Exclusive Interview

LEADERS IN JAPAN

No. 1

Former Governor of the BOJ
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Background of Japan's Unprecedented Monetary Easing & the Direction of Monetary Policy Hereafter

By Sota Kato

Japan SPOTLIGHT **starts from this issue a series of interviews with Japanese leaders attracting attention with their views on various issues. Our first interviewee for the March/April 2024 issue is Mr. Haruhiko Kuroda, former governor of the Bank of Japan (BOJ) and currently professor of the National Graduate Institute for Policy Studies, who has drawn attention worldwide for his monetary policy during his tenure (2013-2023). The interviewer is Dr. Sota Kato, principal researcher of the Tokyo Foundation for Policy Research and a member of *Japan SPOTLIGHT*'s Editorial Committee. He inquires mainly about the background of the BOJ's unprecedented monetary easing and its possible future monetary policy. The big question is whether this monetary easing will continue hereafter.**

(Interviewed on Dec. 20, 2023)

Lessons from "Magnificent Experiment"

Kato: The unprecedented monetary easing you adopted as governor of the BOJ was considered a "magnificent experiment" and attracted a great deal of attention around the world. I think it was a truly pioneering policy. Could you tell us what lessons you think there are from it for the rest of the world?

Kuroda: In the case of Japan, we had been in deflation for 15 years, from 1998 to 2012. The average CPI rate of increase during this deflationary period was a negative 0.3%, a mild degree of deflation. However, there were only four or five years during this period with a positive CPI rate of increase, and in all the other years it was negative. Such a period of deflation had never been experienced by other developed nations. During this period, the rate of wage increases had been on average a negative 0.9%, meaning roughly a 1% decline on average per year. Of these 15 years, there were more than 10 that marked a negative rate of increases in wages. It was extremely abnormal for such a situation to continue.

During this period, Japanese companies did not lay off permanent employees, but instead dismissed non-permanent ones. Thus, though the official unemployment rate during these 15 years had been around 5%, in reality it was worse than that. Furthermore, the cost to companies of keeping their permanent employees was so high that they would not recruit new employees during that period, and it became known as the employment "ice age" – a hard time for job seekers.

At the BOJ we started quantitative and qualitative monetary easing in 2013 to get out of this 15-year period of extraordinary deflation and a worsening employment situation. The United States and European countries as well might not have had any other choice but to adopt such a monetary easing policy if they had found themselves in a similar situation. So I think there is no particular lesson for other nations, as this monetary easing was precisely a response to Japan's unique economic situation. We needed unprecedented monetary easing to cope with unprecedented deflation, and I think all the major policy authorities, central banks governors in the US and Europe, and distinguished economists such as Joseph Stiglitz, Paul Krugman and Larry Summers with whom I have talked, understand this very well.

Background of Unprecedented Deflation in Japan

Kato: Why do you think such extraordinary deflation occurred?

Kuroda: First of all, since 1990 we had been working hard for 10 years to deal with non-performing loans accumulated in our financial institutions due to the bursting of the bubble economy. Thanks to these efforts, in the 2000s Japanese financial institutions recovered their capital mobility, but due to their experience during the collapse of the economic bubble, they have been pursuing extremely modest business strategies and refraining from investing in or financing projects with any risks.

Companies in Japan then were not willing to invest in facilities after restructuring their business activities, and financial institutions had become extremely reluctant to take any risks with their finances. Also, the BOJ's monetary easing policy then was not sufficient, although a number of anti-deflationary measures were taken by each governor: a zero-interest policy and quantitative monetary easing were implemented by Governor Masaru Hayami (1998-2003) and an enormous expansion of quantitative easing was carried out by Governor Toshihiko Fukui (2003-2008), which contributed greatly to raising prices. Then with massive intervention in yen-selling and dollar-buying, which became a sort of non-sterilization policy, extraordinary yen appreciation was stopped and the yen rate stabilized. Then, there was a slight rise in price increases. Under Governor Masaaki Shirakawa (2008-2013), a variety of comprehensive monetary easing measures were adopted to respond to external shocks, such as the 2008 financial crisis and the Great East Japan Earthquake of 2011.

I think those governors implemented many anti-deflationary policies and they were necessary and appropriate, but not sufficient. We were then in a situation where corporate risk aversion continued and prices dropped, and wages also declined due to insufficient monetary easing by the BOJ during these 15 years.

I think there were three factors that caused the bubble economy in the second half of the 1980s. One was the tremendous increase in public construction projects following the recession of the early 1980s, which stimulated investment in local tourism industries as well. In Tokyo, investment in real estate had increased, with the Japanese government's enhanced incentive to make Tokyo into a global financial center. With these projects, real estate prices started to increase in the first half of the 1980s and stock prices started to rise in the second half. With such a solid background for inflation, since the beginning of the 1980s the Japan-US Yen Dollar Committee had been implementing financial deregulation. Banking transactions were liberalized and the short-term fund market was expanded under this initiative.

Furthermore, the extraordinary yen appreciation initiated by the Plaza Agreement had not been stopped in the late 1980s. The G7 tried to stop it with the Louvre Accord, but failed. Meanwhile, Japanese monetary and fiscal policies continued to be expansionary to cope with this yen appreciation. Japan's macroeconomic performance was at its best and realized 5% growth on average in the second half of the 1980s for five years with the inflation rate curbed at only 2.3% or 2.4 % per annum even at the end of the 1980s due to the strong yen. Business companies as well as financial institutions made large-scale investments and stock prices soared, with the Nikkei average having reached around 39,000 in 1989.

Against this background, the BOJ governor at the time, Yasushi Mieno, oversaw the collapse of the bubble economy, regretting that a loose monetary policy had caused it. With the burst of the bubble, share prices fell drastically, though real estate prices did not fall so easily. Since then, the BOJ remained concerned about loose monetary policy possibly triggering another bubble. As a result, through the 1990s monetary policy had been delayed in acting to stop deflation, whereas fiscal policy tended to work more actively. Then in 1998, with the new BOJ law, the bank became completely independent from the government, and since then this reluctance to take an active loose monetary policy has remained robustly in the BOJ policy mindset.

But under such changed economic and monetary situations, without a drastic loose monetary policy we cannot improve the shrinking economy. The three BOJ governors implemented appropriate policies, but they were insufficient, and this caused a vicious cycle of simultaneous declines in wages and prices and the worst employment situation in the postwar period.

To get out of this, I pursued quantitative easing that had been previously done and a zero interest policy, and also comprehensive monetary easing through bond purchases and expanding this policy by massive purchases of long-term government bonds. With such quantitative and qualitative monetary easing, we doubled the monetary base in two years and together with lowered interest rates as a whole we tried to activate the economy. Our policies were inevitable in responding to the unprecedented deflationary state. It was not me but Governor Shirakawa who decided to adopt a 2% inflation rate as a goal for price stability in January 2013. It was also integrated into the BOJ-Japanese government joint statement and thus they decided to conduct monetary easing to realize 2% inflation at the earliest time.

I was inaugurated as governor of the BOJ in March 2013. In the first monetary policy decision meeting in April, we adopted quantitative and qualitative monetary easing. Prior to this decision, we received many views on monetary policy from a variety of experts, including members of the BOJ Policy Board and BOJ staff. There was a view that with the emerging two-year time lag in the effects of monetary policy, even an ultra-loose monetary policy would not bring us closer to the 2% goal any quicker. We discussed how much we should implement these policies by examining simulation outcomes based on various macroeconomic models.

There were two members of the Policy Board opposed to the 2% price goal at the January meeting, but in April we reached a unanimous consensus on this quantitative and qualitative monetary easing. This policy's scale was larger than the previous one and the quality was also different, but it basically remained a BOJ commitment to get the country out of 15 years of continuous deflation and realize 2% inflation as soon as possible.

Assessment of Global Economy & Japanese Economy

Kato: Next we move to current economic situations. At this moment, I think the global economy has changed from a deflationary state to an inflationary one, at least in the short run, and on the whole it is supposed to be moving in that direction a little more continuously. What is your view on this and also what is your outlook?

Kuroda: I have talked with many US and European economists and ex-governors of central banks, and their predominant view is that the age of loose monetary policy is over in general.

With the start of the Ukraine war in 2022, wheat and energy prices soared and that turned the deflationary state into an inflationary one at once, against the background of prices rising after the worst of the Covid-19 pandemic was over. Then developed nations all started tightening their monetary policies by raising interest rates in 2022. So, the perception that the phase of loose monetary policy over the past 10 years has ended now is commonly shared in the US and Europe. Meanwhile, high inflation rates are not likely to continue. So the majority's view in the US and Europe is that with the current monetary tightening, inflation rates in the US and Europe will be lowered and stabilized at around 2% in 2024 or 2025.

However, the situation in Japan is somewhat different. In Japan, with the quantitative and qualitative monetary easing adopted in 2013, inflation reached around 2% but then dropped thereafter. This could be partly due to a last-minute surge in demand before the increase in the consumption tax and a reactionary decline after the increase, but more largely due to the fact that wages were raised only a little against price increases, resulting in a real wage decline. With declining wages and the inflation rate decreasing again, we could not help but expand quantitative and qualitative monetary easing.

One important development in monetary policy was the introduction of a negative interest rate in January 2016. The background of this policy was the continuing large decline in oil prices from around $100 per barrel in 2014 to $50 and eventually $30 in January 2016, which had a significant deflationary impact on our economy. In addition, with the depreciation of the Chinese yuan, China started to export deflation to its trading partners.

Given these economic developments, we decided to further lower the overall interest rate in addition to expanding quantitative easing and we introduced a negative interest rate in January 2016, and in September adopted the so-called yield curve control with a negative 0.1% policy interest rate and 0% in 10-year government bond yields, and thus managed to realize this yield curve with a gradual slope.

During the pandemic, with the big fall in private consumption, prices dropped, but afterwards inflation started to return as the economy recovered from the pandemic's negative impact, and then with the outbreak the Ukraine war, wheat and energy prices started rising. Together with the yen's depreciation, in 2022 Japanese import prices increased by more than 40% from the previous year. This was naturally reflected in the CPI's rate of increase, which having once reached around 4% per annum is now around 3%. Unlike in the US and Europe, in Japan most imports prices rise are reflected in the CPI. The rate of increase in import prices is now negative and oil prices are not expected to rise under the current circumstances, and thus the CPI's rate of increase will be gradually stabilized.

In their Spring Labor Offensive in 2023 the unions decided to demand a 3.6% wage increase, the highest for 30 years. But the realized wage hike was around 2.5% and this means that real wages are still declining, given the 3% rise in the CPI. However, this trend seems likely to stop, as the unions will probably call for a 4-5% wage rate increase in 2024 and so the real wage rate increase would be around 3%. Assuming labor productivity increases around 1% per annum, we would need a 3% wage rate increase in order to achieve a 2% price rate increase in a sustainable and stable manner, and now we can see that possibility. If inflation is stabilized at 2%, we would not have to continue with monetary easing any further. We could start normalizing finances and raise the policy interest rate gradually towards neutral, and with this, the interest rate on government bonds will start rising.

In the US and Europe in general, and also in Asia, monetary policy is now returning to normal and the majority view is that the loose monetary policy of the past 10 years or more will not be conducted in the coming years. However, in Japan the situation is different due to the bursting of the bubble economy and the long period of deflation since 1990. Whether our economy has completely escaped from this extraordinary situation will depend upon the Spring Labor Offensive in 2024.

Social Norms in Prices & Wages in Japan

Kato: In your press conference on the occasion of your leaving the BOJ in April 2023, you mentioned the robust and insistent norms in Japanese society in prices and wages as the reason for your having failed to achieve the 2% inflation target in a stable manner. You bravely tried a variety of policies to achieve this goal, but the triggers for the recent price increase were external shocks to the economy such as the pandemic and the Ukraine war. Do you think the policies you conducted will not be able to change these norms?

Kuroda: Yes, certainly the social norms in Japan that prices and wages would not increase cannot be easily changed. From 2013 until 2019 just before the pandemic, inflation had been around 1% and wage increases had been even lower than that. On the employment side, 40 million jobs were created and the unemployment rate was 2.5%. With such significant improvement in the employment situation, a price increase to a certain extent was achieved but it failed to reach 2%. It is true that this situation has been changed by those two shocks – the pandemic and the Ukraine war.

But we managed to prevent the Japanese economy from falling into stagflation in spite of the continuing pandemic and the Ukraine crisis, with corporate profits doubling and 4 million new jobs created, both achieved by a continued monetary easing policy. Without this improvement in the economic situation, the yen's depreciation due to price increases for wheat and energy from the Ukraine war would have provoked inflation and a significant negative growth rate at the same time.

These norms that developed during the 15 years of deflation are not easily broken. However, it is not right to say that we should have set our inflation rate target at 1% instead of 2% under such insistent norms.

Kato: I think norms is a kind of Nash equilibrium in the academic sense, a situation where the mindset and behavior of all are in accord. In deflationary Japan, might this norm be a rational one simply reflecting the socio-economic situation? Individuals and companies alike are anxious about the future and falling into negative thinking about such issues as depopulation and feeling that nothing positive will happen to the Japanese economy, and that therefore it would be better to save as much money as possible rather than investing or consuming. Do you think such a view on contemporary society has a certain logic and rationale in accordance with the current economic situation in Japan?

Kuroda: No, that does not make sense at all. The population is also decreasing in South Korea and Taiwan. In Europe as well, apart from nations like Germany where immigrants now make up 25% of the total population, in many countries the population is decreasing, but they are not suffering from deflation. It is wrong to think that depopulation will lead to deflation. Depopulation would certainly reduce consumption but also supply capacity as well. With a decrease in both demand and supply, we cannot tell whether an economy would be inflationary or deflationary.

By coincidence, the Japanese working-age population started to decrease in 1995 and the total population started to decrease as well around 2001. This was noted against the background of 15 years of deflation. But after the introduction of quantitative and qualitative monetary easing, 4 million jobs were created. It is certainly true that population growth would significantly affect overall growth potential. For example, the US economic growth potential is 1.5 or 2 and the Japanese one is 0.5 or 1, and the difference between the two is 1%, corresponding to the difference in both nations' population growth, namely the US one is 0.5% and the Japanese one is a negative 0.5%. On the difference in growth potential between Germany and Japan, German growth potential is 1-1.5 with a 0.5 difference from the Japanese one, corresponding to the difference in population growth between the two nations – that is, Germany is zero and Japan is a negative 0.5%. So it is true that population dynamics would affect the mid- or long-term growth potential significantly, but population growth is not the sole factor determining growth potential. Labor productivity growth is another factor. With labor productivity growth having been little different between the US and Japan during these 10-15 years, the difference in their growth potential can be mostly explained by the difference in population growth.

Kato: With a firmly established norm of not encouraging wage or price rises or investing, a person or a company diverging from it would be a loser.

Kuroda: Yes, financial institutions also may have found it better not to take risks. Business corporations with bad memories of the bursting of the bubble hesitated to make new investments. They only lower the prices of their products, not raise them, and employees found it crucial to secure jobs rather than gain higher wages, and thus they were getting into a vicious cycle with a nearly 1% annual decline in wages, mainly in bonus payments.

Kato: I think the government and the BOJ should intervene to move the economy from a bad norm to a good one. I have the impression that the BOJ was actively working on this in the monetary policy area under your leadership. However, the other two key policies needed to change a bad norm, namely fiscal policy and structural economic reform policy, do not seem to have caught up with the BOJ's efforts. Is it necessary to have collaboration between the BOJ and other public policy authorities to save the economy from a bad norm?

Kuroda: I do not think so. Under Abenomics, as you know, a wide range of policy measures have been made, such as encouraging women's social activities, expanding support for raising children, and expanding preferential tax treatment for GX or DX. Such policies worked well, and the majority of the 4 million newly created jobs were for women.

On the issue of raising wages, it was the ruling Liberal Democratic Party, not the opposition parties, that was working with the Japanese Trade Union Confederation in trying to do this. The administration of Prime Minister Shinzo Abe on the whole worked hard on structural reform and fiscal support, as well as trying to save the Japanese economy from the continuing deflation, which resulted in a significant improvement in the employment situation and a certain degree of investment recovery. But our efforts were not successful in achieving a virtuous cycle of wages and prices. Prices increased to a certain extent but did not lead to wage hikes. The mindset behind this vicious cycle was not easily broken.

Kato: In Europe, there is a tradition of neo-corporatism, collaboration in policy making between labor unions, business, and government. Did such a collaborative mechanism exist in the Abe administration as well?

Kuroda: Yes. The Federation of Economic Organizations was also working with us. But even with collaboration among the three, we could not induce both labor unions and corporations to come back to a wage-price virtuous cycle after their 15-year experience of annual 0.9% wage declines and price falls, albeit little and gradual. At this moment, with a more than 40% import price rise due to the Ukraine war leading to a 4% CPI increase, the wage increase demand in the Spring Labor Offensive would reach 3.6% in 2024, and we should be able to break the last barrier to a virtuous cycle. In 2024, if we achieve a wage hike higher than the inflation rate, I expect that the bad norm will be completely broken and we will be able to realize the 2% inflation rate target in a stable, sustainable and continuous manner.

The Cause of the Yen's Depreciation

Kato: On the yen's current depreciation, there must be many factors behind it, such as the interest rate differential between Japan and some other countries, or the Japanese economy's growth potential. What do you think about these factors?

Kuroda: When I was governor of the BOJ for those 10 years, the exchange rate was miraculously stable within a range of 10 yen at about 110 yen to the dollar for nine of those years. Even after 15 years of deflation, the yen rate was more or less maintained. When the Ukraine crisis started on Feb. 24, 2022, the rate was 115 yen to the dollar. So it would be completely wrong to say that the yen is getting weak because the Japanese economy is losing its international competitiveness. The exchange rate cannot be explained by such an argument. Of course, the mid- or long-term exchange rate is fixed by a nation's economic fundamentals. But the yen's depreciation that started in February 2022 cannot be appropriately explained by such fundamentals.

On the other hand, looking at Japan's current balance, often noted as a good indicator of foreign exchange demand and supply, its surplus has been expanding even with the trade balance in deficit. In spite of that, the yen has not appreciated because with the tremendous increase in external assets, the surplus in the primary income balance is largely increasing, even though there is deficit in the trade balance in goods and services.

Returns on FDI or indirect investment overseas are counted in the income balance, but it is another story whether such overseas earnings will come back to the mother nation. Even with a large current surplus, much of it will not necessarily come back to the foreign exchange market. Looking at the capital balance, there are FDI and indirect investments, and the largest fluctuations in capital movement are observed in the short term for indirect investments. So the expanding interest rate gap has been increasingly affecting these short-term investments. There was a narrative that although in 2022 in response to 8% inflation in the US and 11% in Europe, they all at once raised their policy interest rates widely, Japan did not change its yield curve control and then with the interest rate differential between Japan and those nations expanding, the yen's depreciation was triggered. I do not believe it, because it depends on exactly what interest rate differential is being referred to in this narrative – the short-term differential or the long-term one, or a covered interest rate parity or an uncovered one? It also depends on the exchange rate to only the dollar or to other currencies like the euro or Chinese yuan.

I would not predict any future exchange rate value. It is true that the Japanese economy is now performing extremely well. We will see economic growth in the 1% range continuously in 2022, 2023 and 2024, meaning continuous growth higher than Japan's growth potential of 0.5-1.0%. Japanese corporate business profits reached their highest in history, having exceeded those during the bubble economy. The labor market is tight and there is even a shortage of labor. In this light, the current yen rate is too depreciated and at some point it will return to the level of around 110 yen to the dollar. We cannot say when and how this will happen, since it will depend upon market situations.

I think it is easy to predict interest rates, as it is basically to predict the central bank's monetary policy. The central bank seems to control policy interest rates only in general, but it does so by assuming any rate change's impact on mid- and long-term interest rates. Thus we can have a correct prediction for either short-term or long-term interest rates by predicting what the central bank would do.

(From left to right): Interviewer Sota Kato, JEF Editor-in-Chief Naoyuki Haraoka, and former BOJ Governor Haruhiko Kuroda

Share price predictions may appear more difficult, but this is basically equal to predicting corporate profits, and it would be easy to predict them either this year or next year. But you would not be able to correctly predict foreign exchange values, as it would need to be done by taking account of expectations or speculation. Also, government intervention in foreign exchange markets would need to be counted as a final factor that we cannot predict at all. So I think it better not to make any foreign exchange rate prediction.

Kato: Although we are not quite sure about achieving a stable 2% inflation rate, we can see a little hope for it at this moment.

Kuroda: Yes, it is true. What makes Japan different from the US and European countries is that they are now engaged in tightening monetary policy by making rapid and significant interest rate hikes to deal with inflation. Japan is not in such an inflationary state and is pursuing its 2% inflation goal in a stable manner. We need to raise the policy interest rate slowly to achieve it. The household sector in Japan has around 2,000 trillion yen in financial assets and it would benefit from the possible rise in saving deposit rates. Business corporations owning great amounts of cash and deposits will not suffer much from a little interest rate rise. The government itself will be most affected by interest rate rises in Japan. With a gradual rise in the policy interest rate, the interest rate on national bonds would rise, and the government's refinancing bonds or newly issued bonds would be affected by such a rise. Assuming the average interest rate of all government bonds including short-term and long-term ones was a little less than 2% around 2000, government bond interest payments would amount to 30 trillion yen, which would create a much bigger government expenditure increase than the 5 trillion yen increase in defense expenditure or the 3.6 trillion yen increase in government support for child-raising.

Possibility of the BOJ Falling into Excessive Debt

Kato: As the interest rate continues to be raised, it has been pointed out that the BOJ could be in excessive debt due to increased interest payments on reserve deposits. By holding such big "unrealized losses" in government bonds not explicitly present in accounting, could the BOJ achieve its mission by maintaining market confidence?

Kuroda: The BOJ, the Federal Reserve Board and the European Central Bank do not have market evaluations and so there would be few occasions where they fall into excessive debt. But they could have deficits. At this moment, the FRB and ECB have deficits and they do not make payments to the treasury. The Australian Central Bank is now in excessive debt and in its case, all of its assets are subject to market evaluation and with the interest rate raised, government bonds would record a capital loss.

Although the BOJ, FRB and ECB do not have market evaluations for government bonds, with the rises in policy rates their interest payments on reserve deposits would increase. On the other hand, the interest rate on government bonds will increase by the same degree. Therefore, the difference in speed between reinvestment in government bonds with higher interest rates and interest payments on reserve deposits would determine whether the BOJ is in deficit.

If the interest rate on government bonds rises before the policy interest rate, the BOJ replaces the government bonds on due dates with ones with higher interest rates, so they would not be in deficit. But if the policy interest rate is raised prior to the rate on government bonds, as the due dates of government bonds come around only slowly and if the speed of replacing them with new bonds with higher interest rates is slow, then there would be a deficit and the BOJ could not make payments to the national treasury. In the case of the FRB and ECB as well, they raised policy interest rates rapidly and their interest payments increased likewise. But if there was not enough time for them to quickly reinvest in new government bonds with higher interest rates, then they would have a deficit. In Japan, we have an allowance for credit losses reserved annually with half of the difference between interest payments on reserve deposits and operational income from government bonds. So even with a loss margin or deficit, we can use this allowance and the payments to the national treasury would not be easily erased, and even if this becomes zero, it would only be temporary.

Kato: According to the latest BIS report on excessive debt in central banks, they would not need to be so anxious about it. Rather too much concern about it on the part of central banks could provoke a loss of confidence in them, which would make the situation worst.

Kuroda: Yes. The Australian Central Bank is now in a deficit but it is maintaining a presence of mind and behaving firmly.

Relationship Between Government & BOJ

Kato: The Japanese government and the BOJ have occasionally been in conflict, but I have the impression that you managed this relationship very well. Did you pay particular attention to preventing conflicts with the government?

Kuroda: During my 10 years in office, I visited the Prime Minister's Office about twice a year and talked with the three premiers – Mr. Abe, Mr. Suga and Mr. Kishida. On those occasions, I gave detailed explanations of the BOJ's monetary policy. In particular, I often met informally with Mr. Taro Aso, deputy prime minister and finance minister, at various venues. I have never had any order or complaint regarding our monetary policy from them. Under the current BOJ law, the government does not have a way to apply pressure to the BOJ. Under the old Act, the minister of finance could give orders to the BOJ about policies, and he or she could dismiss the governor.

But the new Act eliminated such articles. Now, the BOJ is independent from the government in its monetary policy decision-making, as is the ECB or the Bank of England.

Also, in the old Act, the Policy Board of the BOJ could decide the official discount rate and open market operations, but on reserve ratio manipulation, government permission was needed. But now this permission system has been abolished. Of course, it is the Cabinet that appoints the governor, deputy governor and all the other Policy Board members with the Diet's agreement. During their five-year terms of office, the government cannot pressure any of those members to follow its own intentions, and thus it cannot force the BOJ to buy more government bonds. The BOJ has been easing monetary policy and purchasing lots of government bonds hitherto. This is to bring the Japanese economy out of deflation and not to help the government.

Kato: The BOJ's sharing of its 2% inflation target as a policy goal with the government seems to be one of the reasons for stable relations between the two. However, after this goal is achieved and the BOJ starts to exit from a loose monetary policy, might there be some conflict with the government, in particular on the question of public finances?

Kuroda: Yes. As you said, there is unlikely to be conflict in a situation where both the government and the BOJ must continue efforts to achieve their shared policy goal of a 2% inflation rate. I do not know yet whether any conflict between the two would arise over the question of increasing the government's burden with government bonds after this goal is realized and monetary policy becomes more normalized. Whatever happens, the BOJ would not need to get any instructions from the government and should not do so. I do not think the BOJ would purchase government bonds to expand its balance sheet and provoke serious inflation when prices and interest rates are normalized. As I said, the government has no means to pressure the BOJ and so I am not worried about the BOJ's policy. The concern is over the growing debt in public finances due to increasing interest payments after the rise in the interest rate. The government and the Diet must think about this question in depth.

Kato: If our inflation rate exceeds 2% and gets higher, people may expect the BOJ to have anti-inflationary countermeasures, contrary to the current situation. In that case, the BOJ could be strongly criticized for its long-standing monetary easing policy. At such times, could the BOJ maintain what it believes to be a relevant policy without being influenced by outside views?

Kuroda: It should do so since it is written in the law. In sum, in monetary policy management, the BOJ's most important goal is to achieve healthy economic development through price stability. It should not do anything against this goal. The old BOJ Act did not have such a description of its mission, but this is clearly written in the new one. Its first primary goal is to achieve price stability and the second one is to achieve stability of the payment system. The BOJ is not responsible for achieving stability of the financial system. It is the Financial Services Agency that is responsible for that. The BOJ has had special finances for the banks exposed to crises that were a part of this payment system in order to stabilize it.

However, we have been trying to refrain from speaking about the whole financial system, as we are not responsible for stabilizing it. The FSA's representative and the BOJ's representative are members of Basel Committee on Banking Supervision. In the Basel Agreement, a nation's own government bonds should be risk-free and without risk weight. But after Greece went bankrupt with lots of risk weight, they discussed having a risk weight for each nation's own government bonds. This was not eventually realized, but anyway it is not an issue within the BOJ's jurisdiction. It would be meaningless for the BOJ, with no legal authority in financial regulations, to intervene in this issue. The BOJ must follow the rules of the BOJ Act and do what is defined in this Act.

Kato: Thank you so much for your valuable comments.

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Interviewer: Sota Kato is a research director of the Tokyo Foundation for Policy Research. After earning a law degree from the University of Tokyo, he joined the Ministry of International Trade and Industry (MITI, now the Ministry of Economy, Trade, and Industry, or METI) in 1991. At MITI and METI, he served as assistant director for the Aircraft and Defense Industries Division, deputy director for the International Economic Division, and senior fellow at the Research Institute of Economy, Trade, and Industry (RIETI). He also served as associate professor at Yokohama National University and professor at the International University of Japan (IUJ). He has an MBA (with honors) from Harvard Business School and a PhD in political science from the University of Michigan, and is concurrently a visiting professor at IUJ.