Masaru Hayami: Recent economic developments and monetary policy

Speech by Mr. Masaru Hayami, Governor of the Bank of Japan, at the Research Institute of Japan, Tokyo, 7 March 2001.

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1. Introduction

Two months have passed since the dawn of the new century. After Japan's economy went through a very tough decade at the end of the twentieth century, it has yet to regain economic strength and restore a full-fledged growth.

In 2000 Japan's economy was on a moderate recovery path as improvements became increasingly evident mainly in the corporate sector. However, unsavory developments followed. In particular, US economic growth slowed down in autumn 2000 more steeply than had been expected, and has recently begun to exert a significant influence over Japan's economy.

In a longer-term perspective, there had been a number of incipient cyclical recoveries in Japan's economy during the past decade, but they were followed not by a strong recovery but by a repeated threat of recession. At present, pessimism seems to overwhelm Japan's economic outlook. This has an aspect of both short-term business cycle and longer-term adjustment of Japan's economy.

Bearing these in mind, I would like to discuss, today, recent developments in Japan's economy as well as financial markets, and offer my thought about monetary policy.

2. Recent economic and financial developments

Economic developments

Allow me first to discuss economic and financial market developments. To put it in short, the Bank of Japan is of the view that Japan's economic recovery is slowing further and uncertainty over economic prospects is growing. Accordingly, we are becoming increasingly cautious.

During the past two years, a moderate economic recovery has been supported by the following mechanism. Growth in exports and demand for information technology (IT) has led recovery in production as well as profits, which in turn induced increase in business investment. However, the recovery in the business sector has exerted only a limited impetus to the personal sector because of strong pressures of corporate restructuring. Nonetheless, wages began to grow year on year in summer 2000. In other words, there was a momentum in the economy by which recovery in the business sector led, albeit slowly, that in the personal sector.

In late 2000 it became gradually evident that growth in exports and production slowed under the influence of rapid slowdown in US economic growth. In fact, Japan's exports stopped growing in the final quarter of 2000, which is now being followed by a decline. In accordance with export deceleration, production has come to a halt, and inventories have become somewhat excessive in some areas of industrial materials and semi-conductors whose export demand fell sharply. Consequently, some IT firms have announced a downward revision of their profit forecast although they continued to expect an increase. Under these circumstances, some concern has begun to be voiced with respect to the prospect for business investment. In view of the fact that economic recovery has been pulled by manufacturing and other industries, the recent developments might as well be considered to foreshadow economic outlook.

Downside risks

These discussions lead to the question of what are important risks in economic outlook and the magnitude thereof. The economy always faces a variety of risks, but since last autumn, we have paid particular attention to two downside risks, i.e. slowdown in world economic growth and instability in capital markets both at home and abroad. These risks intensified in early 2001, and now appear to be materializing gradually.

With respect to world economic slowdown, US economy has a key role to play. Having displayed a rapid growth of 5 percent until mid-2000, US economy has slowed its growth considerably in the second half. This slowdown proved to be more drastic than had been widely anticipated. Against this background, the Federal Reserve, or the central bank of the United States, decided on a reduction of its target interest rate by 0.5 percentage points at an unscheduled meeting of the FOMC at the beginning of the year, followed by an additional reduction of 0.5 percentage points at the end of January 2001. This sudden change in the economy is reflected in a significant downward revision of the central tendency among FOMC members with respect to real GDP growth rate from 3 ¼-3¾ percent in July 2000 to 2-2 ½ percent in February 2001.

With respect to US economic outlook, a low growth rate seems inevitable as far as the first half of 2001 is concerned. A more critical question concerns the likelihood and degree of rebound later in the year. Economists and market players are divided in this regard: some expect a quick rebound, some others a modest recovery, and others prolonged deceleration. Optimists, who expect V-shaped recovery in the second half of 2001, point out the continued improvements in productivity bolstered by IT revolution as well as wide room for actions of both monetary and fiscal policies. On the other hand, it is pointed out that after an extremely high economic growth, the subsequent adjustment might prove to be severe and also that the adjustment period is practically unpredictable before it is over. In recent months, optimistic views appear to be receding. Under these circumstances, I would like to remain vigilant as well as unprejudiced about the extent to which US economy regains its strength later in the year.

As I have mentioned earlier, the US economic slowdown has already begun to exert a negative influence on Japan's economy through a variety of channels including an indirect impact involving economic slowdowns in East Asian countries that are closely linked to the US economy. In Japan, production growth slowed under the influence of decreases in exports. If this leads to declines in corporate profits and reductions in business spending, the momentum for economic recovery stemming from the business sector will be put at a greater risk than before. Therefore, we all need to examine carefully the ongoing production, profits, and investment plans for some time.

There is another downside risk for Japan's economy, i.e., capital markets both at home and abroad, especially stock price developments and their impact. Weakness of Japanese stock prices has been particularly pronounced in recent months. Nikkei Stock Average renewed its lowest record during the post-bubble period beginning in 1990 although one must make allowances for the technical changes in the index of April 2000. It is by no means easy to identify the causes for weak stock price developments, but they seem to be influenced by not only US stock market adjustments but also bearish sentiment in the market with respect to Japanese economic outlook. They may as well be a reflection of concerns that the markets both at home and abroad have with respect to delays in addressing a number of structural problems that Japan's economy has. The Bank of Japan will remain vigilant about the influences that these weak stock prices will have on consumer and business sentiment as well as corporate finance.

Price developments

Against the background of recent economic and financial market developments, analysis of price developments is becoming an issue of renewed interest. In recent months, a variety of price indices, such as domestic wholesale prices, consumer prices, and corporate service prices, have been showing small declines year on year, and are expected to be weak for some time.

These price developments have obviously been influenced by both supply and demand elements. A wide output gap remains after a significant improvement on the demand side since the economy hit the bottom two years ago. Because economic growth is decelerating further at present, there is a concern that downward pressures on prices stemming from weak demand might intensify in coming months. On the supply side, a variety of elements are at work, e.g., technological innovation, increase in efficiency in the distribution system, and deregulation, all of which exert a downward pressure on prices. Take domestic wholesale prices for example. Declines in prices of electric equipments and other machines have been most pronounced under the influence of a very rapid technological innovation. For another example, declines in consumer prices have been accounted for in large part by imports and import competitive goods, e.g., clothing.

Let me hasten to add to it by saying that the Bank of Japan has never argued for so-called “good price declines.” Instead, the Bank has repeatedly said that the present price developments have been under the complex influence of both demand and supply elements, and therefore, no one can afford to understand on the basis of movements of price indices alone whether the ongoing price developments are consistent with sound developments in the economy. The issue of utmost importance is whether the current weak prices will invite declines in corporate profits and/or incomes of workers, leading to a deflationary spiral, or vicious cycle of economic recession and price declines. The Bank of Japan is of the view that Japan’s economy has so far avoided such a deflationary spiral, but that because economic growth has recently weakened further as I mentioned a few minutes ago, the economy has entered the phase that warrants enhanced attention to price developments.

3. Deliberation on monetary policy

a. Improvements in the way of liquidity provision and reduction in interest rates

Decisions of February 9 and February 28, 2001

Now let me offer my thought about monetary policy on the basis of the economic and financial developments I have discussed. As you are well aware, the Bank of Japan decided at its Monetary Policy Meeting of February 9, 2001 on both improvements in the way in which liquidity is provided to the market and a reduction in the official discount rate by 0.15 percentage points. With respect to liquidity provision, we decided upon three specific measures: introduction of a Lombard-type standby lending facility, active use of outright purchase operations of short-term government securities, and preparation for bill purchase operations at all offices of the Bank.

At the Monetary Policy Meeting of February 28, 2001, the Bank decided to reduce, by 0.10 percentage points, both its target level of overnight call rate to 0.15 percent and the official discount rate to 0.25 percent.

Lombard-type lending facility and the new role of the official discount rate

Among these policy measures, the Lombard-type lending facility is new to Japan. Officially, it has a name of “Supplementary Lending Facility.” Under the existing framework of liquidity provision, the Bank of Japan selects its counter-parties and decides on the timing as well as amount of lending. In contrast, the Lombard-type lending facility entitles financial institutions to borrow at the Bank of Japan’s discount window the amount that they want at any time they wish, as long as collateral is properly set against the borrowing and the borrower meets the conditions pre-specified with respect to eligibility of collateral and other technical aspects. From a viewpoint of financial institutions, this is a means of funding available any time.

The most important function that this supplementary lending facility performs is to stabilize interest rates in the market. Under usual circumstances, the overnight call rate fluctuates below the official discount rate because the former is the rate of which the Bank of Japan sets such a target level. When end-of-fiscal year pressures mount or a shock arises in the market, e.g., steep declines in stock prices or rumors of a large bankruptcy, interest rates tend to go up in the market. Even in that case, overnight market rates will be kept below the official discount rate because financial institutions are able to borrow at the Bank of Japan’s discount window at their discretion. Moreover, because financial institutions are freer from anxiety over funding capabilities, this will have a stabilizing effect on not only the overnight call rate but also other short-term interest rates across the board. This effect has been strengthened further by two reductions in the official discount rate amounting to 0.25 percentage points in February 2001.

Now let me say a few words about the roles that the official discount rate plays. In the past, the Bank’s decision as to the official discount rate was a basic tool of monetary policy. Therefore, change in that rate had an announcement effect since it embodied change in the basic stance of monetary policy. In 1994, however, deregulation of interest rates was complete, and the institutional linkage between the official discount rate and bank deposit rates disappeared. In 1996, the Bank of Japan made it clear that the Bank would no longer use the discount window lending, to which the official discount rate was applied, as a means of monetary operations. Consequently, the role of the discount rate as a policy variable was played down, whereas the target level of the overnight call rate began to assume that role.

By the introduction of the Lombard-type lending facility, however, the official discount rate is given a new function of setting a ceiling on call rates and thereby ensuring stability of short-term interest rates in the market. The Bank of Japan will continue to guide the call rate at an intended level by daily market operations, but at the same time it will begin to use the new function of the discount rate as a means to supplement the effects of market operations.

Timely and flexible implementation of monetary policy

Having explained the policy decisions made at the two Monetary Policy Meetings in February 2001, allow me to elaborate on their background. First of all, we have taken these policy measures on the basis of our understanding of economic and financial developments at present and in the future. As I said a few minutes ago, economic recovery is weakening in Japan and uncertainty over economic prospects have intensified under the influence of overseas economic slowdown and declines in stock prices. In part of money and capital markets, there was a certain degree of instability, reflecting concerns over the future. Under these circumstances, we decided on the policy measures with a view to ensuring both smooth functioning and stability of the financial market as well as to strengthening monetary support for economic recovery. Subsequently, not only the overnight call rate but also interest rates of longer maturities, e.g., those maturing beyond the fiscal year end and even long-term interest rates, declined by a considerable degree.

Another point I would like to emphasize is the fact that the Bank of Japan continues to conduct monetary policy in a timely and flexible manner, in view of changes in economic conditions. As I said earlier, Japan's economic recovery has decelerated further against the background of sudden slowdown of US economic growth and other elements. In light of these developments, we believe we have taken appropriate policy actions in a timely manner, and will continue to do so in the future. At the same time, the Bank of Japan hopes that the policy measures that it took in February 2001 will contribute to autonomous economic recovery led by private demand.

b. Monetary policy stance in the future

Now let me leave aside the discussion of a series of policy measures the Bank of Japan decided in February and take up something else. There continue to be a variety of arguments about monetary policy in Japan. For example, we sometimes hear the views that the present monetary ease is insufficient, and therefore, the Bank of Japan should resort to so-called "quantitative easing" or return to the zero interest rate policy. I would like to explain the basic thought about monetary policy on the basis of the discussions held at the Policy Board of the Bank of Japan.

First of all, I would like to emphasize the fact that the Bank of Japan has implemented aggressive monetary easing to a degree unprecedented in the history of central banking in the world in terms of both interest rates and volume. Under the influence of this monetary easing, both short and long term interest rates have been kept extremely low. The Bank has also provided the market with ample liquidity and consequently, the monetary base, which consists of money that the Bank directly provides the system with, has shown a considerable growth, to which I will come back later.

A second point I would like to make is whether or not the Bank should resort to additional measures such as "quantitative easing" hinges crucially upon conjectural analysis of growth and price performance of the economy. The word "quantitative easing" is meant differently across people who use this term. For example, there is an argument for stepped up outright purchases of long-term government bonds. The Bank of Japan has been buying such bonds in line with a trend growth in banknotes in circulation. This purchase amounts to \5 trillion per year. If the Bank increased its purchase dramatically, that would have some positive effects but at the same time it might be accompanied by negative side effects. Therefore, a careful examination of both positive effects and side effects must be in place before that policy is implemented. The possible effects of the stepped up bond purchases include a decline in long-term interest rates or a rise in expected rate of inflation. In light of the serious budget situation of today, however, the possibility that such a bold measure would damage credibility of fiscal discipline and in turn raise long-term interest rates cannot be ruled out.

A policy to induce a massive depreciation of the yen's exchange rate is another drastic, unconventional policy. In the present legal framework, it is the Ministry of Finance that has the authority for exchange market intervention. Leaving this issue aside, it is uncertain how effective official intervention can be in affecting exchange rates. Neither is it certain how to cope with terms-of-trade losses stemming from rises in import prices and adverse influences over Asian economies.

After all, before the Bank embarks on unconventional policies like the ones categorized by quantitative easing and the zero interest rate policy, it has to judge that the conditions of the economy and prices warrant such policies. In this regard, the Bank of Japan will continue to examine and analyze the situation with its full force and on that basis it will seek the most appropriate policy that the central bank can take.

A third point I would like to emphasize is we all have to face the reality that during the past decade both monetary and fiscal policies have been eased dramatically and yet they have failed to meet with robust economic growth. There are reasons for it.

Let me mention three numbers here. During the past five years the monetary base expanded at an annual rate of 7.3 percent, the money stock at 3.3 percent, and nominal GDP at 0.4 percent. In contrast to the 1970s and 1980s, when all three indicators grew pari passu, what large differences exist between them in recent years.

The difference between the growth rate of monetary base and that of money stock can be interpreted in the following. The monetary base consists of all banknotes and all current deposits that banks and other financial intermediaries hold at the Bank of Japan. A textbook of monetary economics tells you that the Bank of Japan supplies the monetary base, on which basis banks extend credit so that the monetary base creates a multiple increase in the money stock. In the course of discussions about monetary policy at present, an argument is sometimes made as if the monetary base were in shortage. As I pointed out a minute ago, the monetary base has been expanding at a relatively high rate. Despite this, however, the money stock failed to increase as much. It is mainly credit extension of financial institutions through which the money stock is supplied, but bank lending, which constitutes the core of credit extension, has decreased at an annual rate of 1.4 percent during the past five years. In contrast, bank holding of government bonds expanded at a remarkable rate of 15.7 percent. In other words, financial intermediation took place during this period in the way that government bond issues increased, financing government expenditure, through which channel money circulated to a greater extent.

There is another discrepancy, i.e., the money stock and nominal GDP. The money stock grew at a modest rate of 3.3 percent per annum. This amounts to as much as \20 trillion every year, but nominal GDP stayed virtually unchanged notwithstanding. In sum, despite relatively ample supply of monetary base, economic growth remains lackluster.

All this suggests the significance of structural obstacles in Japan’s economy, e.g., problems of the financial system, and on the flip side of the coin, corporate restructuring. Resolution of these problems will prepare a foundation on which the effectiveness of monetary policy can be enhanced. I plan to come back to this issue before closing my remarks today in conjunction with a topic of non-performing assets.

c. Price stability and monetary policy

Allow me to turn to another topic: the relationship between price stability and monetary policy. I hear often that it is nothing but monetary policy that can prevent deflation as well as inflation. Indeed, the Bank of Japan Law stipulates that the Bank’s purpose is the maintenance of price stability, and the Bank in fact conducts monetary policy in accordance with that idea. In terms of practical implementation of monetary policy, however, the relationship between the objective of price stability and monetary policy is somewhat more complex.

This complexity is mentioned in the report that the Bank of Japan published last year with respect to price stability. For one thing, the relationship differs, depending on the length of time you envision about price stability. For example, during a very long period, say ten or twenty years, excess supply of money in many cases corresponds to rises in prices while short supply does to price declines. This is quite natural in light of the fact that prices are the rate of exchange between goods/services and money. Based on this long-term relationship between prices and money, price fluctuations are referred to as essentially monetary phenomenon and price stability is considered to be the objective of monetary policy.

During a shorter period, say a few months or a few years, however, price fluctuations are influenced by not only money but also a variety of other variables. Output gap of the whole economy, inflation expectation, international commodities prices, exchange rates are interrelated in a complex fashion. In such a complex world, it is no easy task to decide on how precisely monetary policy can control prices, and also on how far it should do. Suppose an oil price shock gives rise to inflation pressures. If we are to contain them in a short period, it will take a very tight monetary policy. The upshot may be a steep decline in economic activity. This is inconsistent with sustainable price stability in the long run. Conversely, at a time when prices decline on account of productivity gains based on rapid technological innovation, a forceful reduction in interest rates with a view to raising prices may amplify economic swings.

I firmly believe that monetary policy is an important determinant that ultimately influences price developments, but in order to fulfill its responsibility in the long run, we must first analyze not only superficial movements in price indices but also a variety of underlying developments, and see if the ongoing price developments are consistent with sustainable economic growth. I believe that this is indeed what the Bank of Japan Law means by its clause that the Bank's currency and monetary control shall be aimed at, "through the pursuit of price stability, contributing to the sound development of the national economy."

4. Concluding remarks

Having discussed monetary policy issues, allow me to close my speech today by touching on structural problems of Japan's economy. In my view, efforts to enhance productivity by addressing the supply side structure of the economy are essential for Japan's economy to achieve strong growth. The fact that US and UK economies revived strongly in the 1990s can be attributed to such efforts. From this viewpoint, it is of utmost importance that Japan speed up reform on the basis of common understanding of the following issues.

First, economic growth stems from the innovative strength of the private sector. Creativity and knowledge of the private sector are the key to bring the economy to its maximum potential. Excessive dependence on the public sector is not the answer.

Second, strength of the private sector will materialize when the market mechanism functions fully. Productivity of the private sector will improve when the resources of capital and labor are reallocated and repositioned between the business area of high growth potential, efficiency, and profitability and that otherwise. This process goes on most efficiently through the market mechanism.

Third, such reform is inevitably accompanied by a certain degree of pains. In the course of structural reform, negative influences may arise to the economy, albeit temporarily, e.g., corporate bankruptcies and restructuring. Opportunities must be accorded to those firms and workers who are defeated amidst structural reform so that they can make a new attempt in the area they can take advantage of their own competitiveness.

There are a variety of views with respect to specific forms of reform, but today I would like to say a few words about my ideas that I have always been turning in my mind.

The first issue concerns the resolution of non-performing assets of banks. During the past three years of my term as Governor of the Bank of Japan, Chairman Greenspan of the Federal Reserve and other eminent people in the international circles have said to me that from the S&L problem and banking crises in the United States, they had learned a lesson about the importance of removing non-performing assets off the balance sheet of the banks. On Japan's side, too, we have maintained that mere provisioning against non-performing assets would not solve the problem and that it is essential to remove them from the balance sheet. During the past several years, the aggregate non-performing assets remained virtually unchanged in the magnitude of \30 trillion. This is a regrettable fact. Under these circumstances, Minister for the Financial Services, Mr. Yanagisawa expressed his view that banks should step up write off. We are of the same opinion. I consider his remark to be both appropriate and timely.

I believe that increase in write off will facilitate structural reform. To promote write off, there are some specific means. For example, a company be split into good and bad parts, and the bad part, or non-performing part be written off. Loan sales markets be also enhanced. It is to be hoped that such specific actions be announced and put in practice soon. At the same time, I strongly hope that management of banks will determine to embark on an enhanced write off. As for the assets classified under the category of "special mention," the importance of sufficient provisions cannot be over-emphasized.

While such stepped up write off will contribute to the resolution of the non-performing problem, it might accelerate bankruptcies and have an adverse influence over employment. The Bank of Japan is prepared to conduct monetary policy to relieve the negative impact of this painful friction on the economy.

The second issue I would like to mention is that it is absolutely necessary to invite the personal sector to stock and bond markets in order to help resolve the problem of banks' non-performing asset as well as to promote structural reform. At present, the aggregate financial assets in the personal sector amount to \1,380 trillion, 54 percent of which is held in the form of cash and deposits.

In Germany a shift from indirect financing to direct financing has been going on successfully in recent years, and as a result risk capital has increased. Between the early 1990s and 1998, the law has been enacted three times to promote financial and capital markets, by which several reforms of the stock market and investment trusts have proceeded. Specific measures include a reduction in the minimum denomination of stock, lifting of a ban on Fund of Funds, improvement in product design of investment trusts, promotion of senior citizens' fund. As a result, the proportion of cash and deposits within total financial assets of the personal sector declined from 45.8 to 35.2 percent in Germany between 1991 and 1999, while in Japan it went up from 50.8 to 54.0 percent. The proportion of stocks and investment trusts went up dramatically in Germany from 14.6 to 27.3 percent while in Japan from 10.9 to 10.4 percent.

Growth of investment trusts and mutual funds are expected to happen also in Japan. In this regard, improvements in product design of investment trusts are an urgent task. In particular, a wide variety of investment trusts should be marketed to meet a variety of demand of the personal sector, and at the same time sound market practices should also be established.

Furthermore, establishment of investment funds can contribute to increasing flow of funds into risk capital. Private Investment Funds Ripplewood, which established *Shinsei Bank* after acquiring the Long Term Credit Bank of Japan, and Lone Star, which bought *Tokyo Sowa Bank,* are both equity funds whose shareholders consist of mutual funds, pension funds, university endowments. In Japan measures to promote the establishment of a large number of such funds should be taken.

If the financial assets of the personal sector that are currently held predominantly in cash and deposits are to be invested more in financial and capital markets through a variety of channels, that would, I hope, contribute to ensuring stability in the financial system through prompter resolution of the non-performing asset problem as well as to facilitating structural reform in Japan.