended ZIRP and quantitative easing, and the experts among my readers may require no proof of that. That is why the lesson extracted by the FRB from the BOJ's experience might not be appropriate if the BOJ had been unable to "normalize" policy as intended. The US economy will return to its pre-crisis status in at least some respects given its continued vitality and flexibility in terms of technical innovation, business start-ups, demographics, and capital markets. On the other hand, there are also some irreversible trends in play, including the re-allocation of production activity with the emerging economies, asset and income disparities, changes in the labor market structure, and the accumulation of wealth in the emerging economies. If there is no guarantee that the transmission mechanisms for monetary policy will be the same under those conditions—and I suspect there is not—we have to reconsider whether the notion of "normalizing" monetary policy is itself still appropriate.

One conclusion reached in the discussion over the BOJ's inflation target was that monetary policy needs to be implemented with a medium- to long-term perspective. In this context, however, "medium- to long-term" has come to mean a horizon of two to three years, reflecting the time needed for policies to work, while the longer term has been viewed as the province of other economic policy. Still, there are times when the central bank needs to accurately identify changes in the financial and economic structure—both domestic and overseas—and alter its strategy accordingly with a view to achieving the desired policy effect. As our own experience with asset bubbles demonstrates, it is precisely during such periods of structural change that it can be easy to make what are ultimately recognized as mistakes in monetary and economic policy. This perspective may be especially important today if, as BOJ Executive Director Masayoshi Amamiya argued in a speech before the Financial Markets Panel in February 2012, the economic structure of the developed economies tends to change with a 20- to 30-year cycle.

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