Yutaka Yamaguchi: The economic situation and monetary policy in Japan[1]

Speech by Mr Yutaka Yamaguchi, Deputy Governor of the Bank of Japan, at the Economic Seminar of the Japan Research Institute, Tokyo, 26 November 2001.

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I am honored to have been given the opportunity to talk before this distinguished audience. My topic today is the economic situation and monetary policy in Japan. There are many issues I would like to talk about related to this topic, but as my time is limited, I would like to focus on the current issue in the economy, the continuous decline in prices. The phenomenon had long been forgotten, as it last emerged just after the war, but it has caught the attention of many and has been actively discussed in recent years. I would therefore like to share my thoughts with you on policy actions that might be taken to stop the decline in prices, which naturally include monetary policy.

I. The Economy: The Present Situation and the Outlook

I would first like to explain the Bank's assessment of the current economic situation based on the Bank's semi-annual report, Outlook and Risk Assessment of the Economy and Prices, "the outlook report" for short, published on October 29.

The Bank started publishing outlook reports last year, and the report is released twice a year in April and October. The aim of publication is to promote public understanding by enhancing the transparency of the conduct of monetary policy by comprehensive disclosure of the views of the Bank's Policy Board members on the outlook for the economy. The October 2001 report covered fiscal years 2001 and 2002, the period from April 2001 through March 2003, and assessed the most likely scenario, or a baseline scenario, for economic and price developments during the period, and the upside and downside risk factors involved.

There is only time today to give a brief summary of the conclusions of the outlook report. It concluded that, as a baseline scenario, Japan's economy would go through a severe adjustment in fiscal years 2001 and 2002. At the same time, however, the report asserted that the economy would stop deteriorating in fiscal 2002 if overseas economies started to recover in fiscal 2002. Even in that case, more time will be needed before clear signs of recovery can be confirmed and prices are expected to continue declining gradually in fiscal years 2001 and 2002.

This outlook clearly involves a high degree of uncertainty and there exist both upside and downside risks to the baseline scenario. Among the risk factors that need to be watched closely are 1) developments in overseas economies, especially those in the U.S., and in IT-related industries; 2) developments in the financial markets at home and abroad, especially stock prices; and 3) the impact of structural reform of the economy, fiscal consolidation, and the NPL disposal.

II. Problems of the Price Decline

If the consumer price index falls, albeit modestly, in fiscal years 2001 and 2002, this will be a post-war record of a continuous decline for three years. To consider the relation between prices and monetary policy, we need to examine the factors behind the price decline.

The projected continuous decline in prices is caused by two factors. The first is the downward pressures on prices brought about by weak demand. Given the baseline scenario that I mentioned earlier, the output gap in the economy will be likely to widen into fiscal 2002. The second is the downward pressures from the supply side, for example, imports of low-priced goods, deregulation, and streamlining of distribution channels.

These two kinds of pressures are both important as factors behind the price decline. But in relation to the short-term economic outlook, it is more of a concern that the downward pressures generated by weak demand will gradually intensify.

[1] English translation prepared by the Bank's staff based on the Japanese original.

This analysis of the price decline does not mean that the Bank is worried only about the pressures due to weak demand and not about those from the supply side. The Bank is well aware of the necessity of stopping the continuous price decline in view of the severe economic situation, and is taking strong monetary easing measures unprecedented in the history of central banking.

Then, what are the problems with the current continuous price decline?

A loss of price stability, regardless of whether this is due to deflation or inflation, could cause the following problems. Firstly, when prices are not stable, the signaling function of prices does not work properly and efficient resource allocation is hampered; and secondly, uncertainty heightens which makes it difficult for economic agents to take decisions for the future. In other words, fluctuations in prices interfere with the most important function of a market mechanism: resource allocation.

We should examine whether the ongoing gradual price decline could cause these problems. However, the Bank's recent concern is more about the danger that a vicious circle might be generated by the price decline: a deflationary spiral emerges when a price decline leads to a recession and this in turn triggers a further fall in prices. A deflationary spiral can develop for various reasons but the background common to all is that various contracts for economic transactions are mostly agreed at a fixed nominal value which cannot be adjusted flexibly for price declines. I will explain this focusing on three economic variables: interest rates, debts, and wages.

The first point concerns interest rates, the so-called "zero interest rate constraint." Currently, not all the market interest rates are zero, but short-term rates, which the Bank can control through its policy, are virtually zero and cannot decline further. Once nominal interest rates decline to zero, there will be no room left for monetary policy to affect aggregate demand or the level of prices by lowering nominal interest rates and, consequently, real interest rates.

The second point concerns debts. Debts held by firms and households are usually fixed at a nominal value, and cannot be adjusted for price declines. Hence, repayment of debts becomes more difficult as prices decline and corporate sales and/or household income decrease. To make matters worse, Japan now faces the associated problems of excessive debts in the corporate sector and the large amount of the NPLs in the banking sector. The gravity of these debt problems aggravated by the heavier debt burden due to price declines is hampering the recovery of our economy. In the past, there were some cases where credit contracted substantially when the economy was in a deflationary spiral, and this was due to a vicious circle in which an increase in debt burden interacted with a price decline.

The third point concerns wages. Nominal wages have a downward rigidity. In general, corporate profits decrease in cases where nominal wages remain rigid while sales decrease due to a price decline. In Japan, nominal wages have been adjusted with a certain amount of flexibility and careful analysis is needed to examine whether or not wage rigidity is exerting downward pressures on corporate profits and heightening the risk of falling into a deflationary spiral.

From what I have said it is clear that developments in nominal income, including corporate profits and employee's income, are important yardsticks to judge whether or not the economy will fall into a deflationary spiral. For example, in 2000, despite some negative inflation rates, the profits of firms marked an increase of 34 percent, and that of employee's income was one percent. Therefore, the probability of the economy falling into a deflationary spiral was low. After the turn of the year, the situation changed and began to give cause for concern, as corporate profits started to decrease and the year-on-year increase in wages has remained negative since summer 2001. Thus, although the pace of price decline was almost the same in calendar years 2000 and 2001, the implications are different this year.

Is there a high probability of Japan's economy falling into a deflationary spiral in the future? In the outlook report in October, the Policy Board members' assessment was that, for fiscal 2002, economic growth will remain negative and prices will continue to decline. However, this assessment did not include the emergence of a deflationary spiral and we assumed that the deterioration of the economy would stop in the second half of fiscal 2002 if overseas economies started to recover. That was our baseline scenario and the associated downside risk factors should not be forgotten. If you recall my earlier explanation of deflationary spirals, I do have a deep concern about developments in corporate profits and financial system problems in a situation where nominal short-term interest rates reach zero. In this sense, we cannot totally rule out the possibility that the economy will fall into a deflationary spiral, and the situation warrants vigilant monitoring.

III. Effects and Limits of Current Monetary Easing Measures

A. Outline of Current Monetary Easing Measures

The Bank of Japan has taken strong monetary easing measures which no other central bank has ever adopted before, against the background of the Bank's severe economic outlook. The framework of the current monetary easing measures can be summarized in the following four points.

First, the main target of market operations was changed from the overnight call rate to the amount outstanding of the current accounts at the Bank. In addition, the new target was raised from four trillion yen to five trillion yen in March, to six trillion yen in August. Since September, in response to a surge in liquidity demand triggered by the terrorist attacks in the U.S., the Bank has provided the market with ample liquidity "aiming at above six trillion yen" without setting an upper limit. As a result, the amount outstanding of the current accounts at the Bank averaged 9.2 trillion yen for the September and 8.8 trillion yen for the October reserve maintenance period.

Second, the Bank has committed itself to continuing the above mentioned framework of monetary operations until the rate of increase of the CPI rises to and remains stably at or above zero percent. This commitment aims to drive down interest rates of longer maturity by clearly stating that the Bank will continue the current monetary easing measures in the future. This monetary easing effect is often called "the commitment effect" or "the duration effect."

Third, the Bank decided that it could increase its outright purchase of long-term Japanese Government Bonds (JGBs) when the Bank found it necessary to smoothly provide ample liquidity to the market, on the condition that the amount outstanding of long-term JGB holdings be within the amount outstanding of banknotes issued. In accordance with this framework, in August the Bank increased the amount and frequency of JGB outright purchase from twice a month amounting to 400 billion yen to three times a month amounting to 600 billion yen.

Fourth, the Bank has established the so-called Lombard-type lending facility. By utilizing this scheme, financial institutions, under certain conditions, are now able to borrow funds from the Bank at the official discount rate as long as they have eligible collateral. This measure has strengthened the monetary easing effect in the sense that financial institutions have been ensured access to ample liquidity and that money market interest rates have been stabilized. The official discount rate, which is applied to this Lombard-type lending facility, has been lowered twice in 2001, in February and in September, and is currently at 0.1 percent.

B. The Strong Monetary Easing Effects in Financial Markets

Current monetary policy has achieved extremely easy conditions in the financial markets. In the money markets, short-term interest rates, including longer ones on term instruments, have declined to a lower level than in the zero-interest-rate period of 1999-2000. Since the unit for transactions of the overnight call rate was changed from 0.01 percent to 0.001 percent in early September, the rate has declined to as low as 0.001 percent to 0.004 percent, a microscopic world indeed.

In the bond markets, the interest rates on JGBs continued to move at levels close to the historical low although they did not decline below the level marked in March this year. Furthermore, medium-term interest rates, such as that of JGBs with five years remaining to maturity, are moving at 0.4-0.5 percent, which is lower than the level in March.

In the CP and corporate bond markets, credit spreads have narrowed with the decline in short- to medium-term interest rates and investors have become more willing to take risks. Therefore, the demand for issuance of new securities in firms with relatively high credit ratings has increased and the amount outstanding of issuance of CP and corporate bonds has maintained a high level. In Japan, the share of corporate financing through the capital markets is still relatively small. However, it has become important as a channel by which the monetary easing measures have permeated through the economy because the credit intermediation function of banks is weakened.

By contrast, the effect of the current policy on asset prices such as stock prices and foreign exchange rates has been relatively limited. Although stock prices rose somewhat after the announcement of the monetary easing measures in March this year, they declined steadily from May onward reflecting a deterioration in business conditions and successive downward revisions of the outlook for corporate profits. Stock prices have not shown a positive response to the increase in the outstanding balance of current accounts at the Bank since August. Foreign exchange rate of the yen also did not depreciate compared to levels in March, as the U.S. economy showed a faster-than-expected slowdown.

C. Easing Effects on the Corporate and the Household Sectors

The crucial point in assessing current monetary policy is whether the ample provision of liquidity by the Bank and consequent easing in the financial markets are affecting the economic entities outside the financial markets such as the corporate and household sectors. Regrettably, the easing effects have not fully permeated to the economy. The monetary base, the sum of banknotes and current accounts at the Bank, is increasing by 14 percent on a year-on-year basis. However, the growth rate of money supply is only 3.6 percent on the same basis, somewhat higher than at the beginning of this year, mainly due to a shift of funds from maturing postal savings. More serious is the fact that bank lending is contracting at 1.9 percent year-on-year and the pace of this decline has been accelerating somewhat. GDP and price conditions also have not shown any improvement. Business capital spending and housing construction do not seem to be stimulated by the historically low interest rates.

IV. The Monetary Policy and Prices

A. Is Deflation a Monetary Phenomenon?

I will return to the reasons behind the weak response of the economy to the strong monetary easing policy. Instead, here, I would like to pose a question: Is it fair to say that the insufficient monetary easing is causing continuous price declines and stagnant economic growth? For example, we often hear the argument that “both inflation and deflation are monetary phenomena and price declines can be stopped only by increasing money supply,” a simplified form of the quantitative theory of money. Is this kind of argument correct?

A part of the above argument that “both inflation and deflation are monetary phenomena” does hold as a long-term economic relationship when the amount of money changes significantly. In fact, the policy objective of many central banks including the Bank, that is to attain “price stability,” is based on the understanding of this relationship. However, this relationship holds only over a sufficiently long period of time and can be interpreted as a sort of definitional or identical relationship. Therefore, at a practical level, it cannot be applied to the conduct of monetary policy.

The first problem with the argument is that, as I mentioned above, it does not make a clear distinction between the relationship in the long term and in the short term. For example, if we look at the relation between money and prices, a close relationship emerges when the amount of money increases or decreases on an extremely large scale and has a dominant impact: The hyper-inflation experienced in Germany after World War I is one example. When the amount of money increases or decreases to a certain extent but not on an extremely large scale, a loose relationship is observed only if we look in the sufficiently long term. However, over a period of one year to a couple of years, unless the amount of money increases or decreases on an extremely large scale as I have just explained, the relationship between money and prices is not stable.

The second problem is that at present the underlying mechanism in the argument will not work as theoretically assumed: a central bank’s efforts to expand liquidity, the current account balance at the Bank or the monetary base, will increase money supply in a broader sense, that is liquidity held by the corporate and household sectors, and, consequently, will push up prices and the level of business activity. Needless to say, monetary policy cannot actually resort to dropping banknotes from the sky--this kind of policy is called “helicopter money” in economics textbooks. If such a policy is implemented, people will rush to purchase goods and services after they receive the cash, and prices can be expected to rise immediately. However, in actual monetary policy, money in a broad sense is provided through a series of “transactions”: a central bank purchases financial assets such as government bonds from financial institutions, in turn creating money in a narrow sense, that is the current account balance at the central bank, and then financial institutions make lending and securities investment. However, what is happening currently in Japan’s economy is that, although funds are abundant in the financial markets, they do not permeate outside those markets, that is, to the corporate and household sectors and money supply has not increased sufficiently. This has been both the cause and result of the stagnant growth in expenditures and the decline in prices. Given that the mechanism to increase money is not working properly, I think it is not following logical steps or is ignoring reality to argue that increasing money could solve all the problems.

As I mentioned, while various factors affect the movement of prices, the most fundamental factor determining price developments is the balance between aggregate demand and supply for goods and services. As the supply capacity changes only slowly, it is the movement of demand that mainly determines the short-term supply-demand balance. In fact, in the time-series data on the Japanese economy, prices begin to rise only after the economic growth rate recovers and the output gap narrows. Statistical analysis of the dynamic correlation between the economic growth rate and the rate of increase in prices shows that the correlation coefficient is the highest when the economic growth is one to two years ahead of a consumer price increase. On the other hand, the rate of increase in prices does not seem to lead the economic growth rate.

In the above discussion, it is clear that in order to halt the continuous decline of prices, it is most important to promote a sustainable, not temporary, growth in aggregate demand. The implementation of monetary policy by the Bank so far has been aimed at halting the decline in prices by providing ample liquidity to the markets to lower interest rates thereby stimulating aggregate demand. The current difficulty in the conduct of monetary policy is that it cannot stimulate aggregate demand even with all the measures employed. We need to face up to this fact.

B. Inflation Targeting

Currently in Japan, we often hear the argument calling for the adoption of inflation targeting. However, this argument is peculiar in the sense that it focuses on first raising prices using every measure. I believe we should devise ways to stimulate economic activity first because prices in nature are the result of economic activity. With this understanding of the environments surrounding price developments and monetary policy, the Bank is currently reluctant to accept the recent argument for inflation targeting.

More fundamentally, inflation targeting should be regarded not as a short-term policy tool but as a framework for improving the transparency of the conduct of monetary policy. As a possible tool for improving the transparency, the Bank considers that inflation targeting is worth examining as one of the options in the future. However, currently, as the short-term interest rate has already reached zero percent, the Bank has very few options for further monetary easing. In addition, the effect of the current monetary easing policy is limited because of the NPL problem. In such circumstances, it is unlikely that the adoption of a too ambitious a target will improve confidence in monetary policy.

At this point, I would expect a counter-argument that however limited the room available for additional monetary easing, adoption of an inflation target will of itself directly affect the “expectation” of economic agents and will produce inflation expectations. I would admit that “expectation” is one of the important channels by which the effects of monetary policy can permeate through the economy. However, controlling “expectation” solely by announcing a policy is unlikely to succeed. I think the Bank can affect people’s expectation only if the announcement is accompanied by effective policy measures. The Bank is in fact already strongly affecting people’s expectation by promising to continue the current monetary easing framework until the year-on-year increase in CPI rises and remains stably above zero percent. In fact, as I mentioned, the interest rate on the JGB with five years remaining to maturity is currently at 0.4-0.5 percent. This interest rate level clearly indicates that market participants are expecting the current historically low interest rates will continue for an extended period of time. In spite of this market development, the actual and expected inflation rates do not show any signs of upward movement.

I understand that some argue that the Bank can cause inflation by purchasing any kind of assets. I will touch upon this issue later.

As an example of successful introduction of inflation targeting, some cite the price level targeting adopted in Sweden in the first half of the 1930s. We at the Bank are also interested in the Swedish experience and have studied it. What we found was a great similarity between the Swedish policy and the Bank’s current policy framework.

The most important similarity is that, while both the Swedish authorities and the Bank of Japan declared their firm determination to prevent price declines, neither adopted a numerical target. In the Swedish comprehensive program for price stability, it was stated that “Monetary policy should not be tied systematically to a particular index figure. A formal and simple rule for monetary policy did not appear feasible.” More specifically, the Riksbank, the Swedish central bank, stressed the importance of carefully monitoring various price indices while taking into account other economic variables such as inventory figures and productivity data. It stated that implementation of the policy should not depend on a specific price index such as the CPI. Therefore, a clear distinction should be made between the Swedish policy and the idea of overcoming deflation by adopting a rigid price targeting scheme using a specific price index.

When comparing Sweden in the 1930s and Japan's current situation, we should be careful because there are critical differences between the two regarding economic and financial environments. The significant differences are the following: (1) in the Swedish economy at the time, the level of nominal interest rates was relatively high so that there was sufficient room for interest rate cuts, (2) the Swedish financial system did not face a serious problem, (3) as a relatively small open economy, the depreciation of the currency in the foreign exchange market contributed to the prevention of price falls. In sum, there is a difficulty in applying the specific measures used in Sweden in the 1930s to the current situation in Japan.

V. Why Japan's Economy is not able to Exit from the Deflation

Now, I would like to raise a question: What kind of economic policies are required to exit from the ongoing deflation, and why is Japan's economy unable to do so? As I have already mentioned, three factors in particular stand out as important: the constraints imposed by zero nominal interest rates, the NPL problem, and the weakening sentiment.

A. Constraints of Zero Nominal Interest Rates

First let us consider the constraints imposed by zero nominal interest rates. Short-term interest rates are already virtually zero, five-year interest rates have also declined very close to zero--the term of debt financing by Japanese firms is in many cases five years or less. A standard mechanism of monetary easing is: (1) inducing a decline in short-term interest rates by providing ample liquidity to the money market, (2) thereby influencing financial variables such as the medium- to long-term interest rates, stock prices, and foreign exchange rates, (3) consequently, expecting such changes in financial variables will affect the behavior of financial institutions, firms and households. Now that nominal interest rates have reached the point where no further decline is possible, monetary easing has also reached the point where little additional effect can be expected. Moreover, real interest rates could rise if a price decline continues in this economic setting.

By the way, facing the limits of further monetary easing with the zero interest rate constraints, what kind of meaning does the massive amount of liquidity provision to the financial markets have? It is premature to give a definite answer to this question. The current policy adopted by the Bank is unique and has not been tried in other countries. The effects of such policy, especially in a situation where serious problems exist in the financial sector, should be assessed empirically but we have not accumulated sufficient experience and data to draw concrete conclusions. At the same time, this does not mean that we have no clues. One example is the surge in liquidity demand in the financial markets and the associated increase in the outstanding balance of the current accounts at the Bank after the terrorist attacks in the US. The surge in liquidity demand itself took place not only in the U.S. but also in other countries and major central banks including the Bank provided a huge amount of liquidity in order to secure stability in the financial markets. While the Federal Reserve and the European Central Bank returned to normality in terms of liquidity provision within a week, in Japan, by contrast, liquidity demand has continued to be high. It appears that there are two factors at work here.

The first factor is waning incentive to invest or lend funds in the markets with the decline in the uncollateralized overnight call rate to 0.001 percent. Thus, financial institutions that hold excess funds would prefer to deposit them in their current accounts at the Bank even if it does not bear interest. Once such behavior spreads to other market participants, borrowers feel worried that they might not be able to borrow funds in the markets, and subsequently, an increasing number of financial institutions will start to defensively accumulate funds in their current accounts at the Bank.

The second factor is the fact that the cost of yen funding through yen-U.S. dollar swaps has become negative for foreign banks. Foreign banks capable of funding yen at negative interest rates can earn an interest margin without worrying about credit risk by depositing the funds in their current accounts at the Bank. In this case, the negative yen funding rate works as a "sweetener" giving an incentive to foreign banks providing Japanese banks with dollar funds.

These two factors, a disincentive to invest in the money markets and negative yen funding costs, give us an interesting insight into the meaning of current market operations in which ample liquidity is provided with the current account balance as an operating target. That is to say, the disincentive to lend funds in the market was largely caused by the ample liquidity provision by the Bank. At the same time, the major reason why the Bank can provide ample liquidity without facing under-subscription in open market operations is that there is demand from foreign banks for excess reserves, and this itself is not expected to lead to a revitalization of economic activity. Of course, we still cannot deny the possibility that the demand for excess reserves will lead to a change in the portfolio of economic entities and ultimately stimulate economic activity in the long run. The Bank is now closely examining this possibility while continuing the current massive provision of liquidity.

B. The NPL Problem

The second reason why Japan's economy is unable to exit from the ongoing deflation is the NPL problem. It is not the case that once the NPLs are disposed of, the deflation will end, and the economy will recover right away. I think that it is now widely understood that the disposal of the NPLs will rather be associated with short-term pain. It is also true, however, that once the economy recovers, the NPLs will decrease. Sustainable economic growth cannot be expected in a situation where a large amount of the NPLs remain and credit intermediation does not function fully, for the following reasons.

First of all, in such a case, financial institutions are facing the risk of their capital being impaired by external factors such as a decline in stock prices and emergence of new NPLs following a downturn in the economy. Capital is the last line of defense against unexpected risks and losses. It is difficult for the management of the financial institutions to take risks when they are concerned about their capital position. From a macroeconomic point of view, sustainable economic growth may only be achieved with continuously favorable external conditions which will require delicate policy management.

Secondly, until the NPL disposal is completed, it is difficult to adjust lending rates to levels adequately reflecting risk and return. Currently Japanese banks are competing with one another to lend to blue-chip companies and credit spreads have become extremely narrow. On the other hand, the Japanese banks are cautious about extending new loans to firms with low credit ratings and the banks have not increased credit spreads adequately on their lending to existing less creditworthy borrowers. In the current situation, if the banks drastically increase credit spreads, their borrowers are likely to go bankrupt and the banks will have to pay the price in the end. However, from the long-term perspective, unless the lending rates are set in an economically rational manner, the lending attitude of financial institutions cannot be aggressive and consequently it is hard to achieve a sustainable economic growth.

C. Weakening Sentiment

The third reason for the deflationary trend in Japan is weakening sentiment. Looking at households, their expenditure has been restrained reflecting their anxieties about the future including the viability of social security systems and employment concerns. In the corporate sector, investment appetite has receded partly because the economic stagnation itself has lowered the expected rate of growth. I understand that listing weakening sentiment as part of the background of deflation sounds like talking about the two sides of the same coin. But I think that the current weak demand cannot be fully explained by the zero interest rate constraint and the NPL problem and there remain some kind of residual factors which should be explained as weakening sentiment. Such a decline in demand caused by weakening sentiment can hardly be solved unless people become confident that the economy has returned to a clear recovery path. At the same time, considering the state of typical households and firms, I think it is difficult to deny that, together with the stagnated economy, various institutional barriers are hampering their challenging spirit. For example, in the corporate sector, public corporations are depriving private institutions of their business, and reviewing legal, taxation, and regulation systems to cope with the era of globalization is lagging behind. As for the household sector, consumption seems to be stagnating due to uncertainty about the future caused by the problems related to the social security system such as pension benefits and the health care system.

VI. Conduct of Monetary Policy

I have talked about various issues, focusing on the decline in prices. Finally, based on above discussion, I would like to talk about what the Bank of Japan can do, and what I expect from the government, which is responsible for economic policy other than monetary policy.

A. The Role that the Bank of Japan Should Play

First, the role the Bank of Japan should play. I would like to reemphasize that the Bank and the government share the same goal of preventing a further decline in prices and of bringing the economy back to a sustainable growth path as soon as possible. Based on the preceding discussion, I would like to express my thinking on what role the Bank should play.

First of all, although it may sound like something which goes without saying, the current monetary easing policy should be tenaciously continued. The effects of the current strong monetary easy measures have not fully permeated to the real economy. But once there is a positive movement in accordance with the progress of structural reforms such as the NPL disposal and improvement of productivity in the economy, it can be expected that the monetary easing policy will support such movement and have powerful effects. It is extremely important to be tenacious in maintaining the current monetary easing conditions, so that they could support any positive movement in the economy when it appears.

The second role is the provision of liquidity in a swift and timely manner. Should there be uncertainty or concern in the financial markets for one reason or another, liquidity has to be provided in a swift and timely manner, so that such uncertainty or concern will not disrupt the markets. It is one of the central bank's most important roles to maintain the stability of the financial markets and the financial system through liquidity provision. Maintaining that stability is also important in making the effect of the monetary easing continuously permeate through the economy.

Now, what could monetary policy do, if economic conditions deteriorate further and the risk of a deflationary spiral is heightened as a result? The Bank is aware of the argument that the Bank should not only increase the outright purchase of long-term JGBs but also purchase any assets such as foreign-currency denominated assets, stocks and even the NPLs to prevent deflation. As I have already expressed my thoughts on this issue on a different occasion, I will reiterate the conclusion in the following three points. First, given that just increasing the amount of liquidity gives only limited stimulus to the economy, the major benefit of purchasing such assets is mainly to influence their prices. If, however, one expects to influence these assets through a change in the supply-demand balance and thereby produce the effect of monetary easing, the purchase must be done on a large scale. Second, taxpayers may ultimately have to pay the price of possible loss resulting from this large-scale purchase and this will also affect the microeconomic resource allocation. And third, such a policy implies that a central bank would be conducting an activity which is close to entering the domain of fiscal policy. The basic rule in a democratic society is that fiscal policy using taxpayer's money needs to be approved as part of a budget by a parliament composed of members elected by the people. I am not worrying about inflation when deflation is a concern, but claiming that such a policy of purchasing various assets should be discussed publicly in the context of governance in a democratic society.

B. The Role that the Government Should Play

As I mentioned earlier, the government and the Bank share a common goal of preventing further price declines and bringing the economy back to the path of sustainable growth as soon as possible. The role that the government should play in this is also quite large. The first role is to foster business conditions that are competitive and attractive in order to induce business fixed investment. To do this, it is important to deregulate, to review the taxation system drastically, and to ensure that reform of public corporations progresses steadily. Another important challenge is to relieve the anxiety of households about the future by reviewing the social security system, including pension benefits. Furthermore, I would like to reemphasize the importance of ensuring that the NPL disposal proceeds as expeditiously and smoothly as possible.

The following point needs to be borne in mind. Progress in the economic and fiscal structural reform and NPL disposal is likely to lead to a decline in demand and to exert downward pressure on price levels in the short term. On the other hand, if a positive outcome of the structural reform bears fruit which leads to an increase in the productivity of the economy as a whole, it will have a significant meaning to prevent further price declines through a revitalization of economic activity. When we consider economic issues, we should always check from the viewpoint of aggregate demand and productivity. Of course, aggregate demand and the productivity are not independent of each other. Even if the growth rate recovers as a result of inefficient public investment, productivity could fall and consumption expenditure could be reduced due to concern about the future tax burden. On the other hand, if the growth rate declines substantially, firms reduce business fixed investment and the R&D expenditures necessary for improving productivity in the future.

Whether to put emphasis on aggregate demand or on productivity needs to be judged objectively based on the economic conditions. No matter where the emphasis is put, the economic consequences need to be objectively recognized and shared among the people.

Given that the price decline will inevitably continue to some extent while the structural reform proceeds, policy initiatives will be focused on preventing the decline in prices leading to a deflationary spiral. Monetary policy, it goes without saying, must play an important role in these efforts. On the other hand, there is a limit to what can be achieved by monetary policy alone. Improvement of the social safety net through measures to secure employment is necessary to prevent a sharp decline in consumption. It is essential that the stability of the financial system as a whole be secured when the NPL disposal is pushed forward.

Finally, one of the important issues is the role that fiscal policy should play. John Maynard Keynes asserted that in a liquidity trap, monetary policy loses effectiveness and fiscal policy is necessary. However, the scope for mobilizing fiscal policy is limited in Japan given the high level of public debt. I would like to expect that, given the capacity for additional fiscal outlays is limited, the government will review the components of expenditures drastically. It is widely accepted internationally that the function of built-in stabilizer should be utilized during a recession. Given the current economic situation of our country, I think it is worth examining, leaving some room for this function to work.

In concluding my speech today, I would like to add that, we at the Bank will continue to do our utmost as the nation’s central bank to provide the foundation for a stable and sustainable growth of Japan’s economy.

Thank you for your attention.