**Mr Hayami reports on recent monetary and economic conditions in Japan and elucidates progress toward the reconstruction of Japan's financial system**

Speech by the Governor of the Bank of Japan, Mr Masaru Hayami, at the Research Institute of Japan in Tokyo on 18 March 1999.

## I. Introduction[1]

It is a great honor to be invited to the Research Institute of Japan and have the opportunity to speak to you.

I will begin with a brief outline of recent monetary policy management and then give my thoughts on today's topic, the progress toward the revitalization of Japan's financial system.

## II. Recent Monetary Policy Management

### Monetary Easing in February 1999

On February 12, the Bank of Japan decided to conduct a further monetary easing. The new guideline for the Bank's money market operations is to "encourage the uncollateralized overnight call rate to move as low as possible" while giving due consideration to avoiding excessive volatility in the markets.

Let me review the economic situation at the time of the decision. The pace of economic deterioration had been moderating since last autumn, supported by the increase in public investment. However, economic activities in the private sector remained sluggish, and business and consumer sentiment was persistently weak. Moreover, the rise in long-term interest rates and the appreciation of the yen against the U.S. dollar since the end of last year had added to the downside risk to the economy. There was concern that, if these trends continued, the economic deterioration would not come to a halt, possibly accelerating once again in the future. In light of these developments, the Bank judged that it would be appropriate to give maximum support to economic activity through monetary policy.

There have been some changes in the financial market since the monetary easing. The overnight call rate has fallen, recently to close to zero percent, reflecting the Bank's provision of ample funds to the market. Money market interest rates on instruments with relatively long maturities, such as one month and three months, have also declined considerably. In addition, long-term interest rates have marked a clear decline, although the monetary easing was probably not the only factor involved. The yen has generally followed a downward trend. Stock prices, as measured by the Nikkei 225 Stock Average, have recovered to around \16,000. We believe that, if these trends in the financial markets continue, they will influence the economy positively through an improvement in returns on investment, a further alleviation of the fund-raising conditions of financial institutions and firms, and a recovery in business and household confidence.

Concurrently, measures such as the injection of public funds into major banks are likely to further advance the reconstruction of Japan's financial system. Also, the effects of the emergency economic package are expected to come out more fully. I strongly hope that the Bank's latest monetary easing, combined with these policy measures, will give substantial support to economic activity.

Given the recent drop in the overnight call rate to close to zero, some market participants have come to think that the Bank of Japan has decided to employ an approach different from past easings, a so-called quantitative monetary expansion. What I would like to emphasize is that interest rates and quantity of money are like two sides of the same coin. It is only natural for the Bank to expect the

[1] This article is excerpted and translated from the speech given in Japanese.

latest monetary easing to lead to an increase in money stock and other monetary aggregates through changes in the behavior of financial institutions and in demand for funds. And this is nothing more than the normal transmission that the Bank expected with any interest rate cut in the past.

The Bank's intention has merely been to carry out money market operations in accordance with the current monetary policy guideline decided by the Policy Board, which states that the Bank should encourage the uncollateralized overnight call rate to "move as low as possible." Of course, the Bank will continue to closely study other possible ways of managing monetary policy. I would like to emphasize, however, that at present the target of policy management is, as it has always been, the overnight call rate, and that the Bank's aim now is to bring this rate down to as low a level as possible.

In inducing declines in the overnight call rate, the Bank is giving, and will continue to give, due consideration to the maintenance of market functions. The recent decline in the overnight call rate has encouraged institutional investors to shift part of their funds to ordinary deposits at banks, thereby causing an approximately 20 percent decrease in the outstanding transaction volume of the call money market. Fortunately, this contraction of the call money market has not hindered smooth settlement of funds. However, considering the recent big changes in the flow of funds, it will be necessary for the Bank to carefully monitor market developments to make sure that they do not impair the proper functioning of the money market.

**Problems Associated with Government Bond Operations by a Central Bank — Underwriting and Increasing of Outright Purchases**

A number of people have suggested that the Bank underwrite Japanese government bonds (JGBs) or increase its outright purchase of JGBs in easing monetary policy. As I have repeatedly stated, however, it is totally unacceptable for a central bank to adopt measures that could lead to unlimited financing of the fiscal deficit or ones that could be interpreted as such.

As you know, the Bank's basic stance on the outright purchase of JGBs is to keep the amount of operations roughly in line with the long-term trend in increase in banknotes. At present, such operations are carried out twice a month, each in the amount of \200 billion.

If the Bank were to change its stance and expand the outright purchase of JGBs without limit, it could very well result in the loss of fiscal discipline, just as could happen with the Bank's underwriting of JGBs.

If a central bank made unlimited purchases of JGBs, the government would of course have no difficulty in funding its fiscal deficit no matter how massive. This would encourage both the public and private sectors to rely on greater-than-necessary stimulative measures financed by a large-scale issuance of JGBs even at the slightest sign of weakness in the economic outlook. Should such massive JGB issuance continue, Japan's economy would only end up having a massive fiscal deficit and an extremely weak supply side in the private sector.

Various shocks are inherent in an economy. Even though there is no need at the moment to consider the risk of inflation, we cannot rule out the possibility of some kind of a "demand shock" occurring over the longer term, such as a plunge of the yen and a tightening of global market conditions. If such a shock hits the economy when the supply side of the economy is feeble, firms will be apt to seek desperately the few skilled workers capable of handling new technology, rush to secure rare materials, or race to invest in plants and equipment in order to seize suddenly appearing business opportunities. Supply shortage, by fueling such a nervous psychology, might intensify inflationary pressure even before economic conditions improve noticeably. To contain such inflationary pressure, it would be necessary to drastically tighten monetary policy. As a result, the economy would be forced to go through severe adjustments.

The risk of inflation causing a wide swing of the economy can only materialize in the distant future, but the Bank of Japan, being responsible for maintaining price stability, must always be fully alert to such a risk. It is this strong commitment to maintaining price stability over time that makes monetary policy that could lead to the loss of fiscal discipline unacceptable.

It may be argued that the Bank should disregard the possibility of future inflation at such a time when Japan's economy is plagued by the risk of deflation. On this point, I would like to stress that the Bank of Japan shares the view that inflation is not at all an immediate threat. We are fully aware that the top priority for Japan's economy at present is to dispel the deflationary psychology. It is precisely for this purpose that the Bank further relaxed its monetary policy in February, and the Bank believes that as of now it has taken all necessary measures. The Bank is also determined to maintain an easy monetary policy stance until the economy gets back on a steady recovery path.

In doing so, the Bank of Japan will avoid employing monetary policy measures that might encourage unwarranted expansion of the fiscal deficit, with unwelcome results of some kind in the future. Instead, the Bank will underpin economic activity on the monetary front while maintaining the discipline of a central bank at all times. The reason independence is essential to a central bank is that it is expected to act constantly with a view to stabilizing even the future value of money, not being swayed by short-sighted concerns. The Bank believes that what it should do now is to provide the market with ample funds and, at the same time, take great care to avoid the risk of future inflation.

## The Importance of Structural Reform

What needs to be done for Japan's economy today is to strengthen the supply side of the economy by restoring the productivity of the private sector, which declined after the collapse of the "bubble." This should be achieved while monetary and fiscal policies are underpinning the economy, which means that the time limit may not be so far away. If policies to stimulate aggregate demand continued to be implemented without any progress in structural reforms that should renew the private sector, Japan's economy would become increasingly inefficient and its productivity would decline further. Such an economy would be vulnerable to shocks that could lead to vicious inflation. In order to achieve sustainable economic growth without people anticipating inflation, the private sector should be continually revitalized through innovations and expansion of business frontiers. One obvious example of this is the U.S. economy, which has enjoyed eight years of uninterrupted expansion.

Firms in various industries are becoming increasingly decisive in disposing of the "negative legacies" inherited from the "bubble" economy in their accounting-year-end settlement in March 1999. These moves can be taken as indicating firms' determination to launch drastic restructuring, and the Bank considers them as a necessary step for reviving the economy. If these efforts to part from the past are accompanied by moves to enhance future activity, it should lead to the ideal picture, in which both structural adjustment of industry and an overall economic recovery are achieved smoothly.

The problem, as things stand today, is the persistence of the risk that the rapid disposal of "negative legacies" will proceed in the absence of sufficient constructive moves, strengthening the deflationary tone of the economy. However, various efforts are starting to be made by firms and the government toward structural reform, and I hope such efforts will gradually bear fruit.

The dynamic process of divesting the economy of its old systems and giving birth to new ones unavoidably involves great uncertainties. Therefore, it is also essential to reconstruct Japan's financial system as promptly as possible to support the activities of firms facing this dynamic process.

Bearing in mind the significance of financial system reconstruction, I would now like to talk about the Bank's thoughts on this issue.

## III. Progress Toward the Reconstruction of Japan's Financial System

### A. The Current Condition of Japan's Financial System

It has been approximately nine years since Japanese stock prices peaked in late 1989 and approximately seven years since land prices began to fall. Meanwhile, a vast amount of money has been used to tackle the nonperforming-loan problem of financial institutions. It is truly regrettable that this problem has not been completely resolved as yet.

Today, the linkage between financial markets in Japan and abroad has strengthened significantly due to the unprecedentedly rapid globalization and computerization of financial services. Therefore, once a shock arises in one market, there is very serious risk that it will infect other markets. This is precisely why not only Japan but also other countries desire an early solution of Japan's nonperforming-loan problem and the restoration of the credibility of Japan's financial system.

Needless to say, the parties concerned have made very great efforts to resolve the problem. In fact, with the enactment of the Financial Function Reconstruction Law and the Financial Function Early Strengthening Law of 1998, great progress has been made in establishing an institutional framework. The stage is now set for the actual task of unflinchingly cleaning up the nonperforming loans.

I have repeatedly stressed the need for enhancing the capital base of Japanese financial institutions, based on my thinking that the fundamental issue behind the deterioration in the credibility of individual institutions and the financial system as a whole is insufficient capital. In this regard, I truly appreciate the government's decision to inject large amounts of public funds into major banks as a significant step toward restoring the credibility of financial institutions. This alone, however, is not enough to solve the problem. The Bank strongly hopes and expects that financial institutions will continue to do their utmost to remove nonperforming loans from their balance sheets and also to restructure their businesses within the context of the restructuring of the entire financial sector.

In the past several years, the United States and Europe have witnessed large-scale mergers and business tie-ups of financial institutions, which illustrate the dynamic competition in the global financial market. There have been mergers and alliances across business and national boundaries in efforts to respond to European unification or to enter new business areas. Meanwhile, similar moves in Japan have been limited. However, the very recent trend toward diverse alliances and reorganizations, which was in part triggered by the injection of public funds, merits attention. It is clear that financial services are becoming greatly diversified driven by deregulation and innovation in information technology. Under these circumstances, the management of financial institutions is required more than ever to establish effective strategies for selection of areas in which they can find comparative advantage and invest management resources, and for efficient supplementation of their weak business areas. In order to achieve corporate objectives, it may be more effective in certain instances not to limit alliance partners to Japanese institutions. These considerations, in my view, should lead to still greater reorganization of the global financial community.

### B. Lessons Learned from Experience

One of the most important issues for Japan today is how to establish an efficient and stable financial system that can fully perform financial intermediation as well as other functions required in the 21st century. Japan is still in the process of resolving the nonperforming-loan problem. Therefore, the lessons that will ultimately be learned from it is not yet known. Nevertheless, I believe it is meaningful to go over the lessons we have learned to date from our experiences in order to successfully build a new financial system.

In my view, we have learned that Japan should have reviewed its principles to place emphasis on risk management and should have utilized the market mechanism much sooner than it actually did, in response to the changes in the conditions surrounding financial industry. Now, in order to catch up with the rest of the world, Japan needs to accelerate this review of principles.

The first concrete factor behind the delay in the review of principles was the inadequacy of the risk management systems of Japanese financial institutions. During the "bubble" economy in the late 1980s, Japanese financial institutions expanded their lending in pursuit of larger profits without satisfactory risk management systems. In retrospect, the insufficient scrutiny of the possibility of land price declines and concentration of loan exposure to the real estate-related industry were manifestations of the absence of basic credit risk management. During this period, major financial institutions overseas were in fierce competition to improve their risk management techniques not only for credit risk but also for market risk. The great damage Japanese financial institutions suffered after the collapse of the "bubble" economy merely exposed their inadequate risk management.

The second factor was the ineffectiveness of the market's checks and balances, or put another way, the deficiency of a system that should encourage the working of this mechanism. One reason for this was the extremely cautious stance of the parties concerned toward disclosure. For example, the prevalent view until not so long ago was that disclosing the amount of nonperforming loans required careful consideration because it might destabilize the financial system. The accounting system and accounting practices have also tended to obscure the actual business condition of financial institutions. These increased the opaqueness of management of financial institutions and, contrary to the expectations of the parties concerned, spurred the deterioration in the credibility of Japan's financial system as a whole.

The third factor was the monetary authorities' insufficient response to the changes in the financial markets. We had historically relied on detailed regulations and one-on-one guidance to financial institutions in maintaining the stability of the financial system. It is true that these methods had worked for a long time. However, it also seems that they allowed Japanese financial institutions to be indifferent to risk management and to their own responsibilities, and encouraged their "do-as-everyone-else-does" philosophy.

Under this so-called "convoy system," Japanese financial institutions offered very similar financial services. It is a fact that there was little incentive to differentiate themselves from their rivals. There was no competition, and even if a financial institution developed a new product, the regulatory system tended to prevent the innovator profiting as he deserved.

The conventional principles might have remained viable, had the financial industry remained static. However, innovation in financial technologies has been dramatic. It is no longer possible for a fine-meshed net of regulations to keep up with the rapidly evolving financial transactions and markets, and to ensure unaided the soundness of financial institutions. This is why it is necessary to establish new principles based on self-responsibility and on the market mechanism.

## C. Establishment of New Principles

### *1. Issues toward April 2001*

At present, the Japanese government provides a comprehensive safety net to the financial system effective until March 31, 2001. The safely net is composed of (1) a framework to recapitalize financial institutions with public funds; (2) full protection of deposits and other financial institution liabilities; and (3) a scheme to establish bridge banks or temporarily nationalize troubled banks. These measures are essential given the current severe situation of the Japanese financial system. However, we believe that unnecessary prolongation of these measures will be inappropriate, because they have the potential of causing (1) an increase in social cost, including the amount of public funds used; (2) moral hazard on the part of depositors and financial institutions; and (3) further delays in solving the nonperforming-loan problem. Moreover, they are totally incompatible with the principles of Japan's financial "Big Bang," which are "free, fair, and global."

I do not mean to say that from April 1, 2001 onward resolution of financial institution failures should in every case involve execution of the so-called "payoff," that is, payment of deposit insurance benefits. What is important as we move toward April 2001 is for individual financial institutions to improve the quality of their balance sheets and strengthen their capital base. At the same time, we must design and build a safety net based on the new principles of financial business, which I will discuss in more detail later, and also on the lessons learned from past examples of financial institution failures. The scheme should incur the minimum social and economic costs, be able to promptly solve problems, and fit the financial system of the 21st century.

*2. Emphasis on risk management*

The foremost among the new principles is to place emphasis on risk management. As suggested by the expansion of derivatives transactions, financial transactions are sure to continue to undergo rapid changes. Especially for major banks that are exposed to keen competition in international financial markets, adequate risk management will require constant efforts to keep up with financial innovation. Needless to say, the management of financial institutions needs to fully understand the substance and nature of the information derived from the risk management system, and effectively use the information in making its management decisions.

*3. Utilization of the market mechanism*

The second is to utilize the checks and balances of the market and to build into the financial system a mechanism that ensures the system's stability. A prerequisite for this is disclosure of more information to the market, which means more transparent financial institution management.

In this regard, it is most important to revise the accounting system. Assessment criteria for nonperforming loans and standards for loan write-offs and loan-loss provisioning are now under review. At the same time, vigorous preparations must also be made for mark-to-market accounting, which is soon to be introduced. The new accounting system is expected to increase the transparency of the balance sheet of financial institutions. Furthermore, it is expected to make financial institutions aware of the risks they are taking by helping them better understand their own financial condition.

For greater transparency of financial institution management, as the Bank has been stressing for some time now, voluntary expansion of the scope of disclosure of an institution's financial condition is also important. Enhanced disclosure may at times mean forcing financial institutions to reveal their unsolved problems. Even so, past experiences teach us that it is more effective in securing the trust of the market to honestly admit the existence of problems and declare how such problems will be solved than to conceal such information. It is also important for the management to explain in its own words the management policy in order to win the trust of the market. Financial institutions should consider disclosure not as a duty but as an opportunity to earn a good reputation with the public, and make active use of such opportunities. Once a pioneering financial institution makes such disclosure, others will follow suit or even improve the content of the disclosure. This will unleash a dynamic competitive process.

Utilization of the market mechanism and increased sophistication of risk management will provide a means of detecting a deterioration in the health of financial institutions. It will therefore not only reduce the cost of regulating and supervising financial institutions but should also lessen the burden on the safety net by preventing failures.

## D. Response of the Bank of Japan

The Bank of Japan believes that it has done its best to counter financial institutions' nonperforming-loan problem within the existing institutional frameworks by, among other things, fulfilling its role as the lender of last resort. However, the Bank needs to continue to examine unceasingly the role a central bank should play based on its experiences in battling the present financial crisis.

### *1. The failure of Nippon Credit Bank*

From this perspective, the first incident we should examine carefully, I believe, is the case of Nippon Credit Bank. The temporary nationalization of this failed bank is likely to cause the Bank of Japan to lose the \80 billion it subscribed to the bank's capital through the New Financial Stabilization Fund. In April 1997, when Nippon Credit Bank drew up its restructuring plan, there was no safety net with which to deal with its management problems. Nor was there a consensus that bank debentures could be protected by the deposit insurance system. Accordingly, there was a strong concern that, if the bank failed, it would seriously disrupt the financial system at home and abroad. The Bank of Japan therefore made a difficult decision to use the New Financial Stabilization Fund. I believe that this was the only choice the Bank had to safeguard the financial system. Unfortunately, subsequent developments have made it quite probable that the money subscribed by the Bank of Japan could be lost. The Bank regards this as a grave situation.

Based on this experience, the Bank believes that it has to further clarify its policy on the provision of funds for the purpose of maintaining an orderly financial system. Specifically, the Bank will have to define in more detail the criteria for assessing the fulfilment of the existing four conditions for funds provision: (1) there is a threat of systemic risk materializing; (2) there is no alternative to the provision of central bank funds; (3) appropriate measures will be taken to prevent moral hazard; and (4) the financial soundness of the Bank of Japan will not be impaired. Now that a safety net, including a scheme to enhance the capital base of institutions with public funds, is in place, the Bank of Japan should be even more discreet in its capital subscription, or the provision of risk capital. The Bank has learned valuable lessons from the disturbances in the financial system associated with the birth and collapse of the "bubble" economy and from its own responses to the disturbances, including the failure of Nippon Credit Bank. These lessons will always be remembered by the Bank of Japan and referred to in making decisions in the future. I believe this is a responsibility assigned to us by the new Bank of Japan Law, which came into effect in April 1998.

### *2. Review of the Bank's on-site examination and off-site monitoring of financial institutions*

Given the changing environment surrounding the financial industry and the Bank's experiences in dealing with financial institution failures, the Bank recognizes the need to review its on-site examination and off-site monitoring of financial institutions from a broad perspective. It cannot be denied that examinations and monitoring by the Bank during the "bubble" period were not fully successful in accurately grasping the financial condition of financial institutions or, based on their findings, in prompting the Bank to take necessary steps to warn other parties of the situation.

A central bank implements its policy through banking transactions. Therefore, its on-site examinations and off-site monitoring, which are designed to accurately grasp the financial condition of individual transaction counterparties, are important starting points for execution of its policy. They are also essential in order for the Bank to accurately identify the risks in the overall financial system and the possibility of their materialization, and thereby prevent disruptions in the financial system.

In conducting on-site examinations, we will continue to place emphasis on the assessment of the financial strength and risk management systems of institutions. In addition, with a view to adapting to the changing environment surrounding financial institution management, the Bank will become more flexible in determining the frequency of examinations and will carry out “targeted examination,” which focuses on specific areas of business and management. The Bank also intends to follow the condition of financial institutions on a continuous basis through a closer integration of on-site examinations and daily off-site monitoring. The Bank believes that the integration should also reduce the regulatory burden on financial institutions.

The Bank will also make public as far as possible the findings of its research and studies on the overall financial system based on the information obtained through examinations and daily monitoring. By doing so, we hope to assist the advancement of financial institutions’ risk management techniques.

*3. Loans to the Deposit Insurance Corporation*

Now, I would like to add a word on the Bank of Japan’s lending to the Deposit Insurance Corporation (DIC). The Bank’s lending to the DIC has increased significantly reflecting the massive funding needs of the DIC in proceeding with the resolution of the nonperforming-loan problem of financial institutions. Moreover, it has become very likely that this loan exposure will be fixed for an extended period of time. The very function of a central bank is to implement monetary policy through the purchase and sale of short-term, liquid financial assets. A sizable increase in fixed assets might not only cause concern about a deterioration in the central bank’s assets but also become a great impediment to the execution of monetary policy and money market operations. The Bank therefore regards the problem to be a very serious one. It is extremely unusual by international standards for a central bank to provide funds to facilitate the operation of the deposit insurance system. In fact, there has been no such case in the major industrialized countries. Therefore, the Bank of Japan believes that the DIC, in raising funds, should first turn to the private sector and, for example, issue bonds, limiting its borrowing from the Bank of Japan to a bare minimum.

Needless to say, given the present condition of the Japanese financial system, the Bank of Japan will not hesitate to provide short-term funds necessary for the smooth operation of the DIC. However, for the reasons I have just described, I wish to stress that the DIC should first seek to raise funds through means other than Bank of Japan loans, and make it clear that central bank money can be used only as temporary bridge funds. In order to avoid taking on long-term fixed assets, the Bank of Japan is deliberating whether to review the lending rate applied to the DIC, which to date has been the same as the official discount rate, to reflect the lending rates charged by private financial institutions.

## Conclusion

The Japanese financial system has been in an unprecedented crisis. This can be viewed as a painful process of transformation of the financial sector from a heavily protected to a competitive industry that generates new know-how and income.

The path of this transformation will not be smooth. However, emerging moves on the part of financial institutions to undertake decisive restructuring and reorganization, and the fact that these institutions still possess sufficient potential in terms of management resources, including human resources, firmly convince me that it will not be too long before they revive as a fully competitive industry, in terms of quality rather than quantity, and driven by foresight rather than hindsight.