Mr. Matsushita reports on recent financial and economic conditions in Japan

Speech by the Governor of the Bank of Japan, Mr. Yasuo Matsushita, to the Japan National Press Club in Tokyo on 12/12/97.

I. Introduction

I truly appreciate this opportunity to address this distinguished audience at the Japan National Press Club.

The circumstances of the Japanese economy and financial system have increased in severity in the past six months. The economy has not shown any definite signs of recovery since its reaction to the rise in the consumption tax rate in April 1997. Rather, economic recovery appears to be decelerating. The currencies and financial markets of South-East Asian countries, which have been the high-growth area, have been in turmoil since summer of 1997, and an adverse impact on the Japanese economy has been anticipated. In addition, recent successive failures of large Japanese financial institutions have once again aroused concern about the stability of Japan's financial system in Japan and abroad. Thus, it is not easy to judge where the Japanese economy is headed and to draw up a prescription for each problem.

In such a situation, it is important that the circumstances be analyzed carefully so as to perceive the underlying mechanism. This is because developments in the economy and the markets -- even, or particularly, when they suggest confusion or disruption -- often provide important indications or warnings that lead to a better solution of the problem.

Today, I would like to discuss and explain the Bank's thinking on three topics: issues concerning Japan's financial system, the turmoil in the Asian currencies and financial markets, and the domestic economic situation. These are three independent issues that in a way are closely correlated. I would like to explain them with a view to clarifying the underlying mechanism.

II. Issues Regarding Japan's Financial System

A. Resolution of Failed Financial Institutions

I would like to start with issues regarding Japan's financial system.

The successive failures of Japanese financial institutions since the fall of 1997 have once again emphasized domestically and internationally the severity of the situation facing the Japanese financial system, temporarily increasing the tension in the financial markets.

First, I would like to explain the measures the Bank has taken to deal with this situation and the thinking behind them.

When a financial institution fails, the most important task is to contain systemic risk. In other words, it is crucial to prevent the failure from affecting other financial institutions or the markets as a whole, disrupting the entire financial system, through widespread anxiety of depositors and market participants or through a chain reaction of defaults.

In order to contain systemic risk, two requirements must be satisfied. First, it must be ensured that smooth repayment of deposits be made by the failed financial institution. Second, it is important to avert liquidity contraction to ensure the stability of the entire financial system. Failure of financial institutions causes market participants to become overly cautious, making it difficult for transactions to come to terms. As a result, upward pressures tend to be placed on interest rates. Therefore, in order for these two requirements to be satisfied, the Bank took decisive measures in response to the financial institution failures.

To meet the first requirement, the Bank extended special loans as necessary to several failed institutions -- for example, Hokkaido Takushoku Bank and Yamaichi Securities -- under Article 25 of the Bank of Japan Law, without requiring the usual collateral.

The Bank has committed itself to providing funds for the purpose of ensuring the stability of the financial system only in cases where all of the following four conditions are met: (1) there is a strong possibility that systemic risk -- a risk that failure of one financial institution to settle transactions with another may trigger a chain reaction of defaults -- will materialize, and that as a result, confidence in other sound financial institutions will be undermined, or that runs on deposits will occur; (2) credit extension by the Bank is indispensable, as there are no other sources of funds; (3) measures are taken to prevent moral hazard; and (4) the financial soundness of the Bank will not be threatened.

In the cases of the recent financial institution failures, the Bank judged it appropriate to extend special loans after thoroughly examining these four points.

While the Bank had previously extended special loans to depository institutions, the loan extension to Yamaichi Securities should be regarded as an extraordinary measure. This is because the failure of a non-depository financial institution such as a securities company differs in several ways from the failure of a depository institution. Customers of a securities company conduct stock and bond transactions through the securities company, and are not in a creditor-debtor relationship with the company. They do deposit money and securities with a securities company, but unlike bank deposits, these are not means of payment. Accordingly, it is usually unlikely that the failure of a securities company would directly give rise to systemic risk.

Yamaichi Securities' decision to close down its business, however, is significant in that the company is one of Japan's four largest securities companies. Furthermore, considering the fact that the Japanese financial system is being viewed more critically and that Yamaichi conducted a wide range of business in domestic and overseas markets and had a large number of customers, any difficulties in returning customers' assets or in settling outstanding transactions in the process of closing down the company were quite likely to lead to withdrawal of customer assets from other securities companies or disrupt market transactions. If no measures had been taken to prevent such a situation, the credibility of the Japanese financial system could have been seriously eroded and disruptions could have been caused in domestic and overseas financial markets, in the end seriously affecting overall economic activity in Japan. Against this backdrop, the Bank decided to provide Yamaichi with necessary liquidity under Article 25 of the Bank of Japan Law in order to minimize the adverse impact of the closing down of the company's business on the domestic and overseas financial markets as well as the Japanese economy.

The Bank's measures had their intended effect: payment and settlement were executed smoothly by the failed institutions, and thus the materialization of systemic risk was avoided. However, the failures of large depository institutions and a securities company made the behavior of market participants very cautious, and as a result, it became difficult for transactions to come to terms, placing upward pressures on market interest rates.

Therefore, to fulfil the second requirement in containing systemic risk, the Bank exerted itself to its utmost to avoid declines in market liquidity through market operations. The Bank utilized various market operations means to provide sufficient liquidity in the markets, to thereby support smooth market transactions and stable formation of market interest rates.

Since September 1995, the Bank has conducted market operations in order to maintain the uncollateralized overnight call money rate at a level on average slightly below the official discount rate. However, demand for funds in the market heightened following the series of financial institution failures, and at the end of November 1997, the call money rate rose far above this targeted level. The Bank therefore made continuous efforts to supply sufficient liquidity to the market, and as a result the rate has recently declined to the targeted level.

Rates on longer-term money market instruments, however, especially 1-month rates on end-of-year funds, remain high due to a rise in the "Japan premium" -- the extra funding cost that Japanese banks have to pay compared to leading U.S. and European banks due to a decline in their creditworthiness in international markets. The Bank would like to emphasize that it will continue to take a firm stance in its market operations toward the end of the year to ensure the stability of money market rates.

The Bank, in cooperation with the government, will continue to commit itself to maintaining the stability of the financial system, and strongly hopes that the public and market participants will act calmly.

B. The Implications of Recent Financial Institution Failures

Significant progress has been made toward the solution of the nonperforming-loan problem, and it can be said that the recent failures of financial institutions occurred amid this notable progress. Therefore, these failures can be considered to have important implications for the strengthening of Japan's financial system and for the restoring of domestic and international confidence in the system.

The disclosed amount of total nonperforming loans held by the Japanese depository institutions decreased from ¥38 trillion as of the end of March 1995 to ¥28 trillion as of the end of March 1997. Of this, the amount that needs to be disposed of, or those not covered by collateral or loan loss reserves, has been reduced from the ¥18 trillion in 1993 to ¥4.5 trillion. While this amount is still substantial, it is fair to say that there has been steady progress in the disposal of nonperforming loans.

A matter of concern is that the pace of disposal differs among financial institutions. For example, some financial institutions have completed removal of nonperforming loans from their balance sheets. Many other institutions seem to be planning to record net losses for the accounting term ending in March 1998 to dispose of a considerable amount of nonperforming loans. The overall progress in solving the nonperforming-loan problem, together with enhanced disclosure practices, has sharpened the contrast between institutions that are being prompt in dealing with their problem and those that lag behind.

Under such circumstances, there seem to be two requirements in restoring confidence in Japan's financial system at home and abroad.

First, it is necessary for financial institutions to further improve disclosure and thereby enhance the transparency of their management. Depositors, creditors, and other market participants are scrutinizing the financial conditions of Japanese financial institutions with increasing severity, and the scheduled introduction of Prompt Corrective Action in April 1998 and the implementation of the Japanese "Big Bang" deregulation measures are likely to encourage such tendency. Therefore, it is vital that individual financial institutions accelerate the disposal of nonperforming loans and the implementation of restructuring measures to ensure the market's confidence.

As for the disclosure of nonperforming loans held by financial institutions, a uniform standard has been established based on a recommendation by the Financial System Research Council to allow comparison between financial institutions, and the range of disclosure has been expanded in line with this standard. To increase the transparency of financial institution management and to thereby strengthen the market's confidence, however, it is essential that institutions expand the range of disclosure on their own initiative, not only with respect to nonperforming loans but also to the implementation of their restructuring measures, and thereby provide the market with a convincing explanation of how they intend to improve, or how they have improved, their financial strength.

Second, the recent series of financial institution failures has highlighted the importance of preventing the surfacing of systemic risk and of thereby ensuring the stability of the entire financial system. It must be remembered that in the financial system, an appropriate balance must be struck between the need to draw out the dynamism of the market mechanism and the need to ensure the stability of the system.

As I stated earlier, the financial strength of financial institutions is being more severely examined in anticipation of the implementation of the Japanese "Big Bang". To maintain the stability of the financial system under these circumstances, it is extremely important to ensure that even if the market were to pass a hard judgment on an institution, this would not shake the entire financial system.

In this regard, the provision of emergency liquidity for preventing any serious disturbance from occurring in the system, which I mentioned earlier, is the responsibility of the central bank as the "lender of last resort".

When the failed institution has a negative net worth, there is the problem of how to dispose of the ultimate losses. However, credit extension by the Bank is aimed solely at providing temporary liquidity, and not at making up for losses. Therefore, it is required that a loss-covering scheme be in place before swift repayment of deposits can be made and resolution of the failed institution be carried out smoothly.

The deposit insurance system is one of the frameworks made available for such schemes, and various measures have been taken to enhance the functions of the Deposit Insurance Corporation. There could be cases, however, where losses are too large for this system to bear. In such cases overseas, public funds have been used subject to certain conditions to solve the problem.

In view of those examples abroad and the current situation of Japan's financial system, an argument has been put forward that public funds should be utilized for the early and fundamental solution of the nonperforming loan problem, triggering serious debate in the Government and Diet. The Bank considers the argument to carry great significance for the domestic financial system, and therefore hopes that a national consensus on the matter will be reached through wide discussions.

The global and domestic conditions facing Japan's financial system are becoming increasingly harsh, as represented by the expansion of the "Japan premium" in international financial markets. Thus, Japan's financial system is at a critical juncture that will determine whether it can restore domestic and international confidence, with financial institutions further enhancing disclosure and accelerating the disposal of nonperforming loans, and the authorities ensuring the stability of the financial system.

III. Financial Conditions in Asia and Their Impact on the Japanese Economy

A. The Background of the Turmoil in Asian Financial Markets

Let me next discuss the recent developments in other Asian economies. In this section, I will refer to Asian economies on the basis of excluding that of Japan. To confront the turmoil in the Asian financial markets which started in summer 1997, various measures have been taken -- each country has been adjusting its macroeconomic policy and setting out measures to stabilize the financial system, and international assistance has been provided under the leadership of the International Monetary Fund (IMF). However, instability remains in the financial and foreign exchange markets of these countries, and uncertainty prevails as to how their economies will evolve under the various economic measures. Today, therefore, I would like to examine the background of the Asian turmoil and its possible impact on the Japanese economy.

First, I would like to emphasize that it is not appropriate to perceive the currency turbulence in Asian countries as having been caused by speculative attacks by global investors on specific currencies and financial markets, and to emphasize the instability of international financial markets. Turmoil in the international financial and foreign exchange markets has occurred several times in the past: the demise of the postwar fixed exchange-rate system, established by the IMF in the 1970s; and the currency crises in the European Monetary System in 1992 and in Mexico in 1994.

In all the above cases, before the turbulence arose in the markets, there had been for some time a gap between the exchange rate of the country's currency and the real economic condition of the country, with that gap expanding gradually preceding the turbulence. Immediate adjustment of the foreign exchange rate is inevitable once market participants detect the situation. In the adjustment process, the exchange rate may overshoot, giving the impression that the market is in disruption. However, it is important that the grounds for such large fluctuations be clearly identified, or otherwise, the warning signals sent out by the market, which are pointing to the expanding gap in this case, will be overlooked.

With the emergence of the Asian currency turmoil, some have questioned the previous achievements of East Asian economies. This view also seems to be rather extreme. It appears that the potential growth rate of East Asia remains high, supported by its high-quality labor, high savings rate, and solid market and industry infrastructures. Although East Asian economies will face adjustment pressures in the short term, they can be expected to establish a foundation for further growth by carrying out various structural reforms based on their recent experiences.

What, then, can be considered to be the background of the recent turmoil in Asian currencies? While Asian countries differ from each other in many ways, one common factor is that most Asian currencies were pegged to the U.S. dollar, and under the peg, large amounts of foreign funds flowed in during the 1990s. This in turn led to excessive financial and investment activities, overheating of the economy, and accordingly, deterioration in the external balance.

It cannot be denied that there was a sense of euphoria, or an overexpectation of economic growth, in East Asia. When there is an influx of abundant funds based on such expectations, upward pressure is exerted on the foreign exchange rate of the country's currency. To maintain the pegged exchange rates, countries were under pressure to ease money to lower domestic interest rates or at least avoid monetary tightening. Such policy response fuelled financial and investment activities, and this may have upheld the euphoria for a certain period of time.

Inflation rates in Asian countries rose due to overheated economic activity, and under their fixed exchange rate system, their currencies became overvalued. Consequently, the international competitiveness of these economies declined gradually and current account deficits expanded. The deficits in the current accounts were not a problem as long as they were financed by foreign capital. However, as soon as market participants began to doubt the sustainability of the external imbalance and the economic boom in the area, foreign funds were abruptly withdrawn from the countries, putting severe pressures on foreign exchange rates and stock prices. Against this backdrop, many countries were compelled to abandon their exchange rate pegs to the U.S. dollar and adopt a floating rate system.

Several important lessons can be drawn from this experience with regard to ensuring the stability of international financial markets. Obviously, preventing an overheating of economic and financial activities through proper macroeconomic policies is the most important prerequisite for securing the stability of one's own economy as well as the international financial markets. It is equally important to ensure flexible foreign exchange developments, promote information disclosure to allow the market mechanism to check the appropriateness of economic policies, and establish a sound financial system by, for example, reviewing the framework of financial institution supervision.

Based on these lessons, East Asian countries have embarked on the restoration of their economies and financial systems with international support. The Bank of Japan, too, continues to play an appropriate role in the framework in which the IMF takes the initiative. In terms of cooperation among Asian central banks, the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP) was established in 1991. The governors' meeting has taken place annually since 1996; the first being held in Tokyo and the second in Shanghai. Taking the opportunity of such meetings, the Bank intends to strengthen its ties with other Asian central banks by exchanging views and extending technical assistance in various fields.

B. Impact on the Japanese Economy

Next, I would like to discuss the impact of developments in the Asian economies on that of Japan.

The economic relations between Japan and other Asian countries have been intensifying, and the region is now the largest trade partner of Japan. Of Japan's total exports, those to Asia's Newly Industrializing Economies (Asian NIEs) and the member countries of the Association of South East Asian Nations (ASEAN) account for about 35 percent, exceeding the share of exports to the United States and to the European Union, 30 percent and 15 percent respectively. As for Japan's imports, the share of imports from Asian NIEs and ASEAN countries has grown to almost 20 percent, approaching the 22 percent from the United States, which holds the largest share.

Accordingly, it is inevitable that the depreciation of the currencies and the economic slowdown due to the implementation of adjustment measures in these countries will affect the real economy of Japan. At present, demand in other regions such as China, the United States, and Europe is firm, and the average exchange rate of the yen (weighted by the value of trade with each country) remains stable. Thus, the export environment is not significantly deteriorating as a whole. However, exports to Asia, especially to Thailand and the Republic of Korea, have started decreasing.

Furthermore, slowdown of economic growth in East Asian countries is bringing about a fall in international commodities prices, especially those of raw materials. This is beginning to affect the profits of materials manufacturers in Japan, and as a result, some of these firms are planning to curtail production. Thus, careful observation of economic trends including these kinds of indirect impact is necessary.

In addition to developments in the real economy, the problem of nonperforming loans is surfacing in the Asian countries, although the degree differs from country to country.

According to statistics compiled by the Bank for International Settlements (BIS), the total credit exposure of Japanese banks to Asian countries amounts to US $270 billion, which accounts for about 30 percent of the total exposure of world's financial institutions to Asia.

However, these figures include Japanese banks' credits to Asian branches and affiliates of Japanese, U.S., and European financial institutions. Furthermore, a large portion of business credits of

Japanese banks are extended to Japanese affiliates with a guarantee given by their parent companies. According to the Bank’s survey, Japanese banks’ credit exposure to non-Japanese firms and local banks in Asia appears to be around 30 to 40 percent of the total credit exposure reported in the BIS statistics. Moreover, most of such credit is loans to sound major banks and firms and project finances, which are unlikely to turn into nonperforming loans.

As discussed above, the impact of the currency and financial turmoil in Asia on the real economy and financial market of Japan has been limited to date. However, the economic situation in this region remains unstable. Therefore, the degree of economic slowdown and developments in the nonperforming-loan problem in these countries must continue to be monitored.

IV. Recent Financial and Economic Conditions and Monetary Policy Management in Japan

A. Domestic Financial and Economic Conditions

I would now like to move on to today’s last topic -- the recent economic situation in Japan.

The decelerating trend of Japan’s economic growth since April 1997 has been intensifying recently. In final demand, exports and business fixed investment continue to be on an upward trend, supporting economic activity. However, household spending such as personal consumption and housing investment, which fell substantially following the rise in the consumption tax rate in April 1997, is recovering only at a very slow pace. In personal consumption, outlays on services such as travel services have shown a moderate increase, while outlays on goods, as indicated by sales of automobiles and household electric appliances as well as department store sales, have remained sluggish. In addition, housing starts have declined more recently to 1.3 million from the 1.5 million per annum level prevailing until spring 1997.

With such weakness in final demand, inventory adjustment pressures remain in the consumer durables- and construction-related industries, and thus industrial production has been declining slightly. Such developments seem to be gradually affecting employment and income.

However, this year’s temporary economic slowdown is inevitable in that the economy is at a phase in which the downward pressures of fiscal tightening appear most strongly. The concern is how these developments will affect the momentum of the self-sustained economic recovery in 1998. At present, corporate profits and employment income, which form the basis of the self-sustained recovery, continue to be on an upward trend. Therefore, it is unlikely that the economy has entered a recession. However, there is some weakening of the virtuous circle of production, income, and expenditure, and if this trend continues, it may undermine the strength of the self-sustained recovery. The Bank will therefore continue closely to monitor the pace of recovery in consumption, progress in inventory adjustment, and developments in household and corporate sentiment.

Meanwhile, prices have remained stable on the whole. Domestic wholesale prices have continued to decline slowly, particularly those of construction materials. Consumer prices, after excluding the effect of the rise in the consumption tax rate, have been at a level slightly above that of the previous year, and corporate service prices remain at the previous year’s level.

In view of such economic and price conditions, the Bank is determined to observe developments carefully in managing monetary policy, placing emphasis on strengthening the foundation of the economic recovery. In the conduct of market operations, the Bank intends to continue supplying sufficient liquidity to the financial market, to thereby ensure smooth transactions and stability of market interest rates.

B. Lending Attitude of Financial Institutions

With regard to the recent financial situation, there have been various discussions concerning the cautious lending attitude of financial institutions.

Today, financial institutions are faced with many challenging management issues, such as expeditious disposal of nonperforming loans, as well as implementation of measures to deal with the Japanese “Big Bang” financial reform and with the introduction of Prompt Corrective Action. Therefore, with a view to enhancing the soundness and efficiency of management, an increasing number of financial institutions are strengthening their risk management and attaching more importance to profitability in their extension of loans. These efforts by financial institutions are indispensable for strengthening Japan’s financial system. However, it is a matter of concern whether the cautious lending attitude of financial institutions has reached the point where it hinders the recovery of the economy as a whole.

To date, partly because of weak corporate demand for funds, there has been neither any significant shortage of funds in corporate financing nor an overall rise in lending rates due to a squeeze in lending. Therefore, the Bank believes that the cautious lending attitude of financial institutions is not hampering economic recovery at present. However, risk management systems of financial institutions are being further reinforced. In addition, the influence of developments in financial markets, such as low stock prices and the rise in the “Japan premium”, on financial institutions’ lending activity requires due attention.

While the current lending activity of financial institutions is not hampering economic recovery, it is not positively contributing to the recovery as it did during past periods of monetary easing. This fact offers a significant point for discussion when considering the interaction between financial activity and real economic activity, because the expected role of financial institutions goes beyond merely responding passively to corporate demand for funds.

Financial institutions are expected to actively support forward-looking business activities -- for example, by helping corporations find new business opportunities and accepting financial risks when new businesses are started. In fact, such functions of financial institutions played a significant role in promoting economic recovery in the past. While it is true that financial institutions went too far in these activities, leading to the emergence of the economic “bubble”, it is also undeniable that in the present phase of economic recovery financial support for economic activity has been weak. In order to ensure economic recovery, it is important to strengthen the functions of financial institutions and the financial market, thereby restoring a strong and efficient financial system. I would like to point out that the cautious lending attitude of financial institutions, causing the so-called “credit crunch”, should therefore be discussed in connection with the issue of strengthening the financial system.

C. The Significance of Stronger Confidence in the Economy

The Bank’s primary concern regarding the economy is the fact that the confidence of firms and households in the Japanese economy and its outlook seems to be deteriorating.

It is very difficult to measure accurately the level of confidence of economic entities. However, the financial and asset markets offer some important information. Asset values, for example, reflect the expectations of market participants as to the future profits which may be earned by holding such assets.

How, then, should we see the recent low level of stock prices? Corporate profits are at a significantly higher level today compared with those in 1995, when there were concerns about a deflationary spiral. However, stock prices are close to the 1995 level. This suggests that confidence in the economy has weakened compared with that in 1995. Under such circumstances, firms and financial institutions would be inclined to hold back from forward-looking activities that involve risks. Weakened confidence would also reduce the effects of monetary easing.

However, it seems unnatural to assume that the potential growth rate of the Japanese economy in the medium to long term has declined significantly in the past two years. In 1995, for example, there were strong concerns over the future of Japanese industry, due to increasing competition with other Asian economies and anxiety over a hollowing-out of industry, but Japanese firms are responding by building new global networks of production and parts procurement, utilizing the new international division of labor. Also, with the depreciation of the yen, apprehension about the international competitiveness of Japanese industry seems to have receded considerably.

In view of these conditions, the weakening confidence in the economy that is reflected in the low stock prices must be attributable to some other factor. A clue in finding the answer is the fact that the “outlook for the economy” does not reflect only the estimated potential growth rate, but also uncertainty regarding its realization.

For example, even when similar levels of profit growth are expected, stock prices will decline when there is greater uncertainty about the realization of the expected profit growth, in other words, when the risk premium expands. The same phenomenon can be observed in the economy as a whole. Uncertainty regarding future developments significantly undermines confidence in the economy.

Thus, it can be said that the present weakness of confidence in the economy is related to the fact that the Japanese economy is at a critical phase of various structural reforms, including financial system reforms. There are many uncertainties surrounding economic entities -- such as the developments in the financial system, the progress of structural reform of the economy such as deregulation, and issues regarding public pensions, which have a substantial impact on household income. Therefore, the important issue now is to clarify the outlook for each of these factors, including the prospect of additional burdens and costs.

I mentioned earlier that confidence in the economic outlook is based on two factors, namely, expected growth and risk premiums. It is quite difficult to boost the potential growth rate or expectation of growth through economic policy in the short term. However, it is possible to reduce uncertainty about the economy, and this is an effective and credible method of reinforcing confidence in a market economy. In this regard, making steady progress in structural reforms such as deregulation and ensuring the stability of the financial system are significant. If these efforts can reduce uncertainty about economic and financial developments, then the present monetary easing will be more effective in stimulating economic activity, strengthening the force of the virtuous circle in the economy.