



December 7, 2013  
Bank of Japan

---

## **Public Policy Study and Monetary Policy Management**

*Speech at the Graduate School of Public Policy,  
the University of Tokyo*

**Haruhiko Kuroda**

*Governor of the Bank of Japan*

## **Introduction**

It is a great honor to have this opportunity to speak at the Public Policy Seminar of the Graduate School of Public Policy, the University of Tokyo, and at the Global Public Policy Network Conference 2013.

I graduated from the University of Tokyo Faculty of Law in 1967 and joined the Ministry of Finance the same year. In the more than 40 years since then, I have been engaged as a practitioner in a wide range of works that relate to public policies, such as fiscal policy, tax policy, foreign exchange policy, development policy, and now monetary policy. During that time, I also had an opportunity to study economics at graduate school in England. What I learned through such experiences was that, to be involved in public policies, it is critical to link academic knowledge of jurisprudence and economics with practical knowledge obtained through the accumulation of experiences as a practitioner in a coordinated fashion. From such a perspective, progress in public policy study seems to be a historical inevitability, and I am quite encouraged by the fact that a global network such as the Global Public Policy Network has been established.

Today, I would first like to provide my summary of the progress in public policy study and changes in monetary policy management. On that basis, I will then explain quantitative and qualitative monetary easing (QQE), which the Bank of Japan introduced this spring, as a specific example. I will conclude by expressing my views about the future of public policy study.

### **I. Progress in Public Policy Study**

Let me start with the progress in public policy study. First, I will cite two numbers: 30 in 2001 and 2,200 in 2012. These are the numbers of economic papers that get a hit when doing an internet search with the keywords "quantitative easing (QE)." In 2001, the Bank introduced the world's first-ever QE. In academia, those within the field of economics did not have a particularly high interest in the QE at the time. It gradually attracted attention, however, and once the Federal Reserve (Fed) and the Bank of England (BOE) introduced their QE policies following the Lehman crisis, studies on QE increased dramatically. Progress in theories of economic policy, including monetary policy, has been made using

policies that were actually implemented as important reference material. And actual policies were in turn designed while learning from those theories. In my view, such interaction between actual policies and theories is basic to economics, public policy studies, and social science in general.

To begin with, the academic knowledge required when managing economic policy is knowledge of economics itself. Economics has been making remarkable progress year after year, both on the theoretical and empirical sides. In the management of economic policy including monetary policy, knowledge of economics has become essential.

It is said that the Great Depression in the 1930s gave birth to a new macroeconomics, and economics has been evolving while overcoming failures in actual economic policies. More recently, from the mid-1980s through the mid-2000s, the global economy enjoyed high growth with low inflation, and that period was called the Great Moderation. With progress in economics, and macroeconomic policies based on such progress, fluctuations in the economy and prices were controlled, and even a view that recession had become a thing of the past was rumored. However, things drastically changed with the occurrence of the Lehman crisis in 2008. The Lehman crisis and the subprime loan problem, which was one cause of the crisis, taught us that greater consideration needs to be paid to the possibility that the financial sector could destabilize the real economy. In addition, the fact that economic growth in many countries has been extremely sluggish even 5 years after the crisis suggests that existing macroeconomic policies might not necessarily have been effective. More fundamentally, it suggests that our understanding of business cycles in economics has not been enough. Namely, we cannot sufficiently answer the following questions: what kind of impact does a plunge in economic activity or impairment in balance sheets have on the growth potential of the economy, and how should macroeconomic policies respond to such shocks?

Meanwhile, the aggressive fiscal and monetary policies that were adopted by countries after the Lehman crisis, which were well outside the usual policy options in historical terms, seem to have revealed that there is considerable fruit to be harvested with regard to economic policy and economics. For example, during this financial crisis, unlike the

Great Depression in the 1930s, a plunge in the real economy has been avoided. That was because once the crisis was recognized, large-scale fiscal stimulus measures were introduced and central banks lowered policy rates boldly and promptly, and after lowering the policy rates to almost 0 percent, they invoked unconventional monetary policies without hesitation. These can be viewed as significant fruits, in that central banks turned a knowledge of economics that also took account of the experience of Japan after the bursting of a bubble into actual policies to overcome their challenges.

In such a manner, economic theory and actual economic policy are closely or even inseparably related, in that they are used to tackle challenges together, and are progressing given that new challenges will emerge one after another. Triggered by this global financial crisis, it is expected that economics will continue to evolve. At the same time, for a practitioner who is involved in public policy, there seems to be an implication that policy should be pursued by utilizing knowledge of economics while understanding its limits.

In actual economic policy management, it is not rare to choose a policy that can be regarded as second best or third best. Even a policy that can be considered optimal or first best -- namely, the most efficient one from the standpoint of economic theory -- might not be suitable. That is, not suitable in terms of such social values as fairness and conventional wisdom, or it might be difficult to reach an agreement within the democratic political process. In addition, there were many cases in which a policy was considered desirable in theory but could not be adopted because of practical difficulty. Some policy needs to go through procedures such as budgeting and legislating when it is to put into practice. Let me take an injection of public funds to deal with a nonperforming asset problem as an example. At the time of the Lehman crisis in 2008, the importance of injecting public funds as soon as possible to dispose of nonperforming assets was widely understood. By contrast, in Japan in the 1990s, it was quite difficult to gain support for such an assertion within the democratic process. In Japan, it was in 1999 when a full-fledged injection of public funds was made to major banks: several years have already passed since the problem in the financial system surfaced. Thus, it is difficult to use taxpayers' money before actual pains materialize, and this phenomenon can happen in any country, albeit with differing degrees.

Taking these points into account, in order to actually pursue policy, it is necessary not only to study economics but also political economy and public policy theory. Specifically, it becomes necessary to have staffers who understand the aforementioned difficulties in actual pursuit of public policy, and who on that basis plan policies and put them into practice. I believe that a variety of staffers with different backgrounds, who not only studied economics or jurisprudence but also public policy theory, will be required as those in charge of economic policy, including monetary policy. I thus expect that public policy study itself will be further developed.

## **II. Changes in Monetary Policy Management**

Based on the summary I have just presented, let us look back at changes in monetary policy among public policies.

In the United States, Europe, and also Japan, a central bank's primary mission had long been to secure the smooth functioning of the financial system, rather than ensure price stability or economic stability. For example, the United Kingdom experienced repeated financial crises in the latter half of the 19th century. Its central bank -- the BOE -- was expected to play the role of preventing disturbance in the financial system as a whole by providing liquidity as a "lender of last resort" to financial institutions on the verge of a crisis. In the United States, the Federal Reserve System was established with the aim of resolving financial system instability, based on the lesson learned from successive financial crises from the end of the 19th century into the early 20th century. This well represents the thinking at the time of the role central banks should play on the financial system front. The Bank of Japan was established in 1882. In addition to the purpose of sorting out the massively issued government banknotes, there was an aim to establish a modern financial system centering around a central bank. In such a manner, the central banks' objective at the time was to prevent the occurrence of a financial panic and to contribute to economic development by ensuring stability of the financial system.

This situation gradually changed after the start of the 20th century. In particular, the international gold standard collapsed in the 1930s and each country shifted to a fiat money

system. As a result, the supply of central bank money was released from the constraints of their gold holdings, and the extent of latitude in monetary policy increased substantially. Partly because of this, the idea of actively aiming to achieve economic stability -- notably price stability -- through monetary policy spread among major countries. While many central banks shouldered the role of supporting government bond prices amid expansion in fiscal spending during World War II, monetary policy after the war was separated from debt management policy, and thus recovered its autonomy.

Since the mid-1980s -- after weathering global surges in commodity prices and general prices due to two oil shocks -- prices stabilized and business cycles became smooth in the United States and other major countries. For example, in the advanced countries, from the 1980s until just before the Lehman crisis, the fluctuations in economic growth rates were moderate, and the average inflation rate declined from 6.5 percent to 2.1 percent (Chart 1). Amid a situation of the global economy showing an unprecedented favorable performance, an idea gradually took hold that central banks should focus on playing the role of converging the inflation rate to a certain level. In addition, institutional frameworks concerning central banks on the back of such changes were gradually established. Namely, there were cases that occurred one after another in which, mainly through revisions of central bank laws, not only independence was given to a central bank but also it was clarified that a central bank should specialize in ensuring price stability. In monetary policy management, this trend led to major central banks' adoption of price stability targets -- namely, inflation targeting.

Amid this global trend, the current Bank of Japan Act was enacted in 1997. At the same time, however, a somewhat different situation from other countries emerged in Japan. Since the 1990s, the financial system destabilized due to the nonperforming loan problem stemming from the bursting of the bubble, and Japan's economy was to suffer from protracted low growth and deflation. The Bank implemented ahead of other countries unprecedented unconventional monetary policies, such as the zero interest rate policy and the QE policy. The government often carried out large-scale fiscal spending. As a result, an economic depression such as that of the 1930s was avoided, and there were periods of economic recovery. However, Japan was not able to overcome deflation for nearly 15

years. Various factors could be considered reasons for the protracted deflation -- a continuation of low economic growth, destabilization of the financial system, a rise of emerging economies, and structural changes in the labor market. However, whatever the reason might be, it has been my view that the Bank, which is the central bank of Japan, is responsible for overcoming deflation and achieving price stability. In other words, I have thought that, because its commitment to ensuring price stability was weak, the Bank was unable to sufficiently influence economic entities' expectations, which is an important transmission channel of monetary policy. Such thoughts led to the introduction of the QQE.

### **III. Ideas of the QQE**

Let me next explain the QQE that the Bank has currently been pursuing.

In April this year, the Bank introduced the QQE in order to achieve a 2 percent price stability target at the earliest possible time, with a time horizon of about two years (Chart 2).

A problem that Japan's economy currently faces is that, amid protracted deflation, people's inflation expectations have declined and a sense that prices will not rise -- namely, a deflationary mindset -- has been embedded. Against such a backdrop, raising inflation expectations has become a policy agenda. Looking back at the history of central banking, raising excessively low inflation expectations through policy is a big challenge. Furthermore, in the case of Japan, short-term interest rates have already declined to close to 0 percent and long-term interest rates have also declined to a level below 1 percent. How should we raise inflation expectations through policy in a situation in which there is little room to further lower nominal interest rates? This is the challenge we are faced with, and the QQE is the prescription.

Specifically, the QQE comprises two elements. First, demonstrate the Bank's determination to definitively overcome deflation in the form of strong and clear commitment, in order to dispel deflationary expectations that have been embedded among firms and households. To this end, the Bank clearly expressed that it would achieve the price stability target of 2 percent in terms of the year-on-year rate of change in the consumer

price index (CPI) at the earliest possible time, with a time horizon of about two years, and clearly specified a timeframe to achieve the target. Second, taking into account that deflation has been continuing for a protracted period, only exhibiting a strong commitment will not be enough to make people believe in the Bank's strong will in the absence of a policy to underpin such commitment. In particular, from the standpoint of "at the earliest possible time," it was necessary to embark on a new phase of bold monetary easing that people could clearly understand was not an extension of the past policies. Therefore, the Bank decided to double the monetary base -- money the Bank directly provides -- in two years. In order to achieve this, it also decided to conduct massive purchases of Japanese government bonds (JGBs) inclusive of those with longer-term remaining maturities. So far, the Bank has indeed been increasing the monetary base and purchasing JGBs as decided (Chart 3).

The QQE aims to put downward pressure on the yield curve as a whole through massive purchases of JGBs, encourage investment in risk assets through portfolio rebalancing, and influence expectations of economic entities. In particular, as a major transmission channel, the Bank aims to lower real interest rates and stimulate economic activity through changing economic entities' expectations and raising their inflation expectations on the one hand, and containing long-term interest rates through massive purchases of JGBs on the other. In addition, through a virtuous cycle, an increase in observed inflation rates resulting from such stimulation to economic activity is expected to lead to a further rise in inflation expectations.

It has been eight months since the introduction of the QQE, and it has steadily produced the anticipated effects so far: favorable turns have been observed in the financial market, economic activity and prices, as well as in the public's expectations. First, looking at financial markets, stock prices have risen by about 50 percent since the beginning of the year (Chart 4). While long-term interest rates in major advanced economies have risen across the board, those in Japan have been powerfully contained due to the massive JGB purchases by the Bank. Interest rates on 10-year JGBs have recently declined to around 0.6 percent from around 0.8 percent at the beginning of the year. In this situation, inflation expectations appear to be rising on the whole, as seen in various surveys showing that an



increased proportion of people consider that prices will rise. As a result, real interest rates have declined, and this has steadily stimulated private demand.

Against this background, Japan's economy has been recovering moderately as a virtuous cycle among income and spending has been operating in both the household and corporate sectors. In terms of real GDP growth rates, the economy continued growing at an annual pace of about 4 percent in the first half of 2013, and has continued to grow at an annual pace of around 2 percent during July-September (Chart 5). As for prices, the year-on-year rate of change in the CPI excluding fresh food turned positive in June, and the pace of increase expanded to 0.9 percent in October (Chart 6). A look at the detailed developments in the CPI shows that not only energy-related goods such as petroleum products have pushed up the index, but also that there have been price increases across a wide range of items as private consumption remains firm and the economy continues to recover moderately.

With regard to the outlook, as shown in its latest Outlook Report published a month ago, the Bank expects the economy to continue growing at a pace of around 2 percent, above its potential growth rate, as a trend (Chart 7). This projection was made on the assumption that the consumption tax will be raised 3 percent in April 2014 and 2 percent in October 2015, as scheduled. Against this background, inflation in terms of the CPI excluding fresh food is likely to gradually accelerate and reach around the price stability target of 2 percent toward the latter half of the projection period through fiscal 2015.

As I have described, the QQE has been producing the anticipated results and Japan's economy has been following the path toward achieving the 2 percent price stability target as expected. The Bank will continue with the QQE, aiming to achieve that target, as long as it is necessary for maintaining it in a stable manner. It will thoroughly examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate.

The prescription of the QQE that I have explained is in line with the basic ideas within economics and public policy theory. First, I firmly believe that, as a central bank is a

public entity, the Bank must manage its policy in conformity with the legally given mandate of ensuring price stability. The Bank must clearly commit to this. Second, in the QQE, we took an approach of raising economic entities' inflation expectations by combining the central bank's clear commitment and underpinning large-scale monetary easing measures. This is putting economics, which recognizes the importance of expectations, into practice. Under such a basic framework, the QQE was designed by incorporating central banks' experiences and practical elements of financial business practices. With this QQE, I believe that Japan can overcome deflation.

#### **IV. Future of Public Policy Study**

I would like to conclude my speech by sharing with you my views on the future of public policy study.

First is the importance of studies on political and administrative feasibilities. In pursuing economic policy, including monetary policy, political and administrative feasibilities should be properly recognized, as they limit the space of policies that can actually be pursued. In recognizing this space, it is necessary to have an accurate understanding of people's behavior and the values of stakeholders who are politically crucial, as well as the background to how the current administrative system and practices have been formed. High-level judgment is required, as these factors are determined by each country's history, culture, and social systems, as well as the social and political situations of the times. I expect public policy study to shed further light on political and administrative feasibilities of economic policy.

Second is the importance of enhancing studies on how economic policy can influence expectations. As mentioned earlier, influencing economic entities' expectations is critical to monetary policy. That has become increasingly emphasized in the recent monetary policy management of major central banks. For example, the Fed, the European Central Bank (ECB), and the BOE have adopted the so-called forward guidance one after another. This policy measure aims to reduce uncertainty and provide further monetary easing effects under the zero lower bound of nominal interest rates, by clearly indicating future management of monetary policy. However, to get market participants to form expectations

just as a central bank intended -- namely, expectation management -- is not an easy task. This is because market participants' expectation formation will be prescribed by various situations, such as their views on financial and economic conditions, past experiences, and portfolios they have created. An analysis of expectation formation in various social and economic situations continues to be an important issue of public policy study, and the fruits of this will substantially contribute to the management of monetary policy.

Third is the importance of global policy interdependence. In a globalized world, not only do relations among countries become stronger but also the interrelationship of each country's economic policy, whereby possibilities of policy coordination arise, becomes important. For example, after the Lehman crisis, each country's government and central bank carried out an aggressive macroeconomic policy to prevent a plunge in economic activity. Many countries took measures to inject public funds to financial institutions and to guarantee financial institutions' debt. In addition, in response to global liquidity tightening, international coordination among central banks, such as dollar funds supplying operations using the dollar swap arrangement with the Fed, has been swiftly implemented. Such policy coordination can be assessed as being successful in preventing a financial crisis from developing into a full-fledged economic crisis. However, in deploying public funds, the potential cost of taxpayers in each country should be taken into account, and we got a sense of the difficulty with international coordination in this regard. This is also the reality that policymakers are facing. To properly pursue policy coordination on the basis of such reality, it will be important not only to design a theoretically optimal policy but also to understand each country's legal system and behavioral principles of stakeholders, which could be a hurdle in pursuing policy coordination.

### **Concluding Remarks**

Today, I have expressed my views under the theme of public policy study and monetary policy management by incorporating my own experiences and providing examples of what is actually happening recently on the economic policy front.

As mentioned at the outset of my speech, in economic policy, academic knowledge and practical knowledge are close or even inseparable, and public policy study that bridges the

two has become extremely important. This situation is common in any country, and as interrelationships among countries' economic policies have been deepening, there is no doubt that the global network has increased its importance. Therefore, it is expected that each country's graduate schools of public policy will promote public policy study through an expansion of joint studies and exchanges between professors and between students. From a central bank's perspective, I have great expectations for properly managing monetary policy by thoroughly utilizing the fruits of such studies. At present, there are not many economic papers that get a hit when doing an internet search with the keywords "quantitative and qualitative monetary easing (QQE)." However, a few years from now, the experience of Japan and the Bank of Japan may have provided a new chapter for economics and public policy study. And I cannot help but expect that a theory worked out then will be one of the powerful weapons that central banks can use in the future to combat deflation.

Thank you for your attention.

# Public Policy Study and Monetary Policy Management

*Speech at the Graduate School of Public Policy,  
the University of Tokyo*

December 7, 2013

Haruhiko Kuroda  
*Governor of the Bank of Japan*

---

## Outline

- I. Progress in Public Policy Study
- II. Changes in Monetary Policy Management
- III. Ideas of the QQE
- IV. Future of Public Policy Study

## Inflation Rate and Growth Rate in Advanced Economies

	1980s (CY 1980 – 1989)	1990s (CY 1990 – 1999)	2000s (CY 2000 – 2007) <Pre-"Lehman crisis">
Inflation rate (CPI all items)	6.5%	2.9%	2.1%
Real GDP growth rate	3.1%	2.8%	2.6%

Source: IMF.

## Quantitative and Qualitative Monetary Easing (QQE)

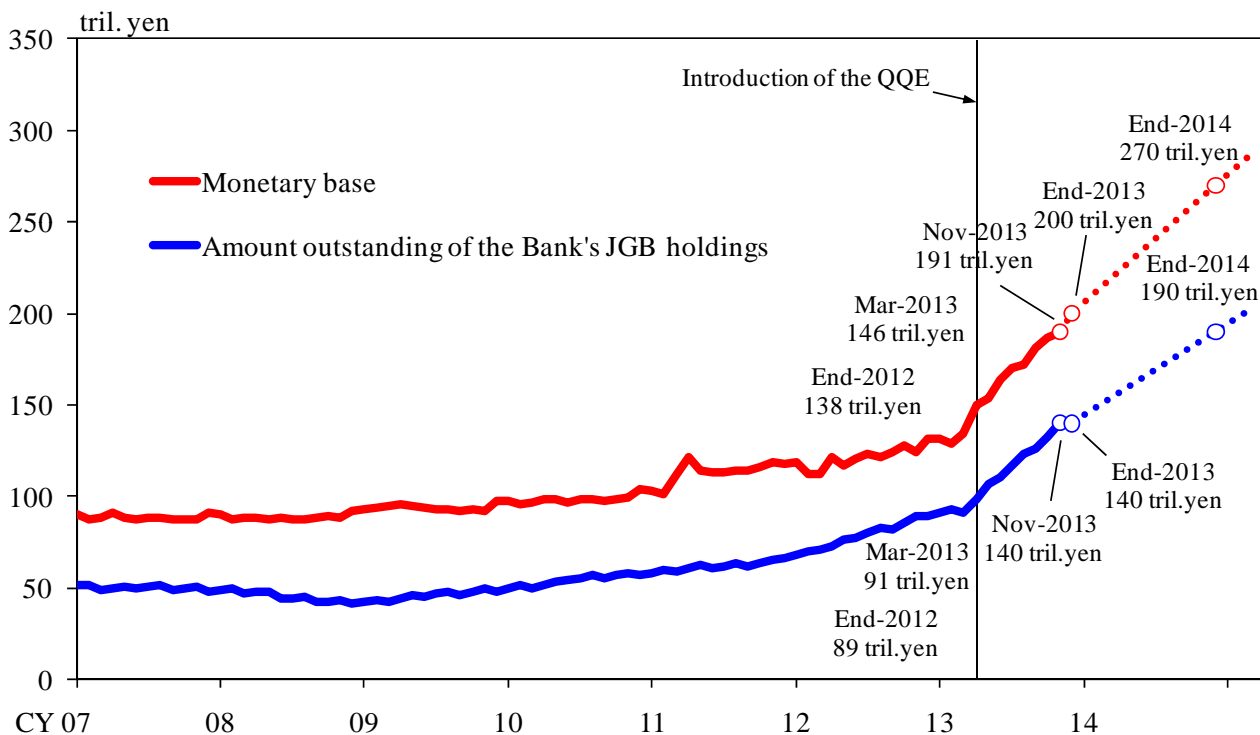
### Strong and Clear Commitment

- Achieve the price stability target of 2%, at the earliest possible time with a time horizon of about 2 years.

### New Phase of Monetary Easing Both in Terms of Quantity and Quality

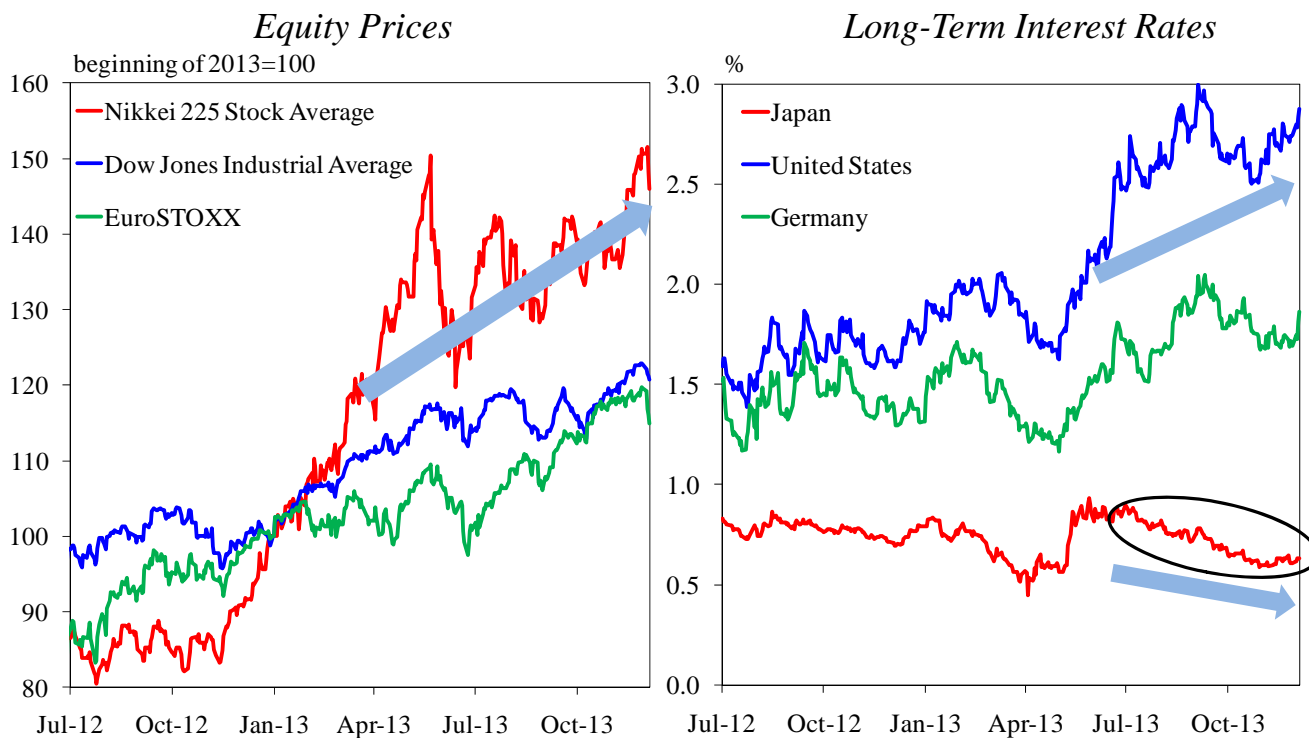
- Monetary base: Annual increase of about 60-70 tril. yen (x2 in 2 years).
- Amount outstanding of the Bank's JGB holdings: Annual increase of about 50 tril. yen (more than x2 in 2 years).
- Average remaining maturity of the Bank's JGB purchases: Extended to about 7 years (more than x2).
- Amount outstanding of ETF holdings: Annual increase of about 1 tril. yen (more than x2 in 2 years).

## Expansion in the Monetary Base and JGB Holdings



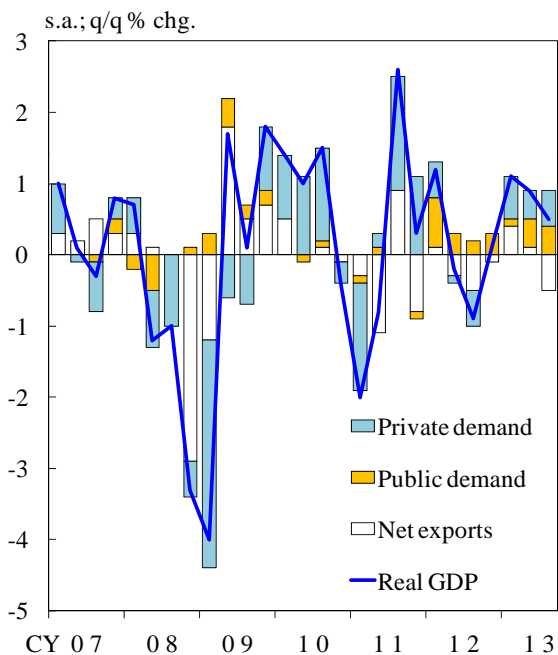
Source: Bank of Japan.

## Financial Markets



Source: Bloomberg.

## Real GDP Growth Rate in Japan

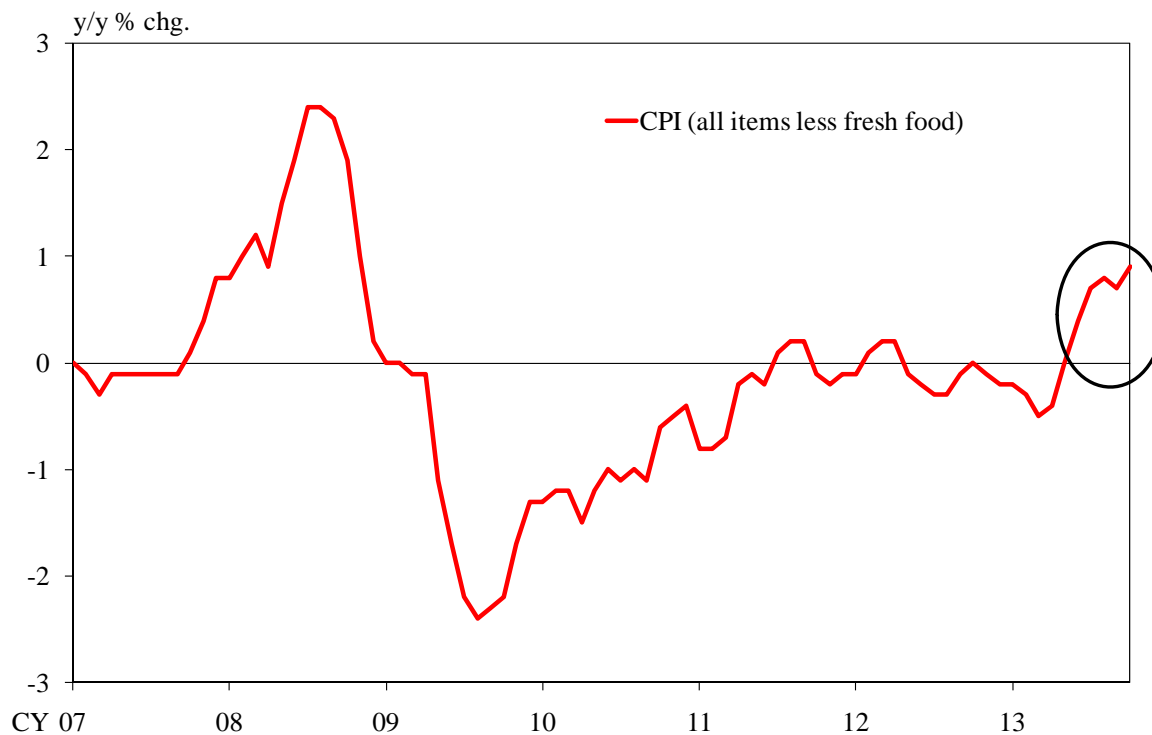


	2012		2013		
	3Q	4Q	1Q	2Q	3Q
Real GDP	-0.9	0.1	1.1	0.9	0.5
[Annual rate]	[-3.7]	[0.6]	[4.3]	[3.8]	[1.9]
Domestic demand	-0.4	0.3	0.7	0.8	0.9
Private demand	-0.5	0.0	0.6	0.4	0.5
Private consumption	-0.2	0.2	0.5	0.4	0.1
Non-Resi. Investment	-0.4	-0.2	0.0	0.1	0.0
Residential investment	0.0	0.1	0.1	0.0	0.1
Private inventory	0.0	-0.2	-0.0	-0.1	0.4
Public demand	0.2	0.3	0.1	0.4	0.4
Public investment	0.1	0.2	0.1	0.2	0.4
Net exports of goods and services	-0.5	-0.1	0.4	0.1	-0.5
Exports	-0.6	-0.4	0.6	0.4	-0.1
Imports	0.0	0.3	-0.2	-0.3	-0.4
Nominal GDP	-1.2	0.2	0.7	1.1	0.4

s.a.; q/q % chg.

Note: Figures of components in real GDP indicate contributions to changes in GDP.  
Source: Cabinet Office.

## Consumer Price Index



Source: Ministry of Internal Affairs and Communications.



## Forecasts of Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2013	<b>+2.7</b> <+2.8>	<b>+0.7</b> <+0.6>	
Fiscal 2014	<b>+1.5</b> <+1.3>	+3.3 <+3.3>	<b>+1.3</b> <+1.3>
Fiscal 2015	<b>+1.5</b> <+1.5>	+2.6 <+2.6>	<b>+1.9</b> <+1.9>

Notes: 1. Figures indicate the median of the Policy Board members' forecasts (point estimates).

2. Figures in angle brackets are the median forecasts made in July 2013.

Source: Bank of Japan.