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Bank of Japan

Japan's Experience and Its Implications for China
-- Monetary Policy and Financial System --

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Introduction

Good afternoon everyone. It is a great honor to have this opportunity to speak to you today at the esteemed Tsinghua University.

China and Japan are only separated by a narrow body of water. This nearness has historically enabled us to interact actively, and our two countries have been learning from each other for a long time. However, knowledge and culture have flowed in one direction or the other over time. During the 19th and 20th centuries, western-style science and technology were transferred through Japan to China, as Japan advanced in its modernization. But before that, over the centuries, Japan had learned a great deal from China. The legacies are still evident in many parts of our society today. For example, learning Chinese classical literature and poems is a part of student life in Japan. When I was a student, I remember struggling to recite poems written by Li Bai or Du Fu and reading Chunqiu or the Analects of Confucius.

I would like to quote a phrase in Chinese that has remained with me over the years.

> 为穷而不困（Wèi Qióng Ér Bú Kùn）、忧而意不衰也（Yōu Ér Yì Bù Shuāi Yě）
> *Never become troubled in adversity, never become depressed when worried.*

These are words from Xunzi. The calligraphy in Slide 1 was written by Yasushi Mieno, the 26th Governor of the Bank of Japan (BOJ), who had a deep understanding of China. He gave this calligraphy to me when I served as his secretary. These words were originally intended to explain the attitude toward learning. Mr. Mieno, however, found in them the importance of fulfilling the responsibilities of the central bank with determination. He always said "one should not run away even when faced with great adversity."

Mr. Mieno enjoyed a good relationship for a long time with Liu Hongru, who was Deputy Governor of the People's Bank of China (PBC) at that time (Slide 2). Mr. Mieno once told me that, upon the two of them having drunk their hotel dry, Mr. Liu gave Mr. Mieno a nickname, "Mr. Prodigious Drinker (海量先生<Hǎi Liàng xiān sheng>)." As you are aware, Mr. Liu not only made great contributions to financial system reform in China, but also made efforts to establish and develop the Graduate School of the PBC, which is now the PBC School of Finance here at Tsinghua University.

With these close connections in mind, today I would like to share Japan's experience and lessons learned from a central bank's perspective.

The main themes of my speech are monetary policy and the financial system. On monetary policy, I will explain the transition of the BOJ's monetary policy instruments from the 1980s to the early 1990s in response to financial liberalization. On the financial system, I will talk about how Japan responded to the financial crisis that occurred after the collapse of the bubble economy and continued through the 1990s and the early 2000s. I will then close my speech by introducing an example of financial cooperation between our two countries; namely, the currency swap agreement between the BOJ and the PBC that was concluded last year.

I. Monetary Policy: Toward Further Utilization of Interest Rate Instruments

Let me start with a discussion on monetary policy. I would like to talk about the experience and lessons regarding the transition of the BOJ's monetary policy instruments in the process of financial liberalization.

Japan's Experience

Up until the mid-1990s, interest rates on bank deposits and loans in Japan were regulated based on the BOJ's loan rate to commercial banks. This loan rate was referred to as the official discount rate. At that time, the BOJ conducted monetary policy by adjusting the official discount rate. However, during the period of rapid economic growth, demand for funds constantly exceeded supply. It was difficult to control banks' lending activities by simply adjusting the official discount rate. For this reason, in 1957, the BOJ introduced an instrument that directly influenced banks' lending behavior. Specifically, it set the amount of loan growth for individual banks. This policy tool was called window guidance.

At that time, this was a very effective monetary policy instrument. By the late 1980s, however, the effectiveness of window guidance declined. This is because, on the back of financial liberalization, the financial intermediary channel for the corporate sector became diversified and overseas funding expanded. To begin with, there was a prominent shift in corporate finance from bank loans to the issuance of corporate bonds (Slide 3). Furthermore, there was a rapid increase in lending by non-banks, which were difficult for the central bank to control directly (Slide 4). In addition, foreign currency and Euroyen lending, which was called "Impact Loans," also increased sharply during this period on the back of capital account liberalization (Slide 5). In response to these changes, the BOJ expanded the scope of window guidance to various types of bank lending activities. Nevertheless, managing the complex flow of funds of financial institutions amid financial liberalization was not feasible, and the effectiveness of window guidance declined.

For this reason, the BOJ shifted from quantity control to interest rate control through open market operations. This is because interest rate instruments can affect not only bank lending but also overall financial activity. Window guidance was finally abolished in 1991.

Implications for China

In China, financial liberalization has made progress steadily in recent years. The size of the short-term money market and the bond market has been increasing. As a result, short-term interest rates, as well as primary and secondary interest rates on government bonds, are being formed in the financial markets. The benchmark interest rates set by the PBC still seem to have a certain impact on bank deposit and lending rates. However, the regulation, which requires that deposit and lending rates be kept within a certain range vis-à-vis the benchmark interest rates, has already been abolished. In addition, gradual capital account liberalization has made both overseas funding and investment easier than before.

Under such circumstances, the PBC has been increasing the role of open-market operations in conducting monetary policy in recent years. At the same time, it also continues to use guidance such as macro-prudential assessment (MPA), which exerts a direct influence on bank lending. The PBC recognizes MPA as an important element of its financial control framework, which consists of monetary policy and macro prudential policy. In fact, Governor Yi Gang mentioned last December that China's monetary policy is still on the way of shifting from quantity control to price control and that quantity control remains very important at this stage.[1]

The current situation in China bears some similarities to that of Japan from the late 1980s to the early 90s when the BOJ increased the role of open market operations while giving a supplementary role to window guidance. Based on the BOJ's experience during the transition phase, I would like to emphasize the following three points.

(1) Effectiveness of Central Bank's Guidance to Influence Bank Lending under Financial Liberalization

The first point is that the effectiveness of direct control of bank lending inevitably declines as financial liberalization progresses.

As I have mentioned, the effectiveness of window guidance by the BOJ decreased as firms diversified their funding sources on the back of financial liberalization. I would like to introduce my own experience related to this.

In the late 1980s, I was part of a team at the BOJ responsible for implementing window guidance. At that time, Japanese banks were very active in providing loans. I still remember how they repeatedly emphasized that the demand for funds was strong on the back of robust economic activity. We tried to check whether that demand was based on sound economic activities or on speculative investments. We also examined whether the increase in bank lending was justified given the diversification of firms' funding sources. However, it was almost impossible to examine every single loan thoroughly. Meanwhile, once banks were granted a certain amount of increase in lending, they used up the full allotment. They took the approval by the BOJ as though they had been given the green light for an increase in loans. In addition, since the BOJ only controlled the increase in lending, the outstanding amount of bank lending itself always exceeded the previous year's result even though the BOJ asked for a restrained stance. As a result, bank lending and money stock continued to grow rapidly in the late 1980s (Slide 6). In retrospect, I think that the BOJ's window

[1] Gang Yi, "China's monetary policy framework: supporting the real economy and striking a balance between internal and external equilibrium," speech at the Tsinghua University in Beijing, December 13, 2018.

guidance not only failed to adequately curb the expansion of credit but also contributed to the formation of the asset-price bubble to some extent.

In China in recent years, corporate bond issuance has been increasing (Slide 7). Non-bank lending, often called shadow banking, has also been surging (Slide 8). In addition, there has been an increase in funding from foreign markets through the bond issuance by overseas subsidiaries (Slide 9). In this context, it is necessary to be well aware that the development of these alternative funding methods in China could make the central bank's quantity control less effective.

(2) Financial Liberalization and Importance of Interest Rate Instruments for Monetary Policy

The second point is that, as financial liberalization proceeds, interest rate control becomes more effective with a view to controlling financial conditions.

It was not just because of the diversification of corporate funding channels that window guidance became less effective in the late 1980s. At that time, the BOJ was quite hesitant about raising interest rates due to several reasons, such as subdued inflation and fear of sharp appreciation of the Japanese yen. From 1987 through 1988, the BOJ required banks to take a disciplined lending approach through window guidance and gradually strengthened the guidance. However, with the official discount rate being unchanged, the effect was very limited.

My sense is that the desirable policy effects could have been obtained if the official discount rate had been appropriately raised at that time. This is because changes in interest rates affect a wider range of financial activities, including those not directly affected by window guidance. Also, as liberalization of deposit and lending rates proceeds, banks' lending stance and firms' funding needs become more sensitive to changes in interest rates. Based on its experience, the BOJ shifted to interest rate control in conducting monetary policy. At the same time, the policy rate was changed from the official discount rate to the short-term market rate that should be guided through open market operations.

At present, the PBC uses a quantity control instrument for exerting direct influence on bank lending while putting more importance on interest rate control through open market operations, as mentioned earlier. The former policy tool of quantity control plays an important role in supplementing interest rate-based monetary policy during the transition phase of financial liberalization. Nonetheless, based on Japan's experience, interest rate instruments need to be utilized with a view to affecting a wide range of financial activities, including bank lending.

In this regard, the PBC announced this August that banks reporting the Loan Prime Rate (LPR), which is the reference rate for interest on bank lending, should determine their lending rates by referring to the rate of money market operations conducted by the PBC. The PBC also stated that all financial institutions should determine interest rates on new loans based on the LPR. The announcement is expected to make banks' lending rates change more flexibly than in the past, and it could lead to further utilization of interest rate instruments.

(3) Importance of Developing Financial Markets

The third point is that it is important to develop financial markets so as to raise the effectiveness of monetary policy using interest rate instruments.

In order to increase the policy effectiveness of guiding short-term interest rates, the transmission mechanism of interest rates should be firmly established. In other words, changes in short-term interest rates in the interbank market need to be transmitted effectively through various interest rates, including the government bond yields. To achieve this, it is necessary not only to liberalize various interest rates, but also to improve the functioning of the financial markets and thereby facilitate arbitrage transactions across markets.

In the case of Japan, the BOJ has made various efforts to develop financial markets. Our efforts focused not only on short-term money markets but also on bond markets and derivatives markets including futures (Slide 10).

In China today, various financial markets are also being developed. In light of our experience, I would like to point out some issues that are particularly important going forward.

First of all, increasing the diversity of market participants is critical. Liquidity of financial markets will improve when there are more transactions among diverse market participants with different business models, asset and liability structures, and views on the future course of interest rates. In addition to developing domestic institutional investors, encouraging entry by foreign financial institutions has great significance. In Japan, the entry of foreign financial institutions into bond markets has increased since the 1980s, and they have contributed to the smooth and flexible formation of both short- and long-term interest rates.

Moreover, communication and cooperation between the central bank and market participants is vital. It is necessary to take into account the needs and burdens of market participants when establishing transaction rules, statistics, and payment systems. The BOJ has engaged in frank discussions with market participants through regular meetings and forums with specific themes.

In this regard, it is very encouraging to see that such initiatives are already being taken in China. For example, financial markets have become increasingly open to foreign investors, especially since last year. Liquidity of financial markets will increase significantly as participation by foreign financial institutions increases. Furthermore, the relevant authorities, including the PBC, have started to make efforts to increase market liquidity, such as allowing more banks to trade bonds via stock exchanges. These efforts are expected to develop a market environment with enhanced market mechanisms.

II. Financial System: Preparation for an Orderly Exit of Insolvent Banks from the Market

Now, I would like to move on to the next theme, the financial system. Financial liberalization has a significant impact on the business environment and behavior of financial institutions. As the liberalization proceeded in Japan in the 1980s, financial institutions became concerned about the decline in profitability and the competition among them became fierce. As a result, they started lending aggressively, which eventually led to the creation of the asset-price bubble (Slide 11). After the burst of the bubble, Japan experienced a severe financial crisis and several major financial institutions failed.

Let me review a series of events leading to the financial crisis.

Japan's Experience

After the burst of the bubble, small and medium financial institutions began to fail in 1991. The main cause of this was their excessive lending during the bubble period, and the consequent piling up of nonperforming real estate loans. In 1995, the resolution of non-bank housing loan companies, which had a significant amount of nonperforming loans, became a serious issue. At that time, however, the injection of public funds was not supported by the general public. Meanwhile, business conditions of financial institutions perceived as sound started to deteriorate. From 1997 to 1998, the default of a middle-sized securities firm triggered a series of failures of major banks and a major securities firm. In fact, the number of failures of Japanese financial institutions increased sharply in the late 1990s (Slide 12).

In February 1998, belatedly, the necessary legislation was put in place to inject public funds into the financial system. However, the amount of public funds injected into major financial institutions was not sufficient and their soundness continued to deteriorate. Finally, a firm resolution framework was established in October 1998, for the smooth processing of failing financial institutions including temporary nationalization. Several major financial institutions with serious problems were nationalized temporarily, and a large amount of public funds was injected into other major financial institutions. In 2002, the Japanese government introduced a program that encouraged the acceleration of disposing nonperforming loans. With these measures, Japan's financial crisis finally took a turn for resolution. The nonperforming loan ratio started to decline (Slide 13).

During the financial crisis, the BOJ provided necessary liquidity as the "lender of last resort." In addition, it provided equity-type funds such as capital and subordinated loans, which was beyond the traditional role of a central bank. These capital injections by the BOJ were unusual but necessary steps to prevent the materialization of systemic risk at the stage before the establishment of the aforementioned resolution framework, including the bailout by public funds.

Implications for China

In China today, the business environment of financial institutions is changing rapidly due to financial liberalization and the slower economic growth. In addition, with the heightened uncertainty about the global economy, the business conditions of financial institutions might be affected in the future. Given the relatively high level of debt, it is important to be well prepared for the potential risk that failure of individual financial institutions might become systemic and have a significant impact on economic activity.

Based on Japan's experience, I would like to emphasize the following three points.

(1) Importance of Establishing Financial Safety Nets

The first point is the importance of building institutional frameworks that contribute to the stability of the financial system, namely, financial safety nets.

In order to prevent failure of individual financial institutions from spreading through the financial system, it is necessary to have a quick and smooth resolution framework. In addition, various prudential schemes are needed for maintaining the soundness and confidence of the entire financial system.

In Japan, a deposit insurance system was established at a relatively early stage in 1971. However, other key financial safety nets were introduced belatedly after Japan faced and dealt with the financial crisis caused by the burst of the bubble. The main examples of these safety nets included the resolution mechanism for financial institutions, the mandatory disclosure scheme on nonperforming loans, accounting standards for the adequate write-off of nonperforming loans, and the prompt corrective action framework (Slide 14).

In the case of Japan, the government established these safety nets while dealing with the failure of financial institutions and the financial crisis. As a result, it took a long time to restore financial stability. In particular, there was no legal framework for injecting public funds into financial institutions. Moreover, in the beginning of the crisis, the general public was strongly opposed to the idea of injecting public funds. Therefore, business conditions of financial institutions deteriorated further until the injection was realized.

In China, a deposit insurance system was established in 2015. Now, it is important to develop financial safety nets further while the financial system is sound.

In this regard, China introduced measures this year to encourage financial institutions to increase capital through the issuance of perpetual bonds. This approach is in line with actions taken by other financial authorities around the world. At present, based on the experience of the global financial crisis, a common understanding among the authorities is that financial institutions should secure adequate capital on their own, relative to their size, rather than rely on public funds in the case of financial stress. In order to ensure the effectiveness of capital reinforcement, regardless of the source of funds, financial institutions need to monitor their own financial conditions carefully and, if necessary, raise capital proactively. In the case of Japan, since financial institutions initially underreported the amount of public funds they needed, the government was not able to inject sufficient funds for capital reinforcement at an early stage. This experience shows the importance of establishing an accounting standard of nonperforming loans and appropriate disclosure.

(2) Dispelling the Myth that Banks Never Fail

The second point is the importance of the recognition within society that, although individual financial institutions could fail, just like non-financial firms, the stability of the financial system can be maintained.

If the general public perceives that "banks are fail-safe," a moral hazard is caused among depositors and banks, leading to the accumulation of risk for the financial system.

Looking back, there was a myth in Japan that banks could not fail. In other words, the possibility of a bank's failure was not considered realistic. In fact, deposit insurance had not been triggered for 20 years, since its establishment until 1991.

If we look back further, Japan experienced a severe financial crisis caused by a series of financial institution failures in the 1920s. Based on this experience, the Japanese financial authorities adopted an administrative approach called the "convoy system." This system strictly regulated competition among financial institutions with respect to interest rate setting and business operations in order to ensure that even financially weak institutions would not fail. The myth that Japanese banks could not fail was formed by this "convoy system" and by undue trust in financial authorities. In addition, there was another myth that land prices could never fall. In fact, the business conditions of Japanese banks were also supported by this "land price myth."

It was not until the burst of the bubble and subsequent financial crisis that these two myths were debunked. Things changed all of a sudden, and the impact of a series of bank failures and the credit crunch in corporate finance on the Japanese economy was extremely severe.

If there is a myth in China that banks never fail, it is important to dispel it in normal circumstances. At the same time, it is also important to build trust among the general public that financial stability as a whole will be maintained even if individual financial institutions fail. For example, one approach is to encourage financial education, including promoting better understanding of the deposit insurance system among the public.

Until this year, China had not seen any bank failures since that of Hainan Development Bank in 1998. After Baoshang Bank was temporarily nationalized this May, there was a case of one major national bank acquiring an urban commercial bank. Accumulating examples like these would help raise social awareness of how the financial stability is secured apart from the failure of individual banks.

(3) Deep Understanding of the Markets' Reaction

The third point is that it is important to pay attention to how financial markets respond to various policy measures for strengthening financial stability.

When faced with financial stress, the resolution of financial institutions, the disposal of a large amount of nonperforming loans, and financial system reform are inevitable in order to protect and strengthen the financial system. However, the authorities' actions could cause strong reactions by the financial markets, which might have counter-productive effects on financial stability itself. Let me introduce two cases from Japan's experience.

The first case is the default of Sanyo Securities in the interbank market in 1997. Sanyo Securities, a medium-sized securities firm, was not a depository institution, and the amount of the default was relatively small. Nevertheless, the impact on the financial markets was significant. As this was the first-ever default in the Japanese interbank market since World War II, market participants became skeptical that those to whom they lent money might fail at any time. Financial institutions showed strong reluctance to provide even short-term funds, and as a result a severe credit crunch occurred. Actually, the financial crisis in Japan was triggered by this small default event in the financial markets.

The second case relates to what was called the Japan premium. In 1997 to 1998, when a number of major financial institutions failed, Japanese banks were required to pay a premium for raising funds in U.S. dollars. At that time, the Japanese government was promoting deregulation of financial markets under the "Big Bang" reform programs and expediting the painful disposal of the nonperforming loans of financial institutions. Market participants were concerned about whether or not financial institutions were able to withstand the drastic reform and the disposal. In this situation, the Japanese banks, including even those with strong balance sheets, had to pay a premium of up to 100 basis points when raising funds in U.S. dollars. This was a heavy burden for the Japanese banks, and some market participants were concerned about a spillover of the financial crisis in Japan to the rest of the world, which fortunately did not happen.

These examples show that financial markets sometimes react strongly to events when faced with financial stress. As a result, their reaction itself may amplify financial instability or make it difficult for the authorities to promote financial sector reform.

In China today, the authorities have started to tackle the resolution of financially weak banks, as I mentioned earlier. They have also been promoting "financial supply-side structural reform" to further strengthen the financial system. Both efforts are steps in the right direction. However, when tackling the resolution and promoting financial sector reform, it is important to pay attention to the market's reaction, and to communicate carefully with the financial market.

Conclusion

Today, I have described Japan's experience and its implications for China by focusing on monetary policy and financial stability. In closing, I would like to talk about the importance of mutual learning and cooperation between Japan and China.

At present, China is simultaneously facing a transition from rapid economic growth to slower growth, financial liberalization, and a declining birthrate and aging population. Japan has already experienced all of these events. Meanwhile, the two countries are now experiencing the same sorts of changes; for example, the digital revolution. In particular, the development of the digital economy in China has been remarkable, and this has drawn the attention of many Japanese companies. It will become more and more important for Japan and China to cooperate and learn from each other. In the beginning of my speech, I explained that knowledge and culture have flowed in one direction or the other between Japan and China over time. Compared with the past, the time now seems ripe for us to learn from each other by sharing our knowledge and experience.

Furthermore, as the economic and financial ties between the two countries grow stronger, there are increasing opportunities for the two central banks to cooperate in addressing common issues. I will give you an example.

In October of last year, the BOJ and the PBC signed a currency swap agreement, allowing for the exchange of local currencies between the two central banks of up to 200 billion renminbi, or 3.4 trillion yen (Slide 15). By utilizing the swap agreement, the BOJ would be prepared to provide liquidity in renminbi should Japanese financial institutions face unexpected difficulties in renminbi settlements, and vice versa with provisions of yen by the PBC. The agreement is designed to enhance the financial stability of the two countries, and hence support economic and financial activities for economic development in each country.

Lastly, I would like to conclude my speech by referring to the words from Xunzi again. The passage that I mentioned in the beginning of my speech continues in this way (Slide 16).

知祸福终始而心不惑也（Zhī Huò Fú Zhōng Shǐ Ér Xīn Bú Huò Yě）

This means that "the aim of learning is to understand misfortune and fortune, ending and beginning, and ultimately, to be able to guide yourself." In this world of great uncertainty, I feel that these words have marked relevance to the continuing efforts of Japan and China to learn from each other and deepen mutual cooperation.

Thank you for your attention.