General Discussion:
Practical Experience with Asset Bubbles and Financial Crises

Chair: Ian Macfarlane

Mr. Macfarlane: Whenever we talk about asset bubbles and monetary policy, the discussion almost always returns to Japan. Some of us are very grateful that we were not in a position where we had three years of zero inflation and an asset price boom and had to explain what we were doing with monetary policy or what we were not doing with monetary policy. That is a task that is always going to have to fall on Japanese representatives. It is a very difficult task and I do not think we should be censorious about it.

Based on the questions we have had so far, it seems that the main issues that everyone wants to talk about are the pros and cons of inflation targeting or what the appropriate exchange rate regime is. That is what the two papers tomorrow are about. I am sure everyone will have plenty of opportunity tomorrow to ask the questions they have desired to ask. Are there any questions about asset price levels? Good. Chuck Freedman was first.

Mr. Freedman: I would like to ask Mr. Yamaguchi a question. One structural element of the Japanese system that has always struck me as perhaps playing an important role in all of this is: a) the power of Japanese banks to buy equities and hold them on balance sheets; and, b) the fact they were able to use some part of the capital gains on the equity as capital, which could support further growth. And there is the potential effect in both directions, of course, for upward movements and downward movements as the equity markets went up and down. I was wondering, in your view, did that play a major role or an important role in the bubble that you saw in Japan? Not as an initiating force but as a propagating force as it started to develop and, of course, in the reverse on the way down?

Mr. Chandross: I have a question or comment for two of the speakers. To Arminio Fraga, I would comment on the exchange rate move where the Real did drop to 2.15 and then rallied back to the mid-1.60s and has recently been quite weak. I just wonder how that, in combination with some criticism of the failure to follow-through on the fiscal efforts, impacts monetary policy. And to what extent you are really prepared to stay out of the foreign exchange market except on a very short-term smoothing basis?

And to Mr. Yamaguchi I make a couple of observations. One thing that I think is pretty clear, while you did not say it, you described in the mid-1980s a massive failure of bank regulation to see what was going on in terms of allocations of portfolios and to deal with it. Perhaps if there had been a more forceful regulatory response, some of that bubble would have been avoided.

In response to your last comment about the most recent experience with capital flows improving: In an environment where the yen has strengthened further and the price level is declining at a fairly sizable pace, the result is that real interest rates, if you use wholesale prices as the inflation measure, are quite high. I just wonder how this is all going to play out? Do you have any thoughts on it that you care to share with us with the rising exchange rate, rising stock market, and a rising real interest rate in terms of what it does to the ability of the corporate sector to rebound?

Mr. King: I have a question for Arminio Fraga. In the recent international financial turmoil, I think many of us came to the conclusion that one of the problems was the currency and maturity mismatch, particularly of national banking systems. You referred to guidelines or regulations on precisely that issue, which seems an extremely interesting development. I wonder if you could say a little bit more about it and whether there are lessons in your plans or experience for other countries?

Mr. Makin: A question for Mr. Yamaguchi. It really goes back to Mervyn King's paper in which he suggested that perhaps a credible way to raise inflation expectations might be to adopt a price level target and this might help to also deal with the possible problem arising real interest rates in Japan. Could you comment on whether there is any thought about either inflation or price level targeting in Japan?

Mr. Frenkel: I have a comment to Arminio Fraga's remarks concerning the pass-through. One of the things that truly amazed all of us was the extraordinary extent to which exchange rate change did not get eroded through prices. In the old days, such a phenomenon was interpreted in terms of the state of the economy: when the economy is soft changes in nominal exchange rates are not translated fully into changes in prices. In the present case, however, there is an added element that reduces the pass-through: the credibility of monetary policy and the expectation that if inflation gets out of control, monetary policy will prevent it. Such expectation, in turn, is validated through a small pass-through, and, therefore, much of the implied change in the real exchange rate, in not being eroded.

The second remark has to do with Brazil's decision not to limit capital inflow. I think this should be contrasted with some of the experiences of other countries that got panicked and tended to close the capital account. Your experience shows that if you allow for exchange rate flexibility, it is actually wise to open up the capital account. But the two are interrelated. The decision to open up the capital account and to introduce flexibility to the exchange rate is actually one decision that cannot be decomposed.

Mr. Sinai: I have two questions for all three of the panelists. What was the role of private debt and debt burdens, in your experience, for businesses, households, and banks in these crises? The ability or lack of ability to assess the risks in the private sector on debt and debt burdens and the role of that in actually dealing with the crisis? And, then the second question is related to capital flows, inflows and outflows.

What are your views on the pluses and the minuses of open capital inflows in the case of your countries?

Mr. Macfarlane: I think there are a whole lot of questions there, and I do not expect the panelists to answer all of them. However, our panelists can pick one or two that they feel they would like to answer. First, Arminio.

Mr. Fraga: On the exchange rate and inflation targeting, we have been acting and telling people that we will look at the exchange rate only to the extent that it impacts inflation.

We went through a series of shocks, both internal and external, both economic and political, over the last three months and we basically floated throughout the period. We are trying to be vigilant about inflation and market conditions in general, about liquidity. We intervened once last week when liquidity in the foreign exchange market dropped out, and there was a jump from the 180s to 200.

Regarding Jacob Frenkel's comment, there is something I forgot to mention. We have been surveying expectations in Brazil; and due to our history, you can imagine there are quite a few people who have tremendous expertise in following inflation. We find that to be a useful tool, and we are quite happy that inflation expectations for next year have converged to our target almost to the decimal point. I would also like to reinforce what I said in my remarks that we have no doubt about the importance of staying on track on the fiscal side, and that is really our main economic policy project. Inflation targeting is important, but it comes in second to the fiscal side.

Regarding capital flows and mismatches and the like, we are testing the hypothesis that an exchange rate regime that is relatively pure, which for the most part really floats, coupled with good prudential supervision of banks will allow us to avoid becoming dependent on short-term flows to finance the current account.

As I mentioned earlier on Mervyn's comments, we have already introduced prudential limits on the foreign exchange exposure of banks in Brazil. And we are going to supplement that with limits on other mismatches (maturity and duration) so as to avoid some of the problems we have seen in some of the emerging countries.

Finally, on the role of private debt. One of the reasons why I think we are at a good point to accomplish a lot of the things we have set out to do, including the floating exchange rate and the inflation targeting system, is that we have very little debt on the balance sheets of our private sector. So they are starting clean—no original sin yet in Brazil, not a lot of dollar debt. Therefore, if we send out consistent macroeconomic signals, the private sector will structure its balance sheet correctly from the start. I also believe this explains why we have not had the deep recession that other countries have. We have a private sector that is ready to go. Confidence is rebounding slowly but surely, and there is really no obstacle for sustainable growth to take place.

Mr. Tosovsky: I would like to comment on the opening up of capital account. We are a country that is financially very open and we would not want to give up the possibility of optimal allocation of resources in the economy. This is such a big advantage that this is why I would stay with it. But, at the same time, we have experienced and recognize that excessive inflows and outflows, both in size and speed, require such a policy reaction, which sometimes is even politically infeasible. In our case, to reduce substantially or offset the inflow of capital in 1995, we would have had to take such a combination of monetary, wage, income and, especially, fiscal policy that the state administration would have been unable to function, including, for example, the army and police because a drastic reduction of expenditures would have been required.

Therefore, we are afraid excessive capital inflows can create boom and bust cycles. We are also thinking monetary policy can do something more than to provide a nominal anchor. Therefore, we are thinking of finding a kind of harbor, which would give us a little bit more certainty. By harbor, I mean more institutionalized links between dominant currency in the region and currency of the small open economy.

Mr. Yamamguchi: I would like to briefly respond to a few questions that were addressed to me. First, Chuck Freedman's question on the role of share holding on the bank's balance sheets. Yes, I think that it played a role because as the value of shares on bank's portfolios steadily increased in the late 1980s, banks increasingly felt that they were not constrained by capital anymore. They felt free to lend without capital constraint, and this may have been a factor to help accelerate the asset markets.

Another aspect is that the so-called cross-share holding structure was also working in those days. As banks acquired more shares issued by nonfinancial businesses, the nonfinancial businesses, in turn, enjoyed a low capital cost, and they used that equity money to invest more in capital and in other assets. So, the unique structure of bank's balance sheets, as well as the so-called cross-share holding structure, I think, played an important role.

Should prudential policy in Japan have addressed more effectively to banks property-related lending? Late in the game, the Japanese government adopted selective credit controls to restrain the rate of increase on properties to within that of total growth in lending. This probably played a role in producing an abrupt deceleration in bank lending to the property market, but I would prefer a more effective risk management on the part of private financial institutions. It is obviously very difficult to employ common sense when you are in the middle of a very strong bubble. But the kind of stress testing that I talked about in my remarks might be a potential way to avert the type of risk that our financial institutions were so heavily exposed to in those days.

What do I think about the potential threat posed by the rapid appreciation of the yen in an environment of substantially declining prices? Well, prices are not declining substantially. CPI has been stable in the last several months and for almost a year. I think that there is a significant gap between the prevailing perception and the reality on inflation currently developing in our country. I believe that the abundant provision of liquidity, along with money increasing at an annual rate of around 4 percent, is, perhaps, playing a role in producing price stability in our current economic setting.

Turning to the exchange market, if the yen appreciates far faster than the improvement in real economic activity or in other asset markets, one would obviously be worried. But that remains to be seen. What kind of exchange rate market development we may see in the coming months remains to be seen.

On the merits or demerits of inflation targeting, I think that under Japan's current economic setting, it would be very difficult to introduce and effectively implement any kind of inflation target because in order to achieve an announced target, you would first have to improve the very large output gap that currently exists in our country. In a situation in which the central bank has already used up most of the conventional instruments in monetary policy, I think it is very, very difficult to deliver what is promised to the public.

Mr. Macfarlane: Thank you very much. That brings today's session to an end.