Masaaki Shirakawa: Revisiting monetary policy

Comments by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the International Monetary Fund / European Central Bank / Federal Reserve Bank (IMF/ECB/FRB) High-Level Conference "Rethinking Central Banking", Session 1: Which central bank policy areas warrant a rethink, Washington DC, 10 October 2010.

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Introduction

Let me first thank the organizers, the IMF, the ECB and the Fed for organizing this timely seminar. The crisis and continuing adjustment process is clearly pushing for a rethink of multiple aspects of central bank policy. The seminar is divided into three sessions and there are separate sessions on macro-prudential policy and financial stability. I will focus my remarks on monetary policy, but since central bank policy must be discussed in its totality, please forgive me for slightly venturing into areas covered in the following sessions.

Lean or clean

The experience during and after the crisis has, I believe, given a rather clear direction with regard to the "lean or clean" debate, if I may borrow the words of my friend Bill White.[1] In other words, the issue is "should monetary policy lean against the wind to prevent the emergence of bubbles or should it simply clean up the mess after the bubble has burst?" The prevailing view before the crisis was that monetary policy should focus on price stability and rather than trying to prevent bubbles, monetary policy should step in aggressively to mop up the mess after it has burst.

Certainly monetary policy has been effective in reducing the macroeconomic impact from the initial shocks caused by the bursting of the bubble. Many central banks in advanced economies have brought down interest rates close to zero to support economic recovery this time. Unconventional measures, such as the large scale purchases of assets, have been introduced as well, in order to support malfunctioning financial markets. These measures have certainly helped to stave off a global depression. Clearly without such innovative measures by central banks, the situation would have been much worse. However, the magnitude of the economic downturn, the loss of jobs, and the declining pace of economic recovery in the major economies, highlight that the cost of allowing bubbles to develop is so large that the "clean-up" strategy by itself is insufficient. Actions to prevent the accumulation of financial imbalances are also necessary.

Now let me look at this issue from the "leaning" side. The question would be, "what is the relationship between low interest rates or long periods of accommodative monetary policy and the emergence of bubbles?"

Here it is important to keep in mind the behavior of market participants as Professor Rajan has argued previously.[2] Institutional investors, in many cases, develop their investment strategies targeting a nominal rate of return, taking into consideration past experience. Insurance firms and pension funds often commit to a fixed rate of return to policy holders. Since investment manager fees are linked to the size of assets under management, managers would aim to raise nominal rates of return to attract customers. These lead to search for yield tendencies or a more active risk taking stance in a low interest rate

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[1] See White (2009).

[2] This paragraph draws on Rajan (2010, ch. 5).

environment, and in the build-up to the recent crisis, supported the growth of sub-prime related securitization with high ratings and surprisingly high nominal returns. Investors had either knowingly or unknowingly taken on large credit and liquidity risk. Such behavior had been amplified in the low interest rate environment where liquidity was plentiful. "Tail risks" which were hard to detect in such an environment were piling up in investor portfolios and financial institution balance sheets.

Another element that would strengthen such activity would be the expectation that a low interest environment and accommodative monetary policy would continue. This would be influenced by multiple elements such as economic conditions, inflation expectations and the central bank policies. Since the 1990s, inflation targeting was introduced in many countries as a framework to enhance transparency and accountability of monetary policy. This helped to anchor inflation rates as well as inflation expectations. At the same time, due to the design of this framework, markets and economists began to narrowly focus on the output gap and inflation rate in assessing the future path of monetary policy. In a stable inflation environment, this tended to create search for yield tendencies by heating the expectation that very low interest rates will continue.

Arguments against leaning against the wind

There are various arguments against the view that monetary policy should play a role in leaning against the wind. Let me raise two here.

One argument would be that it is difficult to detect asset price related bubbles. The counter argument would be that higher asset prices *per se* are not the problem, but rather the build-up of imbalances such as excessive leverage and maturity mismatches which are interlinked with the large rise in asset prices are the problem. Central banks with access to micro information of individual financial institutions which enables them to effectively monitor both economic and financial conditions, are in the best position to detect such imbalances and certainly need to consider what policy actions they can take.

A second argument would be that imbalances such as excess leverage would be best dealt with through supervisory and regulatory measures. The use of micro-prudential tools is certainly called for. But that does not rule out the use of monetary policy. In the Japanese experience, when the Bank of Japan used to conduct window guidance many years ago, there was also the academic debate on whether it alone can be effective in curtailing excessive bank lending. The conclusion was that in a very loose monetary environment, arbitrage behavior would weaken the effects of window guidance. On the other hand, monetary policy on its own could not complete the job. It would become more effective when monetary policy and micro-prudential policies are used in a complimentary fashion.[3]

Challenges in leaning against the wind

I do acknowledge that there are also challenges even if we were to agree that central banks should lean against the wind.

What conditions need to be fulfilled so that the central bank can effectively lean against the wind? Certainly the central bank will need to be independent in making its assessment that unsustainable imbalances are building up in the economy and that it may be necessary to take away the punch bowl in the midst of the party. However, formal independence would not be sufficient.[4] A broad social consensus would be necessary. There would need to be an

[3] See also Shirakawa (2010a).

[4] What responsibility a central bank should bear in democratic society is discussed in Shirakawa (2010b).

understanding that if financial imbalances were allowed to build-up, for example through a rise in asset prices and increase in leverage, the social and economic cost of its collapse would be substantial, and thus pre-emptive policy measures to cool such actions would be appropriate and necessary. Without such a broad consensus, it would be quite difficult for the central bank or any other public authority to embark on policy measures to take away the punch bowl, which will be quite unpopular in the short run.

Another challenge would be how to frame monetary policy, especially in the public policy debate. The importance of the framing effect should not be underestimated. The phrase "inflation targeting" has had both a positive and negative effect on the public understanding of monetary policy and as a result on its implementation.[5] It has enhanced the transparency and accountability of monetary policy in many countries and has helped improve public awareness of the price stability goal of monetary policy. However, looking back to the period as the bubble accumulated, I have the impression that a literal and narrow understanding of "inflation targeting" going beyond its original intention gradually took hold. Though perhaps not acknowledged, this began to constrain the flexible implementation of monetary policy based on overall macroeconomic and financial conditions. Once a narrow understanding becomes engrained in the public mind, it will be quite difficult for the central bank to move beyond this narrow boundary and to act flexibly to an evolving situation, such as a situation where imbalances which could harm long-term growth may be accumulating, although the inflation rate itself is stable. That is why the Bank of Japan has introduced a framework which incorporates the positive elements of inflation targeting while trying to avoid the possible pitfalls. We publish a numerical definition of price stability which we call "understanding of medium- to long-term price stability", and in order to avoid the possible pitfalls, adopted a framework based on two perspectives. Under the first perspective, we assess whether the main scenario for the future path of the economy and prices over a two year time horizon is consistent with price stability while achieving sustainable growth. Under the second perspective, we examine various upside and downside risks associated with the main scenario. A more extended time horizon is also assessed. As the experience of the bubble and its burst shows, we need to consider an event with low-probability but extremely high costs.

A third dimension is the global aspect of monetary policy. The developments before and after the crisis have reconfirmed the extent of globalization of the world economy and financial system. Although monetary policy is only one aspect, monetary conditions especially in major currency areas influence the behavior of market participants and thus global capital flows.

For example, during the credit bubble period till 2007, the current account imbalance for the euro area was quite small, that is to say, investments and savings in the region were generally balanced. However, the increase in gross cross-border lending during the mid-2000s by the banking sector was quite dramatic. The increase in lending was substantial not only toward eastern and central Europe but also to Asia, and European banks have become the largest overseas creditors. The yen carry trade was also a form of large capital flows. In the traditional treatment of monetary policy transmission mechanism, the bank lending channel was mostly a domestic phenomenon. Now the global transmission effects through international active banks and global investors cannot be ignored. This in turn will likely have an effect on the policy decisions of central banks around the globe. This is probably another area where further study and discussions are warranted within the central banking community.

[5] See also Shirakawa (2010c).

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