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Speaking Note by Yutaka Yamaguchi

1. I would like to address some of the issues raised yesterday by Andrew mostly in the context of Japan. First, I agree with Andrew that financial imbalances can develop under low and stable rate of inflation. I would even argue that price stability is perhaps a necessary, though not sufficient, condition of major bubbles that lead to financial instability. In fact the Japanese financial bubbles in the late 1980s expanded when the economy enjoyed almost complete price stability.

   Needless to say, price stability and associated easy money alone can't generate a major asset market bubble. Excessive optimism about the future, which substantially reduces risk premia, is an indispensable ingredient of the chemistry that breeds asset market bubbles. At any rate, expansion and subsequent collapse of asset market bubbles have dominated the Japanese economic scene in the last 15 years. And, in my view, annual 10% asset price deflation has exerted much greater pressure on activity than the less-than-one-percent-per-year deflation of CPI.

2. Let me start with the collapsing phase of an asset market bubble.

   Charles Goodhart pointed out yesterday that in the United States unwinding effects of one bubble is being mitigated by another bubble (or boom) in a different market. In Japan there was no such “different” area, because we had twin bubbles in the 1980s in the equity and property markets. When the turning point arrived, both equity and, with a short time lag, real estate markets collapsed.

Add to this the heavy dominance of the banking system in the Japanese financial intermediation. The vast flow of credit in the 1980s, much of it secured by real estate as collateral, lost value in the 1990s, and had to be written off from the banks’ balance sheets. Inevitably bank capital position was hit hard.

It seems to me that bank-financed property bubble tends to leave behind greater and lingering contractionary effects in comparison with equity driven bubble. The equity market bubble appears to rise and fall even without being supported by massive flow of credit; moreover risks inherent in equity investment should reasonably be understood by average investors, although exuberance tends to blind that reason. That said, capital loss has tended to be concentrated in the banking sector in the Japanese episode, while in the US it is more widely dispersed. But it remains to be seen to what extent the US financial system is effectively protected by the dispersion or transfer of risks and how US households in particular ultimately adjust themselves to the erosion of their major asset component.

3. Let me turn to challenges for monetary policy. The BOJ has been criticized, too often, for having been slow to ease in the first few years after the bubble burst. Some simulations I've read indicate that the BOJ's easing path in the crucial early stage was broadly appropriate as a standard stabilization policy based on then-available information. And yet, it's been argued, that the Bank should have pursued a more aggressive ease given the unusual situation that was to unfold.

4. On past occasions I presented my own view on this. I will briefly summarize my argument as follows.

   First, there is a question of "feasibility". We are talking about a specific phase when inflation is still relatively high and uncertainty is unusually great as the result of bursting bubble. For policymakers to take boldly aggressive steps towards ease when concerns still linger about the risk of reigniting the bubble and accelerating inflation in the short run, they would have to be equipped with near-perfect insight, particularly encompassing the risk of deflation more than a few years down the road.

   Second, a more basic question in the Japanese context is the following. Could an aggressive easing have significantly moderated the falling trend of asset prices?

   I am skeptical. History tells us that once an asset inflation has developed into a major bubble, it is impossible to "soft land" the market when the tide changes. If this is the case, and if the asset market in question has traditionally served as a kind of anchor for financial stability, the capacity of monetary policy to stimulate demand, inflation and even money growth is bound to be severely handicapped.

5. My reference to a strong constraint on central bank's money creation capacity might sound odd, for it defies conventional wisdom explained in Economics A textbooks. But what has actually happened in the last 2 years since the BOJ conducted "quantitative easing" is illustrative: Growth of monetary base accelerated, money multiplier dropped almost correspondingly, and broad money in the hands of businesses and households changed little. This is the reality where businesses are working out excessive debt and banks' risk-taking capacity is impaired --- features of post-bubble economy.

6. The observation so far leads me to a few conclusions with respect to policies in the collapsing phase of a major bubble.

   ---While it is no doubt desirable to gain better insight and more accurate predicting ability to support policy judgement, it promises to be a daunting task, given the high degree of uncertainty in the aftermath of a bubble.

   ---Uncertainty is great as to what an "aggressive easing" can accomplish in terms of its effects on asset prices.

---Prompt actions to address the emerging problems in the banking system are crucial, not merely to stem financial fragility itself, but also to secure a transmission channel for monetary policy.

The point of my argument today is not so much to defend every aspect of the Bank of Japan's policy in the early 1990s, but rather to point to a need to give deeper thought on the complexity in which the Bank had to operate.

7. Finally, let me say a few words on monetary policy when asset bubbles are expanding. Andrew emphasized yesterday a need to consider and achieve price stability over somewhat longer time horizon than, say, two years. I have sympathy for his argument because such an approach would accommodate flexibility in policy to somehow take account of asset market developments particularly when asset price inflation is accompanied by excessive flows of credit and/or investment. It would be rather odd for a central bank to merely watch vast credit flowing into property and other markets simply because the conventional price indices remain relatively benign.

8. That said, I also think there is a limit to how far the central bank can go in terms of "tightening" in a situation where prices are fairly stable. It would be a daunting task to persuade the public into accepting a significantly restrictive policy by explaining the possible medium-term destabilizing effects of asset market developments on conventional prices. Moreover, a moderately

tighter policy short of having restraining effects on asset prices entails an important risk: it might actually add fuel to an evolving bubble, as it could contribute to the public expectation of a well-controlled sustainable economic prosperity.

9. What about the role of prudential policy in such a situation? On this I agree with Phillip Lowe, who said yesterday that supervisors are primarily micro-oriented and therefore are not appropriately positioned to implement policies with macro-economic perspective. Macro-economic viewpoints aside, the second pillar of the Basel II could presumably be utilized as a kind of moral suasion to induce bankers to restrain procyclical lending when, in the eyes of supervisors, asset markets are headed for a bubble. Our past experiences in moral suasion tell us, however, that it can be effective only when equipped with real gun, which in this context means monetary policy. Some novel devices, including dynamic provisioning, are and will be proposed to help stabilize procyclical credit flows. They might be helpful but in my view would fall far short of effective countervailing power to balance the dynamics of a bubble, financial accelerator and indeed human nature at work.

10. Let me quickly conclude. I believe that the central bank's time horizon to achieve and maintain price stability objective should be longer than two years or so. I basically concur with the traditional view that the central bank take into account asset market conditions in the context of their effects on

current and projected inflation. However if asset market developments were to be deemed threatening the goal, monetary policy actions shouldn't be ruled out. Given the risks mentioned above, such actions would have to be carefully designed so as not to unwittingly increase asset market volatility. Much more study is called for to advance in this line the constructive approach for monetary policy to address the challenges posed by the asset markets. Similarly it would be worthwhile to explore ways to incorporate macro-economic perspective into prudential policies since the problem lies in the nexus of monetary and prudential policy spheres.