

# Monetary Policy and Financial Stability

November 1, 2011

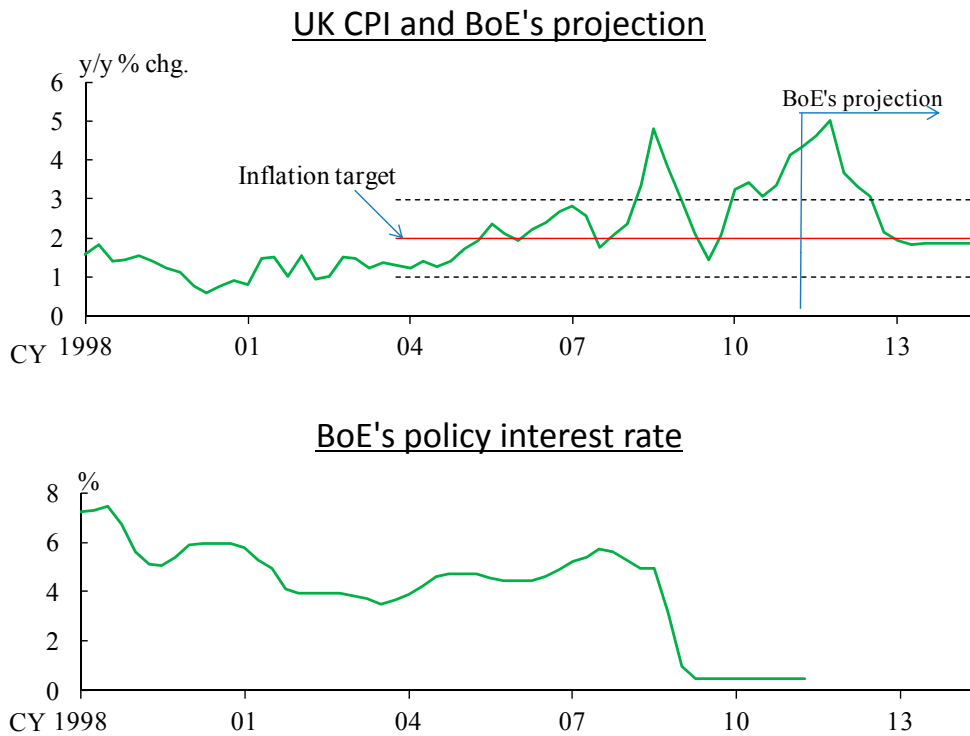
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1. Introduction
2. Central banks and financial imbalances
3. Macroprudential tools
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## Slide 1: Inflation targeting of the Bank of England



Note: BoE's projection of inflation shows a median path projected at August 2011.  
Source: Bank of England.

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## Slide 2: Summary

- (a) Sustained monetary relaxation is likely to lead to the emergence of financial imbalances, which are the sources of financial crises.
- (b) Central banks are in the best position to conduct macroprudential analysis and thus should assume responsibility.
- (c) Macroprudential tools can be useful tools to constrain financial imbalances. However, it may be too optimistic to consider that these tools are sufficient to ensure financial stability.
- (d) BoJ holds the position that it should closely monitor financial system developments and asset price movements, while aiming at the medium and long term price stability, in the conduct of monetary policy.

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## 1. Introduction

## 2. Central banks and financial imbalances

- (1) Financial imbalances could amplify financial crises and bring significant impact on the real economy.
- (2) Persistent expectations for low interest rates could lead to financial imbalances.
- (3) Price stability does not ensure economic stability.
- (4) Wrap-up of this chapter.

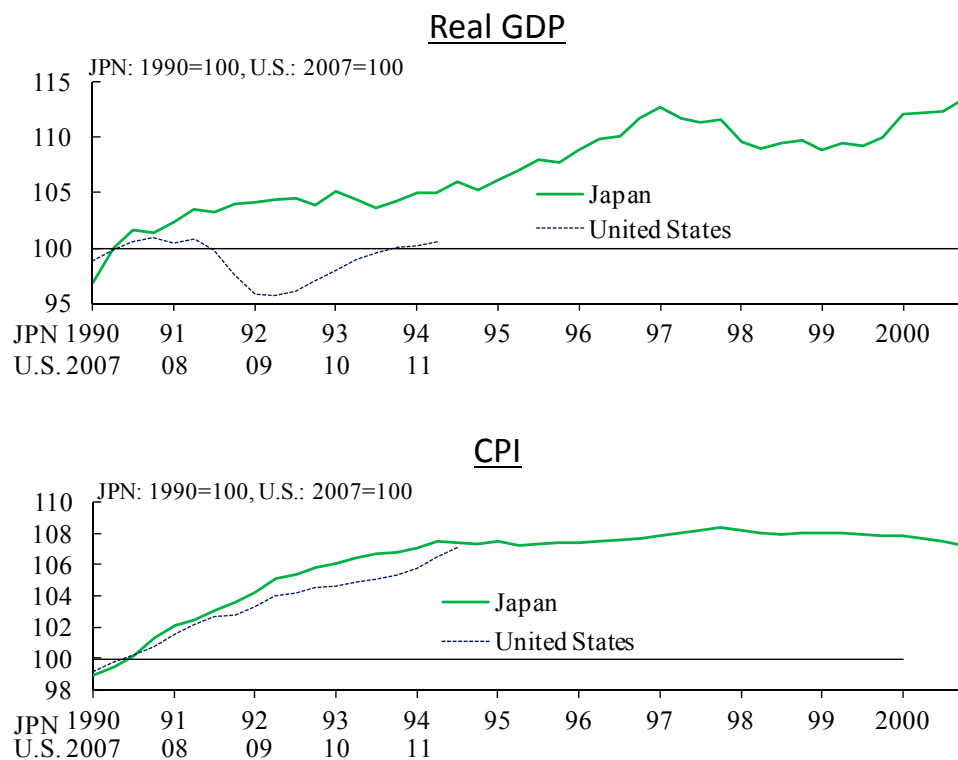
## 3. Macroprudential tools

## 4. Financial stability in monetary policy

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## Slide 3: Economic conditions after bursting the bubbles



Note: Japan's CPI is consumption-tax-adjusted basis and excludes food . US CPI excludes food and energy.  
Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Cabinet Office; Bank of Japan.

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## Slide 4: Driving force behind the bubbles

### 1. Financial and industrial innovations

Overconfidence generated during the time of innovations is likely to result in asset prices overshoot.

### 2. Sustained monetary relaxation

Inflation was under control globally around that time, and the resultant price stability created an environment where central banks kept interest rates low for years.

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## Slide 5: World CPI inflation

	1980-84	1985-89	1990-94	1995-99	2000-04
World	14.1	15.5	30.4	8.4	3.9
Industrial economies	8.7	3.9	3.8	2.0	1.8
Developing countries	31.4	48.0	53.2	13.1	5.6
Africa	16.8	17.9	39.8	20.6	11.0
Asia	9.0	11.5	10.5	7.3	2.4
Latin America	82.4	185.9	232.6	17.2	7.9
Middle East	18.6	22.5	30.4	29.6	15.3
Transition economies	6.2	7.7	363.2	53.9	13.4

Source: K. S. Rogoff, "Globalization and global disinflation," prepared for the symposium sponsored by the Federal Reserve Bank of Kansas City in 2003.

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## Slide 6: Financial crisis and monetary policy

- Price stability is not enough to ensure economic stability.

A bubble can develop and expand, even if price stability is achieved.

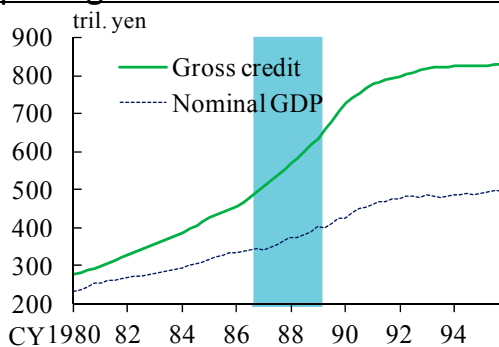
- Monetary policy appears to be deeply involved in the creation of asset bubbles.

A prolonged period of price stability and monetary relaxation along with financial innovations are likely to create expectations among investors for further continuation of the low interest rates, and this appears to have led to creation of bubbles.

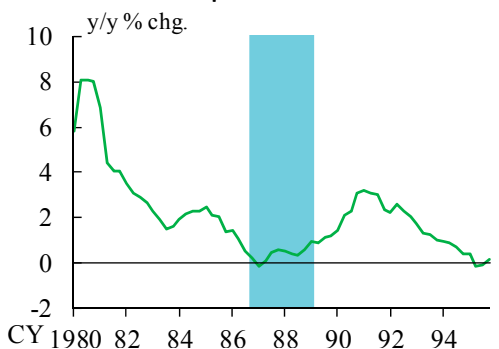
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## Slide 7: Comparison of Japan's and US bubbles

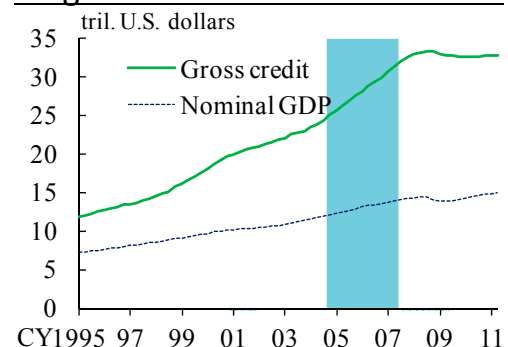
Japan's gross credit and nominal GDP



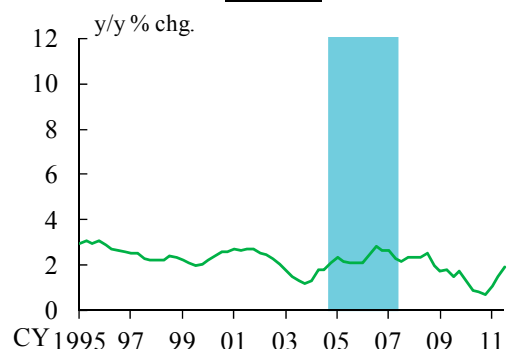
Japan's CPI



US gross credit and nominal GDP



US CPI



Notes: Shaded areas indicate periods of accumulating financial imbalances.

Japan's CPI is consumption-tax-adjusted basis and excludes food. US CPI excludes food and energy.

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve; Cabinet Office; Bank of Japan.

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## Slide 8: Central banks and financial imbalances...wrap-up

- (a) Price stability is a necessary condition for stable economic development but not a sufficient condition. Price stability is not enough to ensure economic stability.
- (b) Fluctuations in asset prices could threaten economic stability through financial system instability. Once financial stability is undermined, it would take much longer to get back to the path for recovery than it would in the case of normal economic cycle.
- (c) A prolonged period of monetary relaxation could lead to creation of bubbles through a build-up of expectations for continuing low interest rates.

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### 3. Macroprudential tools

(1) What are macroprudential tools?

(2) Effects of macroprudential tools should not be overestimated.

(3) Wrap-up of this chapter.

4. Financial stability in monetary policy

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## Slide 9: Macroprudential tools

- Tools aim at exerting direct and indirect influence on the financial system as a whole.
  - ✓ Loan-to-value (LTV) ratio;
  - ✓ Countercyclical capital buffer;
  - ✓ Dynamic provisioning;

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## Slide 10: Macroprudential tools (continued)

### ➤ LTV ratio:

the ratio of the amount of potential loan to the appraised value of real estate collateral.

### ➤ Countercyclical capital buffer:

the buildup of additional capital buffer above the minimum capital requirement.

### Basel III's capital requirements and buffers

	Common Equity	Tier I capital	Total capital
Minimum	4.5%	6.0%	8.0%
Conservation buffer	2.5%		
Minimum plus conservation buffer	7.0%	8.5%	10.5%
Countercyclical buffer range	0-2.5%		

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## Slide 11: Issues related to macroprudential tools

- Effectiveness and speed of macroprudential tools are unknown.

Authorities may not be able to ensure speedy decision-making and action. It is not easy to pull the regulatory trigger that may impact particular areas.

- Effects of macroprudential tools may be mixed and vary.

Robustness and effects of the tools are not clear. In addition, effects of the tools can vary depending on a situation.

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## Slide 12: Macroprudential tools...wrap-up

- (a) Extensive research on macroprudential tools is essential. Along with microprudential supervision, these tools should be included in a toolkit to ensure financial stability.
- (b) However, excessive reliance on these tools is not adequate, as the effects of these tools are not proven.
- (c) While expecting macroprudential policies to act as effective "speed limits," the roles of macroeconomic policies should also be examined.

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  - (1) Fed view vs. BIS view.
  - (2) Challenges in the conduct of monetary policy.
  - (3) Wrap-up of this chapter.
5. Conclusion

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## Slide 13: Fed view

### Fed view:

Central banks should set price stability as its main goal in the conduct of monetary policy and should not make use of monetary policy tools to curb asset bubbles.

The reasons supporting this argument are as follows.

- (a) Asset bubbles cannot be identified before they burst.
- (b) Monetary policy is not effective in controlling the growth of asset bubbles.
- (c) Monetary policy is a blunt tool.
- (d) Monetary expansion after the bursting of a bubble can prevent the subsequent financial instability.

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## Slide 14: BIS view

### BIS view:

Central banks should pay attention to the asset price movements in the conduct of monetary policy.

The reasons supporting this argument are as follows.

- (a) Negative impact of asset price volatilities on the real economy can be tremendous by destabilizing financial system.
- (b) Monetary policy contributes to the formation of asset bubbles.
- (c) Policy tools other than monetary policy have limits in terms of effectiveness and speed. Excessive reliance on these tools is not appropriate at this point.
- (d) Monetary expansion after the bursting of a bubble cannot prevent the resultant financial instability and turmoil. To prevent bubbles from growing, vigilance in monitoring financial system developments and asset price movements is needed in the conduct of monetary policy.

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## Slide 15: Bank of Japan's two perspectives in the conduct of monetary policy

- The first perspective is examining, as regards economic activity and prices one to two years in the future, whether the outlook deemed most likely by the Bank of Japan follows a path of sustainable growth under price stability.
- The second perspective is examining, in a longer term, various risks that are most relevant to the conduct of monetary policy aimed at realizing sustainable growth under price stability. *Risks inherent in asset markets and financial systems are to be examined from the second perspective and incorporated in policy decisions.*

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## Slide 16: Conflicts between price stability and financial stability

- *Central banks may face conflicts in a short term.* They may face conflicts in responding to asset bubbles when inflation remains low and stable, or in addressing financial system instability when a surge in inflation is very much likely.
- When faced with such conflicts, central banks should give priority to either price stability or financial stability and determine whether to tighten or loosen monetary control at their own risk.
- However, *such potential conflicts between pursuit of price stability and pursuit of financial stability dissipate in a longer term.* In terms of the ultimate objective of sustainable economic growth, the long-term price stability does not conflict with the long-term financial stability.

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## Slide 17: Financial stability in monetary policy...wrap-up

- (a) There are two opposing views on how central banks should respond to financial imbalances: the Fed view and the BIS view.
- (b) Monetary control, one of the basic policy tools of central banks, has influence over both price stability and financial stability.
- (c) Central banks should pay close attention to the risks of asset bubbles, while promoting medium- to long-term price stability.
- (d) Not much difference seems to exist between the Fed view and the BIS view in a practical sense.

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### Slide 18: Conclusion

- Bank of Japan publishes the Financial System Report semiannually. ([www.boj.or.jp/en/research/brp/fsr/fsr111018a.htm](http://www.boj.or.jp/en/research/brp/fsr/fsr111018a.htm))
- The latest issue of the Report enhanced the following contents:
  - i. Better assessment of the robustness using macro stress testing;
  - ii. Assessment of a dynamic feedback loop between the real economy and the financial system;
  - iii. Cross-sectional analysis of risks borne by the financial sector;
  - iv. Assessment of financial imbalances using macro indicators; and
  - v. Identification of risks observed in financial markets.

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