Recent Financial and Economic Developments and Monetary Policy

-- Excerpts of a Speech Given by Atsushi Mizuno, Member of the Policy Board, at a Meeting with Business Leaders in Fukuoka Prefecture on August 2, 2006

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Bank of Japan

I. An Update on the Assessment of Economic Developments: Business Fixed Investment as the Driving Force

Japan's economy is expanding moderately. Exports continue to increase, reflecting the strength of overseas economies. Business fixed investment continues to increase, although there is growing concern in the Japanese stock market about future business performance due to uncertainty about whether firms can pass on rises in materials costs to their product prices. Private consumption of services is buoyant, as seen in sales in the food service industry and outlays for travel, despite weak household income growth and the effects of unseasonable weather conditions. Housing investment is increasing moderately. Business construction investment, particularly in urban areas, is maintaining its momentum, reflecting strong demand for new offices. With the rise in demand at home and abroad, production continues to increase.

Given these developments, the Bank of Japan changed the key sentence in its economic assessment presented in its *Monthly Report of Recent Economic and Financial Developments* for July 2006, from "Japan's economy continues to recover steadily" to "Japan's economy is expanding moderately."

Japan's economy is likely to experience a sustained period of expansion under price stability. This is because exports are expected to continue rising against the background of the expansion of overseas economies and domestic private demand is likely to continue increasing. In the Monthly Report, the Bank has been using the combination of the words "expand" and "moderately" for three consecutive months since May to describe future economic developments.

The change of the key sentence in the Monthly Report only reflects the change in the "level" of economic activity or the fact that the output gap has become positive. This change in wording should not be interpreted as an indication that the Bank has revised its assessment of the strength of the economy significantly upward or that the Bank assesses economic growth as accelerating.

At the Monetary Policy Meeting (MPM) on July 13 and 14, 2006, the Policy Board members agreed on the interim assessment in relation to the projection presented in the April 2006 *Outlook for Economic Activity and Prices*, or Outlook Report. The assessment was that Japan's economy was expected to be broadly in line with the projection deemed most likely by the Bank. In other words, the economy was judged to be "on track."

With regard to the possibility of inventory adjustments, which was noted as a downside risk to the economic outlook in the April Outlook Report, I think the extent of the adjustments is likely to be small even if adjustments do occur in or after the latter half of fiscal 2006, given the fact that inventory levels have become more consistent with shipment levels and the growth in production in the April-June quarter has turned out to be moderate. Production of electronic parts and devices has leveled off recently, but is expected to start increasing again in the July-September quarter partly due to new production lines coming into operation. I think the resurgence in production is consistent with the continuing strength in demand for electronic parts and devices used in liquid crystal televisions and mobile phones.

It is my view that the probability of a further acceleration of business fixed investment, which was noted as an upside risk to the economic outlook in the April Outlook Report, has increased. Although I cannot definitely say that business fixed investment will accelerate, there have been at least no signs of deceleration as the momentum for growth in business fixed investment has been retained and seen in a wider range of firms.

Leading indicators of business fixed investment, such as machinery orders (private demand, excluding shipbuilding and orders from electric power companies) and construction starts (floor area, private, nondwelling use), are showing steady developments. I think the recent strength in business fixed investment is attributable mainly to a positive attitude toward investment among nonfinancial firms, which have almost completed the elimination of their excess debt, labor, and production capacity, the so-called "three excesses."

According to the June *Tankan*, or Short-Term Economic Survey of Enterprises in Japan, large manufacturers' fixed investment plans for fiscal 2006 were 16.4 percent higher than actual investment implemented in fiscal 2005, a rate of increase as high as that for plans for fiscal 2005 in last year's June *Tankan*. Large nonmanufacturers' plans also showed a relatively large increase of 8.9 percent from actual investment in fiscal 2005. A closer look reveals that large firms in a wide range of industries planned an increase on last year's business fixed investment. Some examples are electric power (for maintenance and renewal), transportation (for safety measures), real estate (for urban redevelopment projects), information services (for construction/renovation of amusement facilities), and restaurants and accommodations (for their premises). The level of small manufacturers' plans for fiscal 2006 was as high as for fiscal 2004, when actual investment later turned out strong and was the highest in recent years. Their plans for fiscal 2006, which were revised upward by 16.3 percent from the March survey, showed a 1.3 percent decrease from the investment in fiscal 2005. Small nonmanufacturers' plans were revised upward by only a small extent from the March survey, and recorded a 14.6 percent decrease from actual investment in fiscal 2005. Even though these plans are lower than last year's figures for actual investment, we can perhaps assess fixed investment as being relatively firm, as the level of last year's investment was high, showing strong growth of 11.7 percent. Nevertheless, the plans of some small nonmanufacturers that are sensitive to the financial environment remain very weak compared to their actual investment in fiscal 2005, as seen in a fall of 66.4 percent in the real estate industry and 25.0 percent in the wholesaling and retailing industry.

While implementing fixed investment vigorously, some large firms have started to become more active in mergers and acquisitions (M&As) or to increase dividend payouts. Because of the surge in materials costs, the pace of improvement in the ratio of firms' current profits to sales has slowed, and a considerable number of firms are expecting a deceleration of growth in their profits in fiscal 2006. Cash flow from operating activities remains at high levels, but large firms in industries with a high demand for cash have been increasingly using up their cash in hand.

Firms therefore have a growing need for external funds. The Bank's Senior Loan Officer Opinion Survey on Bank Lending Practices at Large Japanese Banks and other information suggest that an increasing number of financial institutions think that large firms' demand for loans, especially for operating funds, has been rising slightly. The lending attitude of financial institutions is accommodative on the whole, and the year-on-year rate of increase in the amount outstanding of lending by major banks, regional banks, and regional banks II, after adjustment for extraordinary factors, was 2.6 percent in June, higher than the 2.0 percent growth in May. Recently, there are signs that the narrowing of loan spreads is coming to a halt, partly reflecting increases in loan rates due to rises in market interest rates. In the corporate bond and CP markets, issuance spreads of corporate bonds are expanding and CP issuance rates are rising somewhat. Nevertheless, it is my view that these rises in financing costs are unlikely to restrain business fixed investment.

The summary of the settlement of accounts for fiscal 2005, released by the Ministry of Finance on July 3, 2006, indicated that Japan's total tax revenues in the general account amounted to 49,065.4 billion yen, exceeding the initial budget by 5,058.4 billion yen and the revised budget by 2,023.4 billion yen. Fiscal 2005 was the third consecutive year in which the tax revenues have exceeded the initial budget. A breakdown shows that, compared with the revised budget, income tax revenue increased by 902.9 billion yen and corporation tax revenue by 800.5 billion yen. Total tax revenues increased by approximately 3.5 trillion yen in fiscal 2005 from fiscal 2004, and the increase was largely due to the economic recovery, except for the revenue of slightly less than 200 billion yen derived from the reduction in the across-the-board income tax credit. Revenues from corporation tax in fiscal 2005 exceeded the initial budget of 11,513.0 billion yen significantly, by approximately 1.8 trillion yen, as a result of an increase in taxable income at nonfinancial firms. In fiscal 2008, an even greater income elasticity of corporation tax is expected because major banks and other financial institutions will be required to pay it.

Growth of taxable income provides nonfinancial firms with more incentives to increase outlays, for example, business fixed investment and personnel expenses, part of which is deductible from taxable income. Therefore, a risk of a further acceleration of business fixed investment, which I mentioned earlier, can also arise from such tax incentives. Unused budget funds for national debt service for fiscal 2005 were as high as 884.3 billion yen. I think these developments suggest that, as long as a rise in long-term interest rates stems from economic expansion, it is highly likely that a larger interest payment by the government can be financed from an increase in tax revenues.

In the Outlook Report, the Bank presented the following view: "Given that the current recovery of the economy has already lasted for over four years and is likely to mature, the growth rate is likely to slow gradually toward the potential growth rate. The forecast is around 2.5 percent for fiscal 2006 and around 2 percent for fiscal 2007." However, if business fixed investment continues to increase further, it will become more likely that the Bank will need to revise upward its forecast for the growth rate of Japan's economy over the course of fiscal 2007.

Since the release of the June *Tankan*, some have taken the view that business fixed investment is firm but not to the extent that it could be described as overheating or showing further acceleration. I think the September *Tankan*, which will be released on October 2, 2006, will indicate further upward revisions to firms' business fixed investment plans for fiscal 2006, but more data should be examined before concluding whether business fixed investment is overheating or not. Nevertheless, if the view that business fixed investment will maintain its current strength turns out to be correct, we will need to accept at least one of the following. First, Japan's potential growth rate has exceeded the 1.5-2.0 percent range, the Bank's estimate presented in the Outlook Report. And second, the economic expansion is likely to mature at a later point in time than the Bank's projection. I consider that it is becoming more likely that we will need to accept both.

If my assessment explained above proves to be correct, Japan's potential growth rate could deviate further upward from the estimate to around the 2.0-2.5 percent range, given a faster growth of productivity. In this case, the momentum for the economic expansion would be maintained during fiscal 2006, and Japan's economy could enjoy, as the U.S. economy did in the 1990s, a long-lasting and ideal expansionary phase in which high economic growth and low inflation are achieved concurrently. A rise in productivity would help disinflation to continue. However, if a wider gap between the levels of the so-called neutral policy interest rate and the actual policy interest rate is ignored, asset price inflation and an increase in inflation expectations as a result of an economic upswing could occur. If this happened, the Bank's conduct of monetary policy would be more likely to be "behind the curve," where the Bank's monetary policy responds with a slight lag to developments in the economy and financial markets.

II. Future Conduct of Monetary Policy

At the MPM on July 14, 2006, the Bank decided to change the guideline for money market operations during the intermeeting period. The new guideline was that it would encourage the uncollateralized overnight call rate to remain at around 0.25 percent. At the same time, the Bank decided to change the basic loan rate applied to the complementary lending facility to 0.4 percent and maintain the temporary waiver of add-on rates for frequent users of the facility.

The stimulus from monetary policy has been gradually amplified against the backdrop of steady improvements in economic activity and prices. In this situation, maintaining the zero interest rate environment might have resulted in large swings in economic activity and prices in the future. Taking account of the current assessment of economic activity and prices from the two perspectives in the new framework for the conduct of monetary policy introduced in March 2006, the Bank judged it appropriate to adjust the level of the policy interest rate at this juncture so that a desirable course of economic activity and prices would be maintained.

In addition to the above assessment, I would personally like to mention some evidence supporting the decisions. First, in terms of economic fundamentals, the conditions before the zero interest rate environment could be brought to an end had already been met at the time of the previous MPM in June, and subsequently released indicators, such as the consumer price index (CPI; excluding fresh food, on a nationwide basis) for May and the June *Tankan*, suggested that economic activity and prices had been developing in line with the projection presented in the April Outlook Report. Second, the call market regained some stability during the reserve maintenance period from June 16 through July 14, although the call rate rose temporarily in late May due to the increase in the general collateral (GC) repo rate. And third, postponing a raise of the overnight call rate target could have surprised the market and caused money market rates to surge, because market participants had already taken for granted that the Bank would bring the zero interest rate environment to an end in July. I think the time was ripe for raising the uncollateralized overnight call rate target to around 0.25 percent at the July MPM as the Policy Board unanimously voted to do.

Regarding the future course of monetary policy, the Bank will conduct monetary policy based on careful assessments of economic activity and prices. If developments in economic activity and prices follow the Bank's projection presented in the April Outlook Report, the Bank will adjust the level of the policy interest rate gradually in the light of developments. In this process, an accommodative monetary environment ensuing from very low interest rates will probably be maintained for some time. As the Bank has said a number of times, adjustment of the policy interest rate will be a slow process based on close examination of developments in economic activity and prices.

I expect such adjustment of the policy interest rate to achieve three things. First, the Bank will advance toward normalization of its monetary policy as a result of bringing the zero interest rate environment to an end in addition to terminating the quantitative easing policy on March 9. Second, such policy changes will bring the spread between Japanese government bonds (JGBs) and non-JGB securities -- such as corporate bonds, municipal bonds, and government-guaranteed bonds -- into line with the creditworthiness of issuers. And third, the policy changes will also foster recovery of the interest rate function and prompt market participants to make a monetary policy forecast, which will make appropriate pricing of financial assets possible, thereby encouraging growth of the financial services industry.

At an interview with a news agency on June 26, I outlined the three most important points that the Bank should keep in mind in its communication policy after the end of the zero interest rate environment. First, the Bank should make efforts to contain market speculation about consecutive raises of the policy interest rate. Second, the Bank should make clear that it is data-dependent and forward-looking in conducting monetary policy. And third, the Bank should also make clear that it will not advance toward the normalization of its monetary policy based on any predetermined plan, because there is still a certain degree of inertia in money and bond markets from the time of low interest rates.

Even after the termination of the quantitative easing policy, market participants still seem to have been watching the change in the year-on-year rate of increase in the CPI (excluding fresh food, on a nationwide basis) very closely. Price indices are indeed an important indicator to check when making a policy decision, but paying too much attention to the movement of a particular type of indicator is unsatisfactory. The Bank will be data-dependent in conducting monetary policy, and this means that it will pay attention to not only the rate of change in the core CPI but also a wide range of economic and price indicators.

In this situation, I am personally paying attention to indicators of labor market conditions such as the following: the ratio of job offers to applicants and the number of regular employees in the Report on Employment Service; regular payments and the number of regular employees in the Monthly Labour Survey; and the number of employees in industries other than agriculture and forestry in the Labour Force Survey. When evaluating the sustainability of economic recovery, I examine the employment and income situation, and for the trend of prices, developments in wages. I also take note of housing indicators as a factor that may pose an upside risk to the economic outlook.

Even though the Bank has brought the zero interest rate environment to an end, the extremely accommodative financial environment has continued. In order to prevent adverse effects on financial markets as a result of the normalization process of the Bank's monetary policy, the Bank will try as much as possible to share its view regarding interest rates with market participants and take policy actions that will not take them by surprise. However, enhancing the transparency of monetary policy does not mean that the Bank should too clearly suggest its next move in the conduct of monetary policy. The Bank will ensure accountability by updating its projection of economic activity and prices for the next one to two years as well as its thinking concerning the future course of monetary policy.

One way to gauge the degree of monetary tightening or easing is to use real interest rates. To calculate the real policy interest rate, I think the most appropriate formula is "the policy interest rate minus the expected inflation rate." As for the expected inflation rate, the recent issue of the Bank's Opinion Survey on the General Public's Views and Behavior and the Cabinet Office's Consumer Confidence Survey suggested that the inflation rate expected by consumers was much higher than 0.6 percent, which was the actual year-on-year rate of increase in the CPI (excluding fresh food) for both May and June. Although we should not take figures for consumers' perception of price developments in both surveys too literally, it is clear that consumers' inflation expectations have been strengthening.

The year-on-year rate of increase in the overall CPI (on a nationwide basis) for June was 1 percent, gathering pace from the increase of 0.4 percent in April and 0.6 percent in May. The main reason for the rise in June was a temporary surge of 9.8 percent in fresh food prices in June, compared to the 2.1 percent increase in May. However, it should be noted that the recent rise in prices of goods for daily use -- such as gasoline, fresh foods, and tissues -- could strengthen consumers' inflation expectations. In addition to this, the moderate acceleration of wages due to tighter labor market conditions should also be noted as it gives firms in the processing industry grounds for passing on rises in materials costs to product prices, eventually affecting consumer prices.

In considering the future conduct of monetary policy, close attention needs to be paid to the following three risks. The first is the risk in the medium to long term of large economic swings in a situation where the stimulus from monetary policy is amplified as the negative real policy interest rate decreases further. The second is the risk that high oil prices may heighten inflation expectations. And, the third is the risk of inflation in asset prices. At the same time, the following also warrant attention: (1) another possible surge in oil prices due to heightening of geopolitical risks resulting from, for example, increasing tension in the Middle East; and (2) a possible worldwide fall in stock prices. Monetary policy will be conducted in a flexible manner in reaction to any change in circumstances.

A cause of concern for me is the risk that market participants may misinterpret the Bank's communication to the effect that it will adjust the level of interest rates slowly as an indication of no further raise within the year, and this may lead to declines in long-term interest rates despite an improvement in economic fundamentals.

If developments in economic activity and prices follow the Bank's projection presented in the April Outlook Report, or if stock prices start to be on an upward trend, market participants' view of interest rate developments is likely to change considerably. Furthermore, if a majority of market participants come to share my view that economic activity and prices are likely to deviate upward from the Bank's projection from fiscal 2006 through fiscal 2007, long-term interest rates will show large swings.

For the time being, I will watch economic indicators in Japan closely and also gather information on economic and financial developments in the United States as well as geographical risks. Based on the information, I will mull over my input to the forecasts for economic activity and prices through fiscal 2007 that will be presented in the next Outlook Report to be released on October 31, 2006, as well as to the forward-looking messages that will be included in the Outlook Report regarding the future conduct of monetary policy.

I will briefly express my view about recent developments in yields on JGBs. The yield curve of JGBs with maturities of up to five years suggests that the market's expectation has factored in "normalization of monetary policy." However, yields on JGBs with maturities of over five years are at levels lower than I expected, despite the likelihood of an adjustment to the present extremely easy financial conditions with negative real interest rates. The implied volatility of JGBs declined markedly in July around the time when the Bank decided to bring the zero interest rate environment to an end, and for JGBs with certain remaining maturities, volatility has declined to the level in February 2006.

In order to minimize fluctuations in long-term interest rates in the medium term, the stability of the money market and appropriate debt management policy are essential, in addition to highly transparent monetary policy conducted by the Bank. I am looking forward to seeing stable formation of interest rates in the money market through market participants' price-discovery activity. I would like the issuer of government debt to consider the following. The first is a gradual extension of the average maturity of JGBs, because banks will no longer purchase and hold a large amount of JGBs after the termination of the quantitative easing policy. And the second is a forward-looking approach in the debt management policy, considering the needs of market participants at home and abroad. Specific measures might include an increase in the issuance of inflation-indexed government bonds, which are popular among foreign investors and pension funds, and diversification of the maturity of JGBs.

III. Issues relating to Financial System Stability

In the process of restoration of Japan’s economy following the bursting of the “bubble,” a prominent feature was the strength of manufacturing industry. Yet, like the major economies in North America and Europe, Japan is gradually becoming a "service economy." Compared with the financial services industry in the United Kingdom and the United States, however, Japan's still has room for development. In particular, the asset management business appears to have high potential for growth and needs to be developed, given that institutional investors and individuals have few investment opportunities. In order to develop such business as well as the overall financial services industry, Japan still needs to address a substantial number of short-term as well as medium to long-term issues.

The stability of Japan's financial system overall has been restored. First, the nonperforming loan (NPL) ratio (NPLs divided by total credit exposure) for major banks decreased from a peak of 8.7 percent in fiscal 2001 to 7.1 percent in fiscal 2002, 5.1 percent in fiscal 2003, 2.9 percent in fiscal 2004, and 1.8 percent in fiscal 2005. For regional banks, the NPL ratio also peaked in fiscal 2001 at 8.1 percent and subsequently declined to 7.9 percent in fiscal 2002, 6.9 percent in fiscal 2003, 5.7 percent in fiscal 2004, and 4.6 percent in fiscal 2005. Second, credit costs at both major banks and regional banks have been falling. The credit cost ratio (credit costs divided by total outstanding loans) of major banks recorded a negative figure of -0.18 percent in fiscal 2005, largely due to sizeable transfers of funds from loan-loss provisions. Third, an increase in fee business income has clearly contributed to the increase in bank profits. Against this background, major and regional banks earned record-high profits in fiscal 2005.

Calculating the various categories of risk -- credit risk, interest rate risk, market risk associated with stockholdings, and operational risk -- and comparing the sum to Tier 1 capital, the total amount of risk is now less than the total capital of banks. This indicates that banks' overall capacity for risk-taking has further recovered (see Chart 17 in the Financial System Report (FSR) published on July 20, 2006).

However, Japanese banks still face large challenges in increasing their profitability.

To begin with, banks' high profits have been greatly boosted by the considerable decline in credit costs, largely due to transfers of funds from loan-loss provisions. These transfers are a one-off event, resulting from the large amount of funds transferred to the provisions several years ago due to the NPL problem and also from the subsequent substantial improvement in borrowers' performance. No such decline in credit costs can be expected to boost banks' profits in the future. At any rate, to prevent profits from being greatly affected by swings in the provisions again, each bank needs to set lending margins that appropriately reflect the credit risk arising from borrowers and make each loan cover the credit cost concerned. In addition, it is important that all parties, including banks, constantly monitor and respond to daily changes in the economic value of assets.

Moreover, globally too, the long-lasting economic recovery under accommodative monetary policy has contributed to the large decrease in corporate defaults and the substantial decline in credit cost ratios for corporate loans. In other words, the present low level of credit cost ratios is a worldwide phenomenon that reflects the economic and financial environment of the past few years (see Chart 40 in the FSR). Keeping this in mind, Japanese banks should be prepared at all times for changes in the economic and financial environment, and not engage in wishful thinking about future credit costs.

Another aspect is that, from the viewpoint of banks' long-term profitability and creation of value added, the continuing low level of credit cost is not necessarily welcome. The reason is as follows. Banking, in the first place, is a professional business that generates profits and value added through management of credit risk that requires expert knowledge. Therefore, taking on risks is the source of banks' profits and it is basically difficult for them to continuously earn profits on loans whose credit risk is low. Moreover, from a long-term perspective, such low-risk borrowers are likely to raise funds directly from financial markets, thereby promoting financial disintermediation.

In this situation U.S. banks, for example, have targeted the relatively high credit-risk market of consumer loans including card loans to develop new revenue bases. On the other hand, Japanese banks, at least in the past few years, kept their corporate-loan portfolios and improved their profits through, for example, transfers of funds from loan-loss provisions. Such profit opportunities, however, should be considered only a temporary windfall. Unlike major foreign banks, Japanese banks have held on to their portfolios of loans to firms with a high credit rating and have also been slow to take on risks.

Of course, until recently, the greatest challenge for Japan's financial system was to overcome the NPL problem and restore confidence in the system, and thus containing risks within the extent of banks' capital buffer took priority over everything else. In this respect, the environment surrounding Japan's financial system has improved -- for example, the ratio of deferred tax assets to capital has declined, stock prices have bottomed out, land prices in major cities have turned around, and deregulation has progressed -- and both the quality and the quantity of banks' capital are improving further. Japan's financial system overall has overcome the NPL problem, and against the background of increased bank capital and decreased credit risk, banks' capital constraints are easing further. However, it is a short step from this abundance of capital to low returns on capital, and banks now have to confront the issue of raising the profitability of capital (see Chart 17 in the FSR). As Japan's financial system has regained stability and is entering a new phase, banks, especially the major ones, now face the next challenge, which is how to strengthen their profitability, for example improve their return on equity (ROE). Fortunately, the favorable situation of the global economy is contributing to the improvement in the management of Japanese financial institutions.

Here, I would like to present a few thoughts on measures to achieve such an improvement in the management of financial institutions.

First, banks need to strengthen their risk management capabilities further and at the same time develop new business by taking risks based on these strengthened capabilities. It is difficult to imagine how Japan's banking sector can develop in the long term if banks continue to struggle for a greater piece of the pie that has been their mainstay, i.e., domestic corporate loans and loans related to real estate including housing. This is because, in the long term, firms with a high credit rating will increasingly go directly to financial markets for financing, and as Japan's population declines, the housing market -- leaving aside questions of quality -- will reach saturation. In this situation, a banking sector that simply concentrates on competing in existing business fields will eventually suffer from a decline in profitability, mainly as a result of a narrowing of profit margins, and remain vulnerable to movements in economic activity and asset prices.

Second, banks need to expedite reconstruction of their overseas strategies. Japanese banks withdrew from their overseas business during the period when there were concerns over financial system stability. As a result, the gap in competitiveness with prominent U.S. and European financial institutions, which have been expanding their global investment banking business, has widened in terms of profitability achieved through overseas risk-taking activity and risk management and in terms of the scale of global investment banking operations. Of course, Japanese banks should not repeat the mistake of increasing risk-taking activity without sufficient risk management capabilities as it did during the bubble era. However, as international competition among financial institutions further intensifies, it is indispensable for those financial institutions aiming to expand global operations to increase the speed of their decision-making in this field. To reduce the gap between their earning power and that of U.S. and European financial institutions, Japanese banks need to reconstruct their overseas strategies. Possible action might include (1) acquisition of risk management expertise through cross-border M&As and (2) hiring competent local staff and establishing local networks in the regions where they do business.

Third, asset management business needs to be strengthened. A major issue is how Japanese financial institutions can add greater value in the management of the huge amount of household savings in Japan. Households' asset management needs have been diversifying with the ageing of the population and the decrease in the birthrate, and there has been a difference in preferences in terms of the degree of safety and liquidity of assets, cash flow patterns, and so forth, according to age group and family structure. In recent years, following deregulation allowing banks to sell investment trusts over the counter, the sale of investment trusts by banks has shown considerable growth. To put it another way, asset management business that responds to the diversification of households' asset management needs is a field with great future prospects. For major U.S. and European financial institutions, private banking business represents an important source of earnings. In the United States, gigantic asset management firms with more than 1 trillion dollars' worth of investment assets are being formed. Although the extent to which this produces synergies is unclear, I think Japanese asset management firms need to consider the merits of scale.

Fourth, further progress needs to be made in addressing structural problems of Japan's financial system. The issues are the following: (1) credit risk continues to be concentrated in the banking sector, because banks' share in financial intermediation continues to be higher than in the major economies in North America and Europe, and (2) Japanese banks hold large amounts of government bonds, and this causes a concentration of interest rate risk in their balance sheets and at the same time is one cause of their low profitability.

I would like to propose the following measures to address these structural issues. First, in downsizing their balance sheets, banks should pay attention to meeting the corporate and household sectors' financial service needs as well as diversifying risks and increasing profitability. Second, with regard to corporate loans, it is important to promote active credit portfolio management by banks and foster the development of credit markets. Third, banks should increase their profitability by further advancing the shift from interest rate business, which weighs on balance sheets, to fee business, which does not. Fourth, banks should change their governance structures and make use of global M&As, which take advantage of structural changes in the stock market. Fifth, any public support measures for the banking sector, other than what is appropriate in normal times, should be terminated. And sixth, the financial authorities should ensure market discipline and keep their interventions to a minimum, thereby bringing Japan's financial system into line with international practice with regard to financial system policy, including Basel II.

The Bank will continue to make efforts to share with financial institutions its ideas on the importance of upgrading risk management, especially through the initiatives taken by its Financial Systems and Bank Examination Department, for example in on-site examinations, off-site monitoring, and seminars organized by the Center for Advanced Financial Technology. The upgrading of risk management not only prevents financial institutions from falling into financial difficulties or failing, but also allows them to develop new business, and thus is important from the viewpoint of ensuring the long-term growth of Japan's financial industry. I personally think it would be good idea if the Bank, which conducts macroprudential policy, could cooperate with private financial institutions and exchange ideas to allow the financial services industry as a whole to develop new business models that would help it to earn profits on a stable basis.

With regard to financial administration, I would like the financial regulator to always think of what kind of relationship it should have with private financial institutions in order for Japan's financial services industry to become comparable to that of the major economies in North America and Europe, and not seek to control each and every activity of financial institutions using the threat of administrative action. While in the conduct of monetary policy it is important to gain understanding through interaction with financial markets, in the conduct of macroprudential and microprudential policies it is important to establish a mutual understanding between financial institutions and the financial regulator.