November 2, 2009

Bank of Japan

Unconventional Policies against Fear of “Unknown Unknowns”

Remarks at the Panel Session "The Repositioned Role of Central Banks in Today's Economic Environment" at the CME Group’s Global Financial Leadership Conference

Kiyohiko G. Nishimura

Deputy Governor of the Bank of Japan

First, I would like to take this opportunity to briefly comment on the unconventional policies[1] of central banks and their gradual wind-down.

Aggravator of the Global Financial Crisis: Fear of "Unknown Unknowns"

I would like to remind you of what aggravated and transformed a peripheral U.S. subprime mortgage problem into a full-blown global crisis: Namely, the contagious erosion of confidence, or the fear of "unknown unknowns" in financial markets. Market participants become excessively fearful that they might be confronting a previously unknown, essentially uncertain and unpredictable world. They assume the most pessimistic scenario possible and try to make the most of it.[2] What is more, market participants tend to stand on the sidelines until market confidence has been restored. The failure and the fear of failure of large international financial institutions caused market participants to be fearful of the possibility of the failure of their counterparties. Haircuts for the collateral rose rapidly and financial institutions were obliged to sell their assets at distressed prices to obtain immediate liquidity. Financial markets became severely segmented and some literally collapsed.

Central Banks' Policy Responses: "Catastrophe Insurance" Provider

In order to address this problem, the central banks of developed countries first conducted ample and enhanced liquidity provision by offering more frequent operations to more counter parties at longer maturities and against broader collateral, in addition to series of policy rate cuts. Then, as the erosion of confidence intensified after the failure of Lehman Brothers and market dysfunctions became more pronounced, the central banks began intervening in specific market segments by introducing and expanding asset purchase programs for commercial papers, corporate bonds and government debts[3].

---

[1] For a more detailed account on the topic, see Nishimura, K. G., "Unconventional Policies of Central Banks: Restoring Market Function and Confidence," Remarks at the Panel Session "Monetary Policy Boundaries: Alternative Instruments and Policy Coordination" at the Money and Banking Conference sponsored by the Central Bank of Argentina on Sept.1, 2009, available online at http://www.boj.or.jp/en/type/press/koen07/ko0909a.pdf.

[2] If a decision maker's confidence is "contaminated" or eroded in the sense that he/she thinks, though with a small probability (say ε), that he/she is ignorant about the situation he/she faces, his/her rational behavior can be described as "maximin" optimization. In the maximin optimization, he/she is particularly sensitive to the worst-case scenario. See, Nishimura, K. G., and H. Ozaki (2006), "An Axiomatic Approach to ε-contamination," *Economic Theory*, Vol. 27(2), pp. 333-340.

[3] Also, the Fed expanded swap lines with other central banks to enable other central banks to provide further dollar liquidity.

By these augmented liquidity provisions and market function-enhancing interventions, the central banks effectively provided “catastrophe insurance,” or put-like options for a broad range of financial institutions to hedge against some unknown, possibly grave downside risks. In this way, these measures were intended to reduce the fear of “unknown unknowns”.

A significantly longer duration of liquidity-provision operations helped to substantially reduce financial institutions’ fear over procuring longer-term liquidity. The expansion of counterparties and collateral eligibility secured them new no-risk funding sources, that is, central banks, to partly alleviate a lingering fear of counterparty risks in money markets. I think no additional words are needed about their put-option characteristics of the asset purchase programs.

Looking Ahead: No Free Umbrella against Plain Old Rain

Clearly, central banks’ provision of catastrophe insurance measures has worked quite well, together with various governmental measures of similar characteristics[4]. Immediate dangers have subsided, though we are still facing a possibly bumpy adjustment process after the collapse of the “credit bubble”.

In order to look ahead, the following two points should be kept in mind.

First, these catastrophe-insurance measures are in fact “free” insurance. Beneficiaries of these measures do not pay fair, or, in many cases, any premium for these hedges. Rather, central banks and governments implemented these measures against the “unusual and exigent” circumstances of contagious confidence erosion. Thus, the measures were to be temporary. A permanent provision of such free put-like options obviously distorts the market mechanism and prompts undesirable risk taking or “moral hazard.” To put it differently, free shelters should be provided against a hurricane, but there should be no free umbrella against plain old rain.

Second, central banks’ ability of providing “catastrophe insurance” is not unlimited and

[4] “Put option-like measures” include measures such as capital injections and debt guarantees.

depends crucially on market participants' confidence in them. Some measures taken by central banks impose financial and possibly reputational risks on themselves. An option provider should make sure that it would not seriously undermine its capital base.

That being said, unconventional, catastrophe insurance-like measures should be explicitly temporary and for some measures "self-fading" as market conditions improve. Currently, we see in fact some measures winding down in the US and other places, including Japan, and some other measures, such as the U.S. Treasury's Guarantee Program for Money Market Funds, to have expired. The wind-down shall be carefully arranged, in some cases step by step, to avoid possible transitional problems as much as possible.

Finally, I would like to add that as the immediate threat subsides and the hurricane shelters are removed, nobody assumes that that is the end of public efforts to rebuild the devastated community. This is exactly the same for central banks' unconventional measures. Although the balance sheets of central banks may be reduced when these unconventional measures are faded out, this is not a sign of a change in the stance of central banks. Rather, this is the sign that central banks can now use conventional means more effectively to pursue current monetary policy.