Macroprudential Issues Relevant to the Recent Unorthodox Monetary Policies

Monetary Policy Workshop on Strengthening Macroprudential Frameworks

March 23, 2012

Shigeto Nagai

Bank of Japan

Macroprudential issues in the conduct of monetary policy in the three phases of the financial crisis

Before the crisis

- How to build macroprudential consideration into the monetary policy framework

During the crisis

- Market Maker of Last Resort (MMLR)

After the crisis

- Effectiveness of aggressive monetary policy in the process of balance-sheet repair
- Policy commitment and macroprudential consideration

How can macroprudential consideration be built into the monetary policy framework?

Challenges: macroprudential analysis, organization, and institutional culture

BOJ’s “Two Perspectives” approach

- First perspective

  As regards economic activity and prices over the next two years, examining whether the outlook deemed most likely by the Bank follows a path of sustainable growth under price stability

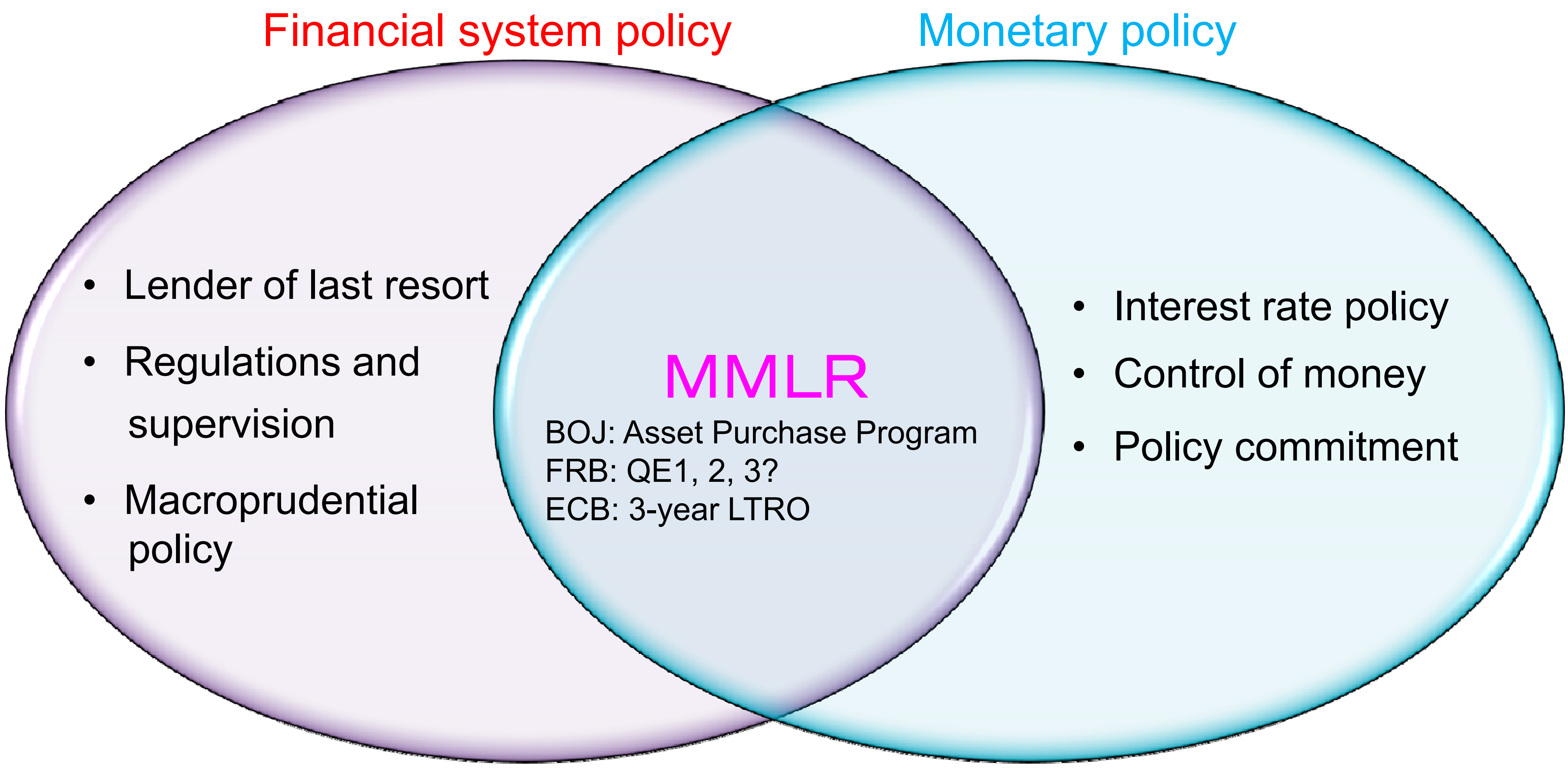
- Second perspective

  On a longer-term basis, examining various risks that are most relevant to the conduct of monetary policy aimed at realizing sustainable growth under price stability

  macroprudential aspects

Market Maker of Last Resort

During the crisis, central banks demonstrated the time-honored effectiveness of the lender of last resort function in overcoming acute symptoms.



Systemic risk: Banks and Markets

	Bank run	Market run
Trigger	Deterioration in banks' liquidity positions	Sharp contraction of market liquidity
	Coordination failures among depositors	Coordination failures among market participants
Transmission channel and mechanism	Psychological impact created by homogeneity of deposits	Synergistic contraction of market liquidity and fund liquidity
	Payment system network	Commonality of market liquidity conditions across countries and financial markets
Identification of problems	Relatively easy to identify which bank has a liquidity problem	Difficult to locate a liquidity funding problem given a wide range of market participants
	Relatively easy to identify solvency, e.g. non-performing loans	Solvency could change suddenly due to asset price fluctuations

Unlike LLR, no rules or principles established for MMLR

Bagehot's Rules for LLR

① **Support illiquid but solvent banks**

② **Lend freely**

③ **Charge a penalty rate**

④ **On good collateral**

(W. Bagehot, "Lombard Street," 1873)

Challenges for MMLR

✓ Identification of problems

Solvency or liquidity problems?

✓ Moral hazard

Incentives of firms and governments

Weaken market functioning

✓ Democratic political process

Possible central bank losses

Distortion in resource allocation

Policy commitment and macroprudential consideration

Trade-off between “flexibility” and “easing effect”

BOJ’s Statement on Monetary Policy on March 13, 2012

“The Bank will continue with this powerful easing until it judges the 1 percent goal to be in sight, though on condition that it identifies no significant risk to the sustainability of economic growth, such as from the accumulation of financial imbalances.”

FOMC Statement on March 13, 2012

“…the Committee … currently anticipates that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.”

Thank you for your attention!

Views expressed are those of Shigeto Nagai and do not necessarily reflect those of the Bank. If you have any questions, please do not hesitate to send me an e-mail at the following address: shigeto.nagai@boj.or.jp