Today’s central bank news tells us a lot about the risks and rewards of proactive central banking.

The Bank of Japan (BoJ) surprised me (and nearly everyone else ) with a dramatic expansion of its unconventional monetary policy this morning, citing renewed risks of deflation. The BOJ announced (i) an increase in the target for monetary base growth to ¥80 trillion ($730 billion) per annum from ¥60–70 trillion; (2) an increase in its Japanese government bond (JGB) purchases to an annual pace of ¥80 trillion from ¥50 trillion; (3) an extension of the average maturity of its JGB purchases to 7–10 years (3 years previously); and (4) a tripling of its targets for the annual purchases of Japan real estate investment trusts (J-REITs) and exchange-traded funds (ETFs).

In addition, and more controversially, the Japanese Government Pension Investment Fund (GPIF) will shift its portfolio away from government bonds and towards equities, both domestic and foreign, doubling the share of equities to 50 percent. As a general rule it’s not such a good idea to use government wealth funds as an instrument of monetary policy in this way, but given that government policy in the past has been so heavily tilted towards support of the bond market, it can be argued that this is a good move from a longer-run perspective, and it does arguably strengthen the near-term wealth effects of quantitative easing.

It is also worth noting that the BoJ has followed the lead of other central banks and moved away from date-based guidance (achieving 2 percent inflation within two years of the start of the program, a target that was always optimistic and now quickly slipping out of reach) to a focus on balance sheet targets. That makes sense.
There was a fair degree of attention paid to the fact that the vote was 5-4 for easing. For most central banks, such a closely divided vote would be a negative. Here, however, I see decisiveness. As long as we assume BoJ Governor Haruhiko Kuroda can command a majority on critical decisions, which I do, his willingness to move proactively as soon as a majority exists shows strength.

There is some speculation in the markets that the BoJ move was given a green light when the U.S. Treasury did not mention yen weakness as a concern in its recent exchange rate report. I think this is oversold as an explanation. What I do see at play is a central bank that—while motivated by domestic considerations—is taking advantage of the Fed’s turn toward normalization to make a dramatic move that, by emphasizing the divergence of policy, ensures a substantial market impact. Today the yen reached a six-year low against the dollar at 112.4 and stocks rose sharply. That said, I would not be surprised to see exchange rate tensions intensify in coming months and feature centrally in upcoming G-7 and G-20 debates.

The BoJ’s move could put additional pressure of the European Central Bank (ECB) to act when it meets next week, though few analysts expect a move to purchase government bonds (sovereign QE) until December at the earliest and more likely next year. There may well be a narrow majority for such a move, but in contrast to the BOJ, failure to act (combined with muddy messaging) ensures that monetary policy will continue to provide weak support for the recovery. Europe needs its own “three arrows”, as well as more aggressive action to deal with the crushing debt overhang.

Finally, the Central Bank of Russia surprised markets with a 150 bp increase in interest rates, raising the benchmark rate to 9.5 percent from 5.5 percent at the start of the tightening cycle. With inflation at 8.4 percent and rising (against a target of 5.5 percent), and food inflation several points higher, the central bank was pressured to act. However, the currency sold off following the announcement, despite announcement of an oil agreement with Ukraine, reading the move as a sign of a sharply weakening economy and recognition of the limited commitment of the central bank to defend the currency. I think that is right. The economy is headed for a deep recession, capital flight is continuing, and sanctions are more likely to be intensified than eased in coming months. In sum, it’s hard not to expect that capital controls will soon follow.

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