November 30, 2011

Bank of Japan

A Macroprudential Perspective in the Conduct of Monetary Policy

Speech at 2011 Asia Economic Policy Conference in San Francisco

Ryuzo Miyao

Member of the Policy Board

Introduction

First of all, I would like to thank the organizer of this conference for inviting the Bank of Japan and allowing me to exchange views among such distinguished panelists and scholars.

Today I would like to highlight one of the key issues regarding the conduct of monetary policy, namely a macroprudential perspective in monetary policy making. More specifically, I will discuss how to take into account the risk of accumulation of financial imbalances in the conduct of monetary policy, which could help prevent financial bubbles and subsequent crises. I would also like to introduce our experience and summarize what the Bank of Japan has done so far in this regard.

You may find it somewhat premature to talk about how to prevent future crises given that the world is still struggling in the aftermath of the global financial crisis. However, in order for Asia to keep playing a leading role in the global economy, the issue must be of great importance, although I should immediately add that we have not observed excessive financial imbalances in the region. Looking back at the period after the Asian crisis, we have witnessed a series of incidents that can be deemed crises. It appears that the frequency of such incidents is rising and that efforts to deal with one crisis might have provided the seeds for a subsequent crisis. In the coming years, Asia will not be allowed the luxury of simply being pleased with the situation.

I. The Essence of the Global Financial Crisis

As background, let me briefly review the essence of the global financial crisis.

Although a variety of economic and financial factors are involved, the essence of the global financial crisis is the formation and bursting of the credit bubble. In forming the bubble, the household sector in the United States expanded borrowing and consumption along with the boom in housing prices. On the financial front, new types of transactions such as securitized products and derivatives prevailed, and leverage also increased significantly. Such excess in real economic activity, asset prices, and financial markets had a shared influence among each of these components, and this led to further excess that spread beyond national borders, resulting in the global credit bubble. Balance-sheet adjustment has continued to constrain recovery in many countries, which is typical after the bursting of a large-scale credit bubble.

Unlike the case of the IT bubble in the early 2000s, the global financial crisis has had such a prolonged and serious aftereffect because financial imbalances have been accumulated widely on a significant scale in the form of the credit bubble. This accumulation of financial imbalances took place during a long period of global monetary easing amid the combination of high growth and stable inflation --the so-called “Great Moderation.” Such an environment led to the prevalence of optimism about the future. There was also growing overconfidence in the sophistication of financial technologies. In those circumstances, imbalances accumulated in the form of expanding credit and leverage as well as the rise in asset prices on a worldwide basis.

At this moment, the most pressing and immediate concern for the global economy is the sovereign debt problem in Europe. The problem could be described as a part of the prolonged balance-sheet adjustment process after the financial crisis. The introduction of a single currency may also have contributed to accommodative financial conditions and macroeconomic stability in the mid-2000s, resulting in the lack of fiscal and financial discipline during the period.

II. Two Views on How to Deal with Asset Price Bubbles

On the monetary policy front, central bankers and economists have attempted to address the issue of what is a desirable response to the accumulation of financial imbalances, especially how a central bank should respond to asset price bubbles.

Discussions on this issue may be categorized into two broad views. The first view emphasizes ex-post measures, arguing that "a central bank should not apply monetary policy to asset price fluctuations but should carry out aggressive monetary easing after the bursting of a bubble." The second view stresses ex-ante responses, arguing that "considering the magnitude of the adverse impact following the bursting of a bubble, a central bank should conduct monetary policy to prevent it."

Monetary policy responses to asset price developments involve a variety of issues, and it may not be possible to simply conclude which is right or wrong. Having said that, the global financial crisis has shown that, when asset price inflation is associated with a credit bubble, the impact of its bursting is significant, and ex-post measures have certain limitations in terms of their effects, no matter how promptly and aggressively they are implemented. As a result, although there remains the challenge of implementation, as I will describe shortly, there is seemingly a growing consensus that monetary policy should be conducted by sufficiently taking into account asset price inflation associated with a credit bubble, and including ex-ante responses.

III. Importance of a Macroprudential Perspective

In other words, we could say that a macroprudential perspective in the conduct of monetary policy has become more widely recognized as of essential importance. When one says "macroprudential," it is usually used in the context of how to ensure financial stability. In a macroprudential approach, risks are analyzed and evaluated from the viewpoint of the entire financial system, and institutional designs and policy responses are formed on these assessments. Such a macroprudential approach is also very useful in examining the risk of accumulation of financial imbalances when conducting monetary policy.

In the preceding discussion, I mainly touched upon asset price bubbles, which are one aspect of financial imbalances that could threaten the stability of the entire financial system and adversely affect economic activity. Such imbalances can also take the form of excessive mismatching in terms of interest rates and foreign exchange rates at financial intermediaries. As we have witnessed in the current crisis, imbalances could also develop in an unprecedented manner as a result of new financial techniques and products. Although they may take different forms, one common feature is that imbalances accumulate through the interconnectedness of financial institutions, financial markets, and other components of the financial system, all of which are accompanied by an excessive expansion of credit and/or leverage. This feature is a key when examining the risk of financial imbalances in the conduct of monetary policy.

IV. Challenges Involved in Implementation

We now understand the importance of examining the risk of accumulating financial imbalances and evaluating where and how much risks lie in the conduct of monetary policy, at least conceptually. For actual implementation, however, difficult challenges remain. One such challenge is how to detect the accumulation of financial imbalances. To this end, efforts have been made globally, including by the Bank of Japan, to develop analytical tools.

Another challenge is how to respond to the accumulation of financial imbalances when they are detected successfully. In the first place, monetary policy by itself is not meant to achieve financial system stability, and moreover it is not possible to fully ensure financial system stability through monetary policy alone. Taking the example of asset price bubbles again, suppose a central bank tries to accomplish a soft landing of asset price inflation through monetary tightening. Then the more market participants believe that such an attempt will be successful, the higher asset prices may increase further. If a central bank conducts monetary tightening aggressively enough to prick bubbles, this could end up with overkill and hurt the real economy.

As such, in order to restrain systemic risks from a macroprudential perspective, it is not appropriate to simply assign monetary policy directly for that purpose. Greater importance should be placed on macroprudential tools such as a restriction on the loan-to-value (LTV) ratio for real estate loans and the countercyclical capital buffer in the Basel III capital adequacy requirements. It is also true that an accumulation of financial imbalances develops in a prolonged period of accommodative financial conditions, and therefore such a risk should be duly considered in the conduct of monetary policy.

V. The Case of BOJ

Now I would like to explain the experience by the Bank of Japan and summarize efforts we have been making so far.

Because we experienced the formation and bursting of a significant credit and asset price bubble in the late 1980s and early 1990s, the Bank of Japan placed importance on the risk of accumulating financial imbalances in the conduct of monetary policy. In 2006, when we exited from the quantitative easing policy, the Bank introduced a monetary policy framework in which economic and price developments are assessed from two perspectives. The first involves assessing the baseline scenario for economic activity and prices, examining whether the economy is on a sustainable growth path with price stability. The second perspective assesses the risks considered most relevant to the conduct of monetary policy, including risks that have a longer time horizon than the first perspective. In line with this second perspective, the Bank examines the accumulation of financial imbalances as one of the risk factors with a longer-term horizon.

The Bank's emphasis on the risk of financial imbalances can also be found in the policy commitment made in October last year in the context of the comprehensive monetary easing framework. The Bank has made it clear that it will continue the virtually zero interest policy until it judges that price stability is in sight on the basis of the "understanding of medium- to long-term price stability" – that is, the level of inflation that each Policy Board member understands as price stability. The current understanding is "a positive range of 2 percent or lower, centering around 1 percent," on the basis of the year-on-year CPI inflation rate. The unique feature in the policy commitment last October is that an explicit macroprudential condition is attached to the commitment, that is to say, the bank will continue the virtually zero interest rate policy "on condition that no problem is identified in examining risk factors, including the accumulation of financial imbalances."

In practice, however, detecting the accumulation of financial imbalances is not an easy task. In searching for early warning indicators for financial crises, vigorous research has been done globally at various institutions such as the IMF and BIS as well as central banks, including us. The results of those efforts have shown that, for the purpose of detecting financial crises, it is useful to assess the degree of financial excesses by monitoring indicators such as asset prices, credit aggregate, total investment, and residential investment, most typically their deviation from a trend. The Bank has established a framework to regularly check such indicators in the conduct of monetary policy.

While developing analytical tools devoted to the conduct of monetary policy, the Bank has also been making efforts to better analyze and assess risks across the entire financial system. Specifically, it has produced diversified stress scenarios as part of macro stress testing and developed the new Financial Macroeconometric Model to analyze the feedback process in which stress exerted on economic conditions and asset prices spreads to the real economy through the behavioral changes of financial institutions. The Bank has also been developing indicators useful in analyzing excessive credit expansion and the financial sector's risk-taking, as well as in detecting signs of instability in the financial system. These new tools and assessments were incorporated in our Financial System Report published in October, which is available at our web site. The Bank also attempts to further promote concerted efforts between these assessments of financial system stability and monetary policy making. The recent economic outlook released in October and subsequent policy judgments reflect these new developments from macroprudential perspectives.

Closing Remarks

Let me conclude. I have described the importance of a macroprudential perspective in the conduct of monetary policy and the Bank of Japan has been making certain efforts in this regard. However, I should admit that these are only partially completed and we should keep up our endeavor. In the aftermath of the global crisis, each country has implemented various policy reforms based on similar grounds. I would like to finish by expressing my sincere hope that a policy framework to prevent future crises will be further established worldwide in the coming period, through sharing experiences at various gatherings such as this conference. Thank you very much.

***