Sakuya Fujiwara: Challenges for Japan’s economy and monetary policy

Remarks by Mr Sakuya Fujiwara, Deputy Governor of the Bank of Japan, at the Foreign Correspondents’ Club of Japan, Tokyo, 25 July 2001.

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Introduction

I am honored and grateful to have been given this opportunity to address members of the Foreign Correspondents’ Club of Japan.

Given the present economic situation and that members of this esteemed Club are well known for their barrage of sharp questions you may think it brave of me to address you. But I immediately accepted the Club’s invitation without any hesitation because I saw it as a golden opportunity to candidly explain the difficulties the Bank of Japan is facing under the current severe economic situation.

As you are no doubt aware, there are various arguments in Japan regarding the management of macroeconomic policy and how to promote structural reform. Until the first quarter of this year, further monetary easing and how to promote the disposal of non-performing loans had been actively discussed almost every day. Indeed, many held that Japan’s economy could only get out of the stagnant state if monetary easing were effected or if non-performing loans were disposed of. Since late April, following the formation of the Koizumi government, structural reform has taken center stage and a ‘basic plan’ which proposes wide-ranging reform agenda was determined by the cabinet at the end of June.

Looking back at all the numerous discussions within only the past six months, the central issue has been whether to first effect macroeconomic policies such as monetary policy and fiscal policy or implement structural reform measures which include the disposal of non-performing loans, deregulation, and review of roles between the public and private sectors.

However, these points have been repeatedly discussed since the bursting of the bubble and thus are not new. The question of what kind of policy measures are desirable in order to bring Japan’s economy back to a sustainable growth path is not one that can be easily answered, especially when taking account of the political economy. The difficulty lies in that you simply cannot make a clear-cut decision and choose either macroeconomic policy or structural reform. Today, I will explain my views on the roles monetary policy and structural reform should play under the current harsh circumstances.

1. Current monetary easing measures

As a starting point, I will explain current monetary easing measures.

Current monetary policy management

As you all know, the Bank of Japan took successive monetary easing measures during February to March this year, and the March decision was a decisive one. There are three points which characterize this series of monetary easing measures.

First, the Bank changed the main operating target of monetary policy operations from the uncollateralized overnight call rate to the outstanding balance of current accounts held at the Bank of Japan. In addition, the Bank increased the average outstanding amount of such accounts by about 25% from some 4 trillion yen to 5 trillion yen.

In response to this ample provision of funds, nominal short-term market interest rates declined to virtually zero percent. In addition, if considered necessary for the smooth provision of liquidity, the Bank will increase its outright purchase of long-term government bonds from the previous 400 billion yen per month subject to certain conditions.

Second, the Bank has clearly stated that it will continue to pursue the new monetary policy framework until the Consumer Price Index registers stably a zero percent or an increase year on year. This aims at guiding longer term interest rates to decline by promising the continuation of monetary easing into the future, and is thus often called the ‘commitment effect’ or ‘policy duration effect’.

Third, the Bank introduced a ‘Lombard-type lending facility’, through which the Bank extends loans at the request of counterparties under certain conditions at the official discount rate. Thanks to this facility, even when there is turmoil in the market, counterparties can flexibly borrow funds from the Bank as long as they have eligible collateral. As a result, the official discount rate shoulders a new role of setting a ceiling to the short-term money market rate. This facility plays a big role in nurturing a sense of security among market participants with respect to their financing and also stabilizes interest rates, thus strengthening the effects of monetary easing.

Effects of monetary easing

These monetary easing measures, unprecedented in central bank history both at home and abroad, were received with considerable surprise when announced. Though such initial surprise tends to fade, these monetary easing measures have potentially powerful effects as is evidenced by the initial surprise. At the same time, however, it is also true that there are limits to the effects. We hope that all concerned will correctly and with balanced judgement recognize both the favorable effects and the limits of current monetary easing measures.

Let me begin with the favorable effects of the current measures. Since monetary easing in March, various interest rates have substantially declined to levels below the lowest levels seen during the zero interest rate policy period. For example, the overnight call rate is 0.01%, the yield on 1-year government bonds 0.01-0.02%, and that on 5-year government bonds once declined to 0.3% and has recently been just over the 0.4% mark. Yields on 10-year government bonds have been moving at the low level of 1.1-1.4%. In addition, the difference between the yield on corporate bonds or CP and yields on government securities, namely the ‘credit spread’, has also been narrowing, implying a continual improvement in fund raising through the market.

As such, there is abundant liquidity in financial markets. What typically reflects such abundant liquidity is the phenomenon of ‘under-subscription’ for Bank of Japan operations to provide liquidity to the market. For example, in competitive yield auctions on May 21st to provide liquidity, while the Bank offered one trillion yen, financial institutions’ bids were less than 400 billion yen even at a rate of 0.01%, virtually zero percent. In other words, under-subscription is an expression of financial institutions’ views that “liquidity has already been provided sufficiently so that there is no need for additional liquidity even at the rate of 0.01%.” Under-subscription was frequently observed from the beginning to the middle of May, and the Bank responded to such situations by reducing the unit for every bid to 0.001%. As a consequence, the lowest interest rate the Bank would accept was also reduced to 0.001%, and, thanks to such efforts which some market participants have termed ‘nano-technology’, under-subscription ceased thereafter. However, this does not guarantee that under-subscription will not occur again in the future. In any event, liquidity is being amply provided to markets and discussion is now geared toward focusing on the marginal difference between 0.01% and 0.001%.

Limits to monetary easing measures

Such experience also implies that there might be a practical limit such that a central bank cannot unlimitedly provide liquidity beyond the demands of financial institutions.

Despite such a practical limit, there would be no problem if liquidity reached corporations which reside outside the financial markets and contributed to rejuvenating economic activity, but regrettably this has not been the case so far.

Let me quote some plain numbers which typically illustrate this. In the last five years, current account deposits which private financial institutions hold with the Bank of Japan increased 12% on an annualized basis. The expectation here is that developments in such accounts affect the credit creation function of financial institutions. Monetary base, which is the sum of Bank of Japan current accounts and banknotes issued, increased as high as 8% a year. However, despite such extremely ample liquidity provision from the Bank, the lending of commercial banks declined by half a percent a year and money supply grew only 3%.

The decline of bank loans compared with the increase in money supply means, on the part of financial institutions, that assets other than loans have been increasing, which turned out to be mainly government bonds. Despite the increased provision of liquidity by the Bank of Japan to the money market, financial institutions only increased investment in credit risk-free government bonds and lending to firms rather declined. As such, under the circumstances where the credit creation function of financial institutions is inactive, economic activity cannot be robust, as evidenced by nominal GDP growth of only 0.6% a year and the Consumer Price Index being almost flat. Such figures illustrate the fact that even if the Bank of Japan provides ample liquidity to the market and guides nominal interest rates to an extremely low level of virtually zero percent, such action itself cannot lift economic activity. Keynes once used the term ‘liquidity trap’ to point out the possibility that the effectiveness of monetary policy might be hampered, and the current state of Japan’s economy is quite close to such a situation.

Policy duration and quantitative easing

However, even though Japan’s economy is in a situation close to a liquidity trap, a central bank cannot be a bystander when the economy is anticipated to deteriorate further. Against this backdrop, the Bank thus took decisive monetary easing measures in March.

In this regard, let me bring your attention to two points.

First is the rationale behind having the outstanding balance of Bank of Japan current accounts as the main operating target and increasing it.

The target of increasing the outstanding balance of current accounts to around 5 trillion yen is substantially more than required reserves of around 4 trillion yen. As previously mentioned, under such ample provision of liquidity, short-term interest rates will move close to zero percent under normal circumstances.

In addition to a decline in interest rates, it is hoped that the quantitative increase in Bank of Japan current accounts itself will have positive effects. If financial institutions hold excess no-risk no-return current account balances, an incentive will emerge to increase the holding of such assets as loans, corporate bonds, stocks, and foreign currency-denominated assets which generate some returns even though accompanied by some risk. In addition, the quantitative increase itself might affect expectations of the public. Of course, under a situation where both long- and short-term interest rates are quite low and the credit intermediation function of financial institutions is also hampered, such effects might not be large. However, under the circumstances where room for a further decline in interest rates is almost exhausted, and bearing in mind the severe outlook for the economy, the Bank judged it necessary to dare decide to take such measures.

Second is the commitment effect.

As I previously mentioned, the Bank of Japan adopted a policy which incorporated a so-called ‘policy duration effect’ in that the Bank is committed to continuing monetary easing into the future. This should be regarded as best efforts in a situation where the central bank is trying to hammer out further monetary easing effects despite conventional monetary policy instruments having almost been mobilized to their limit. With such a commitment in place, the public’s expectations with respect to when prices will start to rise will be adjusted if the economy further deteriorates. In such a case, the public will anticipate that monetary easing will surely be protracted, leading to a more flattened yield curve, thereby strengthening monetary easing effects. As such the current commitment can be said to have a sort of automatic adjustment function against changes in economic conditions.

2. Role of structural reform

As such, while potentially powerful monetary easing has been in place both in terms of interest rates and quantity, it is essential to resolve structural problems facing the financial system and industry in order to allow such monetary easing to permeate the real economy to the fullest extent possible.

Structural reform is, put simply, to establish a function which more effectively allocates resources such as labor and both physical and financial capital, and raises productivity of the economy as a whole. The content of structural reform will be shaped from now on and at this juncture points of emphasis differ. Here, I will not go into specific measures in any depth but take up two points with respect to the basic thrust of structural reform.

Importance of expectations

The first point is what are the conditions for successful structural reform. There could be various ways of looking at this, but my view is that the key for successful structural reform is how to positively affect the expectations of economic agents.

At present, the expectations of firms and households are bearish. When I say we have to work on such expectations and change them I mean we have to restore a situation in which economic agents can hold such a normal expectation that the economy will grow in the future. However, the expectations of private economic agents are far from being in a normal state. Making a rough back-of-the-envelope calculation, if the expenditure of firms and households increased an additional 2%, then nominal GDP growth would be 2% higher. According to a household survey, the monthly consumption expenditures of the average Japanese household in fiscal 2000 was 317,000 yen, so a 2% increase would be about 6,000 yen. And, taking account of the multiplier effect, the expenditure necessary would be less. But things are not so simple.

How expectations are formed is a difficult question. For example, while it was realized that the IT boom in the US would eventually come to an end, relatively bullish views were still dominant until last autumn. In fact, at the last November meeting of the FOMC, which is responsible for setting the short-term interest rate, inflationary concern was pointed out as a potential risk factor for the US economy rather than economic weakness, and it was in November that private forecasters revised their forecasts downward. Subsequently, the FOMC has on successive occasions since January substantially reduced its target FF rate, though it has not yet succeeded in revitalizing the activities of IT-related firms which once drove bullish expectations. Looking back at the experience of Japan during the bubble period, the expectations of economic agents became extremely bullish, to an extent which seems incredible in hindsight, and now we are facing a completely opposite situation.

Then, how do the expectations of firms and households become bullish?

At this moment, I do not have a clear answer. But if one believes bullish expectations naturally emerge when an economy grows, then I think the key is simply to make efforts to raise productivity. Measures to this end were outlined in the cabinet's 'basic plan' for structural reform which was announced this June. What is important is to make clear that emphasis will be on market mechanisms, that the public understand that the government is directing its efforts toward increasing productivity of the economy as a whole through such mechanisms, and implementing policy measures consistent with such a direction.

Speed of structural reform

The second point concerns the speed of structural reform.

In this regard, economists abroad have voiced concern that if various structural reforms are implemented simultaneously, there would be a substantial deflationary impact on the economy in the short run and the deflationary gap in Japan's economy, which is already suffering from lack of demand, might become wider.

We can certainly understand the background to such concern. Indeed, looking at examples of structural reform overseas, there seem to be many cases where there was a deflationary impact in the short term. And, in contrast with the US and UK, the economy cannot expect to receive additional 'dividends' such as a substantial decline in long-term interest rates accompanying fiscal consolidation, since in Japan there is little room for any further decline in interest rates. However, the bond market is not the only market which assesses structural reform. If the stock market favorably evaluates specific efforts toward the resolution of structural problems, there might be positive effects on the economy from this channel even in the short run.

Moreover, it should be noted that, in the case of Japan, delay in effecting structural reform has made the problem of weak demand all the more serious.

In this context, I would like to refer to the fact that private consumption has been very slow to increase. Of course, various factors might be behind this, one being uncertainty with respect to pensions and the tax burden in the future because of the rapidly aging population. Therefore, in order to stimulate private consumption, it is essential to reduce future uncertainty as much as possible.

According to textbook Keynesian economics, the expansion of fiscal expenditure financed by the issuance of government bonds will stimulate an economy unless taxpayers hold back consumption reflecting expectations of a future increase in the tax burden. However, if public investment generated by a fiscal deficit is inefficient, production capacity of the economy as a whole will not increase and the 'wealth' which generates future income and consumption will not accumulate. And, if such investment clearly suggests an increase in the future tax burden and delay in structural adjustment, then it would have an adverse impact on current consumption.

From this viewpoint, once it became clear that the content of fiscal expenditure was going to be shifted from less efficient to more efficient objectives, resulting prospects of an increase in future ‘wealth’ might have a favorable effect on the economy. Compared with a situation where there is little room to mobilize conventional monetary policy instruments, room for effecting policies which focus more on the ‘quality’ of fiscal expenditure seems to be significantly large, as mentioned in the ‘basic plan’.

Nevertheless, what I have just said does not mean that I am optimistic enough to consider that the promotion of structural reform will immediately ignite an improvement in the economy. Presumably, in the process of reform, we cannot deny that there might be ‘pains’ such as increased bankruptcies and heightened unemployment in the short run. However, at the same time, it is not appropriate to single out and emphasize only the short-term deflationary impact on the economy from among the various macroeconomic effects of structural reform. In short, as long as protracted stagnation of Japan’s economy is rooted in structural problems, we are now at a stage where it is not so productive to discuss in general terms whether structural reform is deflationary or not. What is important is, based on specific structural reform measures which will be presented in the future, to make a well-balanced assessment with respect to the economic consequences of such measures.

3. Relationship between structural reform and monetary policy

I have explained the roles of monetary policy and structural policy, but what is the relationship between these roles? Some would say that pains stemming from the adverse impact on the economy as structural reform progresses should be mitigated by further monetary easing, or emphasize that in the process of pursuing structural reform it is mainly the role of monetary policy to ensure economic stability. Bearing these views in mind I will now explain how I see the relationship between monetary policy and structural reform.

At the start I would like to say that the monetary easing policy currently being pursued by the Bank will, because of effects I have previously explained in detail, also give considerable support to structural reform.

First, the current monetary policy framework was determined by taking into account a scenario that the economy might substantially deteriorate, including a short-term deflationary impact stemming from structural reform. In the process of discussion to reach the monetary easing decision in March, because of cyclical adjustment in IT-related areas worldwide coinciding with Japan’s structural adjustment, I could not help but forecast that the economy would worsen considerably in the future. Based on this recognition, I felt strongly, from the viewpoint of forward-looking policy making, that it was necessary to make moves ahead of the foreseeable economic developments and to vote for decisive monetary easing.

Second, even if deflationary pressure intensifies in the short run as a result of structural reform, current monetary policy has an automatic adjustment function such that the easing effects strengthen through the policy duration effect.

Third, in the process of structural reform, liquidity concerns might increase in financial markets when non-performing loans are disposed of. In this regard, the previously mentioned Lombard-type lending facility will have the effect of driving structural reform by containing such liquidity concerns.

And fourth, when corporate and household confidence with respect to the future strengthens and economic activity picks up parallel with the progress of structural reform, current monetary easing will provide very strong support. Put differently, the benefits of recent decisive monetary easing will surface in full when the private sector decides to take advantage of the opportunities.

While the relation of the current monetary policy framework with structural reform is such as I have just mentioned, if I dare to add one more thing, it is that when I voted for monetary easing in March, I did so with the strong hope that since we are stretching ourselves almost to the limit in adopting such decisive monetary easing measures, structural reform ought to be implemented expeditiously. I had a strong feeling such that we should exert some leadership in promoting structural reform efforts in various areas. Looking back, it seems that this desire for structural reform was, and is, also held by the public. Viewed from conventional monetary policy thinking, such a view might be regarded as unconventional, but I have no doubt that decisive monetary easing has contributed to the progress of structural reform.

4. Central bank responsibility

So far I have discussed the roles played by monetary policy and structural reform. In the last part of my speech, I would like to address the issue of central bank responsibility by considering the argument that since Japan's economy is in such a worrisome state the Bank of Japan should mobilize all measures at its disposal even if they might not be the choice in normal times.

When we consider the outlook for the economy, as shown in our April Outlook and Risk Assessment of the Economy and Prices, there are various risk factors. Bearing in mind every possible eventuality, including these risk factors, the Bank of Japan will carefully examine, without any presumptions, the economic outlook and pursue appropriate monetary policy. This is the responsibility that a central bank should discharge.

At the same time, in terms of monetary policy management, it is also a responsibility of a central bank to underline the fact that it has almost exhausted such conventional monetary easing measures as reducing nominal interest rates. The reason I say this is because when listening to debate concerning monetary policy, we are somewhat puzzled that many seem to consider that interest rates can be further substantially lowered. Of course, even at the current level where nominal interest rates are virtually zero percent, we have managed to devise ways to create monetary easing effects. However, such efforts have obvious limits. Among various monetary policy options proposed, some argue that the Bank can freely increase money supply at its discretion as if raining money from the sky. However, as evidenced by figures I have previously introduced, this is not the reality.

Then, how should we address the assertion that since both inflation and deflation are monetary phenomenon, it is only the Bank of Japan which can prevent a price decline. As one who considers how actual monetary policy should be conducted by watching actual economic developments, I have a very mixed feeling when I hear such a view.

For sure, if one takes an extremely long period of time, the relationship between goods and services, and the quantity of money will be a major factor in determining the price level. The fact that price stability is the goal of the Bank of Japan's monetary policy is based on such an understanding. However, at the same time, it is also true that the price level will be considerably affected in the short and medium term by various factors such as costs and changes in productivity.

In fact, the Bank of Japan has eased monetary conditions to the utmost both in terms of interest rates and quantity such as current accounts at the Bank of Japan and monetary base. In addition, as noted in our March statement, current monetary easing was determined to illustrate the Bank's firm determination to prevent prices from declining continuously. However, as figures I previously mentioned show, so far the effects of monetary easing have not been able to lift economic activity and prices continue soft. Our agony as monetary policymakers lies exactly here.

Now, if we focus solely on raising prices and pursuing monetary operations such as buying any type of asset, then prices will eventually start to rise, though we cannot say when for sure. However, it is uncertain whether such a price rise would lead to sustainable economic growth. The questions we have to answer are: Would such extraordinary measures be desirable for Japan's economy as a whole? Would they be consistent with the pursuit of price stability that contributes to the sound development of the national economy, which is the Bank's mission as stated in the Bank of Japan Law?

Of course a central bank always has to be open-minded in examining new policy measures. In fact, both at the time of adopting the zero interest rate policy and decisive monetary easing in March, I believe the Bank adopted an innovative posture. At the same time, however, we cannot make a quick decision to pursue extreme policy when the effects are uncertain simply because some think it is better to do something than nothing.

For example, while an increase in the outright purchase of government bonds by a central bank might have some effects, if it induced market uncertainty with respect to future fiscal discipline, it would lead to an interest rate rise by way of increase in risk premiums and thus entail a risk of having an adverse impact on the economy. In fact, when looking at the recent development of long-term interest rates, they often sensitively responded to views concerning the future issuance of government bonds such that they rose recently reflecting budget discussions. Of course, such a recent rise in interest rates can be regarded as within the range of extremely low interest rates and thus we do not have to worry about any adverse impact on economic activity. However, it is necessary for a policymaker to remember that market participants are sensitive to uncertainty over future fiscal management and resulting bond supply and demand conditions.

In March, the Bank decided to increase its outright purchase of long-term government bonds if deemed necessary for the smooth provision of liquidity, on the condition that the outstanding amount of long-term government bonds held by the Bank be kept below the outstanding balance of banknotes issued. And this decision was arrived at by taking full account of what I have so far mentioned.

In sum, it is because monetary policy has entered uncharted territory that responsible policymakers are required to conduct a careful examination of all the possible favorable effects and side-effects of all likely policy responses. In doing so, it is important to recognize that, with increasingly globalized financial markets, policy in Japan is exposed to harsh assessment by market participants both at home and abroad. In this sense, in conducting monetary policy, not only policy action such as individual policy measures but also the principle behind every policy action becomes important. In a way, such principles might constitute policy.

At present, as production is declining substantially reflecting a fall in exports, economic adjustments are intensifying. Needless to say, the Bank of Japan will continue to carefully examine overall developments in the economy, including adjustments in IT-related areas and the effects of structural reform, and conduct appropriate monetary policy. At the same time, I would like to emphasize that, during such process, ensuring monetary policy credibility as a whole becomes critical for realizing sustainable economic growth.

Thank you for your attention.