Yutaka Yamaguchi: The current state of the Japanese economy

Remarks by Mr Yutaka Yamaguchi, Deputy Governor of the Bank of Japan, at the JCIF International Finance Seminar, Bank of Japan, 17 October 2001.

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It is my great honor to be here at this JCIF seminar. Taking this opportunity, I would like to explain the state of Japan's economy and the nature of confronting problems. I would also like to share my thoughts on how to address the current difficult situation and, in particular, how the Bank of Japan could contribute in such a process.

1. Global economic developments

I would like to start with the state of the global economy, in particular that of the United States, which forms the basis of my assessment of Japan's economy. Currently, discussion about the prospect for the US economy focuses on two issues. The first is the duration of the ongoing economic adjustment process, which started in the IT-related areas, as well as the pace of the subsequent recovery. The second is the economic impact of the tragic terrorist attacks in September.

The impact of the terrorist attacks in the US

Regarding the impact of the terrorist attacks, given great multi-faceted uncertainties, it is premature to make informed judgement even if we narrowly focus on the economic areas. It is however safe to say that we have succeeded in dealing with the most immediate challenge after the attacks, which was to avoid market disruption and to maintain the well-functioning of financial markets with respect to liquidity and settlements.

Soon after the attacks, central banks including the Bank of Japan, Finance Ministries, and financial regulatory bodies in the world made a swift move while maintaining a close contact among each other. In the area of central banking, central banks in major countries swiftly provided significant amount of liquidity to money markets and declared their determination to secure the well-functioning of financial markets and settlement systems. I think that these central bank actions exactly followed a textbook of crisis management. At the same time, participants of financial markets also made their best efforts to preserve the functioning of markets and to execute transactions smoothly. As such, thanks to the coordinated efforts by the financial authorities, both at home and abroad, and market participants, we successfully avoided disruption in financial markets, which could have extended subsequent negative effects to the economy as a whole.

Currently, our focus has shifted to how the attacks and the subsequent developments will affect the global economy especially that of the United States. On this point, as stated by the other financial authorities abroad, we are confident that the attacks will not threaten a basis for economic growth in the medium and long term. At the same time, however, we cannot deny greater uncertainties and a loss of risk appetite in the near term. Looking at the US financial markets, for example, the stock price has almost recovered the level recorded before the terrorist attacks, but still continues nervous movements. In the meantime, credit spreads have remained widened. If such market situation persists, it may affect corporate financing accordingly. In fact, downward revision of earnings involving restructuring is spreading in the corporate sector and there is a risk that capital spending will be depressed further.

Economic adjustment starting from the IT sector

In trying to assess the impact of the terrorist attacks, we should note that the adjustment in the IT sector had already dragged down the US economic growth before the terrorist attacks. Therefore, more fundamental issue for the prospect of the US economy is when the IT sector adjustment will end and how rapidly the subsequent recovery will proceed.

Let me turn the clock back for a moment and review how the prospect for the US economy has changed since the end of the last year. As you may recall, at the time of the FOMC meeting in November last year, risks were weighted towards inflation rather than economic weakness. It was

early January that the FED started to lower the federal funds rate. Until this spring, however, prevailing view was that the US economy would see recovery in the second half of this year, with the main issue being the shape of the recovery: i.e. V or U or others. According to the Blue Chip Economic Indicators, an average forecast for the US economic growth in 2001 was 2.6 percent in January, which was lower than four percent-plus in 2000 but not a significant slowdown. The forecast has now markedly declined to 1.1 percent, which is 2.4 percent point lower than the forecast made a year ago.

In retrospect, we can point out two pillars supporting the prevailing view until spring that the recovery would take place in the second half of the year. The first pillar was the expectation that the IT-related demand would recover relatively soon. Another was the belief that significant room for expansionary macroeconomic policies, both monetary and fiscal, would be effectively used to prevent the economy from falling into a serious recession. In addition, it was often pointed out as a favorable financial condition that, unlike the post-bubble period in Japan, the US financial system did not have a serious balance sheet problem.

Regarding the IT-related demand, as shown in the forecast by the industry, optimistic view on the recovery has receded in terms of its timing as well as its pace. On the policy front, the FED has reduced the federal funds rate from 6.5 percent at the beginning of the year to the current 2.5 percent in early October. It is very unusual to reduce the rate by 4 percent point in just nine months. Tax reduction of totaling $1,350 billion in the next ten years was decided and refunding started in July. Additional fiscal measures are currently being discussed. Such decisive policy measures both in the monetary and fiscal areas notwithstanding, the risks foreseen by the FOMC are still mainly on the downside. In the corporate sector, adjustment in production and stocks has not managed to catch up with a decline in demand especially in the IT-related sectors. It seems difficult to expect an early recovery in fixed investment given a decline in a capacity utilization rate and deterioration in corporate profits. Although consumption has so far shown resiliency, deterioration in employment and income environment, together with adverse wealth effect caused by a fall in stock prices, have heightened uncertainty. All in all, while significant uncertainty remains, more cautious views are warranted regarding the near term prospect of the US economy.

Adjustment caused by a significant change in expectation

Observation of the significant change in expectation and the consequent pressure for economic adjustment in the US prompts me to share a question with you. When bull expectation collapses, how much can monetary policy alleviate the consequent economic adjustment? Since the mid-90s, the US technology and telecom sectors have led the IT-related demand as they experienced an investment boom with massive new entry to the market. The boom reflected a rise in the expected rate of growth based on the good prospect for the Internet business. It also reflected the unique characteristics of the information industry such as the economy of scale and the network externality. The significant development in the IT areas has also raised the expected rate of growth for the US economy as a whole. However, as economic slowdown becomes more evident, cautious views are apparently growing with respect to the IT-led increase in productivity. In this regard, the new GDP series show that growth rate of output and productivity for the period since 1998 have been significantly lower than the previous estimate. The data revision made it necessary for us to re-evaluate the rise in productivity growth in the second half of the 1990s, which has invited heated discussion under the title of "the rise of the new economy." What I would like to discuss here, however, is not whether and to what extent productivity growth accelerated during the period. Rather, I would like to ask how effectively monetary policy can adjust an extreme swing in expectation and the resultant effects on activity. In this regard, Chairman Greenspan stressed in his congressional testimony in July that monetary and fiscal policy could not eliminate booms and busts in economic activity. He argued that often people were prone to recurring bouts of optimism and pessimism and there was no tool to change such human nature. As a central banker, with the current state of Japan's economy in mind, I read the Chairman's statement with great interest as well as sympathy.

2. The state of Japan's economy

I have reviewed the global economic developments focusing on the US economy, which would certainly affect Japan's economy in a significant manner. In the October monthly report, the Bank of Japan disclosed its views on recent economic and financial development that was "adjustments in economic activity are becoming more severe, as the substantial decline in production has a negative influence on employment and income conditions." In April, the Bank published a half-yearly report

called "Outlook and Risk Assessment of the Economy and Prices" which showed relatively harsh outlook at that point. But our views today are even more cautious than in April.

The "baseline scenario" we had in April was as follows. First of all, in the first half of this fiscal year, the economy was likely to remain sluggish as a result of a decline in exports and production against the background of a global economic slowdown. Second, in the latter half of this fiscal year, progress in the adjustment in the US economy would lessen the downward pressure on Japan's economy. Third, it would nonetheless take time for the economy to exhibit a clear recovery because of persistent pressure on the economy arising from various structural problems. Fourth, it seemed likely that the output gap would continue widening and prices would remain weak throughout this fiscal year. Against this "baseline scenario", we identified four major risks: developments in overseas economies, especially that of the United States, and in the IT-related areas; developments in asset prices such as stock prices; the effects of structural adjustments including disposal of non-performing loans; uncertainties felt by the public with respect to the future.

Reviewing the economic developments in the past six months, the negative effects of the first two risks has proved to be evident. On the first risk, overseas economies have slowed down much faster than expected. Consequently, exports and production continue to decline sharply and fixed investment started to decrease against the background of deterioration in corporate profits. Such adjustment in the corporate sector is now affecting household income through softening employment and wages. Consumption has held up relatively well but we are now seeing weaker indicators there. The negative impact of the second risk, i.e. weaker asset prices, is also becoming evident. In particular, a fall in stock prices has not only hurt the business and household sentiment but also weakened the capacity of financial institutions.

Under the circumstances, prices continue to decline. As often discussed, we cannot ignore the supply-side factors in explaining the current price decline in Japan. As global competition intensifies, firms are increasingly utilizing low cost imports. Supply-side factors also include rationalization of distribution system and the effects of deregulation. The price development this year, however, appears to be affected equally or even more by weak demand rather than the supply-side factors.

3. Monetary easing measures since March

Against the background of such severe economic developments, the Bank adopted in March strong monetary easing measures with firm determination to prevent a continuous price decline and to form a basis for a sustainable growth. In August, the Bank took further easing steps based on the framework adopted in March. Furthermore, after the terrorist attacks in September, the Bank took every necessary measure in monetary operations in order to secure smooth fund settlement and financial market stability. The current monetary easing measures consist of four components.

First, the main operating target for monetary operations was changed from the overnight call rate to the outstanding balance of current accounts held at the Bank of Japan. The new target was raised from about four trillion yen to five trillion yen in March and further to six trillion yen in August. As I will discuss a moment later, the Bank did not simply raise the target regardless of demand. The Bank decided the level of the target such as five trillion or six trillion based on a judgement that it was the maximum demand for the current account balance at the time. In September, the Bank swiftly responded to a surge in demand for liquidity following the terrorist attacks. At the subsequent Monetary Policy Meeting, the Bank decided to provide ample liquidity aiming at above six trillion yen, without specifying the limit. In practice, the outstanding balance of the current accounts increased toward the end of September going beyond twelve trillion yen. In October, as money market conditions relaxed after successfully passing the September-end, the half-year book closing, the outstanding balance has declined from its peak but still stays at far above six trillion yen, the level before the terrorist attacks. As such, the call rates stay at effectively zero, reflecting the fact that ample liquidity has been provided to the market far exceeding the required level under the reserve requirement system, about four trillion yen.

Second, the Bank committed itself that the new monetary policy framework would continue until the CPI inflation rate will stably stay at or above zero percent. This is the clear commitment on the continuation of monetary easing in the future which is expected to extend easing effect to interest rates with longer terms. This effect is often called "commitment effect" or "duration effect."

Third, the Bank decided that, while setting an upper limit, it would increase the outright purchase of long-term government bonds if it deemed necessary for providing liquidity smoothly. Based on this

decision, in August, the Bank increased the outright purchase from 400 billion yen per month to 600 billion yen per month in terms of volume and from twice a month to three times a month in terms of frequency.

Fourth, the Bank established the so-called Lombard-type lending facility. Using this facility, financial institutions with collateral can always borrow funds from the Bank at the official discount rate under the conditions pre-specified by the Bank. The facility strengthens the monetary easing effect by reducing concerns over available liquidity and stabilizing market rates. The official discount rate, which is applied to the Lombard-type facility, was reduced twice in February and September and is currently at 0.1 percent.

4. The effect of monetary easing

The Bank believes that the current easing measures are very strong in nature. In fact, the policy to induce short-term interest rates to effectively zero and to make commitment about future policy based on CPI is an unusual step into uncharted territory. Nonetheless, in view of the worsening economic conditions, we decided to take such an unusual step into uncharted waters as long as some effects were thought to exist at least theoretically. The textbook of economics does not give us any guidance regarding the uncharted territory we have stepped in. At best, the theoretical concept of "liquidity trap" presented by Keynes is close to the current situation of Japan's economy. Still, Keynes did not provide monetary policy prescription to exit "liquidity trap," for he simply argued that monetary policy would be ineffective and fiscal expansion was necessary in such a situation. In conducting monetary policy, therefore, we have endeavored to carefully avoid the risk of being caught by dogmatic views regarding the effects and limits of our entrusted policy tools.

As a result, as time passes, we have accumulated more knowledge about the effects and limits of monetary easing measures in the uncharted territory. Based on the experience in the past six months, I would like to provide tentative answers to the questions and hypothesis that I had before the adoption of the current easing measures.

The outstanding balance of current accounts

The first question was whether a central bank could increase the outstanding balance of current accounts even after short-term rates had reached zero. Given the fact that we experienced a shortfall in bids, or "under-subscription," for open market operations under the previous zero interest rates policy, we were not so certain whether we could increase the current account balance smoothly. On this point, our tentative conclusion, to no surprise, is, "with little room left for a rate decline, the current account balance can be increased only when there is demand for it and cannot be increased without demand."

In fact, in May, the Bank frequently experienced a shortfall in bids even at 0.01 percent. To cope with the situation, the Bank decided to change the unit of bidding rates for open market operations from 0.01 percent to 0.001 percent, which enabled the market operation rate to decline further. As a result of this change, we have not experienced a shortfall in bids so far. If such a shortfall happens again for some reasons, however, can we cope with the situation by simply reducing the unit of bidding rates further to 0.0001 percent? This is an interesting theme for economics but I remain skeptical.

In any case, however, the Bank can increase the current account balance flexibly as long as demand for liquidity increases. Demand for liquidity could rise for variety of reasons such as concern for smooth operation of settlement system or financial system instability. In sum, the current account balance can be increased when a certain stress gives incentives for financial institutions to hold larger amount of liquidity in the current account from a precautionary motive. In practice, the balance was raised substantially in response to such a precautionary motive in the end of 1999 in preparations for the Y2K problem and in early 2001 during the process of introducing the Real Time Gross Settlement system. We could raise the current account balance above 12 trillion yen in September because of a surge in demand for liquidity caused by the terrorist attacks, the collapse of a large retailer, and a fall in stock prices. The effects of those factors were also amplified in the period approaching the end of September. The rising demand for liquidity also reflected waning incentives of financial institutions to invest their funds in money markets. Investing 10 billion yen overnight earns merely 273 yen, which is not sufficient to cover various transaction costs. When interest rates significantly decline, financial institutions prefer to hold funds with the Bank of Japan even without any interest earnings. Once such

movement spreads among financial institutions, funding in money markets becomes more difficult which will force the borrowers to build up the current account balance from a precautionary motive.

What is important therefore is not whether we can increase the current account balance under the effectively zero interest rate but what effects such an increase may have. The surge in demand for liquidity after the terrorist attacks is not a favorable development as it reflects rising concern in the financial markets. It may not stimulate economic activities. Having said this, increasing the current account balance in response to rising demand for liquidity is one of significant contribution that a central bank could make because it relieves concern in the markets.

Interest rates, foreign exchange rates, and stock prices

The second issue was whether a substantial increase in the current account balance would affect the asset prices such as interest rates, foreign exchange rates and stock prices. The effect of monetary policy permeates to the real economy through significant changes in these asset prices. Needless to say, an increase in the current account balance results in a decline in overnight interest rates. Once overnight interest rates reach zero percent, however, we can no longer expect a change in interest rates to promote portfolio rebalancing. Therefore, if an additional supply of current account balance results in a change in the prices of financial assets, it could be achieved either through a) reallocation of money from no-risk-no-return current accounts to higher-return-higher-risk assets, or b) effects on inflation expectation for the future. Such effects through these routes could exist at least theoretically and qualitatively.

Let me review the financial market developments since March from the above viewpoints. Not surprisingly, short-term interest rates declined to effectively zero thanks to ample liquidity provision. The Lombard-type facility also helped to stabilize interest rates. Interest rates in the medium-term zones also went below the level experienced under the previous zero interest rate period as the "duration effect" worked strongly. In contrast, long-term rates have risen somewhat compared to the level recorded before the March easing measures. They did not decline even after an increase in the outright purchase of the long-term government bonds in August. Rather, in these days, the JGB market is becoming sensitive to the news implying a possible increase in JGB issuance such as the prospect for the supplementary budget. On the other hand, stock prices once rose soon after the monetary easing in March but have continuously declined after May, reflecting deterioration in economic activities in general and corporate profits in particular. Stock prices did not respond to the monetary policy change in August. Looking at foreign exchange rates, against the background of the more than expected slowdown of the US economy, the yen has not depreciated in comparison to the March level.

Corporate financing in capital markets

The third issue is the effect of a current account balance increase on the corporate financing environment in capital markets such as the CP and corporate bond markets. Facing the weakening role of banks as financial intermediaries, enhancing the function of capital markets could be an important route of monetary easing. In this regard, the environment for corporate financing has improved after the easing measures in March. In particular, the outstanding balance of CPs has maintained the historical high and the outstanding balance of corporate bonds has been showing a two to three percent growth on a year-on-year basis. Credit spreads of CPs and bonds have been narrowing, indicating more risk appetite of investors. Against this background, corporations are more willing to issue CPs and bonds. It should be noted, however, that those firms capable of issuing CPs and bonds often enjoy relatively high credit ratings and, therefore, such monetary easing effect has not benefited those businesses without access to capital markets.

Bank lending

The fourth issue is the impact on bank lending. In this regard, the easing measures since March have not apparently changed banks' lending behavior. In practice, the declining trend in bank lending has mildly accelerated. On the other hand, growth in money supply, deposits held by households and corporations, has changed little at an annual rate of around three percent. The decline in bank lending and moderate growth in deposits should result in an increase in some other investment. In the past year, banks increased investment in the government bonds and the current accounts with the Bank of Japan, both assets free of credit risks.

Then, why doesn't bank lending increase? I will try to give an answer to this question by focusing on financial institutions' lending behavior against the background of the relatively weak credit demand. At the time of an economic downturn, creditworthiness of corporations generally deteriorates and banks have to widen spreads for lending; otherwise they lose profits. However, with deteriorating corporate profits, banks face a decline in the number of projects with sufficient profits to cover wider spreads. In ordinary financial environment, even with the widening of spreads, monetary easing brings lending rates down by lowering banks' funding costs and, consequently, can eventually promote an increase in lending. In the current situation, banks' funding costs cannot go down further because interest rates are effectively at zero. To make matters worse, banks hold a large amount of non-performing assets and unprofitable loans in their portfolio built up in the past. By holding such unprofitable loans for a long time, it will become more difficult for banks to cover by operating profits the necessary cost to deal with the non-performing assets. Needless to say, banks are making efforts to improve profitability of their lending activities by enhancing the credit quality of unprofitable but viable companies through various supports. Nevertheless, there are a substantial number of non-viable companies. Furthermore, making progress in structural reforms in the economy and industries means, looking from the other side, a reduction of banks' unprofitable loans and non-performing assets. Therefore, from a macro perspective, it is inevitable to a certain degree that banks' lending and balance sheet shrink in the process of structural reforms in the economy and industries. Also, for the purpose of restoring sound financial system, it is a necessary condition that banks put emphasis on profitability.

To sum up, the Bank of Japan's abundant liquidity provision has induced desirable impact on the CP and corporate bond markets but the overall effect has not sufficiently transmitted to agents outside the financial system. As a result, we have not seen improvement in economic and price developments. How can we change such a situation? That is the big challenge for Japan's economy and for the conduct of monetary policy.

5. Inflation targeting

I would like to offer some of my thoughts on this difficult challenge in the final part of my speech. But before doing that, I would like to touch upon inflation or price level targeting, which has been frequently discussed. Can it be a prescription for the current problems confronting Japan's economy?

I will start by explaining what I think inflation targeting exactly is. In my understanding, inflation targeting has been introduced as a mechanism to improve the transparency of monetary policy. But I do not think that inflation targeting is the only way to increase transparency. I believe that the way to increase transparency should be judged based on the unique situation of each country. For example, in the United States, interest rates have been cut substantially in a short period of time this year but the CPI inflation rate changed little during the course staying at around three percent. If inflation targeting were adopted during this period, should there be any difference in the conduct of monetary policy or subsequent developments in the US economy? Or could we expect more transparency regarding monetary policy? I have to say that I am skeptical. Price development is one of very important economic indictors and many central banks including the Bank of Japan carry price stability as a policy objective. Still, I think it difficult to make monetary policy judgment solely based on the development of a single price index.

Having said this, I do not deny the benefit of inflation targeting. Main reason the Bank of Japan thinks it inappropriate to adopt inflation targeting is that, in the current economic and financial situation, monetary policy alone cannot prevent a price decline. As I have already discussed, even after exhausting orthodox policy measures, the Bank of Japan has been engaged in monetary operations to significantly increase the current account balance as well as making use of the "duration effect". Despite such dedicated efforts, however, economic activities have not been stimulated and prices have not stopped declining. In that sense, it is indispensable to bring the economy back to an "ordinary" state first. As stated in the Bank's report on price stability published in autumn last year, we think that the adoption of inflation targeting is one of the issues to be examined when the economy goes back to an "ordinary" state. Since this spring, the Bank has held the Workshop on Price Stability for three times in order to promote the mutual understanding of the issues related to prices between academics and the Bank staff. Making use of the outputs of such a workshop, the Bank will continue studying the meaning of price stability and inflation targeting in the context of the conduct of monetary policy.

6. Should the Bank buy any kind of assets?

But I think the ongoing discussion on inflation targeting here in Japan is somewhat different from the discussion abroad which places inflation targeting as a tool to increase transparency. I dare say that many argue that "the Bank of Japan should meet an inflation target by purchasing any kind of assets" and claim that such policy is inflation targeting. In practice, those who call for the adoption of inflation targeting argue that we can cause inflation if the Bank purchases all kinds of assets. Should the Bank increase the outright purchase of long-term government bonds aggressively? Should the Bank purchase foreign currency denominated assets or private debts? Discussions over these issues have been widely covered in the minutes of the Monetary Policy Meetings, speeches by my fellow board members, or papers written by the Bank staff. Therefore, I would like to touch upon the following two issues from somewhat different perspective.

The first issue is the purpose of adopting such measures. By and large, it might be true that, if a central bank continues purchasing all kinds of assets, almost by definition, inflation can be created in the end. However, our goal is not to cause inflation but to realize a sustainable growth. As can been seen in the past experience of Japan's economy, it is not correct to assume that inflation comes first followed by an economic upturn or an increase in growth rate. What happened in the past was opposite: an economic upturn and a rise in growth rate came first and inflation followed with a lag. Therefore, the focus should be how to stimulate economic activities or, in other words, how to make corporations invest more and households spend more.

The second issue is the governance of a central bank in a democratic society. The only explicit constraint for the choice of assets to be purchased by a central bank is a legal one. The Bank of Japan Law stipulates the type of assets to be purchased for the purpose of monetary operations. For example, the Bank can and does purchase government bonds and commercial bills but cannot purchase stocks. Real estates can be purchased for business use but not for the purpose of monetary operations. Then, leaving such legal constraint aside, what kind of assets should a central bank purchase?

Central banks in industrial countries usually do not purchase stocks or corporate bonds for the purpose of monetary operations. It seems that there are probably two reasons.

The first reason is that stocks and corporate bonds have more credit risk compared to government bonds or the short-term commercial bills with plural good names, meaning they are protected by the credit of a bank and a company. If a central bank increases purchasing of stocks and corporate bonds, it may earn profits but, with a certain probability, may incur a loss. A central bank itself does not directly feel a pain because it can issue liabilities without interest rate cost. But taxpayers eventually incur the loss as transfer from a central bank to the Treasury decreases. This is the very reason a central bank is required to issue banknotes by purchasing safe assets. As a second reason, a central bank needs to decide the specific names of stocks and corporate bonds to be purchased. Given the fact that a central bank does not have any advantage over commercial banks in making judgment on the quality of individual companies, it is a natural conclusion that a central bank's market operations should be as neutral as possible to resource allocations.

If a central bank purchases variety of assets aggressively, although it takes a form of monetary policy, it is effectively stepping into the territory of fiscal policy. The reason is that the bank has to incur a loss, which will be transferred to taxpayers in the end, and engages in micro policy regarding resource allocation. Is a central bank allowed to engage in such policy? As a general rule in a democratic state, an independent central bank is entrusted monetary policy function that is to provide liquidity. On the other hand, the use of tax revenue should be decided as fiscal policy by elected representatives in the form of the budget approval process in the Diet. Admittedly, there is no absolute standard for the type of assets held by a central bank and it cannot be free from the state of the economy and financial markets. For instance, fiscal surplus in recent years has prompted the US authorities study the type of assets to be purchased by a central bank assuming that the Treasury securities will diminish in coming years. However, when requiring a central bank to purchase all kinds of assets, especially on a large scale, it should be clearly noted that such purchase effectively has a nature of fiscal policy, which must be decided by voting in the Diet. This point should be recognized first before discussing the type of assets to be purchased in light of the state of the economy.

In this connection, there is an argument that "independence on monetary policy granted to a central bank is operational independence and its objective should be decided by the government." In such an argument, an inflation target appears to be assumed as the objective that should be decided by the government. Looking at central banks overseas, however, the objectives of monetary policy are clearly

stipulated by law; no central bank decides its objectives by itself. The Bank of Japan is no exception and the Bank of Japan Law sets its objective as "contributing to the sound development of the national economy through the pursuit of price stability." Although many central banks carry price stability as their primary objective of monetary policy, whether such an objective is defined in the form of a specific numerical target depends on each country. The Federal Reserve and the European Central Bank do not employ inflation targeting. On the other hand, in the case of the United Kingdom, inflation target was set at 2.5 percent by the government in 1997 and has been maintained thereafter. Even in this case, however, the Bank of England does not conduct monetary policy mechanically but rather in a flexible manner: It has sometimes lowered the policy interest rate when inflation was above the target and tightened when inflation was below the target. What is important here is that the UK government itself assumes significant responsibility in setting the inflation target. The mandates of the UK Treasury require fiscal policy to ensure sound public finances over the medium term and, at the same time, to support monetary policy over the short term. In the case of Japan, to discuss the issue of whether the government should decide the objective of monetary policy beyond those stipulated in the Bank of Japan Law, we believe that the following points should be examined: the objective itself; consistency between the target and necessary policies to achieve it; cooperation from the government, including fiscal policy, to achieve the target.

7. Conclusion

I have covered various issues today. Before finishing my remarks, as a conclusion, I would like to briefly summarize my view on what the government and the Bank of Japan should do in order to overcome the current severe economic situation.

The first point I would like to make here is that the government and the Bank of Japan completely share the policy objective: needs to prevent a continuous decline in prices and to bring the economy back to a sustainable growth path as soon as possible. The Bank of Japan commits itself that the current procedures for monetary operations will be maintained until the annual CPI inflation rate restores the level at or above zero percent in a stable manner.

Second, the Bank of Japan has already established a framework to provide sufficient liquidity to the economy. Under the framework, the Bank provides far more current account balance than required to achieve zero short rates. Therefore, lack of liquidity should not be a cause for difficulties in financing economic activity as a whole. Although it is rarely pointed out, the current pace of growth in the monetary base is significantly exceeding that in the period after the initiation of the aggressive fiscal policy under Finance Minister Takahashi in 1931. Furthermore, if demand begins to rise for the current account balance going forward, the Bank of Japan can easily accommodate it. I believe, and strongly hope, that the current policy by the Bank of Japan will make a significant contribution from the monetary side to the structural reforms led by the government and to the consequent creation of private demand.

Then, what should be done to create demand? This point is discussed in the interim report of the Advanced-Reform Program and the Reform Schedule approved by the Council on Economic and Fiscal Policy. Among them, I myself would like to stress the following points.

To nurture competitive and attractive business environment to promote investment. Important steps for that purpose are decisive deregulation measures, revision of tax system, and reform of special government entities.

To promote private consumption by alleviating households' concern for future through the overhaul of social security system including the pension scheme.

To deal with the associated problems of excessive debts in the business sector and the non-performing loans in the banking system. It is not realistic to expect an instant economic upturn simply by eliminating the non-performing loans. At the same time, however, with a large amount of non-performing loans left, financial intermediaries cannot function properly. Under malfunctioning financial system, it is difficult to expect a sustainable economic growth. Progress has to be made in dealing with the non-performing loans based on the policy stated in the interim report of the Advanced-Reform Program approved by the Council on Economic and Fiscal Policy.

Finally, I would like to touch upon the possible role of fiscal policy. Keynes claimed that, when the economy fell into a liquidity trap, monetary policy was no longer effective and fiscal policy was required to play its role. At the same time, however, given the high level of government debts in Japan, it is also

true that only limited room is left for fiscal policy. Such limited room calls for decisive new measures. According to the minutes of the Council on Economic and Fiscal Policy, members argue that it is dispensable that the components of fiscal expenditure be reviewed with a view to creating private demand. We hope that analysis will be made on the way spending reallocation can stimulate private demand and that decisive actions will follow accordingly. I would also like to add that, looking at the globally prevailing view about fiscal policy, standard prescription for an economic downturn is to leave room for the built-in stabilizers to work. How should we think about this point?

In order to form a basis for a stable and sustainable growth of Japan's economy, the Bank of Japan is determined to continue making every effort as a central bank including those efforts to deal with the non-performing problems.

Thank you very much for your attention.