

Transcript: Shirakawa on Japan's Economy

Bank of Japan Gov. Masaaki Shirakawa met for more than an hour Friday, Feb. 25, with The Wall Street Journal's Washington, D.C.-based central banking reporter Jon Hilsenrath, Tokyo-based BOJ reporter Megumi Fujikawa and Japan Editor Jake Schlesinger. Below, read a transcript of the wide-ranging session, which was conducted in English.

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The Wall Street Journal: I wanted to start off talking about Milton Friedman, who was once your professor. Milton Friedman said that inflation is always and everywhere a monetary phenomenon. Is deflation also always and everywhere a monetary phenomenon?

Masaaki Shirakawa: Even rampant inflation can be cured by reducing money supply drastically. In that sense, I agree with Friedman's famous proposition that inflation is always and everywhere a monetary phenomenon, and this proposition does hold. But I wonder whether the symmetrical proposition that deflation is always and everywhere a monetary phenomenon is fair or not.

And the answer to this question depends on how you interpret this proposition. I agree with the symmetrical proposition on deflation if we define that proposition in a way that if a central bank does not act properly as a lender of last resort in a financial crisis, then the money supply would decline drastically, and hence prices would decline in a drastic manner. In the case of the United States in the Great Depression period, since the Federal Reserve did not act properly as a

lender of last resort, money supply declined by 31% between 1929 and 1933. And prices declined by 25% during the same period.

In the case of Japan, because the Bank of Japan acted properly as a lender of last resort in a crisis situation, we succeeded in avoiding the contraction of the financial system. A case in point is our response to the troubled defunct Yamaichi Securities, which is the Japanese counterpart to Lehman Brothers in the United States.

The BOJ decided to provide liquidity to Yamaichi Securities in an unlimited amount to facilitate the orderly liquidation of this troubled securities house. And because of this, we avoided a financial crisis, and because of this, the money supply didn't decline in that period. Between 1997 and 1998, the price declined by only 0.5% at most. And on a cumulative basis, from 1997 to 2010, consumer prices declined by 3.7%

So, if you defined the symmetrical position on deflation in the manner that I mentioned, then the BOJ acted properly and therefore we avoided a crisis. In that sense, the interpreted definition of Friedman's famous proposition is right. But if the proposition is that prices could be easily raised by increasing the central bank's monetary base and thus money supply alone, then I am skeptical about this proposition.

As you mentioned, I am a student of Milton Friedman. I took his last class in 1975. He's a great teacher and I respect him. Friedman is very famous for stressing the importance of empirical facts. He works very hard to know what happened. That's why he produced the lengthy volume of the famous "A Monetary History of the United States." And it's one of my favorite reads.

And if we interpret the proposition in that manner, then that proposition has been disproven by the facts in both the United States and Japan. The monetary base of Japan was increased by 90%, between 1997

and 2010. Money supply increased by 30%. And prices declined by 3.7% as I mentioned earlier. In the case of the United States, monetary base expanded by 140% between 2008 and 2010. Money supply increased by 10%. And the level of consumer prices increased only 1%, and the annual inflation rate of core consumer prices decreased from 2.5% to 1.0%.

So the proposition has been disproven by the facts. Central banks have increased the monetary base dramatically, but we didn't observe an increase in the consumer inflation rate. So that's my answer to your question.

WSJ: Just to follow on to that, what is the factor that was missing? What has experience taught you?

Mr. Shirakawa: It's a long story. Before responding to your question, I'm not saying that monetary policy is not important. Monetary policy is surely important, and we are making every effort to overcome deflation. What I'm saying is that Japan's deflation can't be solved by a massive increase in monetary base alone. Those efforts have to be complemented by other structural measures, which Japanese society is now doing.

Getting back to your question, I can present two reasons why Japan experienced persistent mild deflation. One is a decline in the trend growth rate. Over the past two decades, the trend growth rate has declined. And therefore, the expected future income by economic agents has been reduced. Given that, they don't expend on goods and services. This is one basic reason.

This is a footnote: If we look at the correlation between the trend growth rate and the expected inflation rate, we observe a very close, positive association. The second reason is flexible wage adjustment. Since around 1997 or 1998, nominal wages weakened. The so-called

downward wage rigidity of nominal wages has disappeared, and wages adjusted very flexibly. And both management and workers decided to maintain employment. Therefore, workers accepted lower wages. And wages declined in absolute terms.

For instance, in 1998, the year-on-year wage growth rate was between minus 3% and minus 4%, which is unthinkable in the U.S. or Europe.

And for this reason, we avoided high unemployment. Flexible wage adjustment and lower wages are translated into deflation in services. The difference between the United States and Japan in terms of the inflation rate is mainly explained by the difference in service inflation. About 90% is explained by the difference in service inflation. As you know, services are a labor-intensive activity. The wage decline is translated into a decline in service prices. So my simple answer is decline in trend growth rate and flexible wage adjustment.

WSJ: If there's a decline in the trend growth rate, shouldn't it be easier to close the output gap, because potential growth is lower?

Mr. Shirakawa: If economic agents expect future income will not increase, then that expectation is already incorporated into the decision today and demand will be depressed in relation to the level of existing capacity. This depresses spending, which is translated into lower prices. At any rate, the fundamental problem is the decline in trend growth and mild deflation is its manifestation.

WSJ: You have argued that the BOJ has employed innovative policies—the 0% interest, the commitment to maintain the interest, the balance sheet expansion, the quantitative easing. And yet the economy did not return to vitality. Why not?

Mr. Shirakawa: There are two ways to answer your question. One is, "Why not?" The other is "what have our innovative measures achieved?" And I take up the second question first.

As you said, the BOJ deployed innovative policy measures. Japan experienced the bursting of the bubble and the ensuing financial crisis ahead of other countries. In the absence of existing prescriptions to address these problems, the BOJ has been a lonely forerunner that has implemented novel, innovative measures in a large-scale manner. For instance, we purchased asset-backed securities, we purchased asset-backed commercial paper, and also we purchased stocks held by financial institutions in the early 2000s. When we announced these measures, these measures attracted little attention or were considered as bizarre measures. But, in retrospect the so-called credit easing adopted by the Federal Reserve is essentially the same as what we did in the early 2000s.

Our innovative measures were effective in the following sense. First, they were effective in maintaining financial system stability. I'm talking about the quantitative easing part of our policies. Also, as you mentioned, we committed to continuing with a zero-interest policy, until consumer price inflation becomes positive on a sustained basis. And also, we purchased risky assets. These measures were effective in creating very accommodative financial conditions, which shored up economic activity.

So, I'm not saying that these measures are not effective. These are effective in the sense which I mentioned. But the underlying trend of declining trend growth was powerful.

These are due to the following two reasons. One is the decline in productivity caused by the bubble bursting and the delay in changing the business model to adapt to globalization.

The second reason is rapid aging, the rapid decline in the working population. The speed at which Japan experienced aging is unprecedented in modern economic history. So, all in all, the trend

growth rate has been reduced. Our innovative measures were effective, but this alone couldn't reverse the trend growth rate.

And therefore, we have to tackle the root cause of the problem, which I will turn to later. Incidentally, what I'm saying is the same as Chairman Bernanke is saying. In December, in Congress, he said that while monetary policy is important, it alone can't resolve these problems. These problems are also the problems the U.S. economy is now facing.

WSJ: You said that when the BOJ came out with these measures, they were disregarded or called bizarre. Do you think, in retrospect, that the BOJ was unfairly criticized for its approach?

Mr. Shirakawa: As I said, Japan was the first to experience these kinds of problems. In those days, there was no reference to those phenomena in textbooks.

I take up one famous quote. One prominent American scholar said in January 2007 that "there are even stronger reasons to believe that the bursting of the bubble in house prices is unlikely to produce financial instability. Not surprisingly, declines in home prices generally have not led to financial instability. Many have learned the wrong lessons from the Japanese experience. The problem in Japan was not so much the bursting of the bubble, but rather the policies that follow."

And he was not alone. This kind of assessment was quite prevalent. So whenever I attended international meetings in the early 2000s, I always faced this kind of criticism.

WSJ: You could have also quoted a Princeton professor named Ben Bernanke. He said some things that weren't so polite.

Mr. Shirakawa: Referring to that is even more impolite.

So in those days, people are not aware of these kinds of problems. First, how severe the bursting of the bubble is. How difficult it is for society to formulate a policy which is very much needed to address the root causes of the problem.

The third aspect which is not well understood is the impact of demographics. Nowadays, for instance, Professor Krugman is often referring to this aspect in his blog. I forgot the exact language, but when he came to Japan six or seven months ago, he wrote an article stressing the importance of demographics.

I'm not saying that textbooks are useless. Textbooks are useful, but standard macroeconomic textbooks need a few more chapters.

WSJ: As you said, the BOJ has done a lot. The two most recent measures were the comprehensive easing measures you announced in October. Earlier last year, you announced the bank lending facility. How will you judge, as the year progresses, whether you should do more with that—the cost and benefits of doing more?

Mr. Shirakawa: I have to respond to the question carefully. First of all, our comprehensive monetary policy is unprecedented. We have to assess both benefits and costs. Again, incidentally, this is the same approach taken by Chairman Bernanke. When I attended the Jackson Hole conference last August, he said: "Any deployment of these options require a careful comparison of benefits and costs." These measures mean QE2.

The costs and benefits differ across the measures we are deploying. But when we try to create a stimulative impact by monetary policy once we approach zero-interest rates, then our policy measures approach the realm of policies that have the flavor or element of fiscal policy.

As for the side effects of these measures, the purchase of, say, risky assets, intervenes in the micro-level allocation of funds to individuals.

Also, there is the possibility that the BOJ will eventually incur losses, which will have to be shouldered by taxpayers. If people start to perceive the central bank as dependent on the government, then the credibility of the central bank, which is the very basis for its monetary policy, could be undermined.

Also, the central bank credibility could be damaged by erosion of a sense of neutrality toward the central bank. This is a cost side. At the same time, it may create stimulative effects. So, we are weighing these cost and benefits. After weighing both costs and benefits, it depends on how or whether our projection, our outlook, deviates materially from our original projection. So, I'm always saying that we are not ruling out the possibility of expanding the comprehensive package. But this should be assessed on costs and benefits and on the outlook.

WSJ: You have had an opportunity to evaluate the benefits and costs of both of these programs, because time has elapsed. What is your evaluation?

Mr. Shirakawa: So far, the benefits outweigh the costs, and these measures were effective. Of course, financial conditions are already very, very accommodative. So, some people may say the additional impact may not be large enough. But even so, it created positive effects. Also, I'd like to draw your attention to the fact that people recognize the need for addressing structural problems. And this is a somewhat delicate channel. Our measures are quite unprecedented and unorthodox. And the reason why we decided on this is that the Japanese economy is now faced with structural problems. And given the problems we decided on this kind of policy. In doing so, we said we have to address the root causes of the problem. And nowadays, we have intensified our efforts to explain what is the root cause of the problem. So, you should not look at our unprecedented measures in isolation from what we are now doing in terms of communication or explanation. And recently, the awareness for those structural issues

has increased. I'm not saying our policy measure alone succeeded in raising the awareness. But our policy is a part of it.

WSJ: You say your decision about whether to expand the program depends in part on how the outlook changes. Based on the latest forecast revisions it sounds like the outlook is improving. Is that your view? Does that continue to be your view in light of the oil price shock that we've seen?

Mr. Shirakawa: Every month in every monetary policy meeting we are checking the outlook. But so far, the actual trajectory of the economy is on track. Last fall we experienced a temporary pause in economic activity. But now it is likely that we are exiting from that temporary pause. And the Japanese economy is once again returning to a moderate growth path. Our economy is moving around those projections. But as you mentioned, rising commodity prices is one risk factor.

WSJ: Are there other risk factors that weigh on you right now?

Mr. Shirakawa: We have identified several risk factors. But the major risk factors are two. One is the downside risk factor pertaining to industrialized countries. Basically, it is a balance sheet adjustment in Europe and the United States. And upside risk is the emerging market economies. Now, commodity prices have increased. When we assess the impact of rising commodity prices, we have to look at this issue in totality. The reason why commodity prices are increasing is basically the high growth in emerging market economies. Therefore, exports to those emerging market economies are now increasing. And also, the investment income coming from foreign direct investment into those economies is increasing. These are positive factors. At the same time, the worsening of terms of trade depresses spending internally. We have to weigh these factors.

WSJ: When you took some of your emergency action last year, clearly another downside risk was the exchange rate, the yen. Do you still see it that way now?

Mr. Shirakawa: Last August, the yen appreciated sharply, and business sentiment worsened, as you know. Since last fall, we have not observed yen appreciation. To that extent, business sentiment has somewhat stabilized so far. And also the yen appreciation offset the negative impact due to the worsening of terms of trade, unlike other countries.

WSJ: So, even though the yen remains considerably stronger than it was 12 months ago, the fact that it is stable makes it a nonrisk for the current forecast.

Mr. Shirakawa: At this moment, it is not working as an additional risk factor. But nobody knows the course of exchange rates. And in recent years, the yen was used as a safe haven currency. So, once global uncertainty emerges, then the yen is likely to appreciate. Therefore, when we look at everything, of course the yen is included.

WSJ: Would a further appreciation of the yen as happened last year be unwelcome? And counterproductive to the recovery?

Mr. Shirakawa: As a central bank governor, I made it a rule not to make comments on the desirability of the level or direction of exchange rates.

WSJ: So, let me try the question a different way. Was the appreciation of the yen last year counterproductive to growth and recovery?

Mr. Shirakawa: I have to be careful. Last year, the yen appreciation decreased business confidence. But, even at that time, we were aware of the future gain from terms of trade due to yen appreciation. So, in the short run, the impact will be negative, but in the long run, positive

impact will be coming. It depends upon the time profile. So we are very sober at analyzing. We are making every effort to make objective analysis.

WSJ: What is the impact in the long run?

Mr. Shirakawa: The yen appreciation means the improvement of terms of trade, which means increase in real income. This is a positive factor. Rising commodity prices worsen terms of trade. Conversely the yen appreciation improves terms of trade. For instance, corporate profits will be increased, other things being equal.

WSJ: You've now had four opportunities to evaluate the impacts of quantitative-easing type policy. There was the impact of Japan's policy from 2002 to 2006, the impact of the latest comprehensive easing, and also the impact of the Fed's two attempts. What do you learn from these observations?

Mr. Shirakawa: All discussions about unconventional monetary policy or quantitative easing are ambiguous, and we have to be clear about the definition of, for instance, quantitative easing. If we define quantitative easing as the policy measures to increase excess reserves, then the stimulative impact from quantitative easing was rather limited.

The mere increase in excess reserves or mere increase in the monetary base was not effective in boosting economic activity itself. But the increase in reserves was effective in maintaining financial system stability, which is very important for returning the economy to the sustainable growth path.

In our case, what we did in addition to the so-called quantitative easing was two things.

One is the so-called commitment. We promised to continue with the zero-interest policy until the consumer price inflation rate becomes

positive on a sustained basis. And this policy was effective in boosting economic activity, especially at the latter stage of the quantitative easing period. In the early part of the quantitative easing period, anyway, people expect zero-interest rates will continue into the future, so there is nothing inherently fresh coming from the commitment. But when the economy recovers, people start to think whether the BOJ is likely to increase short-term interest rates or not. But we promised to maintain zero-interest rates, based upon consumer price inflation. On the other hand, in foreign countries, interest rates have increased, so this expectation created yen depreciation. And also the expansion in foreign economies produced an increase in exports. So in short, the commitment to maintain the zero-interest rate policy was effective.

And the second is our purchase of risky assets such as asset-backed commercial paper, asset-backed securities and importantly the stock held by financial institutions, which were effective. In essence, these measures were to absorb risks held by the financial institutions. We took risk. And what we did is the same as the U.S. Federal Reserve did this time around. This measure lowered risk premiums. So this effect is different from mere increases in reserves. And this facilitated the accommodative financial conditions.

This is my analysis. But as I said at the outset of this interview, these measures alone could not solve the entire problem.

WSJ: The criticism of the BOJ now is that while it tried these innovative policies, they've been too small. The 5 trillion yen, for instance, on comprehensive easing is a very small amount, and that's been the case also in the past. What do you say about that criticism?

Mr. Shirakawa: We entered this uncharted territory in the latter part of the 1990s. Since then, the BOJ has expanded the size of the balance sheet aggressively. And even today, the size of the central bank balance sheet relative to GDP is the biggest for the BOJ. As for

government bond purchases, in addition to the one under comprehensive easing, we are purchasing JGBs. The annual amount in relation to GDP is equal to QE2. Anyway, since we started expanding the balance sheet so early, people tend to forget what we did already. And people just tend to look at the situation through a very narrow window. You are right, if you only stick to a very narrow window.

But if you look at the full situation, then, first of all, our balance sheet is the biggest and our expansion and increase in expansion of the balance sheet is the biggest. Also, as I said, or as Chairman Bernanke said, the aggressiveness of monetary easing should not be measured by sheer size. That is his basic point. And his point is that financial conditions, that is the purpose of so-called QE2. The same is true for us. If we look at financial conditions, I want to point to several facts. For instance, Japan has the lowest short- and long-term interest rates in the world, and also its credit spreads are the tightest. That's what a central bank can deliver. So quantitatively, we are the biggest. Qualitatively we are providing very accommodative policy compared with other countries.

WSJ: I want to ask you a question about commitment. You've said in the past that a very long period of low-interest rates could interfere with the adjustment process in the economy. When I hear a comment like that, it makes me wonder about the commitment [to keep rates low], since it sounds like you find the low interest rates to be counterproductive. So can you explain to me how to think about that?

Mr. Shirakawa: It's a very difficult question. One of the reasons why productivity has declined is the decrease in economic metabolism. So we need fresh entry and also we need the exit of inefficient firms. But given very low interest rates and given abundant liquidity, there is no strong incentive for those inefficient firms to exit the market. That is true. But I don't think that kind of accommodative monetary policy is the sole reason for such lack of economic metabolism. Various social and

economic cultures foster that kind of environment. Monetary policy is only a part of it.

But coming back to your question about how to reconcile the commitment effect with the loss of metabolism. Your remarks are right. That is the dilemma. The commitment is to bring future demand to the present. But over time, the basic trajectory of the economy is determined by working population and productivity. That's why I'm stressing the importance to raise the trajectory of the economy.

WSJ: So the one program that the BOJ is involved in that seems specifically aimed at some of these issues is the bank lending program you launched in April. Can you speak specifically to that and whether you think there's more that the BOJ can and should do on that front? What role if any does the BOJ play in solutions to these demographic and productivity problems?

Mr. Shirakawa: Of course productivity and population are not fields for a central bank, or main fields for a central bank's policy. Having said that, given the importance of this problem, we are making several efforts. First, to provide very accommodative monetary policy under the so-called comprehensive monetary easing. Secondly, as you mentioned, we started funds-providing measures to support the strengthening of foundations for economic growth. The facility in itself may not be able to solve the fundamental problems that Japan is faced with. But it could perform as a catalyst to initiate much-needed reactions by the government, firms and banks to collectively address the problem. Like a catalyst, even though small on its own, this facility may trigger a chain reaction to happen faster than otherwise. We meet with many CEOs and chairmen of large and small firms and I'm encouraged by positive comments from them.

Also, for instance, when I read many economic commentaries which appear since we started this operation, I found many articles stressing

the importance and need for structural reform. So as I said, this is a catalyst. Because already interest rates are so low, additional financial or pecuniary benefits may not be large because the interest rate is already almost zero and liquidity is so abundant. But even so, our facility is somewhat attractive for borrowers and also it illuminates what we should make efforts for.

WSJ: Do you see an opportunity to expand this program to other markets like asset-backed securities or loan-backed securities?

Mr. Shirakawa: We have conducted this fund-providing operation two times since we started. Soon we will conduct this operation for the third time. [Note: The operation was conducted Monday, Feb. 28.] And we are assessing the performance. Like other measures, after a careful assessment of both benefits and costs, we will decide on whether or not we should expand this operation.

WSJ: Not just expanding the yen total, but changing the mix? We read an interesting speech by your Deputy Gov. Yamaguchi last July about this. Is that a realistic way of changing the program?

Mr. Shirakawa: We are hoping that the asset-backed securities market will grow. But unfortunately, the securitized market is not that vigorous in recent years, especially after the collapse of the U.S. securitized market. When we purchased asset-backed securities in 2003, we set up a forum to discuss what industry and the central bank should do with the aim of improving this market. I'm hoping industry people seriously discuss how to improve this market.

WSJ: I want to ask you a fiscal question. Some observers worry the BOJ might be put in a position where it is forced to buy JGBs to hold down the yields. Is this a risk that worries you?

Mr. Shirakawa: First of all, the yield on JGBs is quite low and stable despite the fact that Japan's fiscal situation is in bad shape. There are

several reasons for that. But fundamentally, one of the reasons is that the BOJ is regarded as a central bank which commits to price stability. Therefore, this credibility is quite important. The BOJ is very clear about its conduct of monetary operations. We are purchasing JGBs, but we are not aiming at monetization of government bonds. It is our responsibility to act on such an important principle.

WSJ: You warned in April 2009 I believe of "false dawns." That proved to be very forward looking. Are you as worried today about false dawns as you were when you made that comment? For the global economy. For the U.S. economy. Or Japan.

Mr. Shirakawa: This time around, the Japanese economy is not faced with balance sheet adjustments in the private sector. This was a serious problem between the 1990s and early 2000s. I'm often asked about the similarity or the difference between the U.S. and Japan in terms of the bursting of a bubble. As you mention, I mentioned about "false dawn" in the U.S. context. Like Japan, the burden of budget adjustment is so severe, and the household sector is still faced with the need for balance sheet adjustment. But on the other hand, there is a difference. One difference is the flexibility of the U.S. economic system. Economic metabolism is decreasing in Japan while economic metabolism in the U.S. has not decreased so far. The second factor is demographics. Japan experienced a decline in population but the U.S. is not experiencing a decrease in population so far. This is different. I'm not saying that the U.S. is following the same path of Japan, but I'm carefully watching the U.S. economy from two angles. That is, the need for balance-sheet adjustment and the strength and flexibility of the U.S. economic system.

WSJ: You have very meticulously explained the BOJ's aggressive actions and the steps that it has taken over the years to address the financial and economic situation here. What mistakes has the BOJ made along the way?

Mr. Shirakawa: What period are you referring to?

WSJ: I would say over the period of deflation. Over the period of 15 years. What mistakes has it made?

Mr. Shirakawa: 15 years. [pause]. I don't know whether the choice of the word of "mistake" is appropriate or not. I stress the importance of addressing the structural problem. One is as I said, this is due to two factors: the decline in demographics and also the decline in productivity. First of all, demographics. We have to adjust the economic system to rapidly changing demographics, meaning the various reforms of budget, various reforms of social security system. And also, as for the decline in productivity, the decrease of economic metabolism is important. Probably I guess your question is framed in terms of our monetary policy?

As I said, we acted very aggressively as the lender of last resort. In retrospect, this is the single most important contribution which the central bank could make, once the bubble burst. In that regard, the BOJ's performance has been good. But, if we go back beyond fifteen years, I would say that extreme accommodative monetary policy over an extended period of time was one of the reasons for the bubble, and it might not have been appropriate.

WSJ: We started out by talking about Milton Friedman. I know you spent two years at the University of Chicago. But then you had to return to the BOJ and didn't get a chance to finish your PhD there. I imagine you were very excited by the intellectual ferment at Chicago. Was it a disappointment you weren't able to stay and finish your PhD?

Mr. Shirakawa: It's a personal recollection. At that time I was 26 or 27 years old. And when I went to Chicago, I didn't expect to become excited about studying at Chicago. But as you said, studying at Chicago was so exciting. And I wanted to continue to study to get a PhD degree.

But in those days, the Bank didn't understand the meaning of a PhD, frankly speaking. Therefore I was faced with the difficult choice of going back to the BOJ or quitting the BOJ.

Since I didn't have courage I decided on going back to the BOJ.

But after I returned to the BOJ, the assignment at the BOJ was so exciting and interesting and so gradually I began to realize how interesting the job at the central bank was. But I don't know if my decision was right. If I decided differently, my career would of course have been different. And that life would also be the exciting one. So I can't compare the current situation with the other option. But the work at the central bank was quite challenging.

WSJ: Given your current job I'd say you probably made a good decision.

Mr. Shirakawa: I hope so. [laughter]

WSJ: Have we left anything out? Is there something you feel that you wanted to explain that you didn't get chance?

Mr. Shirakawa: I'd like to cover the lessons of the bursting of the bubble. I'd like to refer to three lessons. One is how to cope with a bubble. For many years, academics and policymakers discussed how to cope with a bubble.

Leaning against the wind or cleaning up after the bursting of the bubble. The long debate. But as I mentioned, about the prominent scholar's remarks, now nobody thinks that the cleanup operation is enough. And in that sense, we have to lean against the bubble. I'm not saying that monetary policy alone should do that. Both central banks and regulators should be preemptive, lean against the bubble. Although this job is really daunting.

Second, when a central bank conducts monetary policy, a central bank should look at not only the inflation rate, but also the broadly defined financial imbalances. By financial imbalances, I mean the increase in asset prices, increase in the credit, or increase in leverage, or increase in mismatched positions, et cetera. These financial imbalances could emerge even though the inflation rate is quite subdued.

And thirdly, central banks and regulators have to grasp the risk profile at the macro level.

Nowadays people are talking about the need for macroprudential policy. I agree with the importance of macroprudential policy. Although it is quite difficult to substantiate the macroprudential policy, it's a worthwhile challenge.

WSJ: I wanted to make sure we didn't leave here without giving you adequate chance to respond to your critics. Your staff has noted that the criticism has diminished in the last few months. But you still have "The Antideflation League," which gives you an F for not doing enough. On the other hand, I can't help wondering how your old professor Milton Friedman would feel about you as a central banker purchasing ETFs and JREITs and talking about spurring an ABS market. How do you respond to critics who say you are not doing enough, and the purists who say you are doing too much?

Mr. Shirakawa: I'm afraid my answer to your question may be somewhat duplicative.

If the whole purpose is just to increase the inflation rate, then I'd like to refer to the famous Paul Krugman remark. He said that in order to overcome deflation, a central bank should credibly commit to be irresponsible. Credibly commit to being irresponsible.

And if a central bank behaves literally in that manner, the inflation could come. But the inflation rate will become quite high. Skyrocketing

inflation. And if the inflation rate increases very rapidly, the people expect central banks to commit to be responsible. If that is the case, inflation cannot be delivered. Central bank is central bank. Then Krugman's famous dictum that central banks should commit to be credibly irresponsible is somewhat self-contradictory.

What we like to attain is sustained growth with price stability. Not just high inflation. And real side is determined by productivity and population. And therefore, the criticism toward the BOJ is somewhat unfounded.

WSJ: To those who say you did too much, that you're entering areas that a central bank should never enter?

Mr. Shirakawa: We discussed this issue very seriously within our bank. Given zero interest rates, the way in which the stimulative effect can be generated is to suppress risk premiums associated with financial assets, such as the REIT or ETF, et cetera.

And as I said, this is approaching the realm of quasi-fiscal policy.

In democratic society, we wonder whether we should embark on such quasi-fiscal policy in the name of monetary policy.

There are two arguments. One is, given the severity of conditions, a central bank should do it. This argument is somewhat understandable.

But at the same time, eventually, this policy is a quasi-fiscal policy. The involvement in these areas could undermine central bank independence, which is the very basis for a stable and sustainable growth path.

So we are weighing these benefits and costs. And therefore we made clear about what we are doing under comprehensive easing. We set up a special fund which explains what we are doing.

So people outside the BOJ can identify what we are doing. And on our part, after carefully reviewing both benefit and costs, we decided on desirable monetary policy.

That is our approach. And I think the central banks in industrial countries are faced with this kind of problem more or less. That is my reading of the situation.

WSJ: Thank you so much.

Mr. Shirakawa: Everything is so much complicated. Of course you have your own assessment and judgment. But I sincerely hope that you could convey what we are struggling to solve. I have a lot of frustration with simplistic criticism.

WSJ: I hear you are compared to a marathon runner, Q-chan. Your drive to learn more is similar to her desire to run two marathons.

Mr. Shirakawa: I like Q-chan. She was a great runner. And as I said, the BOJ was a forerunner for embarking on unconventional central bank policy. And we are now faced with another challenge of demographics. And the BOJ wants to continue to be a front-runner in solving these difficult challenges.

WSJ: Do you like to run?

Mr. Shirakawa: No. I swim. Every weekend I swim.

WSJ: Still?

Mr. Shirakawa: I used to be an avid golfer. But I cannot have time for playing golf. So I switched from golf to swimming.