



Lessons Learned Oral History Project Interview

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Crisis Position	Deputy Governor, Bank of Japan, 2013-2018 Various, Bank of Japan, 1978-2013
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Introduction:

Hiroshi Nakaso joined the Bank of Japan (BOJ) in 1978, rising to deputy governor in 2013. He was instrumental in addressing Japan's domestic crisis of 1997 and its response to the Global Financial Crisis (GFC). He retired from the bank in 2018 and has since served as chairman of the Daiwa Institute of Research in Tokyo.

The Yale Program on Financial Stability (YPFS) reached out to Mr. Nakaso to discuss his experience with financial crises and his thoughts about lessons for policymakers in the future.²

This transcript of a Zoom interview has been edited for accuracy and clarity.

Transcript

YPFS: Let's start in the 1990s. Japan's financial crisis had its roots in the bursting of a real estate and stock market asset bubble, which revealed the bad loans and undercapitalization of Japan's banking system. From 1993-2000, you were with the Bank of Japan's Financial System Division, involved closely with crisis management. Let's discuss this period. What was your role? From your perspective, what were the major events and responses? Were there tools you wish you had? What could have been done differently?

Nakaso: In 1993, I was assigned to the Financial System Division, which was a crisis management unit that was founded in 1990 and operated throughout Japan's home-grown financial crisis of the 1990s. Usually, in Japan's bureaucracy, officials rotated positions every two to three years, but I stayed in this division

¹ The opinions expressed during this interview are those of Mr. Nakaso and not those any of the institutions with which the interview subject is or was affiliated.

² A stylized summary of the key observations and insights gleaned from this interview with Mr. Nakaso is available in the Yale Program on Financial Stability's *Journal of Financial Crises*.

for seven years, which is very exceptional, from 1993 to 2000. So, this was a kind of evidence that Japan's financial crisis was quite a serious one.

Over the time, I think there are basically three periods of dealing with the financial crisis: the period when we were behind the curve, the climax, and then the more systematic approach. I think the crisis management started seriously in about 1994, but then there were series of events, and we were sort of behind the curve until 1997. I have to admit that we initially underestimated the potential magnitude of banks' nonperforming loans (NPLs). Because the economy had shown strong growth until the late 1980s and the Japanese banks were often compared to an Invincible Armada, we had a wishful thinking that things just cannot be so bad. We encountered this so-called Dark November of 1997, during which, in one month, four major financial institutions went under. So, this was a major, major unprecedented crisis. But as I said, the crisis started earlier, like in 1994-1995, around this period, with sporadic failures of small cooperative banks. But this Dark November turned out to be a turning point in the sense that it proved to be a wake-up call as it became visible to lawmakers and the general public that there is in fact a serious crisis. The Japanese lawmakers, who had lagged behind, recognized the need to install necessary, much-needed legislative measures.

After 1997, I think we turned from defensive to offensive, from the perspective of the crisis management. So, this is a general description. I think it was around 2003 or '04 that we felt the crisis was finally over. So, it took a decade to contain the crisis.

As the central bank, we deployed what may be called the "lender of last resort" function or emergency liquidity provision. But as we're going to talk later, this lender of last resort function, as performed by the Bank of Japan, evolved, expanded over time beyond what was regarded as the traditional sphere for the lender of last resort as stipulated, so to speak, by Walter Bagehot a century ago. So, it was a continuous evolution or departure from the traditional notion of lender of last resort.

The tool that we missed the most was not necessarily something that could be deployed by the central bank but was in the hands of the government. And that is, of course, capital injection using public money. This is something that we lacked until the later stage of the financial crisis. It was only in 1998, almost four years after the emergence of the financial disruption, when this capital injection framework finally was installed.

YPFS: Before we go into some of the details, let's talk about general lessons on bank capital standards and then get into capital injections, as you just brought up. And then looking at '98, '99 and into the early 2000s. What are your thoughts on bank capital standards?

Nakaso: Basel I capital standards didn't work, I think. It allowed for 45% of unrealized capital gains of banks' equity holdings to be a part of the Tier 2 capital. So, when the equity prices started to fall after the bubble burst, the unrealized capital gains evaporated, accelerating the decline in banks' capital ratios. This discouraged banks from making new loans to industrial firms, which were badly needed for the economic recovery. The sluggish economy resulted in a further fall in equity prices that exacerbated banks' capital ratios. So, there was a procyclical element embedded in Basel I. That is why the BOJ stepped in at the later stage of the crisis in 2002 to buy and remove equities from banks' balance sheets to cut off this vicious cycle.

Besides, there were domestic technical problems with regard to measuring banks' capital ratio.

In the initial phase of the crisis, banks' capital ratio declined little, surprisingly, obscuring the true state of banks' balance sheets. It was not necessarily the capital standard, per se, that was problematic. In my view, what was lacking at the time is the proper way, methodology, to capture nonperforming loans. Whether or not enough provision was set aside, and bad loans were written off, for example, based on the precise assessment of the nonperforming loans. This is something that had been absent for a long time. So, that's why banks were unable, or the authorities were unable to capture the potential, the right size of the nonperforming loans, which turned out to be much larger than we had anticipated. If the right size of NPLs had been recognized accurately, banks' capital ratio would have declined much further and alarmed the authorities.

YPFS: Could you explain that a little? I mean, what was missing in being able to measure that?

Nakaso: To be specific, at the time, there was a kind of myth that the banks will never be allowed to fail against the backdrop of the so-called "Convoy System." It was a supervisory approach, under which Japanese authorities, whenever there is a problem at the weakest bank, will take care of the weak bank anyway. So, it was not necessary for a bank to capture the amount of nonperforming loans, because they were sure that whatever happens to them, the authority will come in and bail them out. Under the system, write-offs and provisioning required approval of the Ministry of Finance [MoF] in advance. Generally, provisions were deductible only when they met the MoF's stringent criteria.

But otherwise, the banks had to pay tax simultaneously with making provisions. So, obviously, this kind of treatment discouraged banks from making necessary provisions. So, that was another technical issue that prevented the banks from making, putting aside enough provisions. These were all addressed in a later stage of the crisis.

YPFS: When and how were they addressed? What tools did you get?

Nakaso: Tools that made the soundness of a bank's balance sheet more transparent. For example, bank examination and the so-called inspection manual by the authorities, upon which a more specific criteria was installed so that banks were able to report bad loans as they were, actually, and put provision aside. Furthermore, the Resolution and Collection Corporation [RCC] was established in 1999. It was a kind of "bad bank." Banks became able to remove bad loans from their balance sheets by selling them to the RCC on a fair value basis.

YPFS: Many of the policy responses to the Japanese financial crisis are characterized generally as slow and as feeding into what's known as the Lost Decade. Is this fair?

Nakaso: Partially. Yes, but otherwise, no. First of all, we were the first major economy to encounter a financial crisis of this size. Of course, you know there were banking crises, the secondary banking crisis in the UK or the S&L [savings and loan] crisis in the US, but they were mostly to deal with smaller institutions. We were the first to encounter a major collapse of major, big, internationally active financial institutions. And there were no textbooks, so to speak, or precedents from which we could get insights. So, what we had to do was to explore ourselves how to deal with the underlying problems and overcome the crisis.

So, it was kind of navigating uncharted waters. Of course, in retrospect, we should have actually focused more on the Nordic case. They had a major crisis involving big banks a little earlier than Japan, in the early '90s. But this is something we didn't pay enough attention to. We thought this was not something that's going to happen in Japan. We were focusing on small institutions. We were aware that problems were building up at smaller institutions like credit unions, credit cooperatives, but we were not necessarily focusing on larger banks, because we thought, assumed, they were well capitalized. Of course, we turned out to be wrong. Another factor was the delay in much needed capital injection using public funds to under-capitalized weak banks. This was prevented by the strong resentment by the general public against the use of taxpayers' money to bail out weak banks. It was March 1998 when the first round of government's capital injection took place, some four years after we started to see a series of bank failures. With regard to the Lost Decade you mentioned, in retrospect, I think there are three elements that could explain why Japan's economy remained sluggish over a protracted period of time. One is, of course, this banking crisis, which deprived financial institutions or banks of the intermediary function, which was badly needed to support economic recovery. Secondly, as a result, the economy entered into the so-called deflation, a chronic disease that results in economic

contraction. So, consumers, households, spend less; corporate sector capital expenditures are smaller.

And the third element is demography. Around the turn of the century, the population, particularly the working age population, started to decline. So, this is something that we call a population-onus society, where production-age population decelerates at a faster pace than the entire population. So, all the three factors contributed to the sluggish Japanese economy, which unfortunately continued over a decade and a half. Maybe to some extent, we are not out of this yet. So, obviously, the banking problem, the crisis was one of the three factors, but not all.

YPFS: Did the banking reforms address the financial portion of that, at least? How were those meant to address that? Obviously, banking firms can't fix demography.

Nakaso: Yes, of course, the capital injection did work. And the other thing is a major restructuring of the bigger banks. There used to be 21-plus, the so-called internationally active banks. They are more or less consolidated into three megabanks. Tokyo-Mitsubishi, Mitsui Sumitomo, and Mizuho. And with regard to the smaller institutions, like credit unions and credit cooperatives, many of them went bust. So, this was like kind of forced consolidation. The numbers are much smaller, as compared with before the crisis.

So, as for the bigger part of the banking sector, and the smaller tier of the banking sector, I think this consolidation has played a lot in streamlining the banking sector. But the problem is in the middle tier, where regional banks are. They somehow survived the crisis, and therefore the capacities of the so-called regional banks are still relatively big. And this is causing an over-capacity problem. This is the remaining problem of the Japanese banking sector today. Otherwise, many of them have been reformed and streamlined.

YPFS: Could you think a little about some of the lessons that you take from this initial period of crisis—before we get into some of the details on specifics? Particularly, again, the criticism of the slow response. As you said, you're building the book from scratch. So, what's in the book?

Nakaso: Yes, first of all, I think the authorities tend to be caught by what may be called wishful thinking, assuming things simply cannot be that bad, particularly after a period of booming economy. A kind of inertia that results in under-estimating the potential magnitude of a crisis. Not surprisingly, this is the same thing that happened to the US authorities 10 years after in dealing with the subprime loans. You might remember, initially, the US authorities were downplaying the significance of the seriousness of the problem. So, that is first.

And secondly, we lacked the mechanism that I already mentioned: the methodologies to capture the right size of nonperforming loans, which

resulted in unfortunate delay in recognizing the seriousness of the problem. The absence of a capital injection framework using public funds until the later stage of the crisis was another factor. And thirdly, why it took long. This is something that may be referred to as the cost of democracy. Particularly these policies dealing with problem banks encounter resistance from the general public or lawmakers, politicians. Very unpopular, always.

First of all, banks are criticized for the bad management. The authorities are criticized for not handling the crisis properly or not detecting the crisis earlier and dealing with the crisis in a proper manner. So, this was always difficult. And it took a long time in the very dire discussions to come up with any kind of legislation that we thought was useful. November 1997, the Dark November, was a turning point, as I mentioned earlier. The crisis became visible to anyone's eyes. Only then, people recognized no more time should be lost. But until then, things were painfully slow in the democratic process. In this sense, the cost of democracy was quite big.

YPFS: **Okay, let's talk about some of the specific actions in the 1990s. Just as background, there were cracks in the system, as you said: showed up early in the decade with the failure of some of the smaller credit co-ops and the nonbank lenders. In 1997, Sanyo Securities failed, the government let it collapse. And that brought on a run in the interbank market, and the other financial institutions failed soon after, including Yamaichi Securities. In that case, the Bank of Japan provided liquidity support upon request from the government for a more orderly winddown via the Bank of Japan. Was the liquidity support that the bank gave Yamaichi necessary to prevent the Japanese financial crisis from becoming worse?**

Nakaso: Yes, it was absolutely necessary. Yamaichi Securities was one of the four largest securities firms in Japan. It had several bank subsidiaries in Europe. So, it was a kind of financial conglomerate, more or less regarded as a bank overseas—and therefore its weaknesses had the potential for spilling over to financial markets overseas. And this was definitely something that we were determined to prevent from happening. Here, we faced a problem. We heard from an overseas authority that the bank subsidiary in their jurisdiction was quickly running out of cash. They also informed us that another bank subsidiary with surplus cash position in a different jurisdiction was prevented from extending liquidity support to the ailing subsidiary by the authority in that different jurisdiction. This is what we call “ringfencing.” If this was left unaddressed, it was judged that the cash-short subsidiary would go under.

So, ringfencing was regarded as a problem that could make things worse. And this ringfencing was only broken by liquidity provision by the BOJ, which said that the liquidity provision by the BOJ can be used to support liquidity in its subsidiaries as well. And only then, this ringfence was released.

In any case, Yamaichi Securities was a tip that had some implication for the overseas financial markets. But others like Hokkaido Takushoku Bank, which was one of the city banks, and later Long-Term Credit Bank, which was even larger. So, the MoF [Ministry of Finance] at the time, which was supervising the banking sector, as well as the BOJ, shared a slogan which said, "We will never let our problem spill out to overseas and develop into a global financial crisis." And actually, we had pressure from overseas authorities instructing us, so to speak, not to let the Japanese problem spill over to their markets.

YPFS: Should Sanyo have received the same type of support?

Nakaso: Actually yes. In retrospect, yes. Yamaichi's case was an orderly winding down, while Sanyo was shut down immediately for liquidation under the Corporate Reorganization Act, which was similar to the process under Chapter 11 in the United States. It shouldn't have been done in the way it was. So, it was surprising to see Lehman was closed down in a similar manner a decade after...

YPFS: I have asked the same question about Lehman, yes. So...

Nakaso: We moved back and forth; we failed dealing with Sanyo Securities. And therefore, the authorities took a different approach, with orderly winding down of Yamaichi instead of liquidation immediately. But this liquidity assistance by the BOJ turned out to be very costly. Maybe you know that Yamaichi was not a bank and, therefore, was not protected by the Deposit Insurance Corporation of Japan [DIC], which is a governmental institution. In the case of a failure of a depository institution, any loss arising from the BOJ's liquidity assistance was compensated for by the DIC. The DIC paid an indemnity to the BOJ. But Yamaichi was not a depository institution, and therefore there was no mechanism to indemnify against the BOJ's credit loss. So, it ended up in credit loss of 111 billion yen.

And incidentally, this was not the only case in which the BOJ suffered credit losses, because we also provided capital to undercapitalized banks. When the government's infrastructure was still absent, BOJ was the only institution that could move flexibly to provide capital to undercapitalized banks. So, we did this too. But again, many banks went bust subsequently. So, these turned out to be additional credit losses for BOJ. The credit loss that the BOJ incurred during the crisis of the '90s amounted in total to exceed 200 billion yen. So, this was a very painful time for the BOJ.

YPFS: Did the bailout of Yamaichi delay further action that could have helped resolve the underlying crisis that continued?

Nakaso: I think to the contrary. Yamaichi was the third institution to collapse in the Dark November of 1997. And the fourth one was a fairly smaller institution, but these incidents opened eyes. I mean, made the crisis visible to everyone in

Japan, and that forced the legislators to take belated but necessary measures, most typically capital injection for the weakly capitalized banks. Suffering credit losses was painful, but these were kind of necessary costs, in retrospect.

YPFS: **The crisis keeps going. We get to the Long-Term Credit Bank, which failed in 1998. And that was an even bigger failure. There, you went for orderly resolution with purchase by new investors rather than the liquidation that eventually happened with Yamaichi. Can you discuss the differences there and what the thinking was?**

Nakaso: By the late summer of 1998, we knew that the Long-Term Credit Bank was going to fail. Because of the sheer size of the bank, the legislators worked vigorously to make new laws to contain systemic disruptions. And in October 1998, there were two major legislations. One is the Financial Revitalization Act and the other was the Financial Function Early Strengthening Act. The latter is for capital injection using public money to weakly capitalized banks. And the former provided the authorities with the power to nationalize a troubled bank. Long-Term Credit Bank was the first bank to be nationalized under the Financial Revitalization Act. The Long-Term Credit Bank was judged to be insolvent. Therefore, first of all the existing shareholders were wiped out before the government injected new capital. The residual loss was covered by the DIC. In this way, the nationalized bank was able to continue to provide financial services without interruption. So, an entirely new bank was established. This was a very different approach from the conventional ways of dealing with a failed bank.

Now, having said that, if I may: full nationalization of the Long-Term Credit Bank was not our initial idea. BOJ and FSA, a newly created regulatory body in June 1998, initially thought some kind of merger could be worked out with the Sumitomo Trust Bank. We thought that the merger ratio can be significantly in favor of the Sumitomo Trust. We also thought that the government can provide new capital upon merger. Because we knew that making a bank go bust is more costly than a bailout merger. Bailout is less costly, because the capital may be recovered if the merger turns out to be successful in reviving the bank. Whereas if you let the bank go bust and nationalize the bank after cleaning up the balance sheet, you have to cover all the losses by using the taxpayers' money. And that money is not coming back. So initially, we were looking for a less costly solution, which was also possible under this new Revitalization Act.

But legislators or politicians wanted justice to be done. Straight, stringent measures in order to penalize the Long-Term Credit Bank, which was managed very badly. Understandably. That is why all the existing shareholders were wiped out and the management fully replaced. But in a purely economic sense, bailout was probably less costly.

YPFS: **Were there lessons that you would pull out of that experience?**

Nakaso: Yes. One is already something I have mentioned. Bailing out is often less costly, in most if not all cases. But then, of course, you have to strike a good balance between the need to minimize moral hazard.

Secondly, you need to have a good framework, a safety net framework, which can deal with not only banks, but also nonbank financial institutions. Like Yamaichi Securities, Sanyo Securities. An important element is that there is the mechanism that allows failed institutions to keep providing key financial services for the sake of maintaining financial stability. Maybe this is a topic later, but Japan has developed an effective framework of safety net arrangement based on the painful experiences of the Japanese banking crisis in the '90s.

YPFS: In a review of the '97 crisis that you wrote in 2001, you talked about several "what if" questions. I'm going to read them, so that... I'm sure you remember them, but that's so I have them. And maybe we could discuss some of those topics.

The three areas you mentioned were number one, if we had had an adequate financial infrastructure that effectively captured the potential magnitude of the problem, it might have encouraged policymakers to take more decisive actions at an earlier stage. We sort of touched a little on that.

Number two, if policymakers had created a flexible safety net that allowed the use of public funds earlier, before and not after the series of successive failures of major financial institutions, the financial shakeup might not have been as devastating.

And number three, if the management of Japanese banks had the foresight and courage to embark on restructuring at an earlier stage, not all the banks might have been as desperately entangled in bad loans. Okay, so that's you in 2001. We've had another 20 years to think about it.

What are your questions? Your answers now?

Nakaso: Yes. I must admit one can be wise only after the event. On the first point, the importance of being transparent has been more than fully recognized so that investors and authorities can see the actual quality of a bank's balance sheet. And the banks themselves know that if they're not transparent enough, this would be bad for their reputation. So, this kind of new way of thinking has now been filtered through to every corner of the banking sector, which is good.

Second, with regard to the safety net framework, I think we have a very robust one now. Because our safety net is built on the actual experience of dealing with the crisis, the failures and successes we had. And, in my view, the current safety net arrangement can deal with almost any kind of crisis that could erupt

in the future, including nonbank firms, and insurers as well. In this sense lessons were learned. Not everything was lost in the Lost Decade, I think.

And I should also mention the collective efforts by the authorities in formulating Basel III, which is much more effective. And there's also a common kind of methodology to deal with the problems of big global banks. So, I think for the second issue much has been already done to address the problem.

Now the third, I don't know yet. Banks, still in many respects, are regarded as a kind of industry that's been behind the curve in many respects. Doesn't really have the foresight to deal with the new demands in the economy and in the society. So, some issues still remain to be done for the bank managers to keep abreast of the time, I think.

YPFS: Let's move forward in time. Let's get to the 2007-2009 Global Financial Crisis and how the shock waves, starting here in the US and going around the world, affected Japan. Can you talk about the role of the Bank of Japan? The bank had already gone to unconventional monetary policies.

Nakaso: Yes. It was really amazing, how the Lehman debacle changed perspectives on what we experienced during the 1990s. Until this Lehman thing came, our experience was regarded as kind of a unique Japanese experience that did not have much implication or relevance for the rest of the world. But then you find that the way the crisis unfolded in the context of the subprime loans was exactly the kind of thing that we experienced a decade before.

There was a kind of *déjà vu*. And we were quite sure, at the early stage of the GFC, that this was not going to end that easy or any time soon as many people overseas thought it would at the time. So, as for the Japanese banks, they were, in a way, fortunate that they didn't have enough power yet as to engage deeply in complex subprime loan-related instruments, such as CDOs. They were busy cleaning up their balance sheet to become more vigilant and were sidelined when the GFC struck.

So, their balance sheets were relatively, in terms of soundness, intact and this saved them from being deeply involved in the troubles that other major banks in other countries experienced. So, it was a lucky position for Japanese banks. At the time, we already had experience with a crisis. So, the BOJ had a lot of instruments in the toolkit. The BOJ, I think, was very good at inventing new ways of providing liquidity or absorbing liquidity when necessary. So, we deployed in the initial phase, a full range of policy instruments, ranging from traditional liquidity injection to more unconventional measures including purchase of CP [commercial paper], corporate bonds, and so forth.

YPFS: How has the Bank of Japan over time approached deflation?

Nakaso: So, you're moving on to the next question. But there are a couple of things I should also mention in the context of crisis management.

YPFS: You were talking a little about monetary policy and I was mixing them up. So, let's go back to crisis management.

Nakaso: Yes. It's a bit confusing, because unconventional monetary policy tools were used to address the crisis.

YPFS: Nonconventional tools.

Nakaso: Yes, there was one problem we couldn't address on our own. In this regard, issues related to the dollar funding liquidity is a very interesting area. This is the area where a central banking committee worked very, very closely. Closer than ever, I think. Meetings at the BIS in Basel turned out to be very, very useful. What I mean is: the Markets Committee, which is one of the standing committees of the BIS. The committee comprised central bank experts on monetary policy implementation, which means, the operation side of the monetary policy. Among them was Bill Dudley, at the time an SVP representing the New York Fed. In the collective effort, the central banking community invented significant new measures to contain the crisis. Here, a key issue was how to ensure the dollar funding liquidity. Incidentally, this was the issue we faced in our own banking crisis of the '90s. I mean, the Japanese banks suffered from the so-called Japan premium. They had to pay extra premium in raising the dollar liquidity in particular, because of the loss of credibility in the interbank market.

But this time around, because of the loss in reputation, credibility, or ratings more specifically, in the GFC, things were totally opposite. It was the foreign (non-Japanese) banks that had to raise a lot of money paying premium. They had faced extra funding requirements arising from the so-called reintermediation. CDOs and other illiquid assets held by affiliates had to be financed by parent banks. Most of these assets were dollar-denominated. Thus, the dollar shortage was acute. So, there were a lot of funding requirements on the part of the foreign banks, mostly European, but also American, to raise the yen in the Japanese money market and then convert into the foreign currency, the US dollar in particular, in the FX swap market.

So initially, there was a huge excess demand for yen liquidity on the part of the foreign banks operating in Japan. Japanese banks were afraid of lending to foreign banks, because of the counterparty credit risks. Thus, foreign banks had to pay a premium in raising the yen liquidity. Therefore, the BOJ, in order to address this excess demand for yen liquidity, particularly from the foreign banks, injected a huge amount of liquidity almost on a daily basis using the facilities that we had.

This is something that that took place in the initial phase. The role the BOJ was performing was, in effect, substituting the market function by becoming the market maker of last resort in the short-term market and in several other credit markets like CPs.

But as the crisis deepened, even the FX swap market became dysfunctional. Therefore, we had to develop a means to channel US dollars to the banking sector in various jurisdictions that were experiencing dollar shortage. The five central banks—ECB, BOJ, Bank of England, Swiss National Bank, and Bank of Canada—established swap lines with the Fed. Under the swap line arrangement, the five central banks were able to borrow US dollars against their own currencies. The dollars thus obtained were then provided to the respective markets. The swap line was probably the single most important product of the collective effort by the major central banks to contain the liquidity crisis.

YPFS: **So, just talk a little about how the Bank of Japan has approached combating deflation, the tools there, and the lessons there.**

Nakaso: This is also a topic that these days is discussed quite frequently. The BOJ was the first major central bank that encountered the so-called zero lower bound, as early as around the turn of the century, when the policy rate cuts resulted in zero lower bound a decade ahead of the peers. And therefore, we had to invent many measures that today are called unconventional policies. We started with forward guidance, and then embarked on Quantitative Easing or QE, under which we bought a lot of government bonds in order to compress the long-term rate, which still had room to be compressed.

We advanced deeper into the unconventional territory and in 2010 we started to buy credit instruments again like CPs, corporate bonds as well as ETFs and J-REITS. The purchase of these instruments, which today is called Qualitative Easing, aimed at reducing risk premium. The big policy package labelled Quantitative and Qualitative Easing (QQE) launched in 2013 was a combination of quantitative and qualitative measures in large scales. And in order to overcome the zero lower bound, in early 2016 we also went ahead to introduce negative interest rate policy, following the paths of the European Central Bank and the Swiss National Bank. And, in the later stage in 2016, we embarked on the yield curve control to directly control short-term and long-term interest rates, or the shape of the yield curve, more broadly. In this way our monetary policy measures evolved almost constantly, encompassing a whole range of unconventional monetary policies that more or less today are shared by our peers.

YPFS: **You've written about the role of central banks as lenders of last resort, how that's evolved. Can you talk a little about that?**

Nakaso: Yes, it's again a very long story. In the Japanese banking crisis, first of all, we did everything as the lender of last resort. Very strange things, including providing capital to weakly capitalized banks. Of course, we did provide liquidity. But, besides, as I mentioned earlier, because there was not enough safety net infrastructure at the early stage of the crisis, we injected capital in addition to liquidity. The central bank was the only one who could move flexibly in the absence of a governmental framework for capital injection.

So, this is what happened in the 1990s. In the GFC, the BOJ was joined by other major central banks, and, together with them, we further deviated from the traditional notion of the lender of last resort.

Namely, I think there could be three major areas that major central banks, along with the BOJ of course, expanded the role of lender of last resort. One is provision of foreign currency. From our perspective, dollar liquidity. So, in this case, because the dollar is the key currency used in trade and financial transactions, the Fed became the key lender of last resort. And the swap lines, which I explained earlier, functioned very effectively, meaning that other central banks provided dollars they borrowed from the Fed in their own jurisdictions to satisfy the demand for dollars in their own markets, particularly by big internationally active banks. So, this is something we call a global lender of last resort, which is unprecedented. The traditional notion is that a central bank takes care of its own banks in the home jurisdiction, with loans denominated in its own currency. But global lender of last resort was different in the sense it provided dollar liquidity instead of their own currencies. So, global lender of last resort is one thing.

The second one is what we call the market maker of last resort, which means that the central banks intervene in the markets that have become dysfunctional. We saw in the GFC that some markets were disrupted, losing market functioning, be it government bonds, or CPs, or corporate bonds. Some of these market segments became dysfunctional in the early stage of the GFC. And also, in the early stage of the pandemic. So, this is where central banks stepped in to perform as a market maker of last resort by purchasing the instruments, the markets for which have become dysfunctional. So, this is, again, another expansion of lender of last resort.

And the third category is the increased focus on the corporate sector. Lender of last resort traditionally meant to help deal with liquidity problems with the banking sector or a bit more broadly, nonfinancial or nonbank sector. But after the GFC, many central banks focused on supporting corporate financing, directly or indirectly. For example, BOJ's Special Funds-Supplying Operation and ECB's TLTRO were facilities that back-financed, with favorable conditions, those banks that were lending to the corporate sector, particularly with a focus on SMEs, which had no credit channel other than the bank loans. Meanwhile, the Fed's Main Street Lending Program was, in my view, de facto direct lending

by the central bank to corporate firms. So, these measures may be called expanded lender of last resort as the focus shifted from banking to corporate sector.

So, global lender of last resort, market maker of last resort, and expanded lender of last resort focusing on corporate sector, these are the three big new dimensions that I think further added to the already diverse dimensions of the lender of last resort as performed by major central banks.

YPFS: Okay, continuing to move forward to when you became deputy governor of the Bank of Japan in 2013, past the GFC. What were the major issues during this era? Did the Basel frameworks help address any of those issues? Progress made, challenges remaining?

Nakaso: By the time I became Deputy Governor, we had encountered another financial disruption, the European debt crisis, which shook the world. And the European authorities seemingly muddled through from our perspective, like we did in the 90s. And after that, dealing with low rates—the low-for-long problem, low growth rate, and low inflation rate—became the common challenge for the central banking community that we had to collectively address. And here again, I think these international meetings were very useful.

And after all, the central banks are adopting the same level of 2 percent inflation target based on a similar strategy, be it the Fed's average inflation target or BOJ's inflation overshooting commitment, or symmetric 2 percent target by the ECB. They are more or less the same strategy allowing slight deviation to the upside from the target after years of low inflation. So, there is the kind of same concept that underlies the 2 percent targets adopted by the major central banks. And instrumentally speaking, many central banks adopt similar policy measures. QE of course is one thing. Forward guidance is another and credit easing. Also, negative interest rate policy by some central banks.

Mind you, this expansion in policy tools was also the case with the central banks' lender of last resort function. So, inventing new measures to address the unfolding problem resulted in a wider, unprecedented scope of the lender of last resort function, now encompassing global lender of last resort and market maker of last resort. So, things changed very much.

So, the remaining issue, I think, is how to unwind these extraordinary policies and explore implications of the new policy measures for the central banks' independence. The new measures have elements of fiscal policy or industrial policy. I admit central banks had no option but to act quickly and decisively. It was necessary for them to take more expanded measures, away from, very much away from the narrow mandate they were given, which is price stability and financial stability. But over time, both monetary policy and the lender of

last resort function expanded, so we are exposed to credit and market risks. And in terms of QE, we are buying a lot of government bonds, which is a quasi-fiscal policy. So, like it or not, I think central banks' role has been expanding beyond, again, a traditional and relatively narrow area where the central bank was mandated to take care and ensured independence. The kind of new normal that the central banks are heading for is not the old normal that existed before the GFC.

YPFS: **You left that position in 2018, which means that you have now been outside of the Bank of Japan during the most recent crisis, which is the COVID-19 pandemic. Based on what you've dealt with in crisis management, were there lessons from these past decades that carry over into how central banks, financial systems, etc., are dealing with the current crisis?**

Nakaso: Yes, of course. This is an ongoing issue. Maybe a bit too early to make conclusive judgment. But a couple of things are quite clear, from my perspective. And one is, this time around, although this plunge in economic growth was big, recovery is faster as compared with the GFC. In the GFC, where the depth of the plunge was shallower, but it lingered over time. And I think this has much to do with the bank resilience. Banks across the world this time around, particularly in the advanced economies, remained resilient, and the soundness remained more or less intact. I think this was attributed to Basel III and the more stringent regulations introduced after the GFC. So, they were able to support the needed economic recovery. And that's probably one of the reasons why this time around the recovery was quicker. So, the big lesson is that the financial system soundness must be kept at all times.

I think that is one thing. The other thing I wanted to reiterate was that the central banks have done a good job utilizing the lessons learned from dealing with the financial crises in the past. But there is a caveat. As demonstrated in the responses to the pandemic, a big issue is that because of the fact that central banks are taking bigger responsibilities in wider areas, like Paul Tucker says, being unelected power, there may well be questions about the central bank independence and accountability, like it or not. They include how central banks are going to coordinate with other government agencies and to whom they should be held accountable.

I think this is going to lead to, maybe at some point, revisiting the question about the central bank's independence. I think central banks are allowed independence, because of the relatively narrow area of responsibility that should better be left in the hands of technical experts. As I said, price stability and financial stability. But now that they are having bigger responsibility, and thus should be held more accountable, generally speaking. But how they can be made more accountable is a big issue. Whether or not full independence may be limited in some areas or whether there could be a new way of

performing independence. So, this leaves a lot of problems, I think, for the future.

YPFS: **That's a big open question.**

Nakaso: Yes.

YPFS: **Now, is there anything that you would like to say, summarizing again, lessons for policymakers in the future that you wish they had told you?**

Nakaso: Yes, I think that's an interesting issue, which I'm really focusing on to write something myself. Particularly a message to, as you said, to the next generation of policymakers. Before that, with regard to the technical issues that remain to be addressed in terms of lender of last resort, Bill Dudley and I worked together to produce a [BIS CGFS \[Committee on the Global Financial System\] report titled "Designing frameworks for central bank liquidity assistance: addressing new challenges,"](#) which came out in April 2017, and which laid out eight remaining issues to be addressed.

And this is something I said in your joint conference with the BIS in August 2021, so I'm not going to repeat in full context. The eight points laid out in the CGFS report are the remaining issues that central banking community should really address before we are hit by another crisis. Bill and I think there are still very important problems to be addressed by the future generation of policy makers.

The message that I have for the future generation in crisis management has to do with the importance of maintaining the DNA of central bankers. And this comprises three principles. If I may.

The first principle is a bad-news-first principle. By which I mean, humans tend to turn a blind eye to news they don't want to hear or it's hard to believe. And this is why we tended to underestimate the potential size of the crisis in the early stage. Be it our own crisis or the Global Financial Crisis. However, I think the worse the news, the greater the need is to share that news with those concerned and thus make it possible to make the right initial response at the critical moment and act promptly.

The second principle—this is quite obvious too, but still turns out to be quite difficult in reality. The second principle is to prepare for the worst and pray for the best. In a crisis situation a crisis manager has to assume the worst possible outcomes and prepare the best possible countermeasures and only then can one pray for the best. I think the worst is not doing anything and simply praying for that. So, that's the second.

The third one is strong commitment, belief, and singleness of purpose. Staff members dealing with the financial crisis—in retrospect, how should I put

this?—were exceptional. Exceptional dedication was a common virtue, so to speak, at the front lines of the central banking community at the height of the crisis. During the crisis staff members must remain fully committed to the mandate of maintaining financial stability and be united in the singleness of purpose. I think this principle must be shared by all relevant authorities that collectively address the financial crisis, not only confined to the central banking community.

I think these principles must be etched into institutional memories to be carried forward to the next generation of central bankers and supervisors, so that they can effectively handle the next crisis should it happen. So, I very much echo Paul Volcker's last book, "Keeping At It." That book was quite impressive in reminding us of what it means to serve the public. I really hope that his message is conveyed to the next generation of civil servants.

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