

Commentary: Central Banks and Financial Crises

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I want to thank first the Kansas City Fed for inviting me to this splendid symposium. I have found Dr. Buiters's paper long, comprehensive, thought-stimulating and, of course, provocative. It is an interesting read unless you belonged to one of the targeted institutions. In what follows, I will talk more about my own observations mostly on the Fed, rather than offer direct comments on the paper, but I hope my remarks will cross the path of Dr. Buiters's here and there.

The author is highly critical of the Fed's performance in the past year, particularly in monetary policy. The sharp contrast between the Fed and the ECB (and the Bank of England) in monetary policy raises a legitimate question of why the Fed has been so aggressively easing.

The Fed's trajectory since last summer appears to me broadly consistent with the weakening U.S. economic growth and the Fed's dual mandate. But the Fed would not have eased as much as it has if it had not adhered to the "risk management" aspect of monetary policy. The relevant risks here are twofold: a financial systemic instability and inflation. They are both hard to reverse once set in motion or embedded in the system. They point to different policy responses.

The Fed must have weighed the relative importance of these threats and “gambled,” to borrow the word used by Martin Feldstein, to place higher emphasis on the risk of financial disruptions leading to even weaker economic activity. I am sympathetic to this decision and therefore to the Fed’s monetary policy trajectory since last summer.

Now let me examine this “risk management” approach in a broader perspective. As I do so, I’ll be a bit less sympathetic. This approach is a key component of the so-called “clean up the mess after a bubble bursts” argument. It has been a conventional wisdom in recent years among many central bankers around the world. But the ongoing crisis prompts me to revisit the argument. Three questions come to my mind.

The first is about the timing of such “clean up” operation. Taking a look at the Japanese episode first, the Tokyo stock market peaked at the end 1989. The Bank of Japan began to cut the policy rate one-and-a-half years later in July 1991. The lag from the property market peak is a bit ambiguous, given the nature of the market, but it was probably a little shorter. Twenty-some years later, the U.S. housing market peaked in the second half of 2005. The Fed started to ease two years later. Thus, there is striking similarity between the two countries in the timing of the first interest rate cut after a major bubble burst. The similarity has good reasons: It is difficult to recognize on real time if a bubble has in fact burst or not; it is also difficult to ease monetary policy when economic growth still looks robust and financial markets still stable. Yet if the central bank waited till a turbulence has erupted, it might well be too late. When should the central bank start the mopping-up operation?

The second question relates to the exceptional uncertainty in the post-bubble period. We observe in the U.S. economy today unique and substantial uncertainty over the extent of housing price decline, magnitude of losses incurred by the financial system, strength of financial “headwind” against the economy, inflationary potential and so on. These special forces tend to cloud the economic and price picture and, if anything, should make it more difficult for the central bank to take “decisive” actions. Such uncertainty is not new nor is limited to the current U.S. scene. We went through a similar phase of extraordinarily low visibility in the early 1990s. In fact, concern

about a resumption of asset price inflation was rather prevalent even a few years after the stock and property market peaks. It is sometimes argued that Japanese monetary policy failed to take early on some decisive easing actions, such as large and permanent interest rate reduction. The failure to do so, the argument goes, led the economy to deflation. Such argument is totally negligent of the then-existing uncertainty and seems to me quite unrealistic.

Uncertainty over the state of the financial system is particularly relevant for the central bank. When the financial system gets badly impaired in terms of its capital, it becomes vulnerable to shocks. Sentiment shifts often and false dawn arrives a number of times. Above all, monetary policy transmission seriously weakens if not totally breaks down. In the case of Japan, systemic stability was restored only when significant capital was injected into the banking system using public funds. In my view, the lesson to draw from the Japanese episode should be, above all, the importance of an early and large-scale recapitalization of the financial system. How it can be done should vary according to the given circumstances and national context.

The third and last question as regards the “clean up the mess strategy” is that it is inappropriately generalizing one specific experience of addressing the collapsing tech bubble by aggressive rate cuts. But the tech bubble was not after all a major credit bubble. It did not leave behind a massive pile of nonperforming assets. The U.S. financial system was able to emerge from the bubble’s aftermath relatively unscathed. The tech bubble and its aftermath was, if I may say so, an easier type to “clean up” ex-post; it does not have universal applicability to other episodes. From the standpoint of securing financial stability, credit bubbles should be the focus of attention.

This brings me to the final segment of my remarks: the role of monetary policy vis-à-vis credit cycle. Proposals abound these days on how to restrain excessive credit growth in times of upswing. Most of them, including Dr. Buiter’s, advocate some regulatory measures. Few are in favor of “leaning against the wind” by monetary policy—so had I thought until I listened to Prof. Shin yesterday.

Some proposals to use regulatory measures appear sensible. However, I remain skeptical if a regulatory approach alone would work. I happen to belong to the dying species of former central bankers who have had experiences in the past in direct credit controls. Even in the days of heavily regulated banking and financial markets, outright controls tended to invite serious distortions in credit flows. Bank of Japan's guidance on bank lending, for example, was clearly more effective when supported by higher interest rates, as higher funding cost partially offset the banks' incentive to lend. That was then. The world has vastly changed, and we now live in highly sophisticated financial markets. Still, importance of affecting the incentives has not much changed. For instance, if we look at the sequence of what happened in the run-up to the current crisis, there was a sustained easy money and low interest rate environment, which drove market participants to search for yield, which resulted in much tighter credit spreads, which then prompted many players to raise leverage, and things collapsed. Simply capping on leverage, for instance, might invite circumventions and distortions unless the root cause of credit expansion was not addressed.

I believe a more balanced and symmetric approach to address credit cycles, including "leaning against the wind" by monetary policy, is worth considering in the pursuit for both monetary and financial stability.