# Opening Speech

## by Governor Masaru Hayami

Good morning, ladies and gentlemen.

It is a great pleasure to have an opportunity to meet such distinguished guests from academic circles and various central banks on the occasion of the Ninth International Conference hosted by the Institute for Monetary and Economic Studies. I would like to welcome all of you who have kindly found time out of your busy schedules to participate in this conference.

The topic of the conference is "The Role of Monetary Policy under Low Inflation," which is the very problem that the Bank of Japan has faced since the 1990s and perhaps what many central banks might face in the future.

The 1990s is often referred to as the "lost decade" for Japan's economy. During that period, Japan's real GDP growth was next to last among G-7 countries and also recorded the largest drop compared with the 1980s. Inflation declined to almost zero, and at times we faced the danger of falling into a deflationary spiral. In response, the Bank of Japan conducted aggressive monetary easing. In particular, since February 1999 the Bank has pursued the unprecedented policy of guiding short-term money market rates down to virtually zero percent to prevent the economy from tumbling into a deflationary spiral and also to support a recovery.

What are the factors behind Japan's lost decade of the 1990s? One basic structural factor is that a variety of systems which had supported the postwar development of Japan's economy became unsustainable. Another factor is the emergence and bursting of the bubble. While the emergence of the bubble led to many much needed structural reforms being postponed, its bursting brought Japan's economy to the verge of falling into a deflationary spiral.

Though the main purpose of this conference is not to discuss the emergence and bursting of the bubble, when we at the Bank of Japan discuss the role of monetary policy under low inflation, we cannot but refer to the problems we experienced during the bubble period.

In this regard, let me outline some lessons from the bubble period that I find important in an individual study made by Bank staff relating to monetary policy in the late 1980s.

One prominent feature that characterized the bubble period in Japan was the euphoric sentiment which prevailed in every segment of society, and which led to extremely bullish expectations. In this regard, we think it is not sufficient to understand the bubble solely in terms of the rise in asset prices such as property and equity prices. In the study I mentioned, the bubble economy is defined as a combination of the rapid increase in asset prices, the expansion of monetary aggregates, and the overheating of economic activity. Japan's economy did indeed experience such developments from 1987 through 1990.

A number of factors were intertwined in the background of such euphoria, and monetary easing was certainly one of them. Monetary easing was a necessary condition for the emergence of the bubble, and to that extent should be held responsible. But in our defense, I have to say that if we had tried to prevent the emergence and expansion of a bubble by monetary policy alone, we would have had to raise interest rates to levels which could not be justified because of the relatively stable prices at the time. This is one of the difficulties we face in dealing with a bubble.

The next question is: In what respect was monetary policy responsible for the emergence and expansion of the bubble? It is true that we had maintained low interest rates for a relatively long period, even after the summer of 1988 when the economy was clearly on a recovery path, and allowed unfounded expectations to be embedded in the market and society that such low interest rates would continue for a considerable period. We should take it seriously that this was undeniably one of the driving forces behind the expansion of the bubble.

What should be done to avoid repeating such an experience? We hear a variety of suggestions: For example, "The Bank of Japan should have paid more attention to the movement of money supply or the rise in asset prices," and "It has made a mistake by putting too much emphasis on the foreign exchange rate in the conduct of monetary policy." Unfortunately, these are reflections and lessons with the benefit of hindsight, and we cannot fully use them as a practical guideline for making policy on a real-time basis.

We need a more pragmatic approach. From such a viewpoint, the most significant lesson that we should keep in mind is the importance of evaluating risks to the economy at an early stage, and of dealing with them in a preemptive manner. As I have said, it would not have been possible for monetary policy alone to have prevented the bubble from emerging. However, if we had conducted monetary policy in a preemptive manner by taking into account future risks over the long run, economic fluctuation during the bubble period might have been less.

As a matter of fact, it is extremely difficult to identify whether it is a bubble or not when we are actually experiencing bubble expansion. One of the reasons for this difficulty is that we cannot exclude from the observed reality the impact of changes in economic structure. For example, during the bubble period many presented a seemingly plausible argument that a rapid rise in property prices in Tokyo could be justified in view of the increasing role of Tokyo as an international financial center, but which could not be proved to be true at the time.

Inevitably, the central bank faces two risks. They are similar to statistical errors. One risk is that the Bank might mistakenly tighten monetary policy when the economy is about to benefit from a marked improvement in productivity, and as a result suppress the growth potential of the economy. The other risk is that it allows the bubble to expand by wrongly interpreting the supposed improvement in productivity as real. When we make a policy decision, we should evaluate not only which one of these two risks has the greater probability of emerging, but also the socioeconomic cost of each. Our experience of the bubble period seems to indicate that we did not fully recognize that the risk of wrongly interpreting a supposed productivity improvement could deliver such a serious blow to the sound development of the economy over the long run.

What should have been done to calm the euphoric sentiment at that time and turn the focus of society to the potential risk facing the economy from a longer-term perspective? The important lesson from such a viewpoint is that we need to clearly state the objective of monetary policy; in other words, we need to substantiate the abstract concept of price stability.

Looking back at Japan's economy during the bubble period, consumer price index (CPI) inflation had been stable until 1987, began to gradually rise in 1988, and recorded a year-on-year increase of about 1 percent in March 1989, which was immediately before the introduction of the consumption tax. Adjusted for the impact of the consumption tax, it continued to rise after April 1989, reached the 2 percent level in April and the 3 percent level in November 1990, and remained at that level until August 1991.

Since such a price hike considerably lagged the rise in asset prices and could not be regarded as particularly high compared with the figure before the bubble period, the threat of inflation did not constitute a valid argument in convincing the public that monetary conditions needed to be tightened. While inflation during the bubble period was relatively mild, Japan's economy had been brought to the verge of falling into a deflationary spiral in the 1990s. The deflation we observed at that time was largely the result of the bubble economy that had emerged in the late 1980s.

Such an experience suggests that we as the central bank should aim at price stability which supports medium- to long-term sustainable growth, not price stability at a particular point in time. In this context, even if measured inflation is stable, we need to promptly alter interest rates once we judge that the risk of damaging sustainable price stability has become higher. According to this criterion, we have not, to our regret, sufficiently succeeded in maintaining price stability in Japan since the bubble period.

So far, I have mainly described the lessons for monetary policy derived from our experience during the period when the bubble emerged. Of course, we also need to learn from the experience after the bursting of the bubble. It may be too early to summarize the experience and draw lessons, but I am sure we will learn quite a lot from the discussion at this conference.

It is true that there is yet another major factor behind worldwide disinflation. It is the revolutionary progress of information technology, which we may perhaps call a new industrial revolution, and the resulting improvement of productivity. To find answers to what is price stability and an appropriate monetary policy in the face of rapid disinflation due to higher productivity are difficult but positive challenges.

In conclusion, I sincerely hope that through fruitful discussion at the conference, both those from academic circles and central banks will learn more, share the fruit, and make use of the wisdom obtained for the future conduct of monetary policy.

Thank you for your attention.