Haruhiko Kuroda: The role of foreign financial institutions in Japan's financial system

Speech by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at a meeting held by the International Bankers Association of Japan, Tokyo, 29 September 2014.

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Introduction

Thank you for having me at this event commemorating the 30th anniversary of the International Bankers Association of Japan or the IBA Japan.

The IBA is a business association for foreign banks, securities firms, and other associated financial services firms operating in Japan. Since its establishment in 1984, the IBA has been making a substantial contribution to economic and financial developments in Japan. I wholeheartedly honor the 30th anniversary of the IBA Japan and pay respect for its constant efforts to date.

To start with, let me look back on the developments in the cross-border integration of financial markets and the role foreign financial institutions have been playing during the 30 years since the IBA Japan was established. Then, I will touch on the importance of financial system stability from a central bank's perspective, and close my speech by briefly explaining the Bank of Japan's monetary policy management.

Financial globalization and financial system stability

The establishment of the IBA in 1984 coincided with the publication of the report by the joint Japan-U.S. working group on the yen/dollar exchange rate, financial and capital market issues. The report of the working group included the liberalization of, and the entry of foreign financial institutions into, Japan's financial markets, as well as the development of the Euro-yen market in order to promote, so to speak, the opening of Japan's financial markets to the rest of the world. In the 30 years since the publication of the report, the globalization of the economy and the financial system has progressed significantly. With the globalization of the financial system and the growing cross-border integration of financial markets, the role played by foreign financial institutions in Japan has been quite significant. Many foreign financial institutions that have started business one after another in Japan have been playing a leading role in Japan's financial markets in various aspects, including the adoption of new financial technologies, the development of new markets, and the introduction of advanced risk management methods. In addition, they have played an important role in tightly linking financial markets across borders.

The economic and financial globalization has proceeded rapidly in recent years first in advanced economies, then involving emerging economies. Naturally, such developments are part of the process of increasing the interdependence of financial systems in different countries. In case there is a shock in a market, its effects will spread globally and immediately. That suggests that financial system stability needs to be achieved on a global basis, not in each individual country.

In fact, the global financial crisis triggered by the collapse of Lehman Brothers has made it clear that the impact of the manifestation of a risk in globalized markets can be severe and spread to a wide range of areas. Although Japan's financial system was relatively robust when the crisis struck, it was not immune to the crisis. Looking back at the situation, there was a large impact on Japan's financial markets. That included heightened concern over counterparty risk in the money market, the distortion of pricing in financial markets due to a liquidity shortage, and a decline in the functioning of the CP and corporate bond markets.

Unfortunately, there are not a few foreign financial institutions that had to cut back their activities in Japan following the crisis.

Stability and functioning of the financial system

It has become a shared recognition on a global basis that, to avert the reemergence of a financial crisis, it is important to analyze and assess the risks in the entire financial system as well as to take adequate measures to prevent systemic risk from manifesting itself. It is the so-called emphasis on a macroprudential perspective. Various international forums such as the Financial Stability Board and the Basel Committee on Banking Supervision are vigorously examining the substantial reform of international financial regulation. In line with those developments, individual countries have been independently strengthening regulations and substantially reviewing the supervisory system on financial institutions. One of the aspects of a stronger macroprudential approach both on regulatory and supervisory fronts might be to clean up individual problems that have surfaced in the process of the global financial crisis. The cleaning up includes ensuring the soundness of individual financial institutions, solving the too-big-to-fail problem and thereby preventing the moral hazard problem, and avoiding taxpayers' burden in the resolution of failed financial institutions.

During the past decades, financial business has become increasingly sophisticated and complex, financial systems have globalized, and financial markets have integrated across borders. In this context, we should pay more attention to another aspect, to strengthen the financial system as a whole on a global basis. Therefore, it is critical to bear in mind the interconnectedness of financial institutions through market transactions and to gauge more extensively overall changes in financial institutions and financial markets that compose the financial system. On that basis, it is also critical to implement a wide range of initiatives to maintain financial system stability.

In implementing the initiatives to enhance the stability of the financial system, we should not ignore initiatives to enhance its functioning so that the system can firmly support sustainable economic growth from the financial side. It appears that financial institutions' role to support firms' innovation and growth strategy from the financial side, is only bound to become larger in the future. Financial institutions play a variety of roles in encouraging firms' growth, such as developing new financial products corresponding to social changes, providing efficient settlement services and risk-hedging measures, as well as supporting M&As and reorganizations of firms. It is extremely important for financial institutions to enhance such roles constantly. Going forward, from a perspective of supporting Japan's economic growth from the financial side, I strongly hope that foreign financial institutions will continue to implement new initiatives while responding to changes in the surrounding environment.

While taking account of changes including financial and economic globalization, the Bank of Japan will continue to make efforts to strengthen the functioning of Japan's financial markets by enhancing payment and settlement services, including the development of the new Bank of Japan Financial Network System, the so-called BOJ-NET, and the extension of its operating hours, and by participating in initiatives to improve market practices, while closely cooperating with market participants.

A macroprudential perspective for a central bank

Now, let me further talk on the issues of financial stability and a macroprudential perspective for a central bank while taking into account their relationship with monetary policy.

Monetary policy aims at ensuring price stability and does not aim at ensuring the stability of the financial system. However, there is a close relationship between monetary policy and the stability of the financial system. To begin with, monetary policy has a substantial impact not only on price stability but also on financial system stability through its effects on financial intermediation and various asset prices. For example, central banks in advanced economies have been pursuing ultra monetary easing through unconventional monetary policies to achieve price stability while responding to the economic downturn after the global financial crisis. In that situation, investment in high-risk assets such as high-yield bonds and emerging economies' bonds and stocks has been expanding considerably against a backdrop of declining volatility in interest rates, stock prices, and foreign exchange rates, as well as investors' search for yields. Since the effects of monetary policy are transmitted to the real economy through the financial system, financial system stability is the basis for monetary policy that aims at ensuring price stability. If the functioning of the financial system declines, the effects of monetary policy will decline to that extent. If by any chance the functioning of the financial system is significantly impaired due to a financial crisis, it will be certain to see an adverse impact on price stability through a plunge in economic activity.

In any event, central banks cannot be unconcerned about the stability of the financial system. Nowadays, while a macroprudential perspective has attracted attention in the context of regulating and supervising financial institutions, it is not at all new for central banks. Traditionally, central banks possess the Lender of Last Resort function. While that takes the form of central bank lending to individual financial institutions, its aim is to secure the stability of the financial system and it is not to bail out a single financial institution. In the global financial crisis, the Bank of Japan and other central banks responded to a rapid contraction of the markets by providing liquidity to the markets as a whole through open market operations, such as purchases of assets like CP and corporate bonds as well as unlimited fund provisioning to the markets. Those responses are often called a central bank's functioning of Market Maker of Last Resort. And it can also be said to be a policy that is clearly associated with a macroprudential perspective. It safeguards financial system stability through dealing not with the liquidity provision to individual financial institutions but directly with a decline in overall market liquidity.

In considering a central bank's initiatives in a macroprudential aspect, it is often argued that there may sometimes be a trade-off between a central bank's objectives of ensuring price stability and ensuring financial system stability. That point has been discussed at home and abroad and the jury is still out, but at least one can point out that history does suggest that substantial imbalances in financial and economic activity emerge through a feedback loop in which changes in the output gap and changes in the financial cycle reinforce each other. That is evident when you look back on the global financial crisis and the burst of the bubble in Japan in the 1990s. There have been many discussions on how to deal with substantial imbalances including a bubble: to what extent such changes could be gauged in advance and preemptive measures could be taken, or what measures should be implemented in response to the imbalances. In any event, the recognition has become widespread that the financial cycle could lead to significant changes in the economy as a whole. Even at normal times, it is important to appropriately grasp the conditions of the financial system in monetary policy management.

Analysis and assessment on risks in the financial system

Taking those points into account, the Bank examines risks in the financial system in establishing the guidelines for monetary policy. In establishing the guidelines for monetary policy, the Bank assesses the economic and price situation from two perspectives. The first perspective concerns examining whether the outlook for economic activity and prices in the coming two years or so suggests that the economy is on a path toward sustainable growth with price stability. At the same time, the second perspective, based on a longer-term viewpoint, concerns examining the risks that the Bank considers to be the most relevant to monetary policy management in achieving sustainable growth with price stability. This second perspective includes the examination of risks in the financial system as one element of medium- to long-term risks.

Japan's financial system currently maintains stability and has substantial resilience against shocks. Capital bases of financial institutions have been adequate on the whole, given that the accumulation of capital has continued while the amount of risk borne by financial institutions has increased only slightly. Developments in financial intermediation show no indication of overheating or excessively bullish expectations. In the future, the globalization of the economy and transformation of industrial structures could lead to changes in the financial intermediation function and the risk profile of the financial system. In addition, financial and economic developments at home and abroad would affect financial institutions' performance in securities investments. The effects of various environmental changes on financial system stability will continue to warrant attention.

Analyses that form a basis for the Bank's assessment of risks in the financial system as a whole are semiannually published as the *Financial System Report*. The next issue will be published in mid-October and I hope you will have a chance to read it.

Concluding remarks

Let me conclude by briefly touching on the Bank's monetary policy management.

Although a decline following the front-loaded increase in demand prior to the consumption tax hike still remains and there has been some weakness in exports and industrial production, a steady improvement in the employment and income situation has been continuing and household sentiment has been improving. Firms have been maintaining their proactive stance for business fixed investment as corporate profits have improved. The virtuous cycle from income to spending has been operating steadily in both the household and corporate sectors, and Japan's economy is expected to continue its moderate recovery trend and the effects of the decline in demand following the consumption tax hike are expected to wane gradually.

The year-on-year rate of change in the consumer price index, excluding volatile food and the direct effects of the consumption tax hike, is expected to be around 1¼ percent for some time. It is expected to subsequently follow an uptrend again from the second half of this fiscal year and reach about 2 percent around the middle of the current projection period from fiscal 2014 to 2016.

Quantitative and qualitative monetary easing, dubbed QQE, has so far been producing its intended effects. The Bank will continue with QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. If the outlook changes due to the manifestation of risk factors and it is judged necessary for achieving the price stability target, the Bank will make adjustments without hesitation.

I have high hopes that foreign financial institutions will continue to play the significant role they have played in Japan's economy in the past 30 years and will contribute to the robust growth of Japan's economy in the future. With such hopes, let me conclude my speech today.

Thank you.