Toshihiko Fukui: On stabilisation policies - a central banker's reflection

Remarks by Mr Toshihiko Fukui, Governor of the Bank of Japan, at The Bank of Korea International Conference 2005, Seoul, 27 May 2005.

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1. Introduction

Good morning, ladies and gentlemen. It is my privilege to speak at the beginning of the Bank of Korea's international conference.

At the outset, please allow me to strike a personal note. I meet with BOK Governor Park rather frequently, maybe four or five times a year. At the end of each of our conversations, I am impatient for our next meeting. Therefore, it is a tremendous pleasure to see him again this morning, although it is only a month since we had lunch together on a southern Japanese island.

Like our personal relationship, official ties between our two central banks are also close. To avoid using up the time accorded to me, I just point out the fact that, for the first time in many years, the Bank of Japan posted one official at the Japanese embassy in Seoul to cultivate better communication with the Bank of Korea and other contacts here.

Today's symposium covers a broad range of aspects of macro-economic stabilization policies - that is, monetary and fiscal policies. While the phrase "stabilization policies" has been popular for nearly half a century, we can interpret this in a variety of ways. Believing that the profundity of this topic will be revealed in the sessions today, I would rather like to present my personal reflections on Japan's economic policy management over the past two decades when we struggled to stabilize our economy.

2. Japan's success and failure

Let me begin with a brief sketch of what Japan's economy went through after World War II.

We began the post-war reconstruction by creating a uniquely Japanese system. It was built on a tight nexus of the social, political and economic apparatus, with top priority given to attaining high economic growth. Among the striking features of this system were political stability, strong bureaucracy, and lifetime employment. The so-called "iron triangle" between politicians, bureaucrats, and business people was very powerful in promoting growth-oriented business models and building an export-led industrial structure. As it turned out, this was a marvelous success.

Unfortunately, success creates inertia - an intrinsic resistance to change, even when the old system begins to falter. From the early 1980s, globalization and technological innovation began transforming the world economy, posing new challenges for Japan's economy. External imbalances and trade friction led to the currency re-alignment of the Plaza Accord in 1985. This put deflationary pressures on Japan's economy, while making traditional segments of our economy obsolete.

In order to fend off the deflationary forces, Japan made full use of macro-economic policies. The government stepped up fiscal spending to boost domestic demand. The Bank of Japan (BOJ) eased monetary policy for an extended period of time, consequently fuelling the rapid boom in the economy.

Together with various structural factors, these expansionary policies spawned distortions in Japan's economy. To name just a few examples, we saw a nation-wide surge in resort area development at the expense of our green environment. We embarked on the re-development of metropolitan Tokyo to make it an international financial hub, but with little coherent strategy in hindsight. Fiscal profligacy by the government, which I referred to just a few seconds ago, resulted in the building of local roads and ports barely used by travelers - a classical faux pas of pork-barrel politics.

Such economic frenzy generated irrational growth expectations, further prompting excessive investment in both real and financial assets. As you know, the upshot of this euphoria was the asset bubbles and their subsequent bursting.

All these episodes point to one thing: despite the substantial changes in its external circumstances, Japan was not able to depart from the development model it cherished during the economic catch-up period. We had many discussions about how to reform our system in the face of the headwind against

Japan's economy after the Plaza Accord, but we did not follow our words with action. Put differently, it was a reform by word, not in deed.

After the collapse of the economic bubbles in the early 1990s, we finally learned that every boom must evaporate some time. An aging population and declining birth rate also forced us to acknowledge the need to revamp our modus operandi so that we could remain viable in global competition. This perception shift marked the beginning of the long adjustment phase from the mid-1990s - a harrowing decade when Japan's private and public sectors tried to reinvent themselves.

The corporate sector tried hard to get rid of the negative legacies of the bubble era - that is, excesses in production capacity, labor, and debt. Although hard hit by falling employment and wages, the household sector endured relatively well during this painful adjustment.

As the old financial system suffered setbacks amid the bubble burst, Japanese financial institutions faced a mountain of non-performing assets. In the process of cleaning them up, banks not only exhausted the wealth they had accumulated during the high-growth years, but also had to rely upon government bailouts.

In the 1990s, the Japanese government provided large fiscal stimuli to prevent economic stagnation from worsening. But it also pursued deregulation, as a supply-side measure, to foster business formation and innovation.

What did the Bank of Japan do in this adjustment process? We began to ease monetary policy in July 1991, when the consumer price index still registered an increase of around 3%. In September 1995, the official discount rate dropped to 0.5%, the lowest ever recorded in the history of central banks in the world. In February 1999, the BOJ adopted the zero interest rate policy, followed eventually by the quantitative easing policy - again unprecedented in central bank history - that has been in place since March 2001.

Monetary easing in this unprecedented fashion cushioned depressive ramifications from the structural adjustment in the corporate and personal sectors. Also, the ample provision of funds by the BOJ was effective in reducing liquidity squeeze in financial markets at a time when systemic instability and credit crunch were the real threats to the Japanese financial system.

After 13 years of policy struggles, progress has begun to materialize in unwinding past excesses. Major Japanese banks are now in much better shape. Corporations are posting brighter earnings outcomes than ever, and household incomes have begun to improve.

Against this backdrop, we removed the blanket deposit insurance on April 1st, 2005. Considering that the blanket guarantee was maintained as a financial emergency measure, Japan's economy has passed a critical milestone. The next milestone will be passed when Japan brings its economy back on a sustainable growth path.

From the medium-term perspective, Japan needs to carry out the structural overhaul of its public sector, too. For instance, the legacy of an activist fiscal policy throughout the 1990s is still with us, as shown by the huge public debt nearing 160% of our GDP. This leads us to conclude that fiscal consolidation should be examined in a well thought-out manner. Re-designing our social security system in the context of demographic adversity is another policy imperative. No doubt, these are large challenges.

3. Policy lessons from Japan's experience

At this juncture when Japan's structural adjustment has come quite a distance, it might be informative to take stock of some monetary policy implications from our decade-long struggle.

First, in connection with the leitmotif of today's conference, we should not restrict central banks' stabilization policy to a narrow domain of macroeconomic management. There could be circumstances where a central bank needs to play a critical role in safeguarding the stability of the financial system.

In addition, the effectiveness of monetary policy hinges crucially on the proper functioning of financial markets and the financial system. This is because monetary policy is implemented through central banks' lending, deposit-taking, money-market operations, and other activities in financial markets. If financial stability is at risk, central banks' policy would be severely constrained.

Throughout the 1990s, the BOJ conducted its policy while paying close attention to the condition of the financial markets and the financial system. This was especially true in the late 1990s when the systemic dysfunction of our banking system was apparent.

Second, central banks need to tackle two elusive but inter-related questions: how do asset price fluctuations affect economic stability; and how should a central bank respond to big swings in asset prices?

A de-coupling of asset prices and general prices is not necessarily rare. Besides Japan's anomalous experience in the bubble period, recent examples of this sort have been seen in the United States, Britain, and Australia. In many advanced economies, asset prices tend to rise in sync with a cyclical economic upturn, while general price indices are becoming less responsive due to productivity growth and firms' cost retrenchment amid global competition.

However, Japan's painful experience tells us that central banks should keep a close watch on asset prices, for they could have a material impact on the economy and inflation in the medium to long run. Central banks should also be alert to the excessive growth in money and credit which often accompanies asset bubbles. I presume such vigilance should somehow be blended into our conventional wisdom that central banks contribute to economic stabilization by ensuring price stability.

4. Concluding remarks

Now, let me conclude.

As I said earlier, the most pressing task for the Bank of Japan at this moment is to achieve sustainable growth on the basis of price stability. Towards that goal, the BOJ is firmly committed to maintaining the current easing policy.

I am impressed at how Korea has pushed forward structural reform in a wide range of areas following the economic crisis in 1997. I am sure the Bank of Korea has made a significant contribution to this economic revival, and will continue to build more on its success. I would like to express my respect for the decisive leadership of Governor Park.

This conference brings together many eminent scholars and central bankers. I am sure that, based on analysis of the bitter experiences of both Japan and Korea, the confluence of their expertise and insights will provide a thought-provoking discussion of this complex issue of stabilization policies.

Thank you for your attention.