Roles of Central Banks in Financial Stability: Lessons from the Experience of the Bank of Japan

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Financial Stability

- Financial stability: ability of the financial system to consistently supply the credit intermediation and payment services that are needed in the real economy if it is to continue on its growth path. (Rosengren, 2011)

- Note that:
  1. Failures of some financial institutions do not necessarily imply financial instability
  2. Absence of failures does not necessarily imply financial stability
Outline

- Looks bank the historical experience of the Bank of Japan’s role in the efforts to maintain financial stability
- Experiences in the 1920s
- Experiences during the post-war period up to the financial crisis in the late 1990s
- Experiences during the financial crisis and the stagnation (coincides with the period after the BOJ gained legal independence)
- Lessons we can learn from the experiences
BOJ in the 1920s

- BOJ did not have legal independence: the government has power to prohibit any BOJ actions that are considered to be detrimental to the government’s interest.

- Japan experienced many instabilities and the government counted on the BOJ to rescue financial markets, financial institutions, and industrial firms.

- BOJ ended up providing constant Lender of Last Resort (LLR) support for many institutions for a long time.

- This did not help financial stability in the end.
Earthquake Bills and the Panic of 1927

- Bills issued by companies in the affected areas were rediscounted by the BOJ. (similar to central bank purchase of assets in “credit easing”)
- Problem: the “earthquake” bills included the bills of the firms that over-extended during the war years, got into distress, and needed restructuring
- BOJ rediscounting of the earthquake bills allowed the banks and industries to postpone the necessary restructuring
- Suspicion on the health of banking sector led to the Panic of 1927
Lessons learned by the MOF and the BOJ

- MOF: bank failures are costly. The government should not allow any bank to fail.

- BOJ: central bank interventions helped containing financial instability for a while but they eventually led to more serious financial instability by allowing the zombie banks and firms to survive.
Post-War Bank Regulation

- MOF’s no failure policy continued
- BOJ Act changed in 1942 and allowed even heavier government influence
- The BOJ’s LLR function was institutionalized as Section 25, which was used in rare occasions, such as the near failure of Yamaichi Securities in 1965.
- The Japanese financial system was mostly stable until the 1990s: when financial institutions were failing, the MOF asked bigger and healthier financial institutions to absorb them (the convoy system)
- This worked as long as the MOF was able to provide “regulatory” rewards
Financial Deregulation, Decline of Convoy System

- Financial deregulation reduced the “regulatory” rewards that the MOF can promise to acquiring banks of failed banks
- Increased the role of the Deposit Insurance Corporation (DIC) in subsidizing the acquiring banks
- The BOJ’s role in rescue financing also became important
New Bank of Japan Act of 1998

- BOJ gained legal independence
- LLR function is kept as Section 38, but the BOJ now decides without being influenced by the government

- Monetary policy was loosened substantially after the burst of bubbles
- Start of ZIRP in February 1999
- BOJ seems to have understood a danger of continuing ZIRP too long (encouraging zombie bank and firms to survive)
BOJ’s View on the Role of ZIRP

In order to bring Japanese economy back to a solid recovery path, it is important not only to provide support from monetary and fiscal sides but also to steadily promote financial system revitalization and structural reforms.


● ZIRP just buys time for the necessary structural reforms
ZIRP and Prudential Policy

- Dec. 1998: Nationalization of NCB
- Feb. 1999: BOJ started ZIRP
- Apr.-Oct. 1999: Closures of Kokumin, Kofuku, Tokyo Sowa, Namihaya, and Niigata Chuo Banks
- Oct. 1999: Yanagisawa left the FRC, followed by four chairs in the next 14 months, only one of which perceived to be politically neutral
- Aug. 2000: BOJ lifted ZIRP
- Mar. 2001: Back to ZIRP (quantitative easing)
- Feb. 2002: Further quantitative easing simultaneously with government announcement to accelerate structural reforms
Interactions between Monetary Policy and Prudential Policy

- Monetary policy seems to have reacted to the changes in the bank supervisory policy
- Lack of coordination between the BOJ and the FSA may have been the problem
- BOJ seems to have been reluctant to extend the ZIRP because it worried the monetary accommodation slows down the structural reforms
- Attempts of coordination after February 2002 and October 2002 (start of Takenaka plan)
To realize the full permeation of the effects of strong monetary easing, it is essential to strengthen a financial system and ensure its stability by making a swift move to resolve the non-performing loan problem. It is also vital to make progress in structural reform on the economic and industrial fronts through tax reform, streamlining of public financial institutions, and deregulation. The Bank strongly hopes that both the Government and the private sector, in particular financial institutions, will take more determined and effective steps in this regard. (“On Today’s Decision at the Monetary Policy Meeting,” February 28, 2002)
October 2002 announcement

In order to ensure the abundant liquidity provision by the Bank leading to the revitalization of the economy, improvement in credit allocation function of capital markets is important in addition to the strengthening of the financial intermediary function of banks. In this regard, the Bank will closely monitor the impact of expected government measures to accelerate the resolution of the NPL problem on corporate financing and explore possible measures to secure the smooth working of corporate financing. (“Change in the Guideline for Money Market Operations,” October 30, 2002)
Lack of coordination between economic policy authorities

- The equilibrium is characterized by lower supervisory efforts and lower inflation rate than the level either policy maker finds optimal.
- Given the low level of supervisory effort, the central bank is reluctant to generate higher inflation because that would undermine the economic restructuring.
- Given the low inflation rate, the bank regulator is reluctant to step up on the supervisory efforts because that would push up the unemployment rate too high.
- Both policy authorities could gain from cooperation.
Lessons from the BOJ’s Experiences

1. Stability of the financial system is different from the stability of individual financial institutions
2. Consideration for financial stability can influence the monetary policy: the BOJ often pursued too tight monetary policy in the 1990s and the 2000s
3. Coordination between monetary policy and prudential policy can be important → An argument for letting the central bank to be a bank supervisor (with effective tools)