

Title: Differences in unconventional monetary policy of both the Federal Reserve Board and the Bank of Japan

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I. Introduction

Prices are skyrocketing in the US owing to post-Covid-19 conditions and the Ukraine war. Japan has also faced an increase in prices. However, the FED and the Bank of Japan (BOJ) shows a strikingly contractive stance regarding their monetary policy. The Fed started tapering from April 2021 and raised their policy rate (federal funds rate) drastically. Conversely, the BOJ has stubbornly continued with the “unprecedented monetary easing.” The Yen has depreciated from 114.92 JPY per \$ in March 2022 to 148 JPY per \$ in October 2022 (28.9% down). The BOJ is not changing its stance thus far. Why are both banks implementing contrasting policies? This study aims to answer that question.

This study consists of two dimensions: first, to draw the historically penetrating nature of money-supply, monetary policy, and central banks, to clarify what “conventional” monetary policy is; and second, to define “unconventional policy.” Moreover, I will divide “unconventional policy” into different types. Each type gives us different implications for the estimation of current policies. In summary, the unconventional policy of the Fed is not the same as the BOJ’s.

II. Conventional monetary policy

(1) Elements of a Credit System

The modern monetary system, which was separated from the gold standard system, is known as the managed currency system. This system has been established as an enormous credit system. Marx (2000b) states that in the capitalist mode of production, the circulation of commercial bills, which underlie the credit system, prevails, and “money serves here, by and large, merely as a means of payment.” To the extent that such bills of exchange “ultimately neutralise one another through the balancing of claims and debts, they act absolutely as money.” In short, the bill of exchange is commercial money and “form the basis of credit-money proper, of bank-notes, etc.” The basis of the credit system is credit money (Marx, 2000b, pp.532-533).

Moreover, “to the same extent as the system of credit is extended, so is the function of money as a means of payment.” Credit as means of payment “makes itself at home in the sphere of great commercial transaction. Gold and silver coin, on the other are mostly relegated to the sphere of retail trade” (Marx, 2000a, p.202). Gold and silver have apparently faded out as a guarantee for credit. After all, gold has been confined in the central bank reserve.

(2) Contemporary Money

A bank deposit is positioned as the key to the modern currency structure and the primary form in modern currencies, though banknote is legal tender and seems to be the key currency. The banknote evolved from the commercial bill and has been used as a circulation medium in retail trade or as a means of payment (clearing medium) in, for example, credit trade, where the bank system has sufficiently prevailed. To accept it as a means of payment, it can be exchanged at any time with banknotes which “are more or less legal tender.”

However, “a bank-note simply represents the coin of wholesale trade”, as “it is always the deposit which carries the most weight with [a] bank” (Marx, 2000b, p.538). If credit cancels out debt, or a deposit which is the right to demand payment is transferred, the deposit acts as means of purchasing for depositors. At this point, the position of banknotes and deposits are reversed completely. Banknotes are drawn from the account and used as a medium of circulation, or a means of purchasing, and are saved by another account. It shows that banknotes “serve to make the payments claim (that is, the deposit) transferable” (Marx, 2000c, p.539).

(3) Central bank

In any countries which have a contemporary credit system, central banks are “the principal banks issuing notes, being a peculiar mixture of national and private banks” (Marx, 2000c, p.538). On the one hand, notes issued by a central bank “are more or less legal tender,” so that in fact, central banks “actually have the national credit to back them” (Marx, 2000c, p.538) and the characteristics of a “national bank.”

On the other hand, private banks draw its banknotes from their account in the central bank and from there they go out to circulation. The first step of issuing banknotes, therefore, is a loan transaction (that is, banking). Loan transactions between a central bank and commercial banks are credit creation by the central bank. It is a principle of central banking. This shows that central banks have a feature of a “private bank.”

Furthermore, we also consider “a peculiar mixture of national and private bank” from the view of money. The credits or trusts of credit money which command the great majority of money in the contemporary credit system, are backed by fulfilling payments (settlement of credit) and national credit. Under the gold standard system, credit was also backed by the conversion to gold as an artificial system. However, after giving up the conversion to gold, the credit of banknotes is backed only by their reflux to the central bank, maintaining their value (de facto represented amount of gold per banknote).

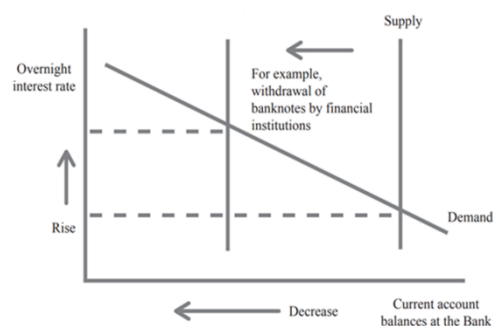
Credits of credit money as both an IOU and legal tender are subject to conditions of real economy and government. Central banks as “a peculiar mixture of national and private bank” must also pay attention to both of them to protect credits of bank notes and BM. Central banks are, therefore, called as “the guard against inflation” or “watcher of currency”

(4) Money supply and monetary policy

Supply of BM is a loan transaction. A central bank lends BM (base money) to commercial banks with interest. BM is a cost to the commercial bank. Therefore, private banks are raising BM from the central bank, as long as it connects with earning opportunity.

However, commercial banks need reserves, as deposits of commercial banks are “IOU.” The aggregate demand for funds (BM) of private banks are regulated by their lending behaviour, because deposits are created by the lending (credit creation) of private banks. In other words, aggregate demand of BM of private banks are fixed in advance from two contributors, the result of both lending (credit creation) and demand for BM with a profitable price (interest rate).

The central bank must always supply the necessary quantity of BM to private banks as the sole issue bank (supplier of BM). Fundamentally, the central bank must supply BM quantitatively to meet the vertical demand of reserve of private banks (passive response). Regardless of the passive position the central bank holds, it can manage the interest rate in the money market by changing the supply curve to this vertical demand curve of BM (manner or extent of supply) during a certain period (the BOJ, 2004, pp113–115).



(5) Conventional monetary policy

As observed in the previous section, the central bank must maintain the value of its note through banking (lending or banking). The first goal of monetary policy is to preserve the value of bank notes. However, the tool used in monetary policy is not control of the BM, as a central bank cannot control the demand for reserves directly. It is forced to rely on the price mechanism of the market. The central bank as a lender must passively have an account with commercial banks. Therefore, controlling of interest rates (short-term interest rate) in the money market becomes

the “conventional monetary policy” of the central bank. I would like to identify here that the conventional monetary policy is the control of short-term interest rates, which then changes banking behaviour. That is, the path that the conventional policy follows, must be drawn from managing and changing short term interest rates, to change the behaviour of private banks and then expect the target amounts of BM.

Incidentally, when chains of debt and credit are broken for some reason (for example, a bubble burst), in the credit system demand for money advances rapidly: “As the heart pants after fresh water, so pants his soul after money, the only money” (Marx, 2000a, pp.199–2000). At the time, the central bank must supply urgent liquidity to prevent the interest rate from skyrocketing and retain trust in the credit system. That policy (money supply for relief) is also included in conventional monetary policy, though it appears to be the exception. By supplying urgent liquidity the central bank keep the stability of credit system and the trust of BM and bank note. At a glance, the central bank seems to give up the stability of value of banknote. However, as this policy defend the trust of bank note by keeping the stability of credit system, it is part of a central bank’s role as the “national bank.”

III. Unconventional monetary policy

(1) Definition

Generally speaking, “unconventional monetary policy” is defined as the policy that the central bank is impelled to use with short-term rates constrained near zero. This definition can’t be applied to the tightening policy, but can be applied to the easing policy. However, we have to also apply it to the tightening policy, if “conventional policy” can be defined as the policy where the central bank has an effect on market movement by using price mechanisms, that is, operating of interest rates (short-term interest rate) in the money market

In fact, we experienced “unconventional policy” in tightening policies historically. For example, during P. Volcker’s time as chair, an “unconventional” tightening policy might be identified. On October 6, 1979, Volcker explained the Federal Open Market Committee (FOMC) would shift its focus to managing the volume of bank reserves in the system instead of trying to manage the day-to-day level of the Federal funds rate (Fed, St. Louis, 1979). It means that FED changed the goal of monetary policy from interest rate to quantity of BM. As a result, the interest rate skyrocketed at that time. It supposes that the FED intended to suppress inflation by compelling an artificial monetary crisis (see the last part of the previous section).

Furthermore, the policy path expected by mainstream macro-economics should also be unconventional monetary policy. It supposes that the central bank can adjust money supply and price level by changing the amounts of BM directly. The policy path that the mainstream assumes is from BM to money supply and prices via the interest rate. This is not conventional monetary policy.

(2) Three patterns of unconventional monetary policy

There are two unconventional monetary policy tools—forward guidance and quantitative easing (FED, St. Louis, 2015). Here, I divide quantitative easing into two patterns and provide my comments. The first pattern is the BOJ policy. The BOJ adopted quantitative easing from 2001/3 to 2006/3. It can be called “original quantitative policy.” President Kuroda, thereafter, accelerated it as “unprecedented monetary easing policy” and has increased BM by large amounts. As a result, the actual average outstanding BM accumulated 39 times of the required average outstanding amount as of Aug. 2022. This policy can be suggested as a simply applied standard macro theory, because its target is just to increase BM.

The second pattern is the case of the FED. It is the policy of purchasing various assets (QE1~QE3 after the Lehman crisis in 2008). However, the FED did not explain that it is the policy of increasing BM, but includes the abnormal purchasing of assets. This is aimed to

influence market movements directly without control of short-term interest rates. The FED gave up on controlling the price (interest rate) of the money market, instead it intended to have an effect on the market price or movement in the real economy directly. It was not a standard application of macro-economics.

Third, forward guidance. Its effect was also different between the FED and the BOJ. It will be explained below.

IV. Consequence and evaluating of unconventional monetary policy

What I made clear in the previous section is that unconventional monetary policy of the FED was the policy that intended to have a direct effect on market movements (such as interest rate and lending) without controlling the money market. From this, we acquire the implication that the FED has worked in the frame of market mechanisms and followed a banking school principle. Therefore, the FED has responded against the changing of economic conditions in comparatively flexible manner since the Lehman crisis. In QE1, the FED aimed for liquidity supply as the remedy for the monetary crisis. In QE2 and 3, it moved its target to reflation.

However, forward guidance of the FED might not go well owing to market movements. Once the FED intended to purchase long term-bonds, the bonds were purchased and asset prices went down and vice versa. As the market foresee the price of the government bond to increase by FED policy, the market intend to sell stocks and buy the bond. Reason why the long-term interest rate was actually lower, is a decrease in real economic activity (Tanaka, 2014).

In contrast to the FED, the BOJ has continued the outright purchase of the government bond as the tool for increasing BM. Moreover, it has been used as the tool to reduce the long-term interest rate (Yield Curve Control (YCC)). The BOJ's operation has been strong, and the yield curve has stuck flatly around the zero zone. The BOJ appears to put the bond market and yield curve under its control artificially. Simultaneously, this operation has supported the government budget due to its dependence on government bonds. At present, the share of government bonds in the asset of the BOJ has reached approximately 80% (2022/10). The BOJ has already been subordinated to the budget. It has fallen into monetization.

The BOJ has also tried to purchase assets just as the FED did. The difference is that the BOJ has just purchased huge quantities of equities through ETFs only to prop up the stock price. Expectable and feasible goal of this operation, therefore, should become so narrow. It has not led to economic growth. Funnily enough, the BOJ is the biggest stockholder in Japan, and it has continued this purchasing policy (Bloomberg UK, 2022). These facts show a distorted and rigid condition that the BOJ is facing. The BOJ must persist with the current stance stubbornly due to these economic conditions or they might not be able to find an exit strategy. Considering on the characteristics of central bank as "private bank," should we accept these current conditions?

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