

Toshihiko Fukui: An overall review of the Bank of Japan's conduct of monetary policy

Statement by Mr Toshihiko Fukui, Governor of the Bank of Japan, concerning the Bank's Semiannual Report on Currency and Monetary Control, before the Committee on Financial Affairs, House of Councillors, Tokyo, 24 July 2003.

* * *

Introduction¹

The Bank of Japan (hereafter, the Bank) submitted its *Semiannual Report on Currency and Monetary Control* for the second half of fiscal 2002 to the Diet in June 2003. I am pleased to have this opportunity to present an overall review of the Bank's conduct of monetary policy.

Today, I would like to make some remarks on the Bank's view of recent economic and financial developments and on the thinking behind our recent conduct of monetary policy.

I. Developments in Japan's economy

Economic activity remains virtually flat. Private consumption continues to be weak due to the severe employment and income situation. On the other hand, business fixed investment is on a gradual recovery trend, albeit showing some fluctuations, reflecting the improvement in corporate profits. Net exports are virtually flat.

Looking at the economic outlook, it is expected that the uptrend in exports and production will gradually resume, and this in turn will initiate the momentum for an economic recovery. This reflected expectations that growth rates in overseas economies will accelerate in the second half of 2003 partly due to diminishing uncertainty over the situation in Iraq and severe acute respiratory syndrome (SARS).

The June *Tankan* (Short-Term Economic Survey of Enterprises in Japan) released by the Bank at the beginning of July 2003 showed that corporate profits were projected to continue their uptrend and also confirmed that business fixed investment was on a recovery trend. However, the recovery in domestic demand is likely to remain modest for some time, since excessive labor input and debts continue to exert downward pressure. As for the environment for exports, there continues to be substantial uncertainty about the recovery of the U.S. economy, while on the domestic front, developments in the financial system and the financial and capital markets continue to require close monitoring.

Regarding prices, consumer prices are projected to continue falling at the current moderate pace for the time being due to the following factors. First, the weakness in demand, technological innovation, and the streamlining of distribution channels continue to exert downward pressure on prices. Second, imports of low-priced consumer goods are still increasing, although only very gradually.

Developments in financial markets have been stable on the whole as the Bank has been providing ample liquidity. In capital markets, stock prices have risen considerably and long-term interest rates have risen, as market participants' pessimistic view of the outlook for the economy and prices has subsided slightly across the world.

In corporate finance, the fund-raising environment continues to be easy on the whole. However, the environment for firms with relatively high credit risk remains severe.

II. Conduct of monetary policy

It has been three months since I presented my previous statement regarding the *Semiannual Report on Currency and Monetary Control*. Since then, the Bank has implemented monetary policy measures

¹ Governor Fukui made almost the same statement regarding the *Semiannual Report on Currency and Monetary Control* for the second half of fiscal 2002 before the Committee on Financial Affairs, House of Representatives, on July 16, 2003.

in a timely manner against the background of increasing uncertainty about the outlook for the Japanese economy.

At the Monetary Policy Meeting on April 30, 2003, the target for the outstanding balance of current accounts held at the Bank was raised by 5 trillion yen. At that time, there was still considerable uncertainty about the prospects for recovery in the U.S. and European economies and the impact of SARS was a matter of concern for East Asian economies. On the financial side, stock prices in Japan, especially for bank stocks, remained weak and volatile. Taking account of this increasing economic and financial uncertainty, the Bank decided to raise the target for the outstanding balance of current accounts to maintain financial market stability and thereby strengthen support for economic recovery.

In the middle of May 2003, the Bank implemented further policy measures to provide support from the financial side after the emergence of problems at Resona Bank. The Bank decided to provide liquidity to Resona Bank when necessary, including loans pursuant to Article 38 of the Bank of Japan Law, which do not require submission of collateral. Furthermore, regarding its money market operations, the Bank decided to further raise its target for the outstanding balance of current accounts by 3 trillion yen to ensure an ample provision of funds. This reflected greater uncertainty about the outlook for the Japanese economy due partly to instability in the stock and foreign exchange markets, in addition to uncertainty about overseas economies. With such significant uncertainties, the risk of further instability in financial markets adversely affecting economic activity was a cause for concern. However, owing to the timely implementation of a series of measures by the Bank, overall conditions in financial markets have remained calm and no funding problems have been observed at Resona Bank.

Subsequent developments seem to suggest that uncertainty about the outlook for the Japanese economy has become somewhat less pronounced.

Regarding developments in overseas economies, which have a considerable effect on Japan's exports, the uncertainty about the U.S. economy has subsided to some degree, and the SARS problem in East Asian economies has been coming to an end. Against this background, in Japan's capital markets, participants' pessimism with regard to the economy and prices has decreased slightly, and stock prices have risen considerably. Bank stock prices in particular have rebounded significantly. In this situation, long-term interest rates rose after falling to their historic lows of 0.4-0.5 percent.

As mentioned, some positive developments were observed, but there remained various structural problems in the Japanese economy. The Bank will continue its efforts to conduct monetary policy in a timely manner, monitoring carefully the strength of the recovery in overseas economies, the state of the financial system, and developments in financial and capital markets.

The Bank is working to strengthen the transmission mechanism to ensure that the effects of monetary easing permeate throughout the economy. As part of its efforts in this regard, the Bank has been preparing to commence purchases of asset-backed securities (ABSs) from July 29, 2003. Although it is unusual for a central bank to directly take on the credit risk of private debt obligations, the Bank considers that, with the weakness of banks' financial intermediary function, it is important to encourage the development of the ABS market.

In formulating the specific details of ABS purchases, the Bank has paid due attention to contributing to the smooth financing of small and medium-sized firms. With regard to underlying assets, a broad range of assets will be deemed eligible, including receivables, loans, and lease claims. Furthermore, the Bank has decided to purchase securities with a BB rating or higher. This decision is based on the fact that there have been only a few investors purchasing securities with lower credit ratings, and this has been impeding development of the ABS market. The ceiling on the Bank's purchases is to be set at 1 trillion yen for the time being.

The ABS market is expected to become one of the most important financial markets in Japan in the future. The Bank hopes that the Bank's purchase of securities will contribute to the autonomous development of the market.

III. Purchases of stocks held by commercial banks

The Bank started to purchase stocks held by commercial banks from November 2002 to reduce the risk that stock price fluctuations might impact negatively upon the business management of individual financial institutions, potentially resulting in instability of the financial system as a whole. The total amount of stocks purchased by the Bank as of July 20, 2003 was 1,505.9 billion yen.

Conclusion

As mentioned, in response to the severe economic situation, the Bank has been bold in its implementation of measures deemed necessary, including measures that are unusual for a central bank. At the same time, the Bank is making efforts to ensure its financial soundness by appropriately assessing the risk associated with holding new assets. The Bank considers its financial soundness to be fundamental to ensuring its ability to conduct monetary policy into the future and to maintaining the public's confidence in the currency.

Japan's economy is still striving to construct a new system to accommodate the significant changes that have occurred since the late 1980s, such as globalization, innovations in information and communication technology, and societal aging and the declining birth rate. Given the various constraints involved, this is a formidable challenge. Nevertheless I believe that, by putting to use the high levels of technology and creativity at Japanese firms, our economy will ultimately succeed in realizing this goal.

While taking into account the private sector's efforts, the Bank, for its own part, will continue to do its utmost to overcome deflation and put the economy back on a sustainable growth path.