Chinese Monetary Policy under Pressure as Asset Bubble Balloons
– Japan's experience and lessons offer useful reference –

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I. Introduction

The Japanese economy experienced years of subpar growth following the collapse of its economic bubble in 1990, and indeed has yet to recover completely from the aftermath. The inception of the bubble can be traced back to the Plaza Accord in September 1985. The Bank of Japan lowered the discount rate five times from 5.0% to 2.5% between January 1986 and February 1987 to help weaker exporters and boost domestic demand as the yen appreciated sharply in the wake of the accord. Interest rates stayed at these record low levels until May 1989. This process encouraged financial excess and money began to flow into the stock and real estate markets creating an asset bubble. As the bubble collapsed, the Japanese economy entered a 20-year period referred to as the lost decades.

In China, too, prices of assets such as real estate are surging on the back of an easy monetary policy, and are taking on the features of a bubble. What should China learn from Japan's experience so that it can avoid making the same mistakes?

II. Asset prices are one of the important variables in monetary policy

The primary objective of a central bank is to maintain the stability of the currency (prices) and the financial system. However, changes in asset prices could become a destabilizing factor for the financial system in the form of an increase in bad bank loans, so when determining monetary policy the central bank should monitor not only the consumer price index (CPI), but also the movements of stock and real estate prices.

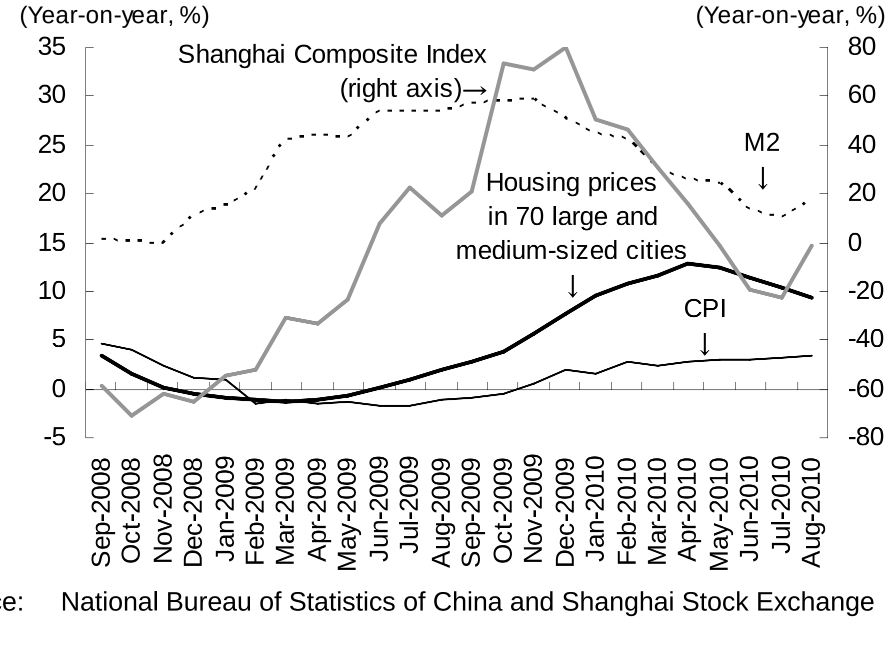
On this point, the Bank for International Settlements (BIS) and the U.S. Federal Reserve Board (FRB) have differing opinions: The former says that "a central bank should tighten monetary policy to avoid financial system destabilization attributable to excessive rises in asset prices, even if prices are stable." In contrast, the latter claims that "a central bank should focus entirely on price stability when carrying out financial reform." Although Fed Chairman Ben Bernanke is known as a theorist representing the latter view, he has attenuated his stance somewhat following the recent financial crisis.

In Japan, although asset prices moved sharply higher following the easy monetary policy of the second half of the 1980s, the monetary authorities then had very little sense of the need to tighten quickly, because overheating of the economy and rising prices were not pronounced. The Bank of Japan began to tighten monetary policy in 1989 as it faced rising inflation pressure, but the economic bubble was by that time already huge. Given a fairly significant time lag between the movements of asset prices and changes in prices as demonstrated above, authorities could find that they are too late to prevent a bubble if monetary policy focuses only on the price behavior of the moment.

Following the collapse of Lehman Brothers and the associated shock, China adopted radical monetary easing. In response, real estate prices soared, with housing prices in 70 large and medium-sized cities rising 12.8% (year on year) in April 2010. As observed this time round, China has been seeing a trend in which prices of assets such as stocks and real estate rise ahead of CPI (figure 1). Therefore, adding asset prices to the target variables of monetary policy is useful not only for preventing a bubble but for stabilizing prices as well.

Figure 1: Stock and Real Estate Prices Move Ahead of Consumer Prices

- Situation after Lehman Brothers Bankruptcy -



Source: National Bureau of Statistics of China and Shanghai Stock Exchange

III. Noteworthy movements of property-related loans

Second, to prevent the expansion of an asset bubble, a central bank needs to pay attention not only to the rate of quantitative growth of credit but also to changes in the structure of loans, particularly the share of loans to the real estate sector.

In Japan, the total of loans to three property-related industries, namely nonbanks, real estate, and construction, accounted for 25% of total bank loans during the bubble era. In particular, loans to the real estate industry were extended through nonbanks known as housing loan companies, which were outside the control of regulatory authorities, and this spurred the expansion of the property bubble and aggravated the bad loan problem after the bubble burst.

Property-related loans in China are still around 20% of overall bank loans, even including housing loans, and this is still lower than the ratio in Japan during the bubble era. However, the size of new housing loans surged in 2009 to a level five times that in 2008 ("China Monetary Policy Report, Fourth Quarter, 2009" of the People's Bank of China, February 11, 2010). This is an alarming phenomenon. Also needing close monitoring is the extent to which bank loans flow out to the real estate market through investment companies established by local governments.

IV. Significance of a forward-looking monetary policy

In addition, the more time that passes after a bubble emerges, the greater will be the damage when it finally bursts and the more difficult the policy response. Consequently, the regulatory authorities should adopt a forward-looking monetary policy by determining the risks inherent in the economy as much as possible when they are still at the potential phase. In this regard, the Bank of Japan "reflects" in retrospect on what it has done, saying that "the most significant lesson that central banks have learned from the emergence of bubble economies (in the second half of the 1980s) is the importance of conducting monetary policy in such a forward-looking manner." (Kunio Okina, Masaaki Shirakawa, and Shigenori Shiratsuka, "The Asset Price Bubble and Monetary Policy: Japan's Experience in the Late 1980s and the Lessons," Monetary and Economic Studies (Special Edition) February 2001, Institute for Monetary and Economic Studies, Bank of Japan).

In Japan at that time, there were domestic concerns about the stronger yen and demand from the United States to reduce the current account surplus and expand domestic demand. Also, given that public opposition to monetary tightening was deep-seated as inflation eased, the response to the asset bubble was slow. It was not until May 1989, more than three years after the sharp rise in asset prices began, that the Bank of Japan began tightening credit. The Nikkei Stock Average rose by a factor of approximately 2.7 from the end of September 1985 when the Plaza Accord was concluded to the end of April 1989. Commercial land prices in the Tokyo area were meanwhile up by a factor of 2.5 in 1988, compared with 1985 levels. Even after monetary policy was tightened, share prices continued to climb for more than six months, while land prices rose for more than two years.

In China, property prices have been surging, and inflation has been accelerating from -0.7% in 2009 to 3.5% (year on year) in August 2010 in terms of CPI. China has shown a trend in which inflation lags GDP growth by about three quarters. Inflationary pressure is expected to rise going forward following the sharp economic recovery (GDP growth was 11.9% in the first quarter and 10.3% in the second quarter of 2009). To prevent a ballooning of the bubble and rising inflation, the "exit strategy" of monetary policy, including a rate hike, needs to be implemented in a timely manner (box).

IV. Foreign exchange intervention could cause the expansion of liquidity

Finally, if the central bank tries to place the policy emphasis on stabilizing the exchange rate, it will be necessary to intervene in the foreign exchange market, and this will considerably constrain the independence of monetary policy.

In Japan, the yen appreciated sharply following the Plaza Accord. Prompted by the Louvre Accord reached by the G7 in February 1987, which recognized that a correction of the strong dollar had been achieved and sought to stabilize the dollar, the Bank of Japan began buying dollars actively. This served to encourage monetary easing as well as the expansion of liquidity, and in turn the ballooning of the asset bubble. As described, it should be understood that the cause of the bubble economy was not the appreciation of the yen itself, but the foreign exchange intervention to stop the yen from strengthening further and the monetary easing to attenuate the deflationary pressure associated with a stronger yen.

The foreign exchange intervention to contain the appreciation of the yuan is also expanding liquidity in China. To stabilize the economy, the exchange rate should be allowed to float more freely, giving the central bank more room to pursue an independent monetary policy. China’s move to further reform its foreign exchange rate regime announced on June 19, 2010 should be welcome as a major step in this direction.

Box: Monetary policy exit strategy begins in China

Chinese monetary authorities are beginning to execute the exit strategy from the expansionary monetary policy they had adopted to maintain stable growth ("China Monetary Policy Report, Fourth Quarter, 2009" of the People's Bank of China, February 11, 2010).
To begin with, in April and May 2009, the People's Bank of China called for commercial banks to pay attention to a rise in the credit risk associated with the rapid increase in loans. It has also

been further stepping up "window guidance" since the middle of the year. Subsequently, in July, the PBC resumed the issuing of the one-year central bank bill for the first time in seven months and obliged some banks where loan growth was deemed excessive to purchase the central bank bill (at a yield below the market rate).

With these measures, growth in lending (year on year) fell to 18.6% in August 2010, down from 34.4% at its peak in June 2009. Growth in monetary supply (M2) has also slowed, declining to 19.2% in August 2010, down from 29.7% at its peak in November 2009. For further monetary tightening, an annual target of limiting the growth rate of M2 to 17% was set in the Report on the Work of the Government delivered by Premier Wen Jiabao in the National People's Congress held in March 2010.

As part of the credit restraint, the PBC raised the statutory reserve requirement applied to large banks twice by a total of 1.5 percentage points starting from the beginning of this year. This means that even if financial institutions have reserves corresponding only to the statutory reserve requirement, funds of 900 billion yuan (1.5% of deposits of 60 trillion yuan) will be frozen because of this measure. However, as the excess reserve ratio of financial institutions (the ratio of reserves held that exceeds the statutory reserve to the deposit balance) reached 1.96% as of the end of March 2010, the tightening effect of the higher statutory deposit reserve requirement is limited at this moment, as the banks subject to the higher requirement are not in a situation where they have to claw back lending immediately to boost their reserves.

Should inflation continue to climb, the PBC would have no choice but to raise interest rates. .