Sakuya Fujiwara: Policies and Internal Management of the Bank of Japan

English translation of a speech by Mr Sakuya Fujiwara, Deputy Governor of the Bank of Japan, given at the Japan National Press Club on 31 January 2001.

This translation covers the full text of his Japanese speech as far as economic outlook and monetary policy are concerned. With respect to the other parts, only summary has been translated.

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Economic Outlook

Today, I would like to discuss the current conditions of the Japanese economy and its prospect. At the end of October 2000, the Bank published a five-page document titled "Outlook and Risk Assessment of the Economy and Prices," which I call the "Outlook Report" to make the title short. The Outlook Report describes our baseline scenario of the economy and assessment of risks. The report is published twice a year and, in the case of the October 2000 issue, it covers the most likely scenario for fiscal years 2000 and 2001. At the Monetary Policy Meetings of the Bank's Policy Board, a number of board members have used the Outlook Report as a yardstick on which they base their arguments about questions such as a) whether the economy is following the baseline scenario or b) whether its risk profile has changed. This is well illustrated by the Minutes of the Monetary Policy Meeting of December 2000, which were released last week.

The baseline scenario in the Outlook Report of October 2000 can be summarized by the following three points. First, moderate economic recovery led by private demand is likely to continue in Japan. Second, strong economic expansion is, however, unlikely to happen because a variety of structural adjustment pressures persist in Japan, including balance-sheet adjustment and continuing restructuring in both the financial and non-financial business sectors. Third, economic recovery will continue to be led by the corporate sector, while the household sector lags behind.

The report points out five downside risks and one upside risk. On the downside: a) IT demand in the global market, b) impact of oil price rises, c) international financial market developments, d) impact of the balance-sheet adjustment and restructuring in both the financial and non-financial business sectors, and e) increase in consumers' anxiety for the future, whereas on the upside, a possible revision of the expected rate of growth medium term in the corporate sector. Since the report raised a greater number of downside risks and described them on a lot more pages, economists and journalists seem to have understood that the Bank's views on risks to the baseline scenario was biased towards the downside. Although you cannot measure our assessment by simply counting the number of risk factors mentioned or the number of pages that are consumed for their description, it is perhaps fair to say that the Bank of Japan was more strongly conscious of downside risks than upside. You may also be aware of the fact that the elements that are being discussed now were already considered seriously at the time when the Outlook Report was released.

Allow me to turn to economic developments after the release of the report. While a moderate economic recovery continues, its pace is slowing down as is reflected in deceleration of production growth caused by export slowdown and pause in improvement in the business sentiment. As you may be aware, the Bank of Japan's assessment in its Monthly Report of Recent Economic and Financial Developments became more cautious in December 2000, and again in January 2001. Setting these economic developments against the aforementioned Outlook Report, the majority of the Policy Board is of the view that the economy has developed in line with the baseline scenario, but, at the same time, some of the downside risks have become greater, especially those related to the global economy.

I would like to explain, first, why we maintain our baseline scenario, i.e., moderate economic recovery led by private demand mainly in the corporate sector. According to the Tankan survey of December 2000, the corporate sector continues to expect a substantial increase in profits and stepping up its business investment plan for this fiscal year. Machinery orders and other leading indicators also suggest that the growth trend in investment is likely to continue, being stimulated by IT businesses. At the same time, we need to monitor carefully the impact that a slowdown in production and exports might have on the business decision-making with respect to investment for the next fiscal year, for the slowdown is a negative element in the corporate sector, which has led the entire economy to date.

Weak as they are, incomes of the household sector have stopped worsening as the supply and demand conditions in the labor market have begun to improve and wages are increasing year on year, albeit to a small extent. Under these circumstances, some positive signs have been witnessed with respect to auto sales, electronic sales and tourism, although personal consumption as whole still lacks buoyancy. All this suggests that despite negative factors like stock price declines, the improvement in corporate profits has gradually been exerting positive influences on the household sector after a certain time lag.

In sum, the momentum for recovery continues in the corporate sector as is shown by profits and business investment, and the trend in the household sector are also showing firm movements amidst a quite modest growth. Therefore, we consider the main thrust of the baseline scenario, or moderate recovery led by private demand, to be maintained.

It is true, however, that risks to this baseline scenario are becoming greater. We are now paying particular attention to two risks: global economic slowdown especially in the United States; instability in stock markets both at home and abroad. Let me elaborate on each of these risks.

First, US economic slowdown is becoming increasingly evident. US economic growth has significantly slowed down after it registered rates over 5 percent, well above its potential growth rate until the first half of 2000. Some slowdown is not surprising at all in view of very fast growth in the preceding period. The slowdown may be desirable for sustainable growth as long as it is what is believed to be a "soft landing."

However, the pace of slowdown in recent months has been more rapid than anticipated. At least in the first half of this year, the US growth rate is likely to stay modest. Although the majority view among economists is the one for recovery towards the second half of the year, it is difficult to envisage the depth and duration of economic adjustment following the very fast growth in recent years. One good news is that there remains significant room for US macroeconomic policy. In this regard, the Federal Reserve cut its federal fund rate target by 0.5 percent in its FOMC meeting of January 3, 2001. I understand that this reflects Federal Reserve's determination to keep the economy on a sustainable growth path in the long and medium run.

These US economic developments could have a significant impact on the global economy, especially the Asian economies, which have close trade relations with the United States. In fact, a slowdown in export growth has been observed in Asia. Under the present circumstances, we have to watch very carefully the impact of the US slowdown on our economy, examining both direct and indirect channels of influence, including Asian economies, stock markets, and global capital flows.

The second risk we are paying particular attention to is unstable developments in stock markets both at home and abroad. The most fundamental determinant of stock prices is prospect for corporate profits, and in this respect, the recent Tankan survey and market analysts' views support a continued increase in profits. In spite of this, stock prices dropped in recent months in Japan. This can be attributed in large part to adjustment of IT stock prices in the global market, which has bearings on the first risk I mentioned a minute ago.

In addition, there is of course a domestic element for consideration. In domestic financial markets, bond yields have declined, and so have stock prices together with the yen's depreciation on the exchange market, the combination of which can be interpreted as a reflection of bearish market sentiment about the Japanese economy. This market sentiment is much more bearish than the economic prospect indicated by corporate profits and other real economic activities. We will therefore have to examine both economic and financial developments attentively and without preoccupation, in order to find out whether the market is excessively pessimistic or simply preceding economic fundamentals to come about.

It is true that the market' s concerns about structural problems are strong and deep-rooted. The market has been reminded of delays in structural reforms in Japan whenever it hears bad news regarding exogenous events such as US economy or stock markets. This has been repeated a number of times. Once a decline in stock prices sets in, it might have a negative impact, irrespective of its proximate cause, on the economy through deterioration in creditworthiness of borrowers as well as risk-taking capability of financial institutions as a result of declines in unrealized profits from their equity holdings and/or deterioration in the confidence of both the business and household sectors. In this respect, however, no changes have actually been observed in lending attitude of banks or credit availability for borrowers covered by the Tankan and other business surveys. Neither have been observed any deterioration in consumer confidence nor business appetite for fixed investments.

Nonetheless, because these changes may not necessarily become readily observable, we have to remain vigilant.

Monetary policy

To sum up, while the baseline scenario of moderate economic recovery still holds, risk elements involving US economic developments and stock markets are becoming more pronounced. Therefore, on the monetary policy front, we consider it to be appropriate to maintain the accommodative stance to support the ongoing recovery. Under these circumstances, we intend to examine closely how such risk elements will influence the Japanese economy.

At the Monetary Policy Meeting of January 19, 2001, Chairman of the Policy Board, Governor Hayami issued instructions to the Bank's staff: the staff will examine possible rooms for further improvements in the way of liquidity provision to the market, with a view to ensuring the smooth functioning and stability of the financial market, and report the results to the Policy Board by the next Monetary Policy Meeting. This is aimed at maximizing the effect of our accommodative monetary policy. Since we have yet to explore, I should refrain from making comments on specific measures. Instead, I would like to discuss here my approach to this question.

First of all, we are exploring whether there is no further room for improving the way in which the Bank of Japan provides the market with liquidity under the current directive of money market operations, i.e., encouraging the overnight call rate to move around 0.25 percent. As long as the market functions properly, this directive can be achieved without problems by using existing operational instruments, and monetary ease will be channeled through financial markets and the financial system to permeate into other markets and corporate finance.

However, this mechanism seizes up at a time of market disruptions or dysfunctioning of financial intermediation. For instance, there was a temporary deficiency in corporate financing in autumn 1998, when low interest rates prevailed in the interbank money market. With a view to supporting corporate fund raising, the Bank of Japan adopted several measures, e.g., increase in CP operations and creation of a temporary lending program.

Take a Y2K episode for another example. This happened at the end of 1999, when possible Y2K computer problems overshadowed financial markets. At that time, mounting demand for New Year liquidity put an upward pressure on interest rates of the contracts maturing beyond the year-end, although there was a widespread perception that the overnight call rate would likely be near-zero for some time under the zero interest rate policy. The Bank of Japan tried to stabilize the market by announcing its intention to provide ample fund maturing beyond the year-end in a flexible manner, and in addition, by enhancing its operational capacity through an introduction of new instruments, e.g., outright purchases and sales of short-term government securities.

These episodes clearly demonstrate that decisions of the overnight call rate guidance level is at times insufficient for monetary ease to permeate the economy, because the effectiveness of monetary policy varies, depending on the conditions of financial markets and financial institutions.

In order to avoid any misunderstanding, I should hasten to add that we, at present, see no seizing up in corporate finance or any other particular area, or anomalies in interest rates on contracts maturing beyond the fiscal year-end. Yet, in view of the greater downside risks that I noted earlier, we cannot rule out the possibility that some negative news might trigger instability in financial markets or uneasiness on the part of market participants about fiscal year-end funding. This consideration led to the Chairman's instructions to improve the Bank's capacity to provide liquidity so that the current monetary ease be maintained even in case of contingencies. I believe that enhanced preparedness on our side will help strengthen confidence among market participants, thereby stabilizing the financial market and thus the Japanese economy.

Financial System Issues (summary)

Let me now turn to financial system issues. Although we still cannot afford to be complacent about the situation, the amount of non-performing loan charge off by the Japanese banking industry has shown a significant decline. In addition, its capital adequacy ratio has improved by raising capital in the market as well as injection of public funds. At present, we think it unlikely that stability of the Japanese financial system will be put at risk. In light of the speed in which circumstances may change both at home and abroad, we should continue to be vigilant with respect to developments in the financial system.

Organization and Operations of the Bank of Japan (summary)

The Bank's operations must be conducted in an efficient manner since its costs are ultimately borne by the public. With the independence in monetary policy established and the autonomy of its management respected, it has become all the more important for the Bank to make efforts to promote the efficiency of its business operations and organization. Moreover, because the central bank is unique in the nation, it must always be mindful of self-examination so that "the Bank's commonsense" matches the "commonsense of the society."

Article 5 of the new Bank of Japan Law stipulates that the Bank "shall endeavor to conduct its business in a proper and efficient manner." I would like to emphasize at this juncture that, even two to three years before the discussion of the revision of the law, reforms had been initiated within the Bank in a variety of ways. Three years have passed since the new law became effective, during which period, the Bank has implemented the most significant restructuring in its own history, which covers the organizational structure, remunerations for the staff and executives, the number of staff, real-estate holdings, and facilities for staff welfare. All of these are intended to bring the Bank's business structure in line with the commonsense of the society. Aiming at further efficiency of business operations, we have reviewed our branch and office network and reached a conclusion that we should close branches in Otaru and Kita-Kyushuu. We are currently trying to obtain understanding of the public, particularly in the regions concerned.

The Bank of Japan will enhance for efficiency uninterruptedly rather than by a one-time reform. In order to become a more efficient central bank in the 21st century, we would like to make initiative in reviewing and re-examining the Bank's organization.