Mr Hayami outlines recent economic conditions in Japan and gives his thoughts on the role of a central bank and its balance sheet

Speech by the Governor of the Bank of Japan, Mr Masaru Hayami, at the Kisaragi-kai meeting in Tokyo on 22/12/98.

I. Introduction

I am truly honored to have this opportunity to speak to you. I will begin with a brief outline of recent economic and financial developments in Japan and then give my thoughts on today's topic, the role and balance sheet of a central bank.

II. Economic Conditions and Monetary Policy Management

A. Current Economic and Financial Conditions

Japan's economy still remains in a severe situation. Recently, however, the pace of economic deterioration has moderated somewhat, thanks to increased public investment and exports. The decline in production has decelerated, reflecting some progress in inventory adjustment. With regard to financial developments, the temporary increase in concern over corporate fund-raising toward the year-end has eased gradually, on account of the government's expansion of credit guarantee system and the Bank's introduction of new market operations measures and lending facilities.

Thus, there have been some bright signs for Japan's economy. However, it is still unclear at this stage whether these suggest an escape from the current vicious circle, or just a pause before further hardship. The results of the December *Tankan*——Short-Term Economic Survey of Enterprises in Japan——published in mid-December showed that the majority of firms still had a cautious view of the economic outlook.

The key to economic recovery lies in whether private demand can lead to a self-sustained recovery of the economy while the public sector is underpinning it. However, given the continued deterioration in corporate profits as well as employment and income conditions, developments in business fixed investment and private consumption require close attention. Prices continue to be weak, reflecting a widening output gap in the economy. Therefore, it needs to be carefully watched whether or not the implementation of the emergency economic package and other measures will have the intended effect of improving business and household confidence.

In the financial markets, concern over credit and liquidity risks continues to exist. One manifestation of this is the market interest rates on instruments maturing after the fiscal year-end in March 1999, which are likely to remain high.

Under these circumstances, the Bank will maintain the current decisive easy stance of monetary policy, and continue to do its best to support economic activity and financial stability.

B. The Bank of Japan's Balance Sheet

The failure of some financial institutions in autumn 1997 was followed by increased anxiety about the stability of the financial system, which has had a dampening influence on economic activity. The Bank has responded to this situation by implementing a variety of monetary policy measures, including an additional lowering of the target call rate on September 9, 1998 and continued provision of ample liquidity under the relaxed policy stance.

The Bank has also taken the following measures in its money market operations. First, the Bank has injected large amounts of longer-term funds to ease the upward pressure on market interest rates maturing beyond the end of the semiannual accounting term in September and the end of the calendar year in 1998. This has caused the Bank's balance sheet to expand by about 40 percent over the year. Second, the Bank has adopted some new measures to facilitate corporate financing, such as increasing commercial paper (CP) repo operations and introducing a temporary lending facility in November 1998. As a result, there has been a continuing rise in the proportion of private-sector debt to the asset account on the Bank's balance sheet. Third, as part of its efforts to maintain financial stability, the Bank has expanded special lending since 1997 under Article 38 of the Bank of Japan Law of 1997. The function of these loans, which is to provide emergency liquidity to ensure financial system stability, has recently been taken over by loans to the Deposit Insurance Corporation (DIC).

The Bank's balance sheet has thus changed dramatically over the past year. The change is a reflection of the Bank's constant efforts to combat the economic downturn and the increasing uncertainty about financial stability. However, the expansion of the balance sheet has also given rise to a significant number of questions and criticisms focusing on a perceived threat to the financial soundness of the Bank. I would therefore like to devote the rest of my speech to a fairly detailed examination of the Bank's role and its approach to provision of credit, in light of the changes in the Bank's balance sheet.

III. Extension of Credit by the Bank of Japan

A. The Role of a Central Bank and Its Balance Sheet

Before explaining why the soundness of the Bank's balance sheet has become an issue, I need to refer to the mission of a central bank.

In brief, the mission of the Bank of Japan, the central bank of Japan, is to issue banknotes, ensure the functions of the currency, and contribute to the sound development of the Japanese economy. Perhaps "ensuring the functions of the currency" sounds a little too abstract. Specifically, the Bank must first ensure the stability of the currency's value, and second maintain an appropriate framework for its circulation. Referring to these two requirements, the role of a central bank is often defined as maintenance of price stability and financial system stability.

On a day-to-day level, the Bank seeks to fulfil its mission by engaging in banking activities that are similar to those of commercial banks. When the economy is experiencing inflation or deflation, the Bank tries to restore and maintain a non-inflationary and non-deflationary situation——that is, a situation of price stability——by influencing the quantity of money in circulation and the levels of various interest rates. The Bank achieves this objective by influencing interest rates in the financial markets. And this is done basically by supplying or absorbing the appropriate amount of funds through the purchase or sale of financial assets. Such activity by the central bank is called "market operations." The same is true of the Bank's activities to maintain an orderly financial system. When the stability of the financial system is at risk due, say, to failure of a commercial bank, the Bank of Japan acts decisively to minimize the ensuing disturbance by injecting funds into the system. The principal tool the Bank employs in such cases is lending.

As with commercial banks, the activities of the Bank are clearly reflected in its assets and liabilities shown on its balance sheet. For instance, when the Bank drastically eases money in order to avert deflation, as is the case at present, the Bank increases provision of funds in the markets by increasing its purchase of financial assets. This naturally causes the Bank's balance sheet to expand.

The key question is whether or not people will trust their central bank and be willing to hold the country's currency (including banknotes, which bear no interest). This depends on whether or not the central bank's behavior has measured up to the expectations of the people, and whether or not it continues to do so. One source of clues for making such a judgment is the balance sheet, and it is therefore natural that people in Japan and abroad take a keen interest in the Bank's balance sheet.

The Bank's balance sheet can be discussed from various perspectives. From the viewpoint of people's confidence in a central bank, it is most important that the financial assets the Bank holds are adequate to secure the banknotes issued. This adequacy, I believe, involves two specific points. First, the Bank's assets must be sound and its financial base must be solid——the latter means that the Bank must have a sufficient capital base——in order for the Bank to continue to act decisively as a central bank in total independence of intervention by a third party. Second, the Bank must have a sufficiently liquid asset portfolio to flexibly inject or withdraw funds as necessary.

I believe that the Bank's balance sheet has also attracted growing attention in other countries. Some observers have expressed concern over the expansion of the Bank's balance sheet as a sign of deterioration in its assets. This may be because a rapid growth of the balance sheet is associated in people's minds with an increase in nonperforming assets that need to be disposed of at a substantial loss. But as I stated at the beginning of my speech, setting aside technical factors, the recent expansion of the Bank's balance sheet is primarily the result of active provision of liquidity under the easing policy. Nevertheless, mere suspicion about an erosion of asset quality can be a serious problem if it undermines people's confidence in the central bank and, in turn, in the national economy. Such loss of confidence could, for example, result in Japan's commercial banks and firms paying an unnecessary premium when raising funds in other countries. That is why the Bank recognizes the need to be vigilant against deterioration in its assets. The Policy Board, the Bank's decision-making body, constantly deliberates whether the various measures implemented to fulfil the Bank's mission could jeopardize the Bank's credibility because of the resulting changes in its balance sheet.

B. Three Key Principles of the Bank of Japan's Portfolio Selection

I will next talk about the philosophy that guides the Bank in portfolio selection——in other words, the key principles in selecting a central bank's portfolio. There are three.

The first principle is to maintain the soundness of the Bank's assets. In other words, assets and collateral held by the Bank must be of high quality.

The Bank has devised a number of methods to achieve this. When supplying funds to financial institutions through loans, the Bank acquires financial assets that are trustworthy as collateral. When providing funds through market operations, it purchases financial assets from financial institutions or other sellers based on repurchase (*gensaki* or repo) agreements. The only exception to this rule for market operations is when the Bank makes outright purchases of government bonds. Thus, the credits provided by the Bank are secured by the creditworthiness of plural entities: not only by the creditworthiness of financial institutions to which the Bank lends directly, but also by that of the government or the entities in the non-banking private sector, which are the issuers of the debt instruments. This approach is common among central banks. At the Bank of Japan, it is called "the double-name principle."

Where the collateral for the Bank's loans and the financial assets purchased in market operations are issued by such entities as private-sector firms, the Bank assesses the eligibility of these assets according to its own criteria——that is, its internal ratings——and reviews it at least once a year. If a firm's financial performance deteriorated, the financial debt of this firm would no longer be acceptable as collateral or as an instrument of market operations, even if it had once been deemed to be suitable for such purposes.

Of course, these measures alone are not enough. The double-name principle might reduce the probability of defaults, but taking a firm's debt as collateral is not sufficient if the firm's creditworthiness is bolstered by the support of the commercial bank to which the Bank of Japan is lending. Nor is it desirable for the Bank's assets and collateral to be concentrated in the liabilities of firms in a particular industry. The Bank pays careful attention not only to the soundness of individual assets but the entire portfolio, ensuring that its assets and collateral are not exposed to linkages of risk or excessive risk concentration.

The second principle is to maintain neutrality with respect to resource allocation. If the Bank held an excessive quantity of certain types of financial assets, price making and resource allocation in the market might be distorted. In view of its role in the economy, the Bank should do its best to minimize such influences. The supply of funds by the Bank of Japan in the context of monetary policy management is aimed at influencing the overall level of market interest rates. Furthermore, provision of funds for the purpose of maintaining an orderly financial system is aimed solely at containing systemic risk and preventing disruption of the entire financial system.

The third principle is to maintain liquid assets. The assets of the Bank must be such as can be liquidated at reasonable cost whenever necessary. This is so that the Bank is ready to respond to any sudden policy decisions. In the management of monetary policy, if the Bank is to control interest rates in rapidly moving financial markets, it must be able to acquire or liquidate financial assets instantly in order to supply or absorb funds. The same principle applies to its provision of funds to maintain an orderly financial system. Asset liquidity is vital to the Bank's capacity to make flexible policy responses while maintaining the Bank's financial soundness.

Bearing in mind these three principles that guide the Bank in its selection of assets and collateral, the Bank has made great efforts to adopt new market operations measures and review collateral requirements to accommodate current policy agenda. One example of this is introduction of new market operations tools to contribute indirectly to the development of financial markets. Another is the Bank's "New Measures for Money Market Operations in Response to the Recent Situations in Corporate Financing Activities," decided on November 13, 1998. As stated in the press release, the aim of these measures is to contribute to facilitating corporate financing activities by devising new methods of market operations and lending.

IV. Some Related Issues

Having outlined the Bank's principles, I would now like to examine its approach in more specific terms by addressing some frequently asked questions relating to the balance sheet.

A. Government Debt or Private-Sector Debt?

The first question is whether a central bank should primarily hold safe assets such as government debt. Some believe that holding private-sector debt reduces the quality of the Bank of Japan's assets, and that the Bank should buy more government bonds.

In fact, the Bank already holds a very substantial amount of government securities. Its holding at the end of November 1998, including short-term securities (financing bills, or FBs), amounted to approximately \52 trillion. This, together with the government securities worth about \5 trillion borrowed through repo operations, accounted for approximately two thirds of total assets. However, such a high ratio is not typical of central banks. In fact, the only central bank having a higher proportion of government securities in its portfolio is the Federal Reserve of the United States. The central banks in continental Europe primarily purchase private-sector debt such as bills and deeds in providing liquidity, and therefore government securities comprise a smaller proportion of their portfolio. The European Central Bank (ECB), which will administer a common monetary policy for the countries participating in the European Monetary Union from January 1999, will also accept both government securities and corporate-sector debt as eligible assets.

Historically, the concept of a central bank dates from when the Bank of England evolved from a commercial bank into a central bank. The traditional activities of central banks have included provision of funds through the rediscounting of bills discounted by commercial banks. Thus, they have long successfully employed corporate-sector debt as collateral for supplying funds by adequately managing the risks involved, although this has not always been easy. Before large-scale issuance of government bonds began in Japan, the Bank of Japan in fact made active use of corporate-sector debt, especially bills, in providing funds.

The important issue in the portfolio selection of a central bank is not the choice between government and private-sector debt, but rather the avoidance of distortions in resource allocation in the respective financial markets. Based on this principle, the Bank intends to make greater use of selected, sound private-sector debt as market operations instruments or as collateral when it deems this necessary to achieve current policy objectives, such as the development of new markets.

B. Transaction Counterparties

The second question is whether the central bank should make direct contact only with the banking sector, and influence the economy indirectly. Some argue that direct contact with the corporate sector is undesirable in that it creates a potential for arbitrary behavior by the central bank, or for the prolongation of the life of inefficient firms.

This is a matter of principle of whether a central bank should limit its counterparties to banks, or whether it should also deal with the non-banking sector.

The concern seems to have originated in the Bank’s active use of private-sector debt through such means as expansion of CP repo operations, which may have given the impression that the Bank is excessively involved in corporate fund-raising. But this concern appears to contain a slight misunderstanding. Although the Bank is indeed buying CP——which is a form of corporate-sector debt——through market operations, it buys the CP from financial institutions including banks, and therefore the counterparties in its operations have not changed. Furthermore, the Bank does not specify the individual CP issues to be submitted, but rather the counterparty financial institutions offer issues of their choice from among those deemed eligible by the Bank. Purchasing CP is no different from providing commercial banks with loans on bills in the sense that the Bank supplies funds to commercial banks by refinancing corporate debt.

However, it merits consideration whether participation in market operations and other Bank transactions should be made open to non-bank entities. If we look at examples overseas, it appears that the ECB will carry out its market operations only with banks. In the United States, however, the Federal Reserve conducts market operations with so-called primary securities dealers, many of which are securities companies that do not have accounts at Federal Reserve banks. A key point in considering this counterparty issue is whether the emphasis is on interbank transactions or open market transactions. If a central bank primarily conducts interbank transactions, the counterparty will naturally be the banking sector. Yet it seems that the global trend is a growing preference by central banks for open market transactions. In Japan, the Bank selects counterparties according to its own eligibility criteria from among banks, securities companies, *tanshi* companies (money market broker-cum-dealers), and other institutions that have accounts with the Bank.

In the final analysis, I think that the rational solution to this issue is not to restrict counterparties to banks, but choose them from a wider range of entities in order to achieve swift and certain permeation of policy effects and adequate control of counterparty risk, while taking into account such factors as changes in the financial structure. It is certainly essential that the money market, where the central bank makes transactions, be sufficiently developed in both qualitative and quantitative terms. In this regard, Japan will soon have a fully fledged FB market with the introduction of a public auction system for FB issues. As such open market transactions expand, leading to diversification of financial services providers, the Bank will review its selection of counterparties in the Bank's market operations.

C. Corporate Bonds and Equities

The third question is whether the Bank should purchase corporate bonds and equities in view of the critical state of the Japanese economy. This argument is based on the fact that the stock market was at one time supported by the public sector's purchase of equities. It is also the view of the advocates of such intervention that, if the Bank is concerned about risks, it can ask for government guarantees.

First of all, I would like to emphasize that a central bank can create liquidity but not capital. There is intrinsically a definite limit to the extent to which a central bank can take on private-sector risk. Assuming such risk and compromising the quality of its assets might impair the Bank's credibility, which is needed to fulfil its mission. This is why the Bank of Japan Law of 1997, like the previous law, does not allow the Bank to buy equities, which are subject to large credit and price volatility risks. Accordingly, the Bank cannot purchase equities and judges that it should not provide funds in a manner that would involve a similar degree of risk. For the same reason, it also believes that it is inappropriate for the Bank to purchase corporate bonds outright and hold them until maturity.

Placement of government guarantees is not a perfect solution. Although this would reduce credit risks, purchase of corporate bonds and equities yet involves another problem——it might lead to the long-term fixing of assets on the Bank's balance sheet. For example, loans extended to the DIC are increasing rapidly, but the Bank cannot justify extending them for a longer term than necessary just because they are government guaranteed. The prolonged holding of such assets would reduce the Bank's flexibility in money market operations. Moreover, if the balance sheet were left expanded, it would arouse concern about a decline in asset quality. In any event, the outcome would be an impairment of Japan's credibility, which would force Japanese banks and firms to pay unnecessarily high financing costs overseas.

In view of the current state of Japan's financial system, the Bank is prepared to provide the DIC with necessary liquidity in order for the corporation to perform its role effectively. However, I believe that the DIC should subsequently secure longer-term funds by swiftly replacing the Bank's loans with government-secured bond issues or commercial bank loans. The Bank must always be ready to carry out flexible money market operations and serve the function of the lender of last resort whenever necessary. And for this, it is essential that the Bank avoid fixing the massive loans to the DIC on its balance sheet.

V. Rebuilding Japan's Economy and Financial System

I hope my remarks today have been able to clarify some of the issues concerning the Bank's balance sheet. Before ending my speech, since the end of 1998 is only a week away, I would like to discuss Japan's policy agenda for the new year and emphasize the Bank's commitment to it.

The most important task for 1999, given the current state of the Japanese economy, will be to rebuild the economy and the financial system. The role of the Bank will be to work relentlessly to (1) support the rebuilding of the Japanese economy by maintaining the current easy stance on monetary policy; and (2) continue to supply sufficient liquidity to ensure the stability of the financial system.

The fundamental problem confronting the Japanese economy is not a shortage of liquidity, but a shortage of capital and reluctance to take the risks that would help economic expansion. The cure for these, as I have stated many times, is firstly to strengthen the capital base of financial institutions and restore their financial intermediary functions, and secondly to act promptly to create in the capital market an environment that makes it easier for investors to take risks. As an essential first step toward improvement in these two areas, household and business confidence must be restored.

In the currency field, January will see the debut of the "euro". As a result, the world will have three major currency areas——those of the dollar, the euro, and the yen——each backed by its own giant economic sphere. Overcoming the aforementioned problems is a prerequisite to making the yen more usable and reliable internationally, enhancing its integrity. This is an extremely important step in accomplishing further development of the Japanese economy by utilizing the world's capital and innovative management techniques.

To repeat, the priorities in 1999 will be to rebuild Japan's economy and financial system, and thereby lay the foundation for a globally credible yen. The Bank of Japan is determined to support these efforts through its monetary policy and financial system policy.

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