

Japanese Monetary Policy: Experience from the Lost Decades

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ABSTRACT

This paper describes the record of Japanese monetary policy since the late 1990s from the viewpoint of practical experience as well as theoretical insight. So-called unconventional monetary policies were implemented in Japan earlier than in other developed economies. Because aspects of these policies are multidimensional, a number of perspectives are necessary to evaluate their effect. Although no clear conclusion can be drawn thus far as to their effectiveness in terms of boosting business activities, the zero interest rate policy and quantitative easing policy had clear effects in terms of stabilizing the financial system. For the past two decades, the main policy task of the Bank of Japan has been to overcome prolonged deflation. This incurred a challenge to central bank independence, as the established policy framework (inflation targeting) is oriented to taming inflation but not necessarily deflation. In addition, the management of public-sector debt, the sometimes-forgotten task of a central bank, has emerged as a high-profile issue in both Japan and other developed economies.

JEL Classifications: E44, E52, E58

Keywords: unconventional monetary policy; zero interest rate policy; quantitative easing policy; comprehensive monetary easing; inflation targeting

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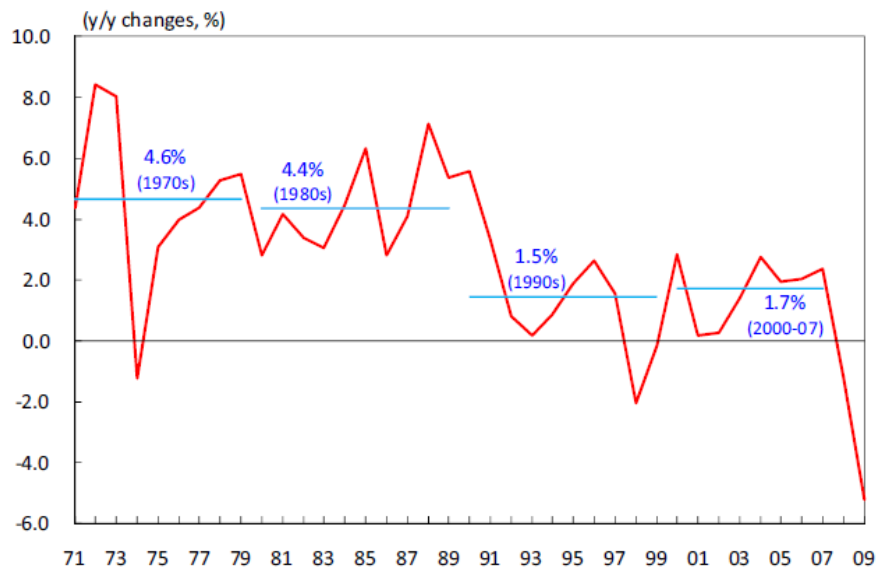
I. INTRODUCTION

Soon after achieving full independence as a central bank in 1998, the Bank of Japan (BOJ) found itself embarked on stormy seas. Its independence compares favorably with global standards, but it has sometimes faced harsh criticism and its path has often been a challenging one.

The challenges faced by the BOJ actually date back two decades. As the 1990s began, Japan confronted the legacy of its collapsed bubble economy. Massive obstacles—termed the “three excesses” in debt, capacity, and employment—blocked the way. These obstacles prevented a smooth recovery in the Japanese economy for more than 10 years. (Figure 1 and Figure 2)

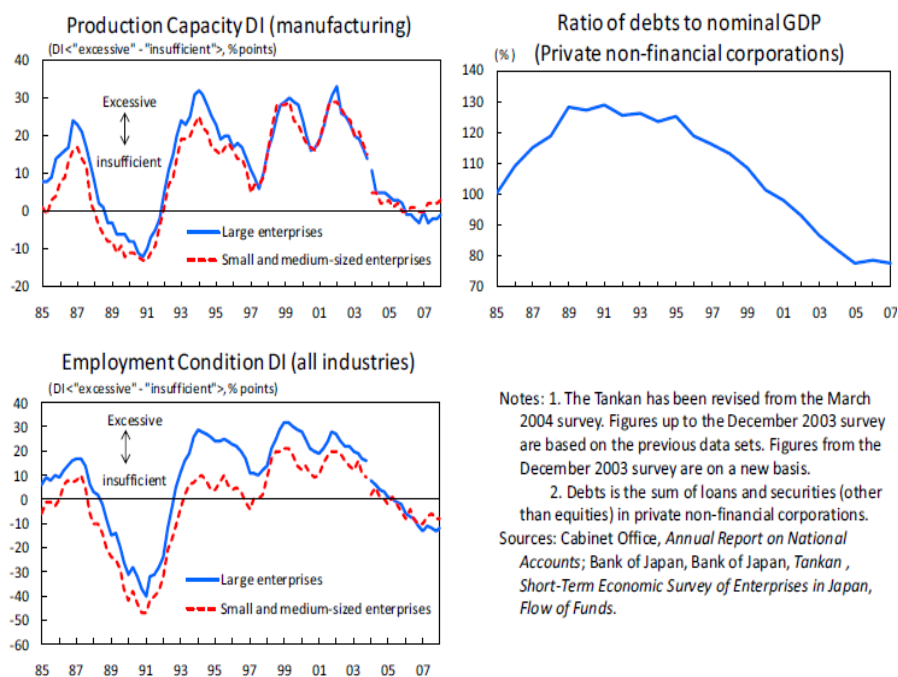
A look at the financial factors behind the three excesses just noted shows that excess debt required borrowers to continue to repay obligations until they could return to an optimal level of leverage. At the time, this process was a severe one since lenders (banks) were likewise required to cut lending to boost their capital position, which had been impaired by the accumulation of nonperforming loans (NPLs). In these circumstances, it is easy to see that standard monetary easing, in which interest rates were cut to boost bank lending, could not work.

Figure 1
Japan’s economic growth



Source: Cabinet Office. *Annual Report on National Accounts*.
Source Shirakawa (2010)

Figure 2
Three excesses in the Japanese economy



Source: Shirakawa (2010)

II. THE JAPANESE ECONOMY SINCE THE 1990S

Before discussing unconventional monetary policies in Japan, to clarify the background to their adoption it is better to begin with an economic preface. After Japan's bubble economy burst at the start of the 1990s, the economic slump continued for more than two decades.¹ Much discussion has focused on pinning down the causes. Some views cite cyclical factors, while others regard the problems as structural. Here, five prominent views can be mentioned.

The first view emphasizes financial factors. According to this conception, the Japanese financial sector had suffered NPLs until the early 2000s. Banks acted to restrain credit, which reinforced economic sluggishness and created further bad assets. This created a vicious circle.

The second view focuses on the central bank's policy stance. As mentioned, in 1998 the BOJ had achieved full independence in terms of monetary policymaking. Some have argued that conservative policies by the independent central bank put deflationary pressure on the Japanese economy.

The third view emphasizes labor market reform. During the bubble economy period of the late 1980s, heavy reliance on overtime work was a key element in numerous sectors of Japan's economy. Cases of sudden death through overwork received media attention, and overtime work was made a topic of social concern.

Reform of the labor market became an urgent issue. As a result, in the 1990s legal restrictions on total labor hours were introduced and actual working hours dropped. It has been argued that this reduced the potential for economic growth.²

The fourth view also focuses on labor issues. This conception notes that Japan has suffered rapid population aging and that the labor force peaked out in 2005. It is argued that the reduction of the labor force has acted to suppress economic growth. While combating prolonged deflation, the BOJ has stressed demographic factors as a cause of deflation and argued for the necessity of a wide range of structural reforms such as a boost in women's participation in the labor market and further innovation in Japanese industry.³

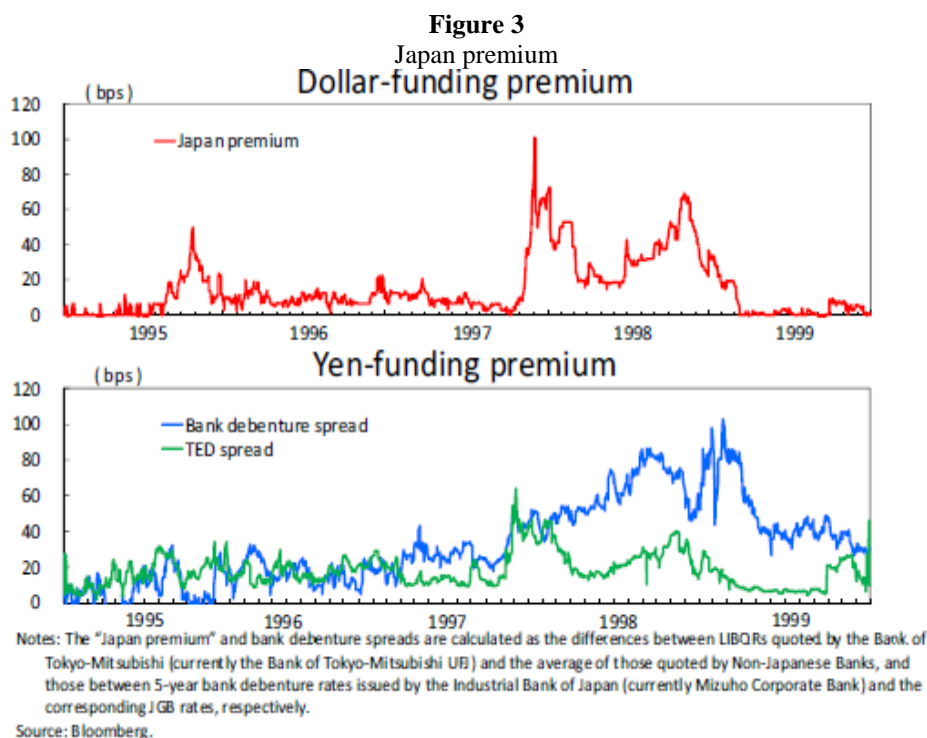
Finally, the fifth view focuses on intensified global competition. In the 1990s, Japan's neighbors in Asia posted higher economic growth. In Japan's low-value industries, competition with China accelerated, while relatively high-value industries faced greater competition from South Korea and Taiwan. Japan's reputation has been that of an economy which is good at applying technology but weak at nurturing innovation. This has left it in a difficult position given the rapid globalization that has progressed since 1989, when the Berlin Wall collapsed. Global trade has expanded greatly, and the growing use of information technology (IT) and module processing production has made it easier to produce value-added products such as home electronics in developing economies. Thus, Japan's sophisticated technology, which enjoyed great success in the 1980s, has fallen behind. Amid growing global competition, Japan has lost its advantage and failed to adjust its economic structure.

In retrospect a number of structural factors may be cited, but essentially it is difficult for policymakers to determine the causes of the economic slump as cyclical or structural when the process is ongoing. Japan's growth rate declined significantly between the 1980s and 1990s, but the drop was taken for granted due to the size of the asset bubble and the subsequent collapse. This cyclical view delayed the policy response to the economic slump in the early 1990s.⁴

Large-scale fiscal measures were adopted in Japan, and nine successive reductions led the official discount rate to decline from a peak of 6.0% in 1991 to 0.5% in 1995. At the time of the 1987 Louvre Accord, the BOJ had reduced the official discount rate to 2.5%, regarded at the time as a record low. By the late 1990s, however, the historical record had been revised downward a number of times. The 1990s were thus a period when policymakers recognized the weak effectiveness of both monetary and fiscal policies.

In this regard, it is worth noting that in the 1990s the movement of capital flows and exchange rates became important issues for the Japanese economy. Under rapid globalization, the rise in international capital flows surpassed the expansion in global trade. The experience of more than three decades shows that even under floating exchange rates, monetary policy cannot avoid affecting other countries. In fact, for the past two decades it has not been possible to formulate monetary policy without taking into account the monetary policies of other countries. Japan and other Asian countries received a massive capital inflow in the 1990s. This boosted the yen's exchange rate, and in 1995 the rate against the U.S. dollar reached at a record high of 79 yen/US\$1. Subsequently, Japan's economy enjoyed a modest recovery after the yen depreciated slightly. In 1997, however, a banking crisis occurred in Japan for the first time in approximately 60 years. The BOJ thus simultaneously faced two issues: a recession and

a banking crisis. Due to the fragile financial conditions, Japanese banks found that they needed to pay a premium on their borrowing rates, which became known as the “Japan premium” (Figure 3).⁵ These problems on the real side as well as the financial side of the economy served as the background to the BOJ’s adoption of the zero interest rate policy (ZIRP) as the first step of unconventional monetary policy in Japan.



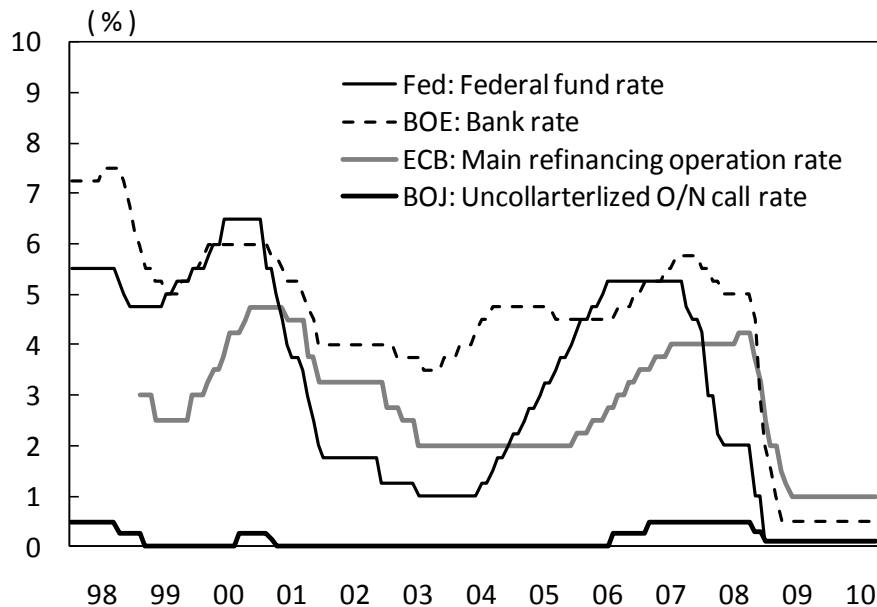
Source: Shirakawa (2010)

III. THE ZERO INTEREST RATE POLICY (ZIRP)

Essentially, because a central bank is a creature, so to speak, of market developments, central banks tend to respect the market mechanism. The BOJ is no exception. In the early 1990s, it promoted deregulation of the money market and changed its policy target from a regulated interest rate (the official discount rate) to a market rate (the overnight call market rate). In July 1991, it also repealed directly regulated measures such as window guidance, under which the BOJ directly controlled increases in the lending of individual banks. As financial liberalization is by now virtually complete in Japan, a change in monetary policy must of necessity be market-based. Confronted, however, with a situation in which interest rates have reached the zero bound and the market risks malfunctioning due to rising credit risk, monetary policy is forced to explore new options.⁶

Before the BOJ implemented the ZIRP, the policy rate had remained at a low level of 0.25%. Subsequently, in February 1999, the BOJ decided to adopt the ZIRP (Figure 4). This was the only measure left in terms of further monetary easing; technically, the zero interest rate was achieved by creating excess reserves. With the creation of these, the monetary base was expected to expand.

Figure 4
Policy rates of major central banks



Source: Bank of England, European Central Bank, Bank of Japan

According to meeting transcripts released 10 years later, the BOJ was concerned at the time about whether the money market would function under the zero interest rate.⁷ Although transactions continued, a dramatic decline in volume took place.

The BOJ Governor, Masaru Hayami, at the time the ZIRP was adopted described the policy as “not normal”.⁸ This could be taken to refer to a situation in which transactions did not take place and interest rates diminished in the market. As already mentioned, the BOJ established the main tools of monetary operations using the market mechanism. Nevertheless, an ironic effect of the policy was to affect market functioning.

During the ZIRP period, Governor Hayami announced that he would continue the policy until deflationary concern was eliminated. This roughly describes the “duration effect,” which was referred to subsequently as “forward guidance.” The ZIRP was already equipped with two essential standard policy measures of unconventional policy: ample provision of liquidity and forward guidance.

It appears that no decisive conclusion has been reached as to the ZIRP's effectiveness in promoting economic recovery. The economy posted a slight recovery in 2000, but it is fair to say that this reflected the IT boom in the United States. On the other hand, the ZIRP had a much clearer effect in promoting financial stability, and it can be said that the ZIRP was a very strong tool in this regard.⁹

The overnight call rate, as the policy rate of the BOJ, is measured as a weighted average of actual transactions in the market. The zero interest rate was attained by conducting all transactions at the zero interest rate. Thus, no transaction was allowed to be conducted above this rate. This meant that since the BOJ provided zero-cost credit to any bank that held eligible collateral, any risk premium would diminish. This gave a great deal of support to troubled banks.

IV. EXIT FROM THE ZIRP

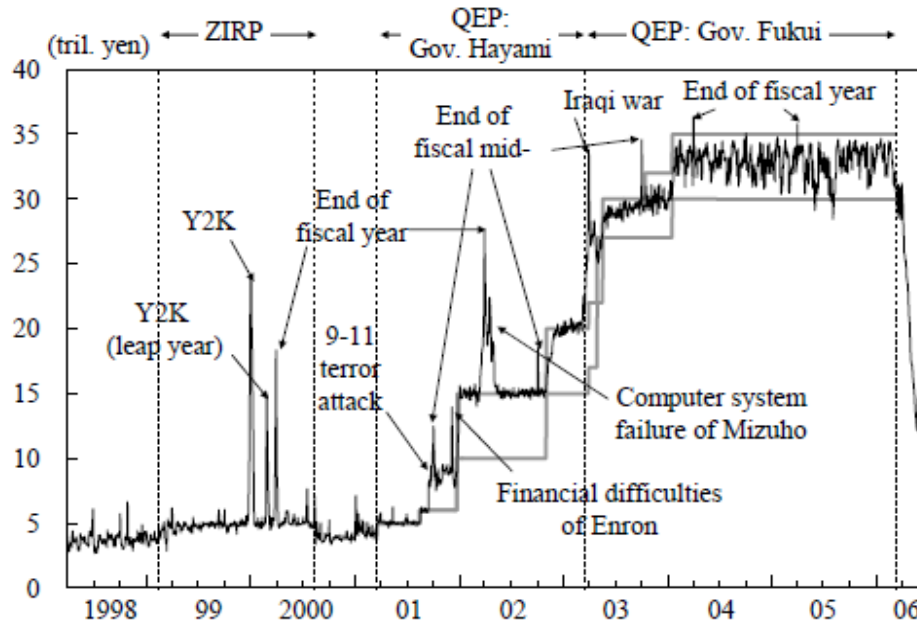
The ZIRP was an emergency measure for the BOJ. Therefore, when the prospect for economic recovery appeared, it was natural for the zero interest rate to be lifted. Although the recovery was viewed cautiously even within the BOJ, positive data confirmed an increase in production, and on August 11, 2000 the BOJ decided to raise the interest rate. It is reported that the BOJ had intended to raise the interest rate in July, but the bankruptcy of Sogo, a giant department store chain in Japan, led to caution regarding a change in policy.¹⁰ At the Monetary Policy Meeting on August 11, 2000, participants from the government submitted a proposal to postpone a vote, but the BOJ's Policy Board approved an increase in the interest rate and unanimously rejected the government's proposal. The Bank of Japan Law specifies the autonomy of the BOJ's policymaking in Article 3, but Article 4 requires the compatibility of monetary policy with other economic policies by the government. The Policy Board's rejection contributed to tension between the government and the BOJ until recently.

V. THE QUANTITATIVE EASING POLICY (QEP)

Unfortunately, in the fall of 2000—shortly after the BOJ had exited the ZIRP—the IT bubble burst in the United States. Interest rates in Japan remained low against the background of low growth and a low inflation rate. Thus, in addition to the negative shock of Japan's banking crisis in 1997, the economy suffered another negative shock, which caused banks to face the zero interest bound once more. At the time, this situation was considered to be unique to Japan, but it has since become a common one for central banks in other developed economies.

In 2001, the BOJ adopted the quantitative easing policy (QEP) (Figure 5). The QEP was achieved by creating excess reserves with ample liquidity provided by the central bank, which contributed to financial system stability. The announcement of time duration was also adopted. The ZIRP and the QEP thus shared two characteristics, of creating excess reserves and announcing the time duration of policy. The main difference was the policy target: the ZIRP targeted the zero interest rate as the policy rate, while the QEP did not necessarily target the zero interest rate. Theoretically, under the QEP regime, the interest rate could have reached a positive number. This allowed the charging of risk premiums on banks that held risks. Accordingly, compared to the ZIRP, the QEP can be said to have respected the market mechanism.

Figure 5
Current account balances at the BOJ



Note: Solid line indicates the outstanding amounts of the current account balances at the Bank of Japan, and shaded lines indicate the ceiling and floor of the target range of the current account balances.

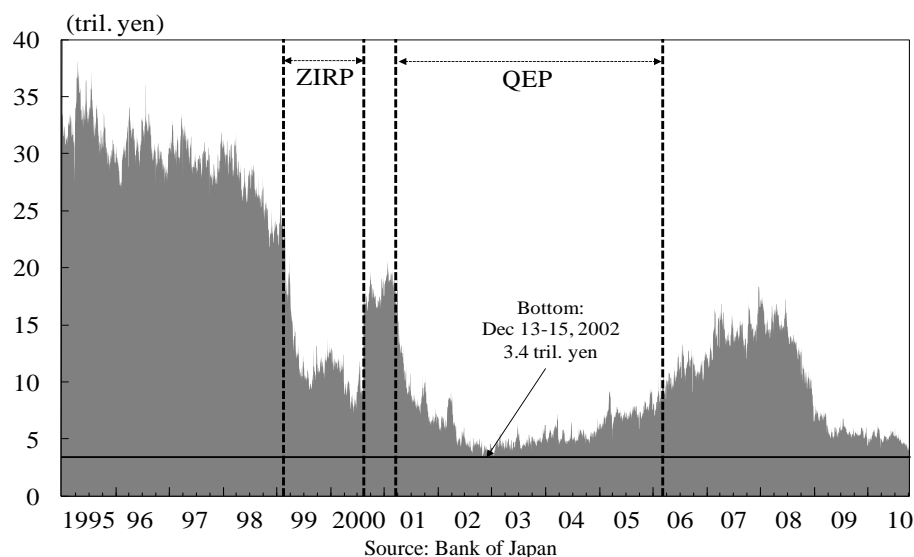
Source: Bank of Japan, *Economic and Financial Statistics Monthly*.

Source: Shiratsuka (2009).

In fact, however, due to the provision of ample liquidity, interest rates remained at zero and transactions in the money market slumped (Figure 6). As the BOJ extended its zero cost credit to banks that held eligible collateral, a risk premium on borrowing failed to appear in the money market.

The QEP has been described as the balance-sheet policy of a central bank. Chairman Ben S. Bernanke of the U.S. Federal Reserve Board has given a detailed definition of this.¹¹ He differentiated from the QEP the policy of increasing current account balances on the liability side of a central bank's balance sheet, and referred to the policy in which a central bank expanded its assets by purchasing risk assets as "credit easing." The Fed subsequently bought a massive amount of mortgage-backed securities. The Fed's balance-sheet policy was called large-scale asset purchase (LASP), indicating a difference in policy from the QEP. During the QEP period of the BOJ, several measures of credit easing were implemented; the BOJ bought risky assets such as asset-backed commercial paper (ABCP). However, since the capital market was relatively small compared to bank loans, there was a natural limit for credit easing in Japan.

Figure 6
Outstanding amounts in the call market



The policy target for the BOJ's QEP became the outstanding balance of current accounts. In the five years from March 2001 to March 2006, the BOJ raised this target eight times, from 5 trillion yen to 30–35 trillion yen. The target was changed so as to be discretionary. It is extremely difficult to find a policy rule such as the Taylor rule for the QEP. The BOJ raised the target to respond to events such as the release of disappointing economic news and changes in economic conditions such as those triggered by yen appreciation.

It is worthwhile here to consider the relationship between the QEP and exchange rate policy. The Japanese government intervened heavily in the foreign exchange market in 2003 and 2004. For a fiscal authority, when fiscal policies are ineffective and the fiscal position is deteriorating, depreciation of the exchange rate is the only remaining tool. Intervention was supported by the BOJ's QEP. The BOJ did not comment on the use of monetary policy to support intervention. Nevertheless, a consequence was that even though the BOJ provided credit independently, it was unsterilized.

The time duration policy triggered the so-called carry trade, which had the played a more important role than intervention in bringing about a depreciation in the exchange rate.¹² From approximately 2004 to 2006, there was massive speculation focused on the purchase of high-yield currencies financed in yen at low interest rates. The situation contradicted the academic convention that currencies of high interest rate economies must depreciate.¹³

Financial stability was maintained under the QEP. Japan announced that it would resume payoff of insured depositors and the banking crisis was finally brought to a conclusion. The BOJ recognized that unconventional policies were ineffective in

promoting real economic recovery when significant structural problems existed, but that the policies could be highly effective in restoring financial stability.

A recovery in Japan became evident around 2004, supported by global recovery. A housing boom, supported by low interest rates, took place in the United States. Emerging economies such as the BRICs also showed high growth. In addition to such external factors, the recovery was supported by the cheap yen. Thus, the excesses that had plagued economy were finally resolved.

An important change also occurred in the global economy. China had been regarded as an exporter of deflation due to the expansion in its low-priced exports. But as emerging economies led by China continued to enjoy an economic boom, global inflation emerged as seen, for example, in rising commodity prices. The BOJ made the commitment that it would continue the QEP until consumer price index (CPI) inflation become positive in a stable manner. A moderate rise in prices became evident, together with a gradual recovery.

VI. EXIT FROM THE QEP

In the spring of 2006, the BOJ decided to terminate the QEP. The BOJ also announced that it would keep interest rates at zero for the time being. Four months later, however, the BOJ raised interest rates. The BOJ had emphasized that as long as interest rates remained low, monetary easing would become more powerful thanks to a decline in real interest rates. However, there was strong criticism that the exit had been too early. In addition, there was a technical complication in connection with the downward revision of the CPI. Positive numbers for the inflation rate, released just before the exit, turned out to be negative following statistical revision. This prompted even stronger criticism of the BOJ's stance. According to this thinking, although Japan had suffered high inflation after the first oil shock in 1974, the BOJ had successfully defended against imported inflation from the second oil shock in 1978 through precautionary monetary tightening. It was argued that this experience had now led the BOJ to adopt a more conservative stance against inflation and hasten to exit the QEP. It was also claimed that this conservatism was responsible for long-lasting deflation in Japan.

The term "exit policy" refers to a return from unconventional to conventional monetary policy. After the exit from the QEP, a reduction in the outstanding balance progressed smoothly. This should be considered a success for the BOJ. The outstanding balance decreased from above 30 trillion yen in March 2006 to around 8 trillion yen in July. The BOJ had bought relatively short-maturity bonds, which made adjustment easy. Generally speaking, a central bank can more easily influence long-term yields, since it purchases longer-term bonds. In Japan, however, since a significant portion of government bonds is held by private-sector banks, the long-term yield remains low. And a lowering in long-term bond yields can be achieved through the commitment of the time duration policy.¹⁴ Thus, it was considered that there was little necessity in Japan for a central bank to purchase long-maturity bonds to pull down long-term interest rates.

With the exit from the QEP, the BOJ terminated its policy commitment. Since the exit from the QEP, communication policy has come to play an important role in monetary policy. This is because central banks present their policy framework to enhance accountability. As several central banks in developed economies had already

done, the BOJ announced its framework of monetary policy in March 2006. This comprised two perspectives. In the first perspective, the BOJ would examine the plausibility of the economic path in terms of the present policies. It would be judged whether standard forecasts satisfied the condition of sustainable growth under price stability. In the second perspective, risk scenarios would be examined, for example, asset prices and the condition of the financial system. This type of dual approach has become common among central banks in the developed economies. The European Central Bank (ECB), for instance, has adopted a two-pillar approach; in addition to the standard forecast of growth and prices, it examines monetary aggregates as the second pillar. Recently, central banks adopting inflation targeting have begun to consider financial stability and other factors such as asset prices as well as price stability; this dual approach type of inflation targeting is termed “flexible inflation targeting.”¹⁵

VII. THE ROUTE TO COMPREHENSIVE MONETARY EASING (CME)

Japan has experienced economic stagnation since the early 1990s, but the legacy of the burst economic bubble from the start of the 1990s—the three excesses described previously—were resolved in the early 2000s (see Figure 2). However, the economic slump continued, exacerbated by the global financial crisis. The cautious prospects for inflation have persisted, dampening economic activity.

As a result of the global financial crisis of 2008, Japan suffered a huge negative shock. This reflected a huge reduction in exports caused by reduced global demand rather than a contagion in the financial sector. Since domestic demand in Japan became fragile after the bursting of the bubble economy, the Japanese economy has grown more dependent on external demand. An expansion in global demand boosted the Japanese economy in 2003 and 2004. But a rapid shrinking in global demand significantly weakened the economy in 2008.

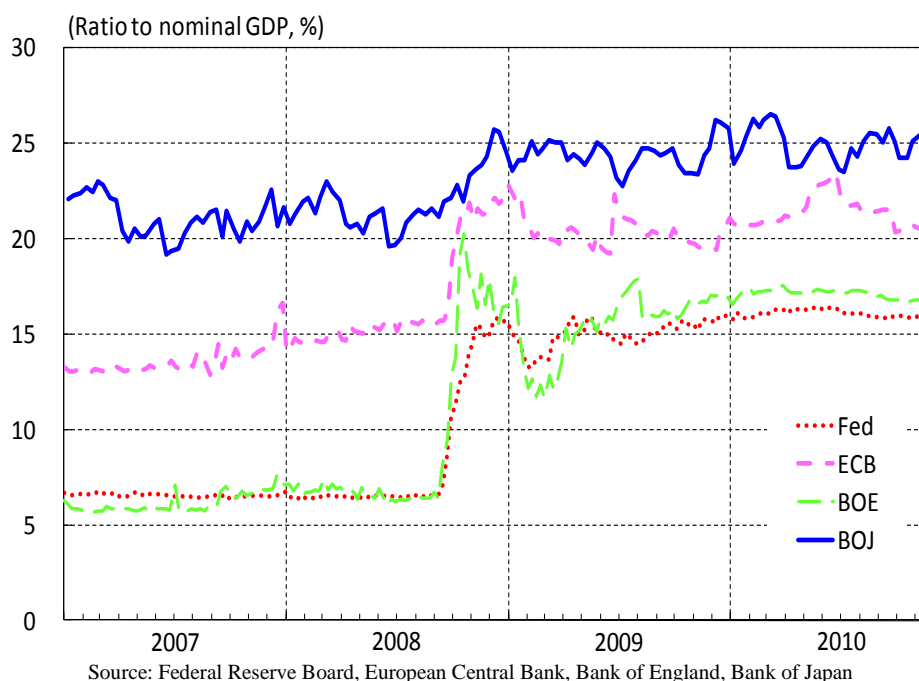
Although the BOJ immediately cut interest rates in response to the rapid economic downturn, it did not rapidly implement unconventional measures. It recognized that the Japanese financial system had maintained relative soundness since it did not hold toxic assets, unlike banks in the United States and Europe. Moreover, it saw that ample liquidity remained in the market. Thus, it was judged that emergency measures were not needed to boost market liquidity.

In fact, in the latter stage of the QEP, underbidding of securities purchase by the BOJ occurred quite frequently. This reflected a decline in precautionary demand for liquidity by banks, since the financial system had regained its stability. The BOJ was criticized for its reluctance to conduct monetary easing, as it could not achieve the target of current account balances in the final stage of the QEP. However, a decline in the current account balances reflected decreasing demand, not a tightening in supply. The BOJ received additional misdirected criticism when other major central banks adopted aggressive unconventional measures following the global financial crisis in 2008.

After the global financial crisis, the main factor behind the economy’s renewed sluggishness was the yen’s appreciation. The yen appreciated at a rapid pace against the U.S. dollar and the euro. There are two explanations for this. The first focuses on the difference in monetary expansion, in particular, the monetary base (Figure 7). Since the United States and Europe started quantitative easing while Japan did not, the growth of

the monetary base in Japan became much smaller than those in the United States and Europe; as a simple monetary approach would suggest, this led to a rise in the yen. The second explanation focuses on the situation regarding risk. According to this view, the yen was bought as a safe currency. Empirical studies show that rising risks in the U.S. market—measured in terms of the VIX—lead to the yen’s appreciation. According to this explanation, the yen would have appreciated even if the BOJ had started much earlier to increase the monetary base.

Figure 7
Central bank’s balance sheets



VIII. CME

Given the deterioration in the economy, in October 2010 the BOJ adopted a new measure of monetary easing—comprehensive monetary easing (CME)—which it continued to April 2013. CME’s basic elements were similar to the previous unconventional policies such as the ZIRP and the QEP. Excess reserves were created and the commitment of policy duration was made.

At the same time, there were several innovations in CME. One was the setup of asset purchase schemes (APSs) separately from conventional securities purchase on the BOJ account. The BOJ purchases long-term government bonds to finance the issuance of banknotes as a routine provision of central bank credit. As part of CME, the BOJ purchased long-term government bonds as an unconventional monetary policy measure. The BOJ thought that setting up a special fund for special purposes would make

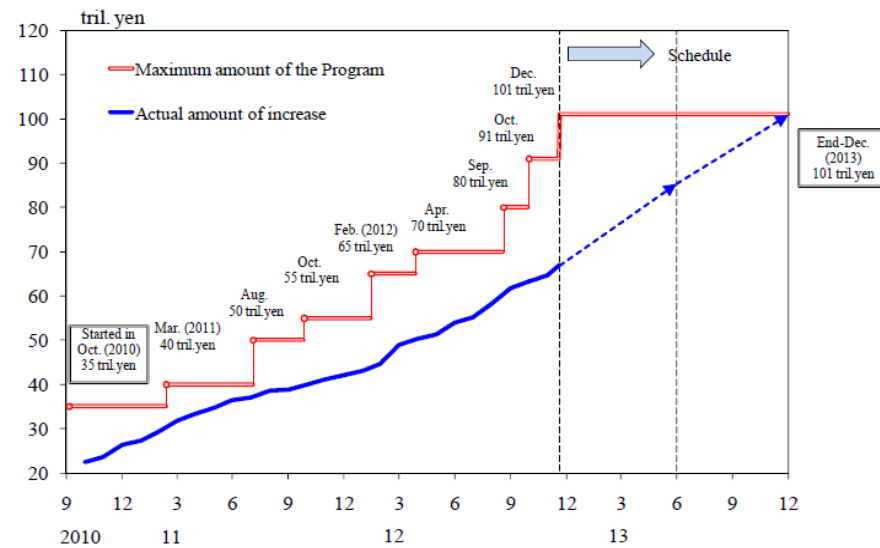
policies more accountable in the conduct of unconventional measures. With this framework, the BOJ could demonstrate the magnitude of unconventional policy in terms of the size of the APS (Figure 8). At many central banks in developed economies, it is common sense for the central banks to keep the volume of government bond holdings within the outstanding amount of issued banknotes. This is called the “banknote rule.” When the BOJ started CME, it already held a massive amount of government bonds and it was expected that the BOJ would be unable to maintain the banknote rule. By setting up a different fund, the BOJ thus characterized the massive purchase of government bonds under CME as a temporary emergency measure. The size of program of asset purchase became the target of CME. The BOJ also started to purchase real estate investment trusts (REITs) and exchange-traded funds (ETFs) as credit easing measures.

The other innovation of CME was the setup of a scheme to support corporate finance.¹⁶ The BOJ had already begun the outright purchase of corporate bonds in May 2009. In December 2008, with the Special Funds-Supplying Operations to Facilitate Corporate Financing, it had already launched a fixed-rate funds-supplying operation to provide a three-year loan to banks at the short-term policy rate, aiming to reduce the lending rate of private banks and to expand bank loans.

In addition to CME, in June 2010 the BOJ started the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth. Under this scheme, the BOJ provided a type of back finance of private-sector bank loans for promising industries in the medical, environment, and other sectors. This scheme was enhanced later by loosening the requirements.

Figure 8

Size of the Asset Purchase Program



Note: Dates indicate the intended timescale for completing the increase.

Source: Shirai (2013)

The measures described above to support economic growth are not regarded as conventional monetary policy. They were adopted based on the judgment that to overcome deflation it was essential to enhance growth potential and that even the unconventional measures implemented to that point had been insufficient in boosting growth.

IX. PRICE STABILITY

The adoption of inflation targeting has been a major task for the BOJ. In 2002, the adoption of inflation targeting had already discussed been at the Policy Board's Monetary Policy Meetings. The minutes of the meetings reveal that although monetary policy proved to be effective in controlling inflation, there is no evidence of its effectiveness at overcoming deflation. Because it could not determine an effective measure for achieving the price target under deflation, the BOJ was cautious about adopting an inflation target.

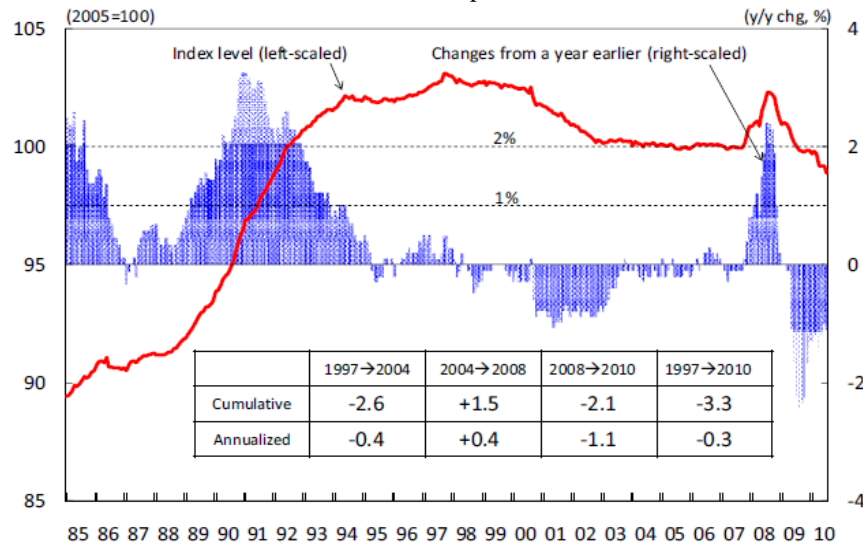
When the BOJ exited from the QEP, it terminated its commitment. Independent central banks in developed economies are disciplined by the commitment to the inflation target. While the BOJ had explained the concept of price stability previously, the BOJ was required to announce a more concrete idea of price stability as "the understanding of price stability." It revealed the concrete figure of 1% as the median of desirable inflation rates of all Policy Board members.

Despite the strengthening of monetary easing, there had been no clear sign of rising prices. Thus, a more concrete concept had been adopted. In February 2012, the BOJ announced the "goal" of price stability of 1%. This differed from the previous concept. The goal was chosen as a consensus of the Policy Board. However, the BOJ did not link the goal strongly to the policy operation.

Following a landslide victory in the Lower House election in December 2012, after making comments favoring revision of the Bank of Japan Law, Prime Minister Shinzo Abe pressed the BOJ to adopt a 2% inflation target to show a strong commitment. The goal of 1% inflation had been based on historical evidence that inflation in Japan had been around 1% during the economic boom of the previous three decades and had rarely exceeded 2%. A case in which inflation rose above 2% was considered to reflect rising import prices. This was classified as cost-push inflation, which was undesirable. The BOJ nevertheless adopted the 2% inflation target in January 2013. Although the BOJ assumes that the growth policy of the Abe Government will succeed in raising actual economic growth, 2% inflation is an ambitious target (Figure 9).

As seen from the above, the policy framework for the inflation target has changed from a mechanical application to a flexible one. The BOJ has stated that this change accords with its adoption of the inflation target at this time. Given the recent pressure by the government, however, the explanation is not completely convincing.

Figure 9
Consumer prices



Note: Figures are adjusted for the impact of consumption tax, which introduced at 3 percent in 1989, and raised to 5 percent in 1997.
Source: Ministry of Internal Affairs and Communications, *Consumer Price Index*.

Source: Shirakawa (2010)

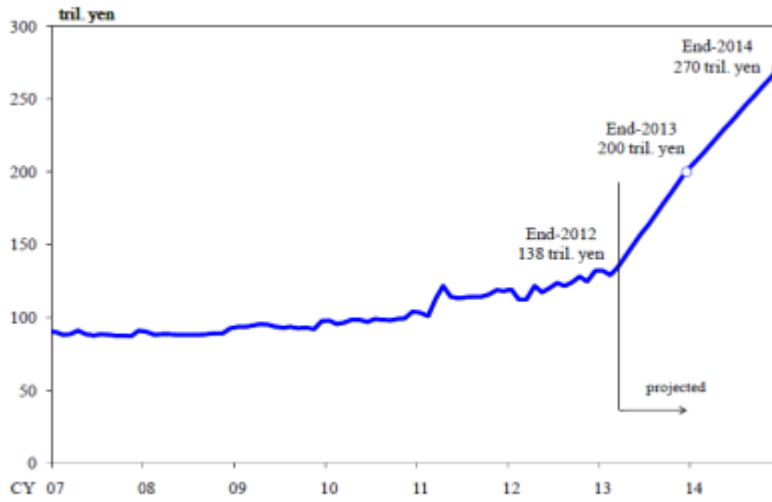
X. QUANTITATIVE AND QUALITATIVE MONETARY EASING

With the strong support of the government, Haruhiko Kuroda took office in March 2013 as the new Governor of the BOJ. At his first Monetary Policy Meeting on April 3 and 4, 2013, he declared the adoption of whatever measures were necessary, and the meeting decided another set of bold monetary easing measures and terminated the CME. As part of this, first, the BOJ made the commitment to achieve the inflation target of 2% with a time horizon of about two years. Second, to achieve the commitment, it declared an expansion in the monetary base, which became the new policy target in place of the APSs,¹⁷ of about 60–70 trillion yen. As shown in Figure 10, the monetary base will reach 200 trillion yen at the end of 2013 and 270 trillion yen—more than 50% of GDP—at the end of 2014. Third, as qualitative measures, the BOJ has started to purchase longer-term-maturity bonds and increased purchases of REITs and ETFs. As a result, the maturity of government bonds held by the BOJ has lengthened from two to three years to around seven years.

Under CME, the BOJ purchased the government bonds in two ways: financing the issuance of banknotes as a conventional measure and the APS as an unconventional policy measure. The BOJ now synthesizes the purchasing of both methods.

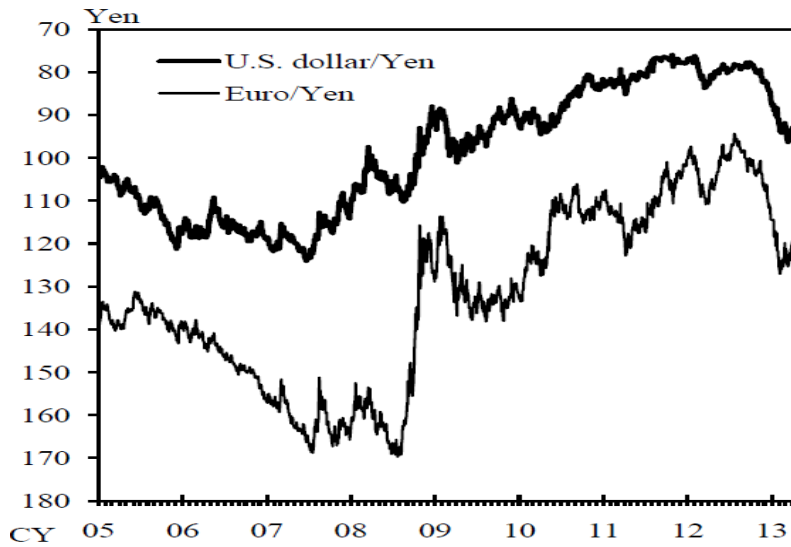
Since the autumn of 2012, stock prices in Japan have started to rise and exchange rates have started to depreciate (Figure 11). This basically reflects changes in the global economy as the U.S. economy recovers and the European economy is restored to a modest degree of soundness. Expectations regarding the new BOJ Governor have worked to boost the current trend.

Figure 10
Monetary base target

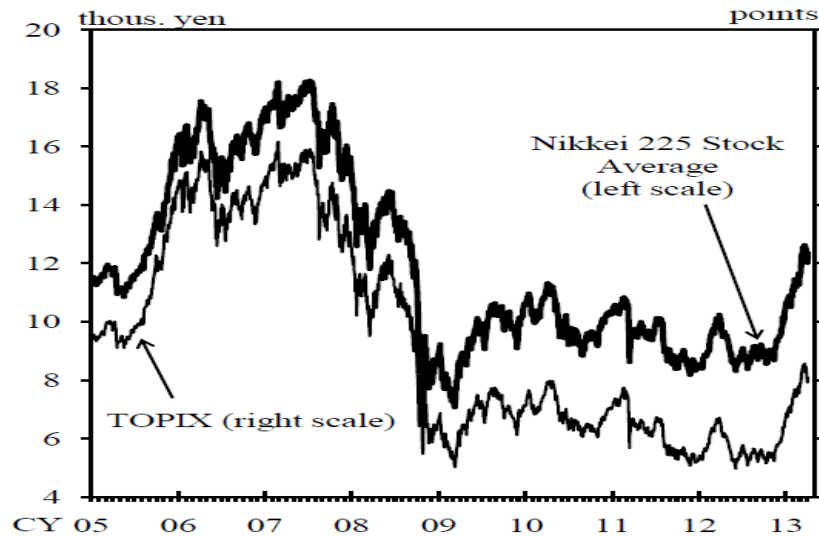


Source: Kuroda (2013)

Figure 11
Exchange Rates and Stock Prices



Source: Bank of Japan (2013)

Figure 11 (continued)

XI. CONCLUSION

With the revision of the Bank of Japan Law in 1997, the BOJ obtained full independence in its conduct of monetary policy that compared favorably with the advanced global standard. However, prolonged and poor macroeconomic performance in Japan (stagnant growth and deflation) attracted heavy criticism. With the current government voicing harsh criticism of the policies implemented thus far, Governor Kuroda was chosen as the new Governor of the BOJ, seeking aggressive monetary easing to overcome deflation.

After several decades, it is clear that the BOJ is a pioneer in the adoption of unconventional monetary policy. It has been the first, so to speak, to set sail in stormy seas without a chart. A look at the record of unconventional monetary policy from the time of Governor Hayami to Governor Shirakawa shows a major achievement in terms of attaining monetary stability. It cannot be said, however, that the policies were effective in achieving recovery. This fed frustration outside the BOJ, among politicians and others.

The policy of the past five years, in particular, has been criticized for its reluctance to implement aggressive monetary easing. In this regard, it is unfortunate for the BOJ that the rapid pace of yen appreciation suppressed economic recovery. This is because in Japan it is the Ministry of Finance that is responsible for exchange rate policy, not the BOJ, and even though the Minister of Finance often intervenes in the market, the power is quite limited in terms of influencing the exchange rate. On the other hand, in recent years the exchange rate has become increasingly important for monetary policy.

Given his powerful declarations and the positive market response thus far, the start of Governor Kuroda's term seems successful.¹⁸ Although the policy enunciated by

Governor Kuroda has been described as a “new dimension” except for the difference in approach to timing and the magnitude, his policy has many factors in common with those of Governor Shirakawa. The previous CMS also contained aspects of both quantitative and qualitative easing. Thus, it is a puzzle as to why market views have turned optimistic and expectations have changed so dramatically. Self-fulfilling expectations are important to break out of the deflation equilibrium.¹⁹ Thus, it will be crucial for optimistic views to be maintained even if disappointing developments occur in the coming months. In particular, as pointed out, the Japanese economy has grown increasingly dependent on the global economy. The question ahead may be whether markets will remain optimistic if developments in the global economy disappoint.

Moreover, because of the massive purchase of government bonds under the BOJ’s new policy, the task of government has been made more difficult.²⁰ To maintain low interest rates, the BOJ must continue to purchase government bonds. This presents an obstacle to the development of the government bond market, which is the heart of financial markets, and poses the risk of a large capital loss for the BOJ.

ENDNOTES

1. A conventional view of the Japanese bubble economy in the late 1980s is given by Okina, Shirakawa, and Shiratsuka (2001). Hattori, Shin, and Takahashi (2009) focus on the financial side of bubble creation.
2. See Hayashi and Prescott (2002).
3. A number of papers have been published by the BOJ on this point; for example, Shirakawa (2012) and Katagiri (2012).
4. Ueda (2012) provides a comparison between Japan in the 1990s and the United States after the financial crisis with respect to developments in economic conditions and the policy response. In particular, he noted the quick response by the Fed to support recovery in the United States.
5. Several papers on the Japan premium have been published by the BOJ; for example, an early article was Hanajiri (1999).
6. Takahashi (2012) discusses developments in the Japanese financial system from the viewpoint of political governance and attributes the bubble in Japan to the weakened governance system.
7. In fact, the announcement following the Monetary Policy Meeting on February 12, 1999 stated, “To avoid excessive volatility in the short-term financial markets, the Bank of Japan will, by paying due consideration to maintaining market function, initially aim to guide the above call rate to move around 0.15%, and subsequently induce further decline in view of the market developments.”
8. See the transcript of the Monetary Policy Meeting on June 28, 2000, *which is only available in Japanese only...*
9. See Figure 3 on the Japan premium. A dramatic reduction in the premium was observed during the ZIRP period.
10. Sogo represented a typical failed Japanese firm that held too much debt and posted sluggish sales.
11. See Bernanke (2009).
12. On October 10, 2003, the BOJ strengthened its commitment as described in “Enhancement of Monetary Policy.” It was stated, first, that the BOJ required not

- only that the most recently published core consumer price index (CPI) should register stably 0% or an increase year on year, but also that such a tendency should be confirmed over several months. Second, the BOJ must be convinced that the prospective core CPI would not be expected to register below 0%.
13. Hattori and Shin (2007) show the mechanism of the carry trade and the implication for monetary policy.
 14. This was confirmed by empirical studies; for example, Okina and Shiratsuka (2003).
 15. See King (2012).
 16. Following the Lehman crisis, a liquidity crisis developed in several major world markets. With the establishment of the U.S. dollar swap arrangement between the Federal Reserve Bank of New York and central banks outside the United States, the dollar funding scheme began in September 2008. Under this scheme, central banks outside United States were able to provide dollars to private banks in their local markets. This scheme terminated in January 2010, but was resumed in October the same year because of increasing turmoil in European financial markets.
 17. Under CME, the formal policy target was the short-term interest rate. But as the short-term rate remained at zero, the BOJ has announced the increase in the APSs as an indication of monetary easing.
 18. Ueda (2013) discusses how a recent rise in asset prices is supported by the optimistic views of investors. Although this finding is not robust, it is possible that the rise will be sustained through self-fulfilling expectations.
 19. See Bullard (2010).
 20. The control of national debt has become an important issue for many developed economies. BIS (2012) discusses this problem in terms of “fiscal dominance” from the viewpoint of the operation of monetary policy.

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