Haruhiko Kuroda: Quantitative and qualitative monetary easing and the financial system – toward realisation of a vigorous financial system

Speech by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at the 2013 Spring Annual Meeting of the Japan Society of Monetary Economics, Tokyo, 26 May 2013.

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Introduction

It is a great honor to be invited to the 2013 Spring Annual Meeting of the Japan Society of Monetary Economics.

The Bank of Japan's mission is to ensure price stability and financial system stability.

To ensure price stability, the Bank introduced the "quantitative and qualitative monetary easing" at the Monetary Policy Meeting held on April 3 and 4, 2013. This was decided based on the Bank's strong determination to do whatever is necessary to overcome the deflation that has persisted for the past 15 years.

In terms of ensuring financial system stability, no major problems are observed at present in the financial system. However, financial institutions face the challenge of the continued decline in their profitability in their lending operations, which is the main source of their profits. Over the years, the situation has remained the same, in that the amount of credit risk borne by financial institutions – a barometer of financial intermediation via lending – has decreased and the amount of interest rate risk associated with bondholdings has accumulated.

The Bank expects its quantitative and qualitative monetary easing to effect a major change in the current situation of the financial system. The transmission channels assumed in this policy – such as influence on the yield curve and risk premia as well as portfolio rebalancing – will work through the financial system. I believe that more vigorous financial intermediation will be necessary if the policy effect permeates through Japan's economy and thereby increases positive economic activity. The process to overcome deflation is also the process for the financial system to recover its vigor.

Today, bearing these points in mind, I will talk about the relationship between the quantitative and qualitative monetary easing and the financial system, and the thinking on the Bank's conduct of prudential policy.

I. Quantitative and qualitative monetary easing and the outlook for economic activity and prices

Key features of the quantitative and qualitative monetary easing

I will first briefly explain the quantitative and qualitative monetary easing. This policy has the following features (Charts 1 and 2).

First is a strong and clear commitment.

The Bank clearly announced that it would achieve the price stability target of 2 percent in terms of the year-on-year rate of change in the consumer price index (CPI) at the earliest possible time, with a time horizon of about two years.

Second is introduction of a new phase of monetary easing both in terms of quantity and quality in order to clearly underpin such a commitment.

The Bank decided to change the main operating target for money market operations from the uncollateralized overnight call rate (i.e., interest rates) to the monetary base (i.e., quantity) and conduct money market operations so that the monetary base will increase at an annual pace of about 60–70 trillion yen. To this end, the Bank will purchase Japanese government bonds (JGBs) so that its holding of their amount outstanding on its balance sheet will increase at an annual pace of about 50 trillion yen. In terms of quality, in increasing the purchases of JGBs, those with all maturities including 40-year bonds were made eligible for purchase, and the average remaining maturity of the Bank's JGB purchases was extended from slightly less than three years to about seven years. Furthermore, the Bank decided to purchase exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their amounts outstanding on the Bank's balance sheet will increase at an annual pace of about 1 trillion yen and about 30 billion yen, respectively.

Third is enhancement of the intelligibility of monetary policy.

For instance, the Bank's purchases of JGBs had been conducted according to two types of operations: one under the Asset Purchase Program introduced in October 2010 and the other for facilitating money market operations, often referred to as *Rinban* operations. The Bank decided to synthesize the two purchasing methods of JGBs and to express the target of JGB purchases as a net increase in its JGB holdings, instead of the total size of JGB purchases. We believe that these changes facilitate understanding of the Bank's intention with regard to monetary easing in a straightforward manner. The Bank's adoption of the monetary base as an indicator for quantitative easing also reflects our judgment that the monetary base will be the most appropriate indicator for conveying the Bank's aggressive stance on the monetary easing to the public.

Fourth is explicit indication of the Bank's thinking on the continuation of monetary easing.

The Bank will continue with the quantitative and qualitative monetary easing, "aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner." Obviously, there will be both upside and downside risks to economic activity and prices going forward. The Bank will examine these risks carefully and will not hesitate to make adjustments as appropriate, should circumstances warrant.

Transmission channels of the quantitative and qualitative monetary easing

I will next explain the mechanism of achieving the 2 percent target under the quantitative and qualitative monetary easing (Chart 3). The Bank expects that the effects of monetary easing will permeate primarily through three channels.

First, the purchases of JGBs, ETFs, and J-REITs will encourage a further decline in interest rates across the yield curve and lower risk premia of asset prices. This will raise firms' credit demand through a decline in funding costs.

Second, as a result of the Bank's massive purchases of JGBs, both investors and financial institutions investing in JGBs are expected to shift from JGBs to such risk assets as stocks and foreign-denominated bonds and/or to increase lending within their portfolios, which can be described as a portfolio rebalancing effect. The extension of the average remaining maturity of JGB purchases reflects our understanding of such an effect.

And third, the clear commitment to achieve the price stability target at the earliest possible time and the continuation of massive purchases of assets underpinning this commitment are thought to drastically change the expectations of markets and economic entities. A rise in the expected inflation rate will not only influence actual prices but also stimulate private demand through a decline in real interest rates.

Outlook for economic activity and prices

On April 26, 2013, the Bank published the Policy Board members' forecasts for economic activity and prices for the projection period of three years – from fiscal 2013 to fiscal 2015 – in its *Outlook for Economic Activity and Prices*. I will now talk about the Bank's outlook for economic activity and prices under the quantitative and qualitative monetary easing (Chart 4).

Japan's economy has started picking up. Looking ahead, it is expected to return to a moderate recovery path around mid-2013, mainly against the background that domestic demand remains resilient due to the effects of monetary easing as well as various economic measures, and that growth rates of overseas economies gradually pick up.

Thereafter, while the economy will be affected by the front-loaded increase and subsequent decline in demand prior to and after the two scheduled consumption tax hikes, it is likely to continue growing at a pace above its potential, as a trend, as a virtuous cycle among production, income, and spending is maintained. Specifically, the annual real GDP growth rate is projected to be around 3.0 percent for fiscal 2013 and around 1.5 percent for fiscal 2014 and fiscal 2015, above the potential growth rate considered to be around 0.5 percent.

The year-on-year rate of change in the CPI has recently been at around 0 percent or slightly negative, but looking to the future, the rate of increase is projected to rise, reflecting factors such as the improvement in the aggregate supply and demand balance as well as the rise in medium- to long-term inflation expectations on the back of the change in expectations of economic entities, and it is likely to reach around 2 percent – the price stability target – toward the latter half of the projection period.

II. Financial system stability

Next, I will talk about the relationship between the quantitative and qualitative monetary easing and the financial system. I believe that, if the effect of this policy fully permeates through financial and economic activity, firms and households are likely to increase their positive demand for funds. In this sense, it is vital for the financial system to maintain stability and fundamental strength so that it can adjust to future changes in the situation and respond properly to the increased demand for funds.

The Bank regularly examines the conditions of the financial system. It now judges that Japan's financial system can properly perform the financial intermediation function to support future economic growth. There are two main reasons behind this judgment.

Soundness of financial institutions: relationship between the amount of risks and capital

The first reason is that financial institutions as a whole hold sufficient capital relative to the amount of risks they bear (Chart 5).

Recently, financial institutions have steadily increased their capital, as they have continued to raise equity capital and accumulate retained earnings. The amount of risks has decreased moderately, especially credit risk and risk associated with stockholdings. Credit risk has declined because the growth in lending has been slow, reflecting prolonged deflation and sluggish economic activity, and corporate bankruptcies have remained at a low level. Moreover, the decline in risk associated with stockholdings resulted from steady efforts made by the banking sector to reduce strategic stockholdings. The proportion of stockholdings at major banks has decreased significantly – from 150 percent of their Tier I capital in around 2000 to about 40 percent of their capital recently. This reduction and enhancement of financial institutions' Tier I capital have increased their capability to respond to a possible increase in demand for funds.

Resilience of the financial system: macro stress testing

The second reason is that the financial system as a whole seems to possess sufficient resilience against such shocks as a rise in interest rates and deterioration in economic conditions. Since the real economy and the financial system affect each other, a significant negative shock can be amplified beyond the first-round effects, as in the case observed in the latter half of the 1990s, when a vicious cycle occurred as the result of a more cautious lending stance, deterioration in economic activity, a subsequent increase in nonperforming loans (NPLs), and a further cautious lending stance. The Bank examines the resilience of the financial system by conducting stress tests with various adverse shocks, using a financial macro-econometric model that takes account of such a mechanism. The examination of the resilience against an interest rate rise is an important issue especially during the process of overcoming deflation and achieving the price stability target under the quantitative and qualitative monetary easing.

In the April 2013 *Financial System Report*, the Bank estimated the effects on the financial system of a scenario in which interest rates rose by around 1–3 percentage points (Chart 6). Of course, we should bear in mind that such a quantitative analysis comes with many reservations and limitations, and that the estimation should be interpreted with some latitude. However, even if interest rates rise by this degree, as long as the rise is accompanied by improved developments in economic activity and prices, there are no major concerns over possible instability in the financial system, as financial institutions' profits will be boosted, for example, by an increase in lending, improvement in interest rate margins on loans, and a rise in stock prices.

On the other hand, if interest rates rise due to heightened concerns over fiscal conditions in the absence of improvement in economic conditions, positive effects such as an increase in lending or improvement in interest rate margins on loans are unlikely to occur, thereby inducing strong adverse effects on financial institutions, namely, the occurrence of unrealized capital losses on bondholdings. Although financial institutions have the capacity to absorb such adverse effects, this depends on the degree and pace at which the interest rates rise. To prevent concerns over fiscal sustainability from emerging, it is important for the government to steadily proceed with its initiatives on fiscal structural reforms.

III. Low profitability of lending and challenges to enhancement of the functioning of financial intermediation

As should be clear, the financial system does not face major problems in terms of stability and fundamental strength. Nonetheless, I believe that the current financial institutions' financial intermediation cannot be described as full of vigor or dynamism. This is mainly because of the low profitability of lending.

I will now discuss how the quantitative and qualitative monetary easing will affect the low profitability of lending and whether the problem of low profitability hinders the spread of the monetary easing effects.

Low profitability of lending and the background

Financial institutions' lending stance used to be restrained due to limited capital when they were suffering from the NPL problem. At present, however, they are not under any restrictions in terms of financial strength with a sufficient amount of capital, and have taken an aggressive lending stance toward positive demand for funds. In fact, they have recently increased loans to large firms for mergers and acquisitions and acquisition of interest in natural resources, as well as real estate-related loans and overseas loans.

Nevertheless, such activity is still limited. Loans to small and medium-sized firms have remained sluggish. Although financial institutions have advanced their initiatives to facilitate financing in recent years, improvement in the quality of their loan assets has been slow. The profitability of lending and interest rate margins on loans have remained on a long-term downtrend because of intense competition among many lenders to attract limited positive demand for funds and borrower firms that are top rated (Chart 7).

Such a problem is basically a reflection of prolonged deflation, sluggish economic activity, and weak demand for funds. Therefore, if the effects of the quantitative and qualitative monetary easing permeate through Japan's economy and stimulate positive economic activity, it is expected that loans will increase and the problem of low profitability and the issues related to the quality of loan assets will gradually be resolved. However, given the intense lending competition, it is unclear to what extent the supply and demand conditions should improve and demand for funds should increase for interest rate margins on loans to start improving.

Toward enhancing financial institutions' financial intermediation

Financial institutions are expected to actively elicit positive activity from firms and households, instead of passively waiting for such activity, and to work to enhance their capability for financial intermediation. This will raise the added value of their financial intermediation, and enable them to secure borrower firms without competing to reduce interest rate margins on loans and increase their profits as a result. At the same time, from a macroeconomic perspective, enhancing the capability for financial intermediation will bring about favorable conditions for a virtuous cycle to operate between financial and economic activity.

In this regard, financial institutions have worked to facilitate financing, corporate turnarounds, and firms' business reconstruction. They have also sought to identify firms planning to launch operations in areas with growth potential and help these firms to increase their growth through various measures including the Bank's fund-provisioning measure to support strengthening the foundations for economic growth. I believe that such efforts have steadily enhanced financial institutions' capability for financial intermediation.

Given the sluggish economic activity and deflation, despite the efforts made by financial institutions, it might have been difficult to discern the outcome of such efforts through, for example, an increase in loans or improvement in the quality of financial institutions' assets. However, I am sure that these initiatives made by financial institutions to support firms – formulation and monitoring of corporate turnaround plans, provision of advice on improving financial conditions, and support of firms' projects through corporate tie-ups and exploration of new markets – will steadily enhance the added value of financial services. I hope that financial institutions will further strengthen the ability in order to tap potential demand for funds and identify firms and business areas with high growth potential.

The Bank will continue to support the lending operations of financial institutions mainly through the fund-provisioning measure to support strengthening the foundations for economic growth and the fund-provisioning measure to stimulate bank lending. The Bank has been exchanging views with and advising financial institutions, through its day-to-day off-site monitoring and on-site examinations, about enhancing credit screening and monitoring capabilities that are the basis for financial intermediation as well as increasing the ability to assess firms' projects and improving arrangements for the support of firms. The Bank has also continued to conduct research on financial methods that will enhance the added value of financial intermediation – such as asset-based lending that uses movable assets or accounts receivable as collateral, new financial methods utilizing electronically recorded monetary claims, and business reconstruction – and has shared information with financial institutions through seminars.

IV. Quantitative and qualitative monetary easing and prudential policy

Next, I will talk about the relationship between the quantitative and qualitative monetary easing and the Bank's prudential policy.

The quantitative and qualitative monetary easing is a policy that encourages financial institutions and investors to take on risks and affects asset prices by influencing the yield curve and risk premia. On the other hand, prudential policy is a policy under which the Bank encourages financial institutions to strengthen and enhance their risk management and closely monitors any signs of financial imbalances in, for example, asset prices. Based on these, some people may question whether the quantitative and qualitative monetary easing and prudential policy conflict with each other or whether the Bank's thinking on the conduct of prudential policy will change under the quantitative and qualitative monetary easing.

However, I would like to emphasize that the quantitative and qualitative monetary easing and prudential policy do not conflict with each other and are consistent, and that the Bank's thinking on the conduct of prudential policy remains unchanged. This thinking can be summarized into two points.

First, although the Bank expects financial institutions to actively take on risks under the quantitative and qualitative monetary easing, its basic stance remains unchanged, in that it will urge financial institutions to appropriately manage the amount of risks they bear relative to their financial strength. Excessive risk-taking may not immediately cause problems but will eventually lead to instability in financial institutions' business conditions and the financial system, and will not promote improvement in economic conditions in the long term. On the contrary, expansion of risk-taking is a favorable action to increase profits as long as risks are managed properly. As I mentioned, the Bank has been working to exchange views with and advise financial institutions through on-site examinations, off-site monitoring, and seminars about risk management and ways to enhance the institutions' capabilities for financial intermediation and business reconstruction.

And second, the Bank's basic thinking about the overheating of asset prices and financial imbalances also remains the same. It is difficult to discern financial imbalances, but if the Bank judges that financial imbalances exist, it is necessary to take appropriate action. On the other hand, if a rise in asset prices is a reflection of the policy effects or improved outlook for the real economy, it will have positive effects on the real economy by means of the wealth effect. As far as is shown by a range of indicators and financial institutions' behavior, there is no sign at this point of excessively bullish expectations in asset markets or in the activities of financial institutions.

The financial system and developments in economic activity and prices affect each other. I would like to stress that the stability of these two should be compatible and they do not conflict with each other.

Concluding remarks

Today, I have talked about the relationship between the quantitative and qualitative monetary easing and the financial system. In the final part of my remarks, I will briefly touch on a topic that I have not yet mentioned today. I will raise two points that I consider of importance in enhancing the vigor and the functioning of the financial system.

Diversification of the portfolio selection of households

First is the importance of diversifying the portfolio selection of households. Much time has passed since the issue of a shift "from savings to investment" by households was a topic of interest, but the households' stance of preferring safe assets has not yet changed. In this situation, the amount outstanding of deposits at financial institutions has continued to increase despite the low interest rates. The preference of Japan's households can also be seen in their composition of financial assets, which is greatly biased toward safe assets compared with other countries.

As a result, financial institutions have been facing the situation of an increase in funds available for investment amid the sluggish growth in lending. The gap between the amounts outstanding of deposits and loans at financial institutions (banks and *shinkin* banks) expanded from about 60 trillion yen at the end of 2000 to about 230 trillion yen at the end of 2012. The difference has been invested in securities, mainly in JGBs.

It is natural for the proportion of JGB holdings to total assets to expand at financial institutions when the weight of fiscal financing in the overall economy has risen, increasing the amount outstanding of JGB issuance. However, looking at the financial system as a whole, it is desirable for households to diversify their selection of assets other than deposits in terms of the portfolio rebalancing. This will support financial institutions' business conditions, in that it will increase fees and commissions through sales and management of risk assets held by individual customers. In this regard, some financial institutions have refocused on sales of financial products to individual customers, partly reflecting the introduction of the Individual Savings Account (ISA).

Responses to stricter international financial regulations

Second is the importance of appropriately responding to reforms of international financial regulations. Recently, financial regulations have been reviewed widely around the globe, given the experience of the Lehman shock and the European debt crisis. A massive amount of rulemaking is in progress, such as regulations on financial institutions' capital adequacy ratios and leverage ratios, regulations on derivatives transactions, and establishment of a framework that enables the resolution of systemically important financial institutions.

These deliberations on new regulations are based on a lesson from the experience of global financial crises, and they show the strong determination of financial authorities worldwide to establish a stable financial system to avoid another financial crisis.

The global financial regulations will be reflected in regulations in each country including Japan, and Japan's financial institutions will be subject to these regulations. Major financial institutions in Japan that conduct overseas operations will need to adjust to the local laws overseas. Introduction of new regulations entails a considerable increase in costs for financial institutions in the short term as they adjust to the new regulatory environments. Nevertheless, from a long-term perspective, it will further stabilize their profits by restraining their excessive risk-taking, and further strengthen the foundations for sustainable growth of the overall economy, thereby underpinning the development of financial institutions.

The initiatives to establish global financial stability will continue into the future. I expect Japan's financial institutions to actively take part in such initiatives. The Bank is determined to diligently join international discussions such as meetings of the Financial Stability Board and the Basel Committee on Banking Supervision.

I would like to close my speech by noting that the Bank will do its utmost to overcome deflation at the earliest possible time and achieve a vigorous financial system. Thank you.

Chart 1

Introduction of the "Quantitative and Qualitative Monetary Easing" (1)

Strong and Clear Commitment

- The Bank will achieve the price stability target of 2% at the earliest possible time, with a time horizon of about 2 years.

New Phase of Monetary Easing Both in Terms of Quantity and Quality

- Monetary base: Annual increase of about 60-70 tril. yen (x2 in 2 years).
- Amount outstanding of JGB holdings: Annual increase of about 50 tril. yen (more than x2 in 2 years).
- Average remaining maturity of the Bank's JGB purchases: Extended to about 7 years (more than x2 in 2 years).
- Amount outstanding of ETF holdings: Annual increase of about 1 tril. yen (more than x2 in 2 years).
- Amount outstanding of J-REIT holdings: Annual increase of about 30 bil. yen.

Chart 2

Introduction of the "Quantitative and Qualitative Monetary Easing" (2)

Intelligible Monetary Policy

- The Bank has terminated the Asset Purchase Program and synthesized purchasing methods of JGBs.
- It has adopted the monetary base as an indicator for quantitative easing.

Continuation of Monetary Easing

- The Bank will continue with the quantitative and qualitative monetary easing, aiming to achieve the price stability target of 2%, as long as it is necessary for maintaining that target in a stable manner.
- It will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate.

Chart 3

Effects of the "Quantitative and Qualitative Monetary Easing"

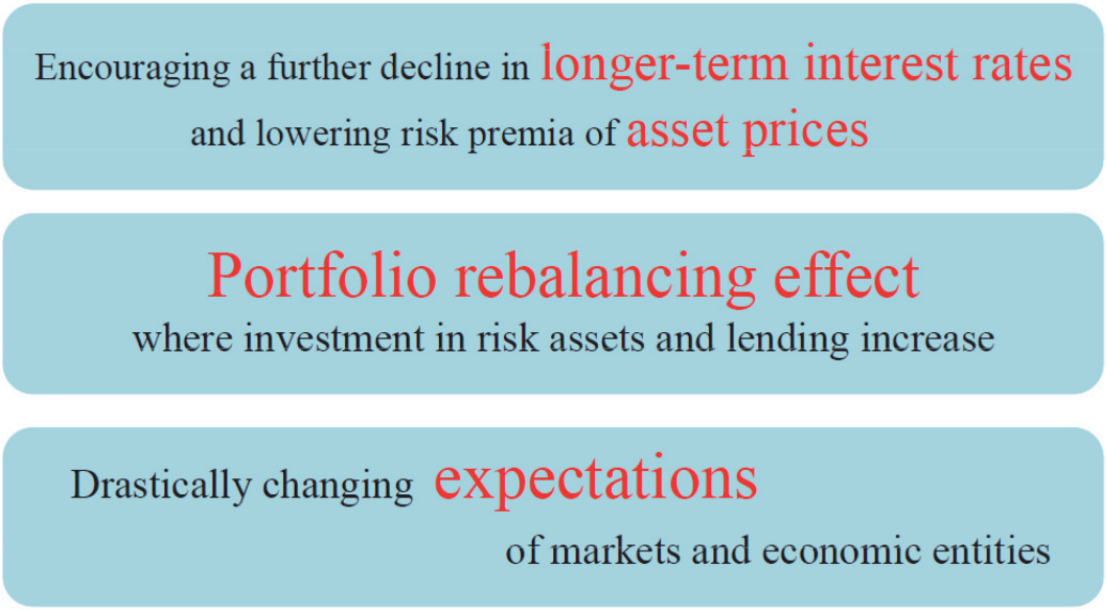


Chart 4

Forecasts of the Majority of Policy Board Members[1]

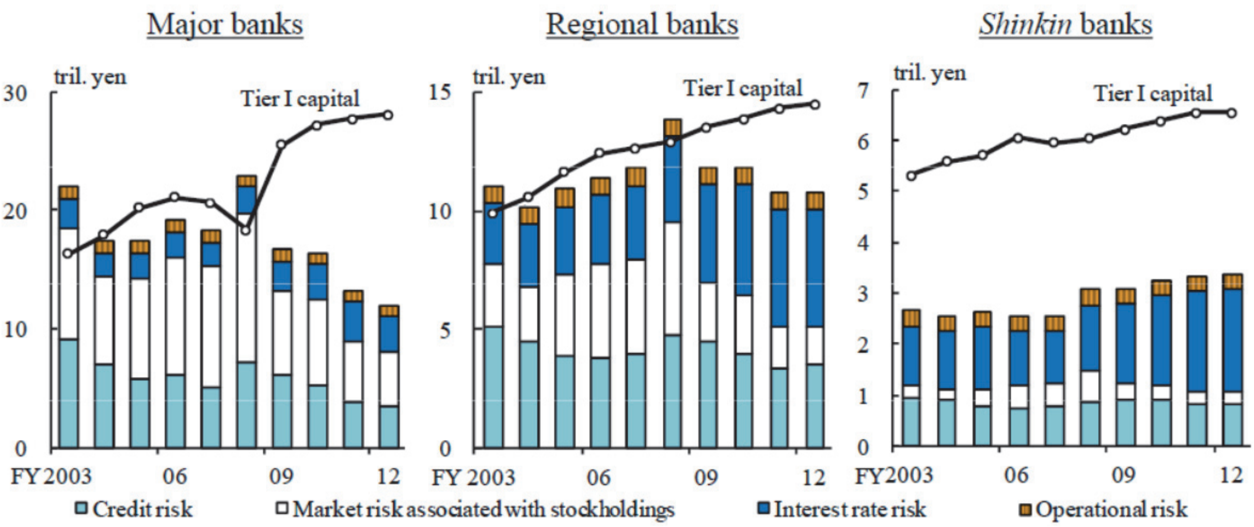
y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2013	+2.4 to +3.0 [+2.9]	+0.4 to +0.8 [+0.7]	
Fiscal 2014	+1.0 to +1.5 [+1.4]	+2.7 to +3.6 [+3.4]	+0.7 to +1.6 [+1.4]
Fiscal 2015	+1.4 to +1.9 [+1.6]	+1.6 to +2.9 [+2.6]	+0.9 to +2.2 [+1.9]

Note: *1*. Figures in brackets indicate the median of the Policy Board members' forecasts (point estimates).

Chart 5

Risks and Tier I Capital[1,2]



Notes: *1.* The latest data are as of end-September 2012.
2. For *shinkin* banks, figures for Tier I capital, the amount outstanding of stockholdings, and credit risks in fiscal 2012 are assumed to be unchanged from end-March 2012, and those for gross profits are assumed to be unchanged from fiscal 2011.
Source: BOJ.

Chart 6

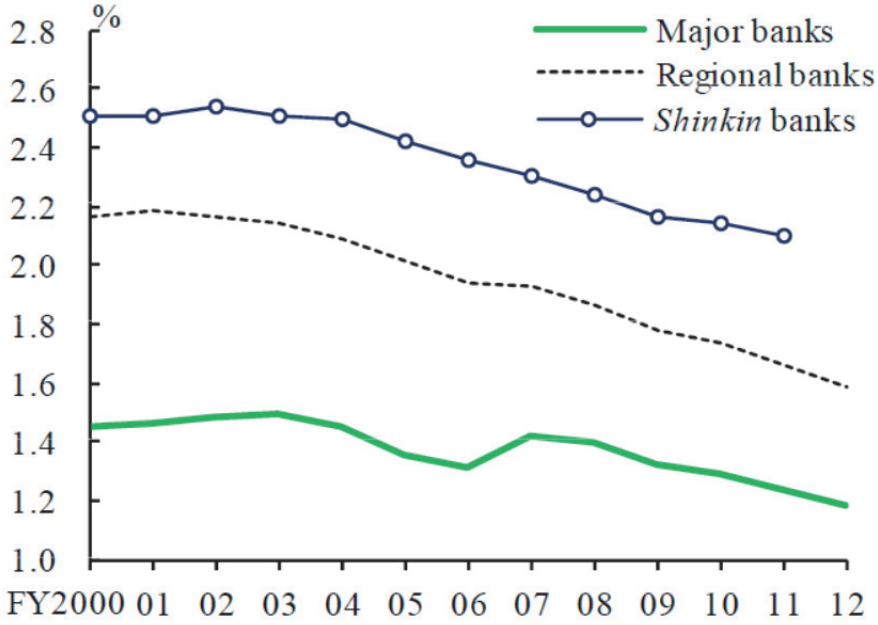
Effects of a Rise in Interest Rates on Tier I Capital Ratio[1,2,3]

			Base point	Upward shift		
				1 % pt	2 % pts	3 % pts
Steepening scenario	Tier I capital ratio (%)		13.4	13.9	13.9	13.5
		Changes (% pts)	—	0.5	0.5	0.0
Parallel shift scenario	Tier I capital ratio (%)		13.4	13.6	12.7	12.4
		Changes (% pts)	—	0.1	-0.7	-1.1

Notes: *1.* Effects on internationally active banks.
2. Changes indicate the Tier I capital ratio at end-March 2014 under each scenario minus that at the base point (end-March 2013).
3. For the estimate of the Tier I capital ratio, profits, unrealized gains on securities holdings, and the tax effects are taken into account.
Source: BOJ.

Chart 7

Net Interest Margin



Source: BOJ.