Masaru Hayami: The challenges facing Japan's economy

Speech by Mr Masaru Hayami, Governor of the Bank of Japan, at the Naigai Josei Chousa Kai (The Research Institute of Japan), Tokyo, 24 July 2002.

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I. Introduction

Led by an increase in exports and production, Japan's economy is entering a cyclical recovery for the third time in ten years. During the previous two recoveries, during 1993-1996 and 1999-2000 according to the Reference Date of Business Cycle of the government, momentum disappeared over a period of several months against a background of a slowdown in overseas economies and uncertainty surrounding the domestic financial system, and the sustainable growth of private domestic demand was not realized.

Today, I would like to talk about the conditions and challenges for the economy to firmly return to a sustainable growth path this time around when some signs of recovery are finally being seen. In doing so, I will focus on three issues. First, how to strengthen the financial intermediary function. Second, the complete removal of the blanket deposit guarantee scheduled for April 2003. And third, the important role of the private sector in structural reform.

II. Recent economic and financial developments and monetary policy

A. Current economic situation

After the deterioration from the beginning of 2001 because of sharp downward pressure from IT-related industries worldwide, Japan's economy has been showing some positive signs due to a surge in exports reflecting the recovery of overseas economies. Against this background, inventory reduction has progressed rapidly, and production has recovered significantly. In addition, the TANKAN (Short-Term Economic Survey of Enterprises in Japan) survey released early this month showed an improvement in corporate business sentiment.

While we factored in, to a certain degree, the recovery of exports and production in the April issue of our Outlook Report (Outlook and Risk Assessment of the Economy and Prices, issued twice a year in April and October), the recovery is now slightly stronger than was expected at that time.

However, domestic private demand components continue to be sluggish reflecting the severe employment and income conditions, and downward pressure stemming from corporate balance sheet adjustment.

Nevertheless, there are some positive signs in domestic demand reflecting the increase in exports and production. Some business fixed investment indicators, such as machinery orders in the manufacturing sector, are showing signs that they have stopped declining. In addition, new job offers and overtime hours are slightly increasing reflecting the rise in production.

Wholesale prices have been leveling out since February reflecting higher import prices and improvement in the supply-demand balance which is due to the completion of inventory liquidation. However, consumer prices have continued to decline moderately.

B. Economic outlook

Despite such positive signs, prospects for economic recovery have not necessarily become solid. Uncertainty has increased somewhat recently because of the fall in US stock prices and the US dollar, and their effects on Japan's export conditions through developments in the US economy.

The recent declines in US stock prices and the dollar seem to have been brought about by factors such as corporate accounting malfeasance, concern about the political situation worldwide, and cautious views about the outlook for the US economy. While recent economic indicators generally suggest that the US economy is recovering and that productivity has been continuing to increase, there is caution with respect to business fixed investment and corporate profits.

With such developments in mind, we need to stay vigilant for a while about developments in the US economy, international capital flows inclusive of Latin American countries, stock prices worldwide, and foreign exchange markets.

C. Recent monetary policy

Next, I would like to move on to the recent conduct of monetary policy.

In March last year when overnight interest rates reached virtually zero, the Bank, firmly determined to halt the continuing fall in prices, adopted a new framework for money market operations by shifting the operating target to the 'quantity' of liquidity, namely the outstanding balance of current accounts held at the Bank. Under the new framework, the Bank has conducted decisive monetary easing which is unprecedented in the history of central banking both at home and abroad.

As a result, short-term interest rates across the board have declined to virtually zero percent, from overnight call rates to those with three-month and six-month maturity. Medium- to long-term interest rates have also declined to extremely low levels. For example, yields on three-year JGBs are currently at 0.1-0.2 percent, and those on five-year JGBs are at around 0.4 percent. The growth rate of the monetary base, an indicator of the amount of funds provided by the Bank, has been increasing considerably at a rate close to 30 percent year on year. The ratio of monetary base to nominal GDP has been at its highest level in Japan's history, except during World War II.

Monetary easing has played an important role in preventing deterioration of the economy and has secured financial market stability. This was especially so when the economy was under significant downward pressure following the terrorist attacks in the US and also when concern about financial system stability heightened from the end of December last year to the end of March this year.

Since April this year, the economy has started to show positive signs, and liquidity demand in financial markets has gradually stabilized reflecting the abatement of concern about financial system stability. However, as mentioned earlier, the economic recovery is still in a nascent stage and there are also risks for the economic outlook. The Bank should therefore continue strong monetary easing to support recent positive movements.

As I mentioned earlier, it is extremely difficult to revitalize Japan's economy solely by monetary easing when it faces various structural problems. However, the Bank's strong monetary easing will continue to firmly underpin the recovery of the economy by stabilizing financial markets. Furthermore, it is expected that the effects of the Bank's monetary easing measures will be fully felt when forward-looking economic activity increases as structural reform progresses and efforts to strengthen the financial system bear fruit.

III. Strengthening the financial intermediary function

As Japan's economy is finally showing signs of recovery, whether the financial system can fulfill a growing need for funds in the course of the recovery is the key to ensuring a return to sustainable growth led by private demand.

At the same time, it has been tackling the non-performing loan, or NPL, problem, which is a negative legacy from the past. Financial institutions should strive to promote the disposal of NPLs while reviewing unprofitable loans, a process which could be painful for many firms. However, there is basically no contradiction between fostering soundness of banking business and fortifying the financial intermediary function.

I would like to outline three key tasks that need to be addressed in strengthening the financial intermediary function while improving financial system soundness.

A. Securing lending margins

First, it is important for financial institutions to set lending rates in line with credit risk (risk-based pricing).

At present, a large proportion of the loan assets of financial institutions are, in fact, unprofitable if default risk is taken into account. This is evidenced by the fact that NPL disposals by financial institutions have exceeded their 'core' profits, in other words interest rate margins obtained from lending, in each of the eight years since 1994. The risk-based pricing of lending rates is to secure the lending margins of financial institutions. It is essential that financial institutions fortify their financial strength by striving to dispose of NPLs, reduce credit costs, and secure lending margins.

I would like to emphasize that risk-based pricing is vital not only for financial institutions to increase profitability and secure soundness but also for firms to expand their opportunities to procure funds.

Risk-based pricing will more than ever require firms to decide the size of their debts according to risks arising from their business and borrowing costs. At the same time, firms will be able to obtain necessary credit as long as they pay interest margins which cover the risk. Firms in a serious financial situation can also seek ways to overcome difficulties by clarifying how they can improve their business and financial situation and thereby lower borrowing costs through close dialogue with financial institutions. In Japan today, the mainstream of lending is corporate financing, which largely depends on the creditworthiness of firms. Further use of other types of lending, such as project finance that focuses on the profitability of a project itself would, in my judgement, strengthen the financial intermediary function.

During the bubble period, financial institutions did not put much weight on examining firms' profitability and risks when negotiating lending conditions, as they believed that collateral would always secure their loan assets and land prices would never fall. This is no longer the case, and in this regard I welcome the recent move on the part of financial institutions to strive to maintain close contact with firms to ensure common understanding about their profitability and risks.

Financial institutions have only recently started to further utilize risk-based pricing and there is still room for further improvement, but, at the same time, the financial strength of firms needs to be bolstered to support financial institutions' lending margins. Thus, it will certainly take a while for the positive effects of risk-based pricing to prevail in the banking sector.

B. Securitization and sale of loan assets

The second important task for strengthening the financial intermediary function is expanding markets for the securitization and sale of loan assets, and extension of commitment lines by financial institutions.

The secondary market for loan assets has been developed. In this market, loan assets, which are usually held by financial institutions until maturity, are traded among institutional investors and other financial institutions. Furthermore, a market for loan syndication is also being fostered whereby lending rates are determined at the time of loan extension for resale in the market for loan assets. The outstanding balance of loan assets transferred to a third party by the original lender institution amounted to 6 trillion yen at the end of June. This, however, accounts for only a small portion of total bank loans of 433 trillion yen.

Development of the secondary market for loan assets will contribute to strengthening the financial intermediary function in two ways. First, it enhances the transparency of the pricing of credit risks and enables risk-based pricing because credit risks attaching to loan assets that are traded can be evaluated by markets on a continuous basis. And second, it strengthens the financial intermediary function of financial institutions while maintaining their capital base. In addition, it efficiently reallocates risks among investors who are willing to, and have capacity to, take risks, and thus the capacity to take risks in the financial system as a whole will increase.

Financial institutions can extend commitment lines. A commitment line is a contract between a bank and a corporate client which legally obliges the bank to extend loans upon request up to the amount and the term of validity which are agreed in advance. In this way, firms can obtain credit flexibly and at the same time streamline their balance sheets. Since their introduction in 1999, commitment lines have been widely used as a means of fund-raising not only by large firms but also small and medium-sized ones. The contract amount of funds extended by commitment lines is slightly over 14 trillion yen, accounting for 3 percent of the total loans of financial institutions. I consider that the potential need for this type of funding is huge bearing in mind continuing efforts by firms to cut interest-bearing debt and improve their financial position.

C. Expansion of the role of the capital market

The third important task is to further develop the capital market. In Japan where bank lending (indirect financing) rather than capital markets (direct financing) is the main channel of financing, the financial intermediary function depends heavily on the soundness of financial institutions, and this has been reaffirmed by events of recent years. Fostering intermediary channels for raising funds through markets while achieving an appropriate balance between direct and indirect financing will help to buffer external shocks, thereby contributing to financial system stability.

Given current economic and industrial structural changes, how to smoothly provide funds for innovative and new business efforts is another important issue to be addressed. It is essentially the responsibility of capital markets, such as the stock and bond markets, to provide funds to such businesses which are 'risky but quite promising.'

Even though Japan's capital markets have been growing recently, there seems to be room for further growth.

Firstly, funding from the capital market has been marking a year-on-year increase while bank lending has been declining. The share of corporate bonds and commercial paper (CP) in total fund raising has recently increased to around 20 percent. In the US, however, there is a wide range of markets from those for AAA-rated bonds to those for non-investment grade bonds, thus fulfilling a variety of corporate fund-raising needs. In Japan, the corporate bond and CP markets are virtually limited to bonds issued by firms with relatively high credit ratings.

Secondly, markets for asset-backed securities (ABS) and asset-backed CP (ABCP) where firms raise funds by securitizing their assets such as sales credits and loan credit receivables have been rapidly expanding, but the volume and liquidity of these markets are still limited compared with those in the US.

D. Role of the government and that of the Bank

I have mentioned three important tasks to be undertaken to improve the financial intermediary function of the financial system. If steady progress is made, funds necessary for economic growth can be supplied in significant quantities.

That said, the role of the government is also significant in preparing an environment conducive to strengthening the financial intermediary function.

For example, in Japan, the loans extended by government financial institutions have generally been on an increasing trend as a proportion of total loans in the past ten years, accounting for some 20 percent, a level with no precedent in other countries. If the proportion is too high, depending on the financial environment, private financial institutions will have difficulty in carrying out lending activities based on market principles. From the viewpoint of promoting risk-based pricing, the role and function of public financial institutions should be discussed taking into account the prevailing financial environment.

An adequate investment-related tax system and also disclosure system are very important infrastructure for smooth provision of risk capital. Investment trusts are crucial in providing a bridge from household savings to capital markets. Since the failure of Enron last fall, investors have been shifting their money away from investment trusts because some money market mutual funds that held Enron bonds fell below par. The recognition of risks and return through appropriate disclosure will be necessary to create mature markets for financial instruments including bonds and investment trusts.

The Bank is also supporting private sector efforts to strengthen the financial intermediary function in various ways.

As mentioned earlier, we are taking decisive monetary easing measures. These measures are also contributing to smooth corporate finance through encouraging positive lending activity on the part of financial institutions by dispelling concern about liquidity, and keeping extremely low the market interest rates which serve as a benchmark for setting lending rates.

The Bank is constantly reviewing the operational tools for money market operations from the viewpoint of ensuring the effectiveness of monetary policy, paying due regard to the development of financial and capital markets. For example, in October 1999 and in December 2001, the Bank decided to accept ABSs and ABCP as eligible collateral in conducting money market operations. These measures not only enhance the Bank's ability to provide funds, but also foster capital markets. The Bank is also actively taking part in projects to improve market infrastructure, such as improving securities settlement systems and setting rules regarding market practices.

E. Change in the financial system and financial institution lending

I should add that while all three ways mentioned will contribute to improving the financial intermediary function, they may not necessarily lead to an increase in loans outstanding extended by financial institutions in the short run. Arguably, financial institution lending is an important channel for monetary easing effects to permeate the economy. In the process of disposing of excessive debt and NPLs, however, it should be noted that total loans outstanding could decrease as the financial intermediary function operates more smoothly and strengthens.

IV. Financial system challenges arising from the complete termination of blanket deposit guarantee

Toward the end of March this year, a significant amount of deposits shifted from time and savings deposits to demand deposits ahead of the April termination of blanket deposit guarantee for time and savings deposits. Though the shift gradually weakened after April, it seems that depositors are still risk-averse in general. Developments in the run-up to next April when blanket deposit guarantee will be completely terminated, for example the movement of funds and the possible effects on the financial intermediary function of financial institutions, are key issues not only in terms of financial system stability but also for the economy which is entering a recovery phase.

In this regard, an imminent task for Japan's financial system is to ensure that the termination of blanket deposit guarantee passes without any undue disruption. Individual financial institutions must make further efforts to secure market and depositor confidence by further advancing measures to dispose of NPLs.

A. Voices calling for the postponement of the complete termination of blanket deposit guarantee

A view that the planned complete termination of blanket deposit guarantee in April 2003 should be postponed has started to gain some ground. The background to this is the considerable shift of funds from time and savings deposits to demand deposits which took place this spring before the partial lifting of deposit guarantee.

Until the end of fiscal 2001, the government fully protected deposits whenever financial institutions failed, in order to restore financial system soundness by disposing of NPLs and non-viable financial institutions while maintaining system stability.

However, we cannot maintain such generous measures indefinitely that insure deposits for an amount exceeding that covered by the normal deposit guarantee scheme, that is, any amount exceeding 10 million yen in principal and interest, since it would increase moral hazard. Thus, it was decided that blanket deposit guarantee would be terminated on all deposits next April after a transition period this fiscal year during which demand deposits are fully protected.

Given this, I believe it undesirable to maintain blanket deposit guarantee for demand deposits indefinitely.

Needless to say, in order to terminate blanket deposit guarantee, circumstances should allow for depositors to have confidence in individual financial institutions. To this end, it is essential to clearly indicate the path to overcoming the NPL problem.

Prospects for overcoming the NPL problem are, unfortunately, not yet clear at this stage despite the large disposal of NPLs to date, as new NPLs have been emerging. In addition to the problems of the excessive debt of large firms, an issue even more crucial from now on in relation to the NPL problem will be the disposal of NPLs to small and medium-sized firms in financial difficulty due to structural adjustment. Financial institutions need to make further efforts to dispose of their NPLs.

B. Introduction of impairment accounting and the new Basel Capital Accord

In relation to the disposal of NPLs, two issues must be borne in mind besides the removal of blanket deposit guarantee. One is the introduction of impairment accounting and the other is the revision to the capital adequacy regulatory framework. The idea of fixed asset impairment accounting rules is that when the profitability of firm's fixed assets is lower than planned, the rules require firms to recognize the difference from initial plans as a loss, the aim being to narrow divergence between firms' balance sheets and their actual business condition. The Business Accounting Council released a draft of the accounting rules this April, and fixed asset impairment accounting rules are scheduled to be introduced from fiscal 2005.

The Basel Committee on Banking Supervision, an international forum on banking supervision, is considering revising international bank capital adequacy requirements with a view to implementing the revised requirements from the end of 2006.

The most important point of the revision is in line with that of the introduction of impairment accounting rules. The new accord will introduce a mechanism that acknowledges any deterioration in the value of financial institution's loan assets at an early stage and requires banks to promptly increase their capital relative to the risks associated with a loan project and any change in degree of risk. Under the current 1998 Basel Capital Accord, financial institutions are required to hold the minimum requirement of 8 percent of capital to corporate loans, while under the new accord they will estimate the probability of default associated with each borrower according to its business condition and hold capital based on such estimates. Leading banks overseas have already adopted practices to acknowledge in a timely manner any deterioration in the value of loan assets within their credit risk management framework.

C. The need to promote the disposal of NPLs

Financial institutions should make every effort to address business management tasks, including the disposal of NPLs, in preparation for the introduction of the new accounting rules and regulatory changes. If the complete removal of blanket deposit guarantee were to be postponed without such efforts being made on the part of financial institutions, this would merely be putting off the decision.

To overcome the NPL problem, it is important that financial institutions make, in advance, loan-loss provisions sufficient to dispose of their NPLs. Financial institutions are, then, expected to make further use of various measures that have been introduced to date such as the expanded function of the Resolution and Collection Corporation and the guideline on out-of-court procedures for corporate reconstruction.

Financial institutions that have used up most of their cushion of capital might be confronted with an inadequate capital base when they carry forward measures to drastically dispose of NPLs. If this gives rise to serious concern about a loss of confidence in the financial system as a whole, measures such as the injection of public funds should be taken in a timely manner, as I have repeatedly said in the past. If public funds are to be injected, it is essential that the receiving institutions implement measures to improve their profitability such as a comprehensive review of their business and corporate restructuring.

As the central bank, we will also swiftly implement necessary measures to maintain financial system stability, including the provision of liquidity, based on an accurate grasp of the situation through careful monitoring.

V. Role of the private sector in structural reform

My last topic today is structural reform in Japan.

The necessity of structural reform measures is already widely recognized, and I have talked about the subject on various occasions. So today, I will limit myself to two points that may be the starting point of structural reform.

A. The important role of the private sector

The first is the significance of active participation by the private sector in pursuing structural reform.

The government regards structural reform as an important task. In June this year, the so-called "Basic Policies 2002 (Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2002)" were decided which proposed concrete measures on issues such as economic revitalization, tax reform, and a review of government expenditure. However, what I feel somewhat lacking in recent discussions is the fact that the leading role in structural reform should always be played by private economic entities, that is, individual enterprises.

Structural reform means reallocation of production resources such as labor, land, and capital to enhance productivity in the overall economy in response to significant changes in the economic environment such as economic globalization, aging, a declining birthrate, and the bursting of bubbles. It is not the government that decides how such resources should be reallocated. Efficient reallocation can only be realized through the economic activity, such as production and investment, of individual enterprises under the market mechanism. The same applies to overcoming financial system problems. The main force in enhancing the financial intermediary function is the profit incentive of financial institutions and investors.

Tax reform, deregulation, and the review of pension and medical systems currently being promoted by the government are indeed important. However, these are basically done to provide an environment that promotes free and creative activity on the part of individual enterprises.

We need not recite the words of Schumpeter, a prominent economist in the 20th century, to know that one of the important driving forces promoting economic growth is innovation by entrepreneurs. Historically, there are countless examples both in Japan and abroad where innovative enterprises and entrepreneurs started new businesses by combining available technology and resources, which created demand, and as a result enriched the overall economy. Therefore, I have little doubt that new business chances will emerge in line with changes in the financial and economic structure, and I look forward to seeing both enterprises and individuals pursuing innovation.

B. Potential strength of the economy and timeframe for reform

The second point of structural reform is the potential strength of Japan's economy and the timeframe for such reform. Looking at recent arguments on the progress of structural reform, it is not hard to find ones which take a pessimistic line. Indeed, while the situation may not justify an optimistic view, excessive loss of confidence may hinder momentum for reform.

Looking back, the Japanese economy has, over the years, overcome various big changes in the economic environment such as the termination of convertibility of US dollar into gold, two oil shocks, and the Plaza Accord. All these severely impacted the terms of trade of a country with poor natural resources and a high degree of dependence on trade. In each of these adjustment phases, Japan experienced drastic restructuring, the exit of weak enterprises, and a change in industrial structure. However, from the efforts and ideas to overcome such 'pains,' higher value-added products that satisfied the needs of the times that called for energy-saving products, diversification of life styles, and environmental concerns, were created and in turn enriched the Japanese economy. Japan would not be what it is today if it just avoided pains. And, I would like to stress that all this was achieved by none other than our nation's private sector.

Since the aftermath of the bursting of asset bubbles still lingers, the structural reform our economy needs may perhaps be more challenging than changes in the economic environment, which we have often experienced in the past. While it goes without saying that we need to quicken the pace of structural reform, it is also true that such reform cannot be accomplished in a short time.

The 1990s are often called 'the lost decade', but I do not think they were. Both in the industrial and financial arena, we have already seen reorganization and cooperation on a scale that was unimaginable ten years ago. New business models adapting to globalization are beginning to emerge. Cross shareholdings, keiretsu relationships, and long-term employment are being reviewed in response to recent changes in the economic environment. Corporate governance is also changing steadily. As a successful outcome of these developments, export-oriented enterprises are able to secure profits even in the severe environment presented by a sharp decline in production in the IT industry and increasing productivity in China and other East Asian economies. Though there are no real observable results in the overall economy, I believe that these individual efforts will in the end bear fruit.

Fortunately, our country has abundant personal financial assets and foreign claims. This means that unlike countries where weakness in the economy directly leads to external debt repayment problems, Japan can ensure the necessary timeframe for reform. This is our country's strongest advantage and may perhaps also be a weakness in that our sense of crisis may be lacking. We know where the problems lie.

I would like to conclude my speech today by repeating that the present situation, where economic recovery is beginning to be seen, is a good opportunity to overcome the challenges with a clear will and vision.

Thank you for your attention.