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MONETARY EASE AND GLOBAL REBALANCING:

DEBUNKING THE JAPANESE SCARE STORY

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Monetary Policy and Global Rebalancing

Adam S. Posen

Thank you for coming out on a Tuesday evening to talk about economics. I am very glad to have the opportunity to appear at Queen's University under the auspices of the Economic and Financial Institutions Research Group. In accord with this distinguished institution's pedagogical standards, I would like to address a current policy issue from a broad and empirically grounded perspective. The issue is that of adjusting global imbalances, that is, how to manage the transitional pattern of employment and prices when some major economies have been consuming far more or far less than they can afford for several years in a row. Put that way it sounds sort of bloodless, but, as the people of this audience are well aware, that adjustment has been the source of rather contentious political jousting across the Pacific and around the globe of late. I will try to offer tonight some analytical insights into why it is right and reasonable for the major surplus countries to undertake more adjustment than they have so far.

I believe that it is in the surplus economies' own self-interest to further expand their domestic demand, and that it is consistent with those countries' central banks' missions to support this process. To some this will appear to be merely the politically motivated talk of someone serving the self-interest of the Anglo-American deficit economies; to others, my arguments will be irrelevant because the decisions by the policymakers in charge will be made on the basis of short-term political negotiations, not economic analysis. All I can do is try to set out the valid economic arguments as I see them, and hope that at least it makes it more difficult for politicians in both surplus and deficit economies to cover any short-sighted political opportunism with false economic claims

In particular, I want to argue that accommodative monetary policy does not cause asset price bubbles. This argument is based on the empirically supported premise that it is private capital flows and differences in productivity that determine current accounts (and asset prices) for the most part. Barring the self-destructive subjugation of all macroeconomic goals to a fixed exchange rate, the instruments available to central banks of short-term interest rates and bank reserves are of little lasting impact on current accounts.

Japan's extended economic stagnation since its stock market peaked on December 29, 1989, has prompted a series of investigations, recommendations, and self-examinations, both in Japan and abroad. As I have argued in several places, it takes more than a bubble to become Japan.[2] While asset price booms and even busts are not uncommon, the persistence of Japan's Great Recession is, and it was not the bubble and its bursting that produced this outcome. Some noted European commentators, however, have asserted that the Bundesbank's resistance to international pressures for domestic stimulus in the mid-to late-1980s was what saved Germany from Japan's fate. More recently, some Chinese and other East Asian commentators have picked up this claim as a reason for China not to accede to analogous requests today. All these participants in the discussion would claim that American pressure on Japan produced the bubble, and the bubble produced the subsequent disaster.

This view is mistaken, despite its apparent political and intuitive appeal. It was not 'excessive laxity' of Japanese monetary policy in 1986–89 which caused the bubble in Japanese equity and real estate prices, nor was it yen appreciation against the dollar which caused the bubble's impact, except as an induced echo of the asset price boom. As I set out last December, there is no evidence across countries over time that excessive monetary ease was a sufficient condition for the Japanese bubble ("if there is a sustained monetary ease, then a bubble occurs"), a necessary condition for the Japanese bubble ("if a bubble occurs, then there must have been prior monetary ease"), or both.[3] The foundation for such claims turns out to be little more than ones of coincident timing—in Japan in the second half of the 1980s, money supply was growing, velocity was declining, and no increase showed up in wholesale or consumer prices, so the contemporaneous growth in real estate and equity prices must have been the result of this liquidity increase.

Yet, this is a rather tenuous link to make. As Japan itself has demonstrated for more than a decade, one can have all these conditions present (expanding money supply, declining velocity, no growth in the price level) and still see no upward trend in asset prices. Without some forward-

[2] See Posen (1998, 2003, 2010) and the references therein.
[3] See Posen (2009) and the references therein.

looking expectations on the part of investors that returns will be rising relative to base interest rates, that profits will be growing, there will be no buying of real estate or of equities.

For monetary policy to be the source of a bubble, the relative price of one part of the economy (here financial and real estate assets) has to be pumped up by a blunt instrument that usually affects *all* prices in the economy. And it has to do so in such a way that the relative price shift either does not raise expectations of a countervailing shift in monetary policy in the near future (which relies on strange notions of what the imputed future income from increasing land and stock prices will generate), or is expected to only be affected by monetary policy on the upside but not on the down (which there is no reason to believe, if liquidity is the source of the relative price shift in the first place). Either way, this has to take place when we know both analytically and empirically that the relationship between a policy of low interest rates or high money growth and equity or real estate prices is actually indeterminate over time.[4]

Of course, one can resolve this logical tension by positing that the investors have unrealistic expectations about monetary policy. Some research has done so, for example, by characterizing with some justification Japanese investors in the bubble years as believing unduly in low interest rates over a decade or longer horizon. Then, however, it is the expectations of investors, which are driving the asset price process, not the actions of monetary policy. In that case, any monetary policy short of starving the economy of credit could give rise to a boom, and a boom can arise even without excessive ease. Another way to see this inconsistency is that supposedly loose Federal Reserve monetary policy in the early 2000s built the US real estate bubble, and now supposedly loose Fed policy is fuelling capital outflows from the US to emerging markets. Clearly, something other than monetary policy is determining in which direction investors move.

As documented in a number of places, the claim that monetary ease leads to bubbles has not been established with respect to bubbles or asset price booms in general.[5] If this supposed causal link

[4] For example, Michael Hutchison has pointed out using Japanese data that a drop in interest rates today might drive up housing prices in the short-term by making them more affordable, but in the medium-term tends to drive prices *down* because it portends a monetary tightening or slower growth. In any event, as seen in cities like New York and London today, supply factors dominate monetary factors as consistent determinants of land prices.

[5] See Assenmacher and Gerlach (2008), Goodhart and Hoffman (2009), and Posen (2003, 2009).

between monetary laxity and the Japanese bubble is not as apparent in other known cases of asset price booms, then there clearly is more at work in the Japanese case than just monetary ease. In the discussion of monetary policy with respect to perceived bubbles, particularly but not just with regard to Japan, there is usually the sense that it took significant sustained ease to cause the bubble—booms do not seem to pop up frequently enough to be associated with minor mistakes of overly easy monetary policy.

So what is the evidence for the claim, "if ease, then boom"? None worth mentioning – there are many instances across countries over time of sustained easy conditions measured either by ample money growth or by low interest rates not resulting in booms, and even no indication on average that greater ease is associated with greater likelihood of booms.[6] The idea that monetary ease alone is a sufficient condition for asset price booms might appear to be something of a straw man, though it is one that is often put forward without question in the current excuse giving for staying on exchange rate pegs. Perhaps this confusion is because those speaking about Japan actually subscribe to the idea of sustained monetary ease as a necessary, not a sufficient, condition for a boom to occur—if there is an asset price boom, then there must have been prior ease. In other words, on this hypothesis, while there can be periods of ease which do not result in bubbles, there are no bubbles that occur absent monetary ease. Utilizing the same datasets of booms and periods of monetary ease, looking at a large number of cases around the world since the early 1970s, however, the literature has no more support for this formulation than the prior one.

The direct association often drawn between the Bank of Japan's monetary policy stance in the late 1980s and the Japanese bubble therefore bears closer scrutiny. In short, there is more to the story than just that the BOJ did not raise rates in time. The (Japanese) textbook version of the story is that international pressure upon Japan from the United States led to too much ease from the BOJ, and that ease led to the bubble. Japan had come out of the second oil shock, carefully closing its public deficits and managing money for price stability. At the time, protectionist

[6] There is some relationship between broad money growth and real estate prices. There are two reasons not to exaggerate the significance: first, central banks do not control broad money, so it is not directly correlated with easing of policy; second, there is a reverse causality of rising real estate prices causing rises in perceived collateral fuelling lending growth.

pressures were mounting in the US Congress due to the large US trade deficits and the rise of the Reagan-Volcker dollar. First in the Plaza Accord of September 22, 1985, and then (after additional bilateral pressures from the US government) in the Louvre Agreement of February 20, 1987, the Japanese government agreed to stimulate domestic growth and help manage an appreciation of the yen against the dollar.

Under direction from the MOF, the BOJ began to make interest rate cuts in January 1986, starting with an overnight rate of 5 percent. By the time of the last cut three years later, the BOJ had cut its overnight rate to 1 percent. Meanwhile, the MOF did not wish to imperil its hard won budgetary consolidation by engaging in expansionary fiscal policy, so the burden of stimulus fell totally on the BOJ. The yen appreciated from a low of ¥240 per dollar to ¥125 per dollar, inducing the short-lived *Endaka* (high-yen) recession of 1985–86. The *Heisei* boom that we think of as the bubble years began shortly thereafter. No obvious increases in the CPI or WPI arose for the remainder of the decade, and most private sector forecasts were for continued low inflation (Ahearne et al. 2002). The 'Black Monday' US stock market crash of October 1987 provided another reason for the BOJ to keep interest rates low. In this version of the story, the issue is whether the BOJ could have raised interest rates some time in 1988 and in so doing have pricked the bubble.

Yet, none of this explains why there should have been a bubble in Japanese equity and real estate markets in the first place. Something had to channel the easy monetary policy into asset price appreciation rather than either more general price pressures or sustainable growth, or something else had to give rise to the bubble. Again, the sole argument for blaming monetary policy seems to be one of timing. Even that, however, does not hold up well. Land prices were already rising before the Plaza Accord, and well before the full force of the BOJ's rate cuts: one common index shows a 12.7 percent increase in FY1984 and a 28.9 percent increase in FY1985. And the run-up in stocks began even when the *Endaka* experience was fresh in people's minds, but the public commitment of the BOJ was to keep the yen on an *upward* trend.

If the decision to cut rates in 1986–89 was truly a political decision in response to US pressures on the MOF, and MOF pressures on the BOJ—as reported upon in the press and clearly

grumbled about by BOJ officials—why was the BOJ's frustrated case for tighter policy not persuasive to the bond markets? Surely, if it were clear that the BOJ were violating its normal policy priorities due to obvious international pressure, the idea that such low rates would be sustainable without any effect on inflation or medium-term growth would have been discounted. The fault for the asset price increases seems to lie in the unrealistic expectations of participants in a bubble, not in Japanese monetary ease itself.

Let us turn the question around: should the BOJ have believed in the macroeconomics of the *Heisei*-boom in the second half of the 1980s? Or should they have been in a position to discount this story? The debate among monetary economists over this period usually is cast as whether or not a central bank can read asset prices any better than financial markets and can assess the evaluation of equities. As the Japanese case of the late 1980s illustrates, this debate is misfocused. Whatever the state of asset prices, central banks have to assess the potential growth rate of the economy they oversee, and this macroeconomic assessment can be done largely independently of any specific relative prices in the economy. For Japan in 1987–91, output was 2 percent a year above trend, and 1988 showed the highest growth rate (7 percent) seen since the mid-1970s.

Meanwhile, just looking at overall market averages, the stock and bond prices implied either 15 or more years of low interest rates or a massive drop in the risk premium. Could a significant drop in the risk premium be held credible for aging Japanese savers, given well-known demographic trends and savings behavior? Alternatively, how could interest rates be expected to stay low indefinitely if the boom's euphoria was based on a real increase in the potential rate of output—and therefore of the economy's natural rate of interest—over the long run? The apparent surge in Japanese labor productivity in the late 1980s was something to be suspicious about. Given limited deregulation before the 1990s, the end of catch-up growth, and the absence of any new technological revolution, what would justify a near-doubling of productivity growth from its around 3 percent average of 1979–87? What precedent was there for a 2 percent jump in trend productivity anywhere except emerging markets making the great leap as Japan already had in the 1950s?

In short, the BOJ could have decided to tighten policy in the 1980s without any reference to asset prices beyond the most general evaluation of interest rate expectations. It was not lack of explicit attention to rises in asset prices that led monetary policy astray, no expectations based on a reasonable evaluation of monetary policy could have supported these macroeconomic assumptions embodied in the overall asset market. Kuttner and Posen (2004) establishes that for any of a wide range of potential output estimates—using real-time available information and varying in method but never explicitly including asset prices—the BOJ would have normally been expected to raise rates some time in 1987–88. Of course, even if interest rates had been increased, it is not evident that alone would have 'popped' the bubble.

One could try to restore the link between the Japanese asset price bubble and monetary policy by asserting that a firm belief in ongoing pressure from the United States for yen appreciation in response to the United States's endemic trade deficits, rather than actual faith in the potential output measures implied, was what underlay the belief in monetary ease and thus the boom. Perhaps that would have been more rational than belief in the bubble per se. As McKinnon and Ohno (1997) have shown, however, at least theoretically a long-term expectation of sustained yen appreciation should result in *deflationary* expectations (including of asset prices) in Japan. So there is no way to square this circle of the bubble somehow logically resting on expectations of future Japanese monetary policy. The bubble was based on assumptions independent of if not in contradiction of those held about monetary policy.

We should turn instead to the obvious nonmonetary factors in the creation of the Japanese bubble. There is a consensus view among economists on how partial financial deregulation in Japan in the 1980s led to a lending boom: Japan's banks lost their best corporate customers after liberalization of securities markets allowed large firms to reduce their cost of capital by seeking direct financing. The banks' ability to move into new lines of business was still partially constrained by regulation, and their franchise value was declining, yet they retained the same large amount of loanable funds due to deposit insurance. The 'Convoy' system of financial supervision, which equated banking system stability with no closure of banks, kept overcapacity in the system, leading to low profits and undercapitalization, increasing the desire to take risks with taxpayer insured deposits. [Hoshi and Kashyap (2003)]

As a result, Japanese banks made a huge shift into lending to small and medium enterprises (SMEs), increasing that share of their loan portfolios from 42 percent in 1983 to 57 percent in 1989, while their loan portfolios expanded by more than half. The banks nearly doubled their overall lending in selected sectors favorable to the SMEs. Companies hold substantial real estate in Japan, and used this as collateral of rising worth to borrow more; households also took advantage of rising home prices and declining lending standards (mortgage limits rose from 65 percent of home value on average to 100 percent on the assumption that land prices would go up). Two additional indicators of this lending/real estate boom arising out of the partial deregulation/ongoing deposits dynamic were the increase in Japanese banks lending directly to firms in the real estate sector, from 6 percent of total lending in 1983 to more than 12 percent in 1989, and the extreme pressure on the long-term credit banks who were most dependent on the borrowing of major corporations.

It is easy to draw the chain of causality from improved access to capital for both large and small business, due to rising collateral values as well as deregulation and shifts in lending standards, to rising expectations of profits and stock prices. And in Japan's system of cross-shareholdings and banks owning significant share portfolios in borrower firms, these effects are amplified through increases in bank capital. Some belief in the rising value of land does underlie this dynamic, but once that is given, one can understand the emergence of a bubble in both stock and asset prices with no reference to monetary ease whatsoever. For comparison, remember that the analogous dynamic seen in the US savings and loan industry took place in the early and mid-1980s, hardly a time of monetary ease. This is consistent with my view (Posen (2009)) that regulatory rather than monetary factors are the source of most real estate bubbles.[7]

What is the implication of this reality for today's debate? No one in East Asia or elsewhere can credibly claim that fear of feeding an asset price bubble is justification for keeping an exchange rate undervalued. Japan's bubbles of the 1980s and their bursting took place due to non-monetary domestic factors. If despite all evidence to the contrary, someone insists that monetary

[7] And shifts in technology are the primary source of equity bubbles, but that's another topic.

policy can have a sustained influence on asset prices, an appreciation of the exchange rate should be a deflationary effect (obvious, but somehow ignored in current discussion).

If anything, the degree to which some major emerging market economies have spoken out about their fear of capital-inflow induced bubbles shows the relative impotence of monetary policy in open economies to offset asset price movements. According to the 'lean against the wind' proponents, this should be simple for these countries' central banks: raise interest rates significantly, and the bubble will pop, it is claimed. That might usually be politically difficult, but looking at the aftermath of recent events in the supposedly errant Anglo-American economies, and the endorsement of such a view by prominent *Mitteleuropean* monetary institutions, there would seem to be plenty of cover.[8] I think central bankers in emerging markets are too smart to fall for such monetary snake oil, no matter how slick the salesmen. If not, we will soon have a demonstration of how raising interest rates in an open economy will fuel bubbles further by attracting more capital inflows, rather than popping bubbles.

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[8] See the discussion in Bean, et al (2010), with which I am largely in accord, and their references to proponents of this mistaken view.

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