Yutaka Yamaguchi: Central banking in uncharted territory

Remarks by Mr Yutaka Yamaguchi, Deputy Governor of the Bank of Japan, at the Foreign Correspondents' Club of Japan, Tokyo, 3 July 2002.

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1. Introduction

It is my great honor and pleasure to address the Foreign Correspondents' Club of Japan today.

Recalling last year's experience at this Club, my colleague, Deputy Governor Fujiwara, warned me to be prepared for a high risk of receiving very tough questions today. I think there are two cases when a cautious central banker willingly takes such a risk. The first is when the economy is doing so well and the central banker wants to display a good job. The other is when he/she really wants to ensure listeners better understand the state of the economy.

Unfortunately, my decision to be here today is the latter case. Japan's economy now faces a broad range of difficulties. Various comments are made on Japan's economy and monetary policy by economists both in Japan and abroad. Listening to some of them, I sometimes feel a perception gap which is difficult to remedy.

Using the limited time given today, I would like to discuss the challenges facing Japan's economy and the role of monetary policy. I would also like to touch upon the perception gap in the context of the transparency of monetary policy.

2. Economic and financial developments in Japan

Just like other economies, from the end of 2000, Japan's economy experienced a sharp downturn in exports and production against the background of a slowdown in the US economy and the collapse of the global IT boom. Downward pressure on the economy initially hit the corporate sector in the form of deterioration in profits and a fall in capital expenditures. Since summer last year, the adjustment process has gradually spread to the household sector through weakening employment and wages. Against this background, the underlying trend of private consumption remains weak.

In recent months, we have at last seen some positive signs. Exports have clearly started to increase and production has been recovering. Major factors inducing such positive changes are again external developments including the US economic recovery and the progress of stock adjustment in the IT-related industries.

The issue here is whether such positive moves could lead to a sustainable economic recovery. The Bank of Japan publishes a half-yearly report entitled "Outlook and Risk Assessment of the Economy and Prices", and the most recent April issue gives the outlook for this fiscal year. As a standard scenario for Japan' economy for the rest of this fiscal year, the report assumes a recovery led by exports and production, an outlook I still fully endorse.

At the same time, it is difficult to assume that the coming recovery will soon become a domestic-demand-led spontaneous one. For one, it is hard to presume that the upward momentum supported by exports and production will fast spread to non-manufacturing and small business sectors. Given the relatively high labor's income share, restructuring efforts by firms to cut labor costs are likely to continue. Therefore, the expected recovery in the corporate sector may not be fully transmitted into an improvement in the employment and income situation and, in that case, downward pressure on households may persist for a while.

Turning to recent price developments, the Outlook report assumes that prices will continue to decline, albeit somewhat less compared to last fiscal year, as downward pressure will continue both from the demand and supply sides. The Bank of Japan saw a need to prevent such a price decline and has adopted strong monetary easing measures. Reviewing the debate over deflation since last year, an important question is how to interpret the relationship between prices and economic activity. To be more specific, it is crucial whether a price decline associated with economic slowdown would further accelerate economic deterioration. In the past few years, this question has been actively discussed in the context of the possibility of a deflationary spiral where a vicious circle of price declines and economic deterioration emerges. Reviewing actual economic data, however, we have thankfully not seen the economic situation assumed by the deflationary spiral camp.

It seems to me that price development can be better understood more as a result of economic activity rather than vice versa. According to research by my colleagues at the Bank, a loose correlation between changes in CPI and the output gap is observed. But the deviation of actual CPI inflation from estimates based on a calculated output gap could be as large as a full percentage point in each direction, which requires us to have an approximate two-percentage-point allowance in total. This reflects various factors including the effects of structural changes on the supply side and simple technical drifts associated with assembling the index. Our experience in 1999 and 2000 showed that, under certain conditions, the economy could recover while a mild decline in the CPI continued. It is my impression that declining asset prices, especially in the property market, has had a much more severe impact on economic activity rather than the moderate deflation of goods and services.

There exist various uncertainties and risks to the standard scenario. As the Outlook report discussed such risks in detail, here I would just like to touch upon the following two issues.

First is the global economic developments, especially in the US, which is expected to play a key role for Japan's recovery in the near future. (Needless to say, from the US point of view, Japan's economy might be regarded a risk factor. This is a clear evidence that we are living in a world of interdependence). Looking at the US developments in recent months, a large gap has been witnessed between macroeconomic data showing signs of recovery and the soft stock market.

If we look at global financial and capital markets, the effective exchange rate of the US dollar reached its peak in January and has been depreciating significantly since then. Such foreign exchange rate movements reflect recent changes in global capital flows such as a decline in direct investment into the United States in favor of the euro zone. These developments warrant careful monitoring as they could have a global impact.

Second is the vulnerability of Japan's economy to exogenous shocks and stresses. Since the 1990s, the economy experienced sharp downturns triggered, for example, by concern over the financial system, withdrawal of fiscal support, and the global economic slowdown. We should always be prepared for such exogenous shocks but, given the present condition of the financial system, we should be especially aware that Japan's economy is currently vulnerable to major shocks.

3. Monetary policy by the Bank of Japan

Against the economic and financial background that I have just described, the Bank took a series of easing measures in February and March last year, stepping into an unprecedented policy area in the history of central banking.

Among the several pillars of this new monetary easing framework, the most important is the change in the target of money market operations. The target was changed from the overnight call money rate, that is the interest rate for the shortest term, to the outstanding balance of current accounts held at the Bank of Japan which represents the quantity of liquidity. This change was introduced to explore the possibility of further monetary easing even after short-term interest rates, the starting point of the transmission mechanism of monetary policy, had effectively fallen to zero. This framework is often called 'quantitative easing.'

Let me share with you some facts and figures to show why these are unprecedented monetary easing measures in the history of central banking.

First of all, the call money rate declined to very close to zero at 0.001%. The rate on one-year government bills declined below 0.01% and, since summer last year, the long-term government bond yield has stayed at a historically low level of 1.3-1.5%.

Turning to 'quantity,' the current account balance at the Bank of Japan has increased to 15 trillion yen. You may not fully appreciate how large this figure is. The amount of reserves legally required to be held is only 4 trillion yen. Thus, financial institutions are holding 11 trillion yen in excess liquidity without earning any interest.

The size of monetary base, that is the sum of cash in circulation and the outstanding balance of current accounts at the Bank of Japan, has posted dramatic double-digit growth on a year-on-year basis to reach almost 17% of GDP. This is the highest level over the last hundred years with the exception of a period during World War II.

The minutes of the Monetary Policy Meeting in March 2001 describe how Policy Board members arrived at the decision to adopt a quantitative easing framework. I will summarize the steps leading to this decision. First, the members felt that the effects of such a framework were uncertain and might have negative side effects. Second, therefore, whether the Bank should adopt such a framework depended on the specific economic situation. Third, they concluded that, although it had not been appropriate to adopt such measures in the preceding two years when the economy had been gradually recovering, the worsening situation in March 2001 required the Bank adopt strong measures.

The Bank of Japan has pursued such strong monetary easing measures while concurrently examining their effects, in other words, on a 'learning by doing' basis. Through this process, we have learned a lot about the new measures but, at the same time, more questions have arisen. It is said that it took a long time for Man to learn the concept of 'zero'. I am increasingly convinced that it will also require a long time for central bankers and economists to completely understand the meaning of a zero interest rate.

Let me share some of my observations and current thinking on this subject. As most evident effects, we can point out that the abundant and flexible provision of liquidity under the quantitative easing framework successfully maintained extremely easy monetary conditions, thereby preserving financial market stability.

You may think such effects nothing special but recall the difficulties we have experienced since the end of 2000, namely a global economic retreat triggered by the bursting of the global IT bubble and the tragic events of September 11th. Additionally, we suffered from the adverse impact of structural adjustment and rising concerns over the financial system. It is thus significant that our flexible and abundant provision of liquidity contained market participants' concerns over liquidity financing. There is little doubt such accommodative monetary conditions played the key role in avoiding a deflationary spiral.

Apart from this role in mitigating negative impacts, what other positive effects have our monetary easing measures had on the economy?

The effectiveness of additional liquidity provision after the short-term interest rate reached zero has not been fully examined and will continue to be discussed by economists. A key here is whether such additional liquidity provision will lead to increased investment in riskier assets, often called asset reallocation.

There are two theoretical hypotheses. One interprets the situation as a liquidity trap. Caught in this trap, without room for a further decline in short-term interest rates, any increase in liquidity provision by the Bank will merely result in higher idle balances in the Bank's current accounts. In other words, additional liquidity will be fully absorbed by an increase in demand as financial institutions no longer hesitate to hold more excess liquidity because the cost of doing so is zero. In this case, a quantitative increase cannot give any stimulus to economic activity.

The other interpretation sees an increase in liquidity provision inviting liquidity saturation and, consequently, somehow inducing investment in riskier assets. For example, increased investment in stocks would raise their prices and more investment in foreign-currency denominated assets would promote the depreciation of the yen. This camp argues that such a change in asset prices would stimulate economic activity.

What do actual data tell about the effects of quantitative easing? It is always difficult to single out the effects of quantitative easing because there always exist various other factors; There also exists a certain time lag in effect of monetary policy. Although I am not able to make an assertive judgment, let me try to present some facts related to the question based on four yardsticks.

The first yardstick is whether the growth of monetary aggregates such as money supply has increased. The annual growth rate of M2+CDs was at the 2% level in March last year and has been at the 3% level in recent months. This marginal change reflects a shift of funds into cash and demand deposits after the massive redemption of investment trusts following the failure of Enron. In fact, the growth rate of broadly-defined liquidity, which covers a wider rage of financial assets, has been declining.

The relatively high growth of monetary aggregates with higher liquidity reflects a greater preference for liquidity as a result of lower interest rates. It also reflects an increase in demand deposits which will be guaranteed even after the partial removal of the blanket guarantee of bank deposits in April. Looking at bank lending which plays the key role in credit creation, the outstanding amount has been showing a negative growth rate against the background of weak credit demand. In the meantime, the lending attitude of commercial banks has rather tightened reflecting their desire to strengthen profitability.

The second yardstick is whether asset prices have changed in the direction assumed by the process of quantitative easing. In actuality, stock prices in Japan have declined compared to the level in March last year. And, while the yen began to depreciate from last autumn, it has started to appreciate since April this year. This appears to indicate that the yen rate has been dominated by changes in the market perception of business conditions in the US and Japan.

The third yardstick is whether prices have stopped declining. For those who claim that deflation is a monetary phenomenon, a significant increase in the monetary base should induce a significant rise in prices. As I have already explained, however, we have so far seen little change in the gradual declining trend of prices.

The fourth yardstick is whether economic activity has recovered. Although we are seeing some positive signs in recent months after a sharp economic downturn, it appears to largely reflect an export increase against the backdrop of the global economic recovery.

I have discussed the effect of quantitative easing, that is to increase the current account balance at the Bank under the zero interest rate constraint. It will take some time to judge which camp is right, namely the liquidity trap or the liquidity saturation. Even in retrospect, it might be difficult to draw a clear conclusion.

In any event, having listened to my explanation of quantitative easing, you may come up with the following question: If quantitative easing proves to be ineffective, why don't you try `unconventional` policies of purchasing some specific assets such as stocks and property in order to affect their prices? By adopting such options, a central bank would significantly intervene in microeconomic resource and capital allocation. I am also skeptical if the central bank operations could directly affect asset prices in this world of free capital flows. I refer those of you who have an interest in this subject to other speeches of mine in which I discuss this kind of policy in more detail. Today I would like to add just one comment.

And that is, leaving the issue of the effectiveness of such policy aside, the zero interest rate environment enables those who believe in such effects, the government or private firms, to carry out such purchases funding at zero interest rates. Thus, the real question is what parties would be best suited to issue short-term debt at zero interest rates and to purchase specific assets.

4. What is needed to return to a sustainable growth path?

Next, I would like to turn to the question of what is needed to return to a sustainable growth path. To be honest, this is a difficult question. This is because, in order to answer it, we have to consider another difficult question. Why has Japan's economy remained stagnant for ten years?

The most pressing issue for Japan's economy is a shortage of demand relative to supply capacity. Therefore, what is crucial is to increase demand to fill the output gap and make the economy grow at its growth potential.

As I have discussed, with the zero interest rate constraint, the effect of monetary policy may be limited in creating demand. But, once demand starts to increase responding to exogenous factors, the present monetary policy has the potential to strongly support such moves. In this regard, another pillar of our framework is going to play an important role. And this is the policy commitment of continuing the current easing framework until the Consumer Price Index registers stably zero or an increase.

Monetary policy is usually conducted in a forward-looking manner based on the expected inflation rate. This is because the effect of monetary policy materializes with a time lag. When an economic recovery is seen, long-term interest rates automatically rise as market participants come to expect the tightening of monetary policy.

In contrast, the policy commitment of the Bank promises that the present strong easing framework will continue until the currently negative CPI inflation rate registers stably above zero. This commitment, by stabilizing short- to medium-term interest rates at low levels, is expected to support economic recovery as it unfolds.

On the other hand, it is known that actively using fiscal policy in the interest of stabilization could rather destabilize economic activity or distort resource allocation. For this reason, in recent years, many countries let monetary policy play the key role in stabilizing economic activity. At the same time, it is also known that, theoretically, in the face of the zero interest rate constraint, there is a role for fiscal policy in increasing demand.

The outstanding balance of government debt has reached nearly 140% in terms of GDP. But, if fiscal funds obtained from the issuance of new debt are used effectively to boost aggregate demand, the associated growth of income and production would lower the level of government debt in terms of GDP. To the contrary, if used in an inefficient way, fiscal spending funded by debt would restrain long-term growth prospects. It is difficult to judge a priori which scenario is more likely to happen, because, in the end, it all depends on which policy the public will support.

I have so far discussed demand-side policy. What about structural reform, which has been actively talked about? ‘Structural reform’ means different things to different people. A very general definition could be to regard it as supply-side policy to improve productivity. Improving productivity is always crucial because the long-term growth path depends on productivity growth. To that end, resources - such as labor, land, and capital - have to be reallocated in the most efficient way to adapt to a changing economic environment. It is a quite orthodox policy indeed. The reallocation of resources is required at various levels such as inside a corporation, among corporations within the same industry, among various industries, and among various regions. In the end, the non-performing loan problem in our country is the reflection of such inefficient firms and industries.

Efforts to improve productivity are important. However, if demand is not created to meet an increase in supply capacity, the output gap will widen further. In addition, there is a risk that, before seeing an increase in supply capacity, a deflationary impact may emerge as competition, inevitably induces firms to exit from the market.

On the other hand, however, if policy efforts to promote future growth are seen to be promising, it could lead to an increase in the current demand partly through a rise in stock prices. Taking the example of business investment, it is the key for improving productivity and, at the same time, is in itself a demand. Therefore, it is quite important to promote competition and improve the domestic environment for such investment. Given that the ultimate goal of such investment is to fulfill private consumption demand, it is equally necessary to remove public concern over the future so that consumption can increase.

These things are easy to say but difficult to implement. Fully recognizing that this is the conundrum facing Japan’s economy, I want to stress here that, when pursuing ‘structural reforms,’ it should clearly be recognized that such reforms could cut both ways as I have explained.

In the end, the public determines the desirable sequencing of policy change. A decision to realize the efficient reallocation of resources all at once will be associated with significant pain but, at the same time, it could pave a way for faster recovery later. To the contrary, a decision to realize reallocation in a gradual manner could avoid a sharp downturn but it could delay a sustainable recovery.

An economist from abroad who had believed that Japan’s economy was almost moribund changed his view after arriving in Japan and was said to have called the situation here a “golden recession.” As this story indicates, after the bursting of bubbles, Japan has in effect chosen the latter gradualist approach with respect to resource reallocation. As a result, we have avoided a situation where unemployment has skyrocketed to double-digit figures or GDP dropping by 5 percent a year.

It is hard to say which approach is appropriate a priori. Having said that, given the speed of change in today’s economy as well as the fact that the economy has recorded low growth for ten years or so, the shortcomings of the gradual approach are becoming more evident.

I have so far mainly discussed how to improve Japan’s economy through policy efforts. Finally, I would like to touch upon the role of individuals and business firms. In a market economy, the importance of individuals and business firms cannot be emphasized enough. In this regard, it is impressive to review how Japanese players have established themselves in major league baseball in the US.

Ten years ago, there were no Japanese baseball players in the major league but now there are thirteen. Have the skills of Japanese players improved dramatically in the past ten years? I don’t think this is the case. Rather, I suspect that one player challenged the major league and his success invited others to follow.

5. Transparency of monetary policy

My final topic today is the transparency of monetary policy and the perception gap between critics and the Bank of Japan.

The Bank of Japan has been making efforts to improve external communication and to enhance the transparency of monetary policy since the new Bank of Japan Law was enacted in 1998. The new law includes “transparency” along with “independence” as its basic concepts. There are two reasons why transparency is important for a central bank.

First, it is important from the viewpoint of accountability. In a democratic society, an independent central bank should fully explain its actions to people and their representatives in the legislature. Transparency makes a central bank keenly aware of the responsibility associated with independence.

Second, transparency is important in helping to secure the effects of monetary policy. This has been the case for many years but, as economic developments in the past 15 years both domestically and abroad witnessed, asset prices are increasingly playing an important role in the transmission mechanism of monetary policy. An important characteristic of asset prices is that they fluctuate reflecting expectations for the future. Although a central bank cannot manipulate asset prices, given that information from a central bank could affect their movements, it is extremely important to accurately communicate its policy intention by enhancing transparency.

So far I have used the abstract phrase “transparency of monetary policy.” Let me be a bit more specific. I think enhancing the transparency of monetary policy has three aspects. The first concerns the goal of monetary policy. The second is about the central bank assessment of the economy. The third is, given such goals and assessment, the policy response. If there is a perception gap between critics and the Bank, where does such a gap exist?

With regard to the first aspect, i.e. the goals of monetary policy, the Bank of Japan Law clearly stipulates that policy should aim “at, through the pursuit of price stability, contributing to the sound development of the national economy.” The Bank has also adopted monetary easing measures in a determined manner aiming at overcoming deflation. This is evident in our policy commitment to continue the current easing framework until CPI inflation stably registers zero percent or a year-on-year increase.

In this regard, there are some that believe the Bank of Japan should adopt an inflation targeting framework. As I have talked about this subject on other occasions, I will not go into detail today but would like to make just one comment. That is, in an environment where a zero interest rate constraint exists and a central bank lacks effective policy measures to raise inflation rates, the adoption of inflation targeting would not only fail to improve the transparency of policy-making but could also hurt the credibility.

Next, on the second aspect of transparency, that is the assessment of economic and financial developments, the Bank communicates the views of Policy Board members to the public in its monthly report. The Bank also publishes the Outlook report every six months which contains a forecast of prices and growth rates by Board members as reference.

How about the third aspect of transparency, that is the policy response with the given policy goals and economic assessment? Some critics raise harsh questions as to how current monetary policy is related to the policy goal of the Bank’s monetary policy, which is price stability. On this point, the Bank is facing difficulty in winning full public understanding, largely due to the fact that views differ on some important issues, namely how to interpret the background to current mild deflation and also how to assess the effects of quantitative easing under the zero interest rate constraint.

For example, many of you might have heard the mantra-like argument which claims that ‘deflation is a monetary phenomenon.’ I think this phrase comes from the famous proposition by a Nobel laureate economist Milton Friedman. Based on research into the monetary history of the US, he said that “inflation is always and everywhere a monetary phenomenon.” I do not know if rampant inflation and mild deflation can be symmetrically treated as ‘monetary phenomenon.’ If I may quote another giant, John Maynard Keynes offered a different view on deflation. In “A Treatise on Money” published in 1930, Keynes referred to British deflation in the late 19th century and wrote “I consider, therefore, that the history of this period is a perfect example of a prolonged commodity deflation - developing and persisting in spite of a great increase in the total volume of bank money.”

As a central banker, I am increasingly convinced that, when facing an unprecedented situation, what is required for us is to take a pragmatic approach without being dogmatic. It requires considering the background and possible solutions by referring to available theories and historical experience both at home and abroad and by analyzing the observed hard facts.

Recalling various economic changes in the past, it is surprising that we could not recognize many such changes on a real-time basis. We often have difficulty in recognizing changes when they are taking place. This can be said in the case of the rise and bursting of the financial bubbles and the development of IT technology. Ongoing global disinflation, which is demanding the attention of central banks worldwide, could turn out to be a major change in retrospect.

If we look at CPI inflation at the end of last year, in East Asia, the Taiwan Province of China, Hong Kong SAR, Singapore, Malaysia and China recorded negative figures. Looking at the G7 countries, all except two registered inflation rates below 2%. Such a trend is more evident if we look at WPI or PPI inflation. The Taiwan Province of China, Hong Kong SAR, Singapore, Malaysia, China and Korea registered negative inflation rates as did all the G7 countries with the exception of Canada and Germany. Such price developments must to a large extent reflect cyclical economic weakness but may also be affected by other factors.

6. Closing remarks

Japan's economy currently faces various challenges. The Bank of Japan also faces an unprecedented economic environment in the history of central banking characterized by the zero interest rate constraint and the non-performing loan problem. To cope with the challenges, the Bank has been making its utmost efforts.

I believe that, in order to fully perform its duty, a central bank needs to be able to accurately assess the economic environment, demonstrate a strong will to conduct appropriate monetary policy, and explain its policy fully. With this in mind, we will continue to exert our best efforts.

Thank you for your kind attention.