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Bank of Japan

Recent Economic and Financial Conditions and Policy Measures: The Importance of Safety Nets for the Financial System and Employment

Excerpts of a Speech at a Meeting with Business Leaders in Gifu

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I. Economic Outlook and Risk Factors

A. Overview

A comprehensive look at economic and financial conditions worldwide shows that the effects of financial crises and the deterioration in the U.S. and European economies have spread to emerging economies, initiating an adverse feedback loop between financial and economic activity around the world.

The tightening of the lending stance of U.S. and European financial institutions toward businesses and households has reached a degree that by far exceeds the one that prevailed during the previous economic downturn after the burst of the IT bubble. The contraction of credit has generated an adverse feedback loop, and the recovery in real purchasing power resulting from the fall in energy and food prices is insufficient to offset the negative effects of the financial shocks triggered by the U.S. subprime mortgage problem. Furthermore, although the speed of adjustment on the supply side, such as through the reduction in output, has been swift, this has been outpaced by the decline in demand resulting from the global demand shock.

The U.S. subprime mortgage problem is a kind of nonperforming-loan (NPL) problem. When NPLs emerged in Japan, it was corporate balance sheets that were the first to deteriorate. The fall in commercial real estate prices delayed the reduction of the so-called three excesses in corporate debt, production capacity, and employment, leading to a slump in business activity. This time around in the United States, it is the household sector, under the burden of excessive debt from housing as well as from consumption, that was first forced to implement a balance-sheet adjustment. But more recently, corporate balance sheets have also begun to undergo adjustment, with sharp cuts in production and capital spending as well as a reduction in jobs. Private consumption has also started to decline. The decline in U.S. domestic demand has affected the rest of the world as well. The "decoupling" theory, much touted last year, according to which global economic expansion would continue steadily as growth in emerging economies would offset deceleration in industrialized economies, has proved to be unfounded. The recent sharp deterioration in economic indicators in emerging economies, such as export and production indicators, suggests that the high growth of these economies over the past few years was supported by excessive spending by U.S. consumers backed by rising housing prices. Thus, it is important to recognize that the current global economic adjustment is not simply a cyclical adjustment, but to a large extent a structural one.

Japan, whose economy is highly dependent on exports, is not immune from this global structural adjustment, and it is possible that the supply structure will change drastically, with exporting firms playing a central role. Manufacturers appear to be holding back investment for capacity expansion, and it cannot be denied that they may curtail such investment and reduce their employment drastically. Regarding employment, the media tend to highlight reductions in the number of nonregular workers, but recent data show that regular workers' overtime hours worked and bonus payments are also decreasing, resulting in a decline in total employee income. Moreover, the decrease in employment may spread from the manufacturing to nonmanufacturing sectors and may be accompanied by such measures as early retirement programs or even by a widening of involuntary job losses through corporate failures. The unemployment rate for December (seasonally adjusted) was 4.4 percent overall, 4.6 percent for men, and 4.3 percent for women, all up by 0.5 percentage point from the previous month. The number of the unemployed increased in December by about 390,000 from a year earlier, of whom 250,000 were dismissed by the employer, up sharply from 60,000 in November. Consumer behavior is showing increased awareness of the cost of living and a preference for inexpensive goods and services and reduced spending. Depending on developments in the employment and income situation, this tendency could further intensify.

Furthermore, the increased caution of financial institutions in taking on credit risk due to capital and balance-sheet constraints could add to downward pressure on the economy.

B. Risk Factors in the World Economy

Turning to the world economy, the downturn is expected to continue until at least the middle of 2009. In the worst-case scenario, the world economy may not hit bottom until 2010. In this context, I would like to talk about three issues: (1) the possibility that it will take longer than expected for the U.S. economy to make a full-fledged recovery; (2) the contraction in the cross-border flow of people, goods, and money; and (3) the risk of a rise in protectionism, although of a different form than in the past.

Regarding the first issue, even if the large-scale fiscal stimulus package put forth by the Obama Administration succeeds in placing the U.S. economy on a recovery track in 2010, the risk remains that it will take time for the economy to extricate itself from the balance-sheet recession. It has also been argued that the potential growth rate of the U.S. economy could fall as a result of a greater-than-expected deleveraging in the financial and household sectors. Furthermore, it is expected that it will take quite a long time for major financial institutions in leading economies to return to an active lending stance. This is due to (1) the procyclical effects of the Basel II framework (balance-sheet constraints), (2) the increased default risk of borrowers, (3) lower risk tolerance due to capital constraints, and (4) reduced availability of liquidity. Although the authorities around the world have implemented policies to stabilize the financial system, such as injecting public funds into financial institutions, money and credit markets are expected to remain under increased strain because counterparty risk cannot be completely eliminated.

Regarding the second issue -- the contraction in the cross-border flow of people, goods, and money -- I personally agree with the view that this is really a cause for concern. Looking at Japan's external trade, both the Quantum Index of the Ministry of Finance and the Real Exports/Imports Index of the Bank of Japan are on a downward trend. In China, trade data for December 2008 showed that the country's exports and imports fell by 2.8 percent and 21.3 percent, respectively, on a year-on-year basis, marking declines in both for two consecutive months. Given that exports and imports had been expanding at a pace of almost 20 percent year on year until October last year, the change is dramatic. The media tend to highlight the trade balance, but more noteworthy is the plunge in the trade value -- the total value of exports and imports. The sharp decline in exports is common to countries all over the world, underlining the existence of an adverse feedback loop, a process whereby deceleration in domestic demand in any one country lowers its imports, leading to a corresponding decrease in the exports of its trading partners, and the net result is a worldwide economic downturn. It is no surprise that the shipping market has plunged and that commodity prices have fallen.

Global portfolio investment is also on a downward trend. One of the obstacles to recovery of the world economy is the deterioration in the financial intermediary function of major financial institutions in leading economies. Responsible for this situation are the collapse of the highly leveraged business model of investment banks in combination with the weakened lending capacity of commercial banks stemming from balance-sheet constraints.

On the basis of these factors, it cannot be denied that it may take longer than expected for the world economy to return to a stable growth path. The growth expectations of firms in leading economies may fall further until emerging economies begin to expand again. There is a high risk that these firms will scale down fixed investment plans and refrain from mergers and acquisitions. Furthermore, deterioration in firms' financial positions due to the financial shocks could aggravate the situation further.

Finally, the third issue relates to the risk of "protectionism" appearing in various guises. The United States has decided, in addition to the injection of public funds into major financial institutions, to provide financial support to General Motors Corporation and its financial subsidiary, GMAC Financial Services. While the Bush Administration affirmed capitalism and "small government" as its basic principles, the new administration under President Obama, in order to break the adverse feedback loop between financial and economic activity, does not shy away from political intervention and is turning in the direction of "large government" and the "expansion of the Federal Reserve's balance sheet." In a similar manner, as the financial crisis deepens, countries around the world are increasingly considering the option of providing financial support to core industries in addition to financial institutions. Although the traditional form of protectionism of raising tariffs on imports, such as the one announced by Russia on used cars, is still rare, the U.K. government, following the United States, has announced an additional major rescue package for the financial sector with a view to stemming the slide in the values of financial stocks and the pound sterling. Similar actions are being considered in the euro area as well as emerging economies. While these protective policy measures are understandable from the viewpoint of job security, the underpinning of the economy, and financial stabilization, it is necessary to be careful that these measures do not provide excessive protection for national economies and industries.

In the event that a form of protectionism does emerge, a conflict of national interests is likely to follow, causing havoc to the regime of international cooperation. What is more, the tightening of government reins on the economic activities of private firms represents a double-edged sword, as this usually fosters moral hazards. Of course, a completely different matter is the formulation and application of international rules, such as international accounting standards. Japan should be prepared to play an active part in the discussions over a new international system of financial regulation in the aftermath of the current global financial crisis. Unless Japan makes its voice heard, there is a risk that the clout of Japan's financial sector will diminish.

II. Central Bank and Government Measures to Deal with the Financial Crisis

A. The Global Financial Crisis

While it is usually said that the origin of the current global financial crisis is the "U.S. subprime mortgage problem," I think it is appropriate to describe the present situation as a "credit bubble problem." This is also the view taken by the Bank for International Settlements, which states in its annual report that several factors support the hypothesis that the sudden deterioration in both financial and macroeconomic conditions looks more like a typical "bust" after a credit "boom."

Following the bust of the credit bubble, the world economy is now decelerating rapidly. There are at least three reasons why the effects of the bust of the credit bubble have spread around the globe. The first is the fact that many major financial institutions in the United States and Europe experienced capital shortages, which in many cases developed into solvency problems. The second reason is that, at least until 2007, the central banks of the United States and major European countries believed that the problem facing the financial industry was a liquidity shortage and that it was likely that financial stability could be restored by the provision of ample liquidity. The third reason is that the speed of the impact of the financial crisis on economies around the world has been much quicker than anticipated by policymakers, partly due to economic and financial globalization.

Normally, the appropriate process for the disposal of NPLs would consist of the following steps: (1) assessment of the extent of NPLs; (2) removal of such loans from balance sheets; and (3) raising of capital by financial institutions that suffer a capital shortage, or injection of public funds into them. However, looking at major U.S. and European financial institutions in the current situation, the third step is being taken first since the quality of their assets is being questioned and high capital ratios are required by the market. One reason that governments are injecting public funds into financial institutions is because they hope this will increase the supply of domestic bank loans. However, financial institutions receiving such injections remain reluctant to expand their balance sheets. Against this background, the United States and many European countries are considering additional measures to stabilize the financial system. The main pillars of the measures are likely to consist of (1) an injection of additional public funds into major financial institutions, (2) the creation of a system whereby toxic assets, particularly loans, are removed from balance sheets, and (3) efforts to promote the restructuring of the financial industry.

I would now like to consider the role of the injection of public funds. Since the failure of Lehman Brothers Holdings Inc. shocked financial markets in September 2008, solvency risk has increased because of the massive losses suffered by financial institutions, giving rise to a lack of trust among many market participants in the creditworthiness of major U.S. and European financial institutions. In response to this situation, it is not enough for central banks to provide ample liquidity, and, as a backstop, the injection of public funds is required. However, it should be noted that in the final analysis the injection of public funds is only a backstop and nothing more. In order to fix the economy, what is ultimately needed is to overcome the various excesses, and as long as this process is not complete, the economy will not fully recover.

Major U.S. and European financial institutions, even if they wanted to, are not in a position to easily increase lending. Nevertheless, because some of them have received public funds, governments are now applying pressure on them to increase their lending. At the same time, financial institutions are under fire from the general public, which feels that managers' compensation is excessive. This situation is very similar to the experience of Japanese financial institutions. While it is true that the injection of public funds is necessary, it is also true that financial institutions find it hard to expand lending in a sagging economy.

The situation in the United States and Europe illustrates once again that tremendous effort is required to explain to the general public the intricacies involved in the injection of public funds.

Changing the topic slightly, the sector affected the most by the contraction of balance sheets of major U.S. and European financial institutions is the hedge fund industry. According to some estimates, the assets held by hedge funds have halved to around 1 trillion U.S. dollars as of the end of 2008, from their peak of around 2 trillion dollars. The unwinding of positions by hedge funds due to requests for redemption by clients since October 2008 is likely one of the causes of the fall in Japanese stock prices and the appreciation of the yen. Policymakers need to be prepared for swings in financial markets that may go against fundamentals, triggered by additional failures of small and medium-sized hedge funds and/or the liquidation of their assets.

In any case, hedge funds and private equity firms are likely to shrink dramatically in scale, and major U.S. and European financial institutions are likely to see declines in their prime brokerage business and also in trading on their own account. What this means is a possible weakening of the forces of the market mechanism that normally help to correct for any overshooting of prices and bring them back into line with economic fundamentals. Market anomalies may remain uncorrected because of a loss of influence by investors that, with a high degree of risk tolerance, are capable of taking countervailing positions and by hedge funds, which take positions based on temporary anomalies in yield curves and credit spreads.

As was suggested in President Obama's inauguration speech, the challenges of the current financial crisis triggered by the U.S. subprime mortgage problem will not be met easily or in a short span of time. Stock prices may rise on notes of occasional optimism, but are likely to be brought down again each time by headlines containing negative news.

B. The Importance of Policy Action

The United States and major European countries have made clear their intention to fully support financial institutions whose failure could trigger systemic risk and also to rescue businesses that they could not allow to fail, such as General Motors in the United States. This followed the failure of Lehman Brothers, which the U.S. government did not rescue, resulting in a deepening of the financial crisis in the United States and adversely affecting Japan's economy and emerging economies. While the fast pace of changes in the global economy and financial markets is likely to continue this year, there is no denying that the scope of possible policy measures to combat the deepening economic downturn due to the financial crisis has narrowed: policy interest rates are already low and bulging fiscal deficits do not leave much leeway for further fiscal stimuli. Under these circumstances, it is vital that the authorities get the order of their priorities right and adopt the appropriate policies.

Central banks in the United States and Europe are taking bold measures to alleviate the adverse effects of the financial crisis on the economy. These include (1) steep interest rate cuts; (2) the provision of liquidity through tools designed to improve the functioning of money markets, which currently suffer from increased counterparty risk; and (3) designating eligible collateral for market operations and financial instruments to be purchased with a view to restoring liquidity through direct intervention in dysfunctional markets.

In response to the deepening financial crisis, U.S. and European governments have started since October last year to introduce more comprehensive policy packages, such as providing guarantees for banks' liabilities, providing guarantees for interbank borrowing, and injecting large sums of capital into major financial institutions. Yet, although these extensive policy packages by governments and monetary authorities have brought some measure of order to the global financial system, liquidity remains tight and the global market continues to be tense and nervous. Judging from the latest quarterly results, major U.S. and European financial institutions are not yet out of the woods. One reason for this is that removal of toxic assets from their balance sheets has been slow. This is the reason why the emphasis of the stabilization measures by the authorities is shifting from capital injections to the purchase of toxic assets. Concurrently, discussions are underway on changes to banking regulation and accounting to deal with the post-crisis situation. It is important that Japan take an active part in these discussions.

The policy interest rates for Japan, the United States, and Switzerland have been lowered to almost 0 percent, and those for the United Kingdom and the euro area have come down slowly but surely. Debate on monetary policy is no longer centered on the level of policy interest rates but on how to increase the volume of bank lending and on ways to restore the proper functioning of money and credit markets. At present, three-month and six-month interest rates remain high and credit spreads, having narrowed only slightly, remain wide. Recently, the term "balance-sheet policy" as a means for monetary easing other than lowering the policy interest rate has been widely used in the central banking community. This term provides a good description of the policy currently pursued by the Fed.

III. The Thinking behind Current Monetary Policy

I believe that the conduct of monetary policy should be consistent with a central bank's outlook for the economy and prices.

Since the beginning of fiscal 2008, the Bank has gradually revised downward its assessment of the economy. To be more specific, the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) for October 2008 stated, "Economic activity in Japan has become increasingly sluggish due to the effects of earlier increases in energy and materials prices and the leveling-off of exports." The Bank's assessment of the economy in the *Monthly Report of Recent Economic and Financial Developments* (hereafter the Monthly Report) for November 2008 used the same wording as this Outlook Report. I, however, was personally of the view that the downside risk to the economy was quite high and that it was necessary to prepare even for options that would normally belong to the realm of fiscal policy.

Subsequently, at the Monetary Policy Meeting on December 18 and 19, 2008, Policy Board members agreed that it would be appropriate to use the harsher wording that "Japan's economic conditions have been deteriorating" in the December 2008 Monthly Report. And in the January 2009 Monthly Report, the expression used was that "Japan's economic conditions have been deteriorating significantly" -- the most severe assessment that has ever appeared in a Monthly Report.

Because Japanese financial institutions do not face the same need for profound balance-sheet adjustments as their U.S. and European counterparts, Japan has not entered a stage where an adverse feedback loop between financial and economic activity is imminent. It is undeniable, however, that the extent of production cuts, inventory adjustments, and reductions in capital spending caused by recent declines in exports and corporate earnings is quite remarkable. If the employment situation worsens further, consequent weak growth in total employee income could cause private consumption to decrease more than expected.

At the Monetary Policy Meeting on January 21 and 22, 2009, I voted for the introduction of a scheme for outright purchases of CP by the Bank and the motion to examine the possibility of outright purchases of corporate bonds with residual maturities of up to one year. The basis for my decision in favor of these unprecedented moves by the Bank was the severe assessment of the economy and the outlook just mentioned.

A. Developments in Credit Markets before the January Monetary Policy Meeting

Let us now look at developments in Japanese financial markets since last October. The issuance of CP and corporate bonds became increasingly difficult, and firms came to rely on bank loans for their funding. As a result, the CP and corporate bond markets ceased to function properly. In this situation, the Bank took various policy steps to facilitate corporate financing and improve the flow of funds. For example, the Bank announced that it would increase the frequency and size of CP repo operations and implemented such operations regularly with increased frequency in line with this announcement. Increased CP repo operations were welcomed by financial institutions that were holding CP they had underwritten as inventory. It should be noted, however, that such operations were intended primarily to increase the availability of liquidity. Even as late as the beginning of December 2008, CP issuance rates generally remained high, except for CP with high ratings. Issuance of CP basically remained low, although some borrowers started to accept the high rates and issue CP.

Japanese government bond (JGB) repo rates, in addition to LIBOR and TIBOR, also stayed high in the period immediately after the Monetary Policy Meeting held on November 20 and 21, 2008.

Subsequently, the December *Tankan* (Short-Term Economic Survey of Enterprises in Japan) showed that the diffusion index for firms' financial positions had deteriorated. In addition, new issuance of CP and corporate bonds and secondary market liquidity for them had decreased. These developments suggested that corporate financing conditions might tighten further over the fiscal year-end and that, if no policy action were taken, this might adversely affect economic activity by firms to revise downward their fixed investment plans. In this situation, the Bank decided, as a temporary measure, to purchase outright CP fulfilling certain criteria.

B. Decisions Made at the January Monetary Policy Meeting and Issues to Be Discussed for the Conduct of Monetary Policy in the Near Future

According to the forecast released by the International Monetary Fund (IMF) last week, the rate of world economic growth in 2009 will be 0.5 percent, the lowest rate since World War II. The growth rates for the United States, the euro area, and Japan are forecasted to be minus 1.6 percent, minus 2.0 percent, and minus 2.6 percent, respectively.

On January 22, 2009, the Bank made public its interim assessment of forecasts made in the October 2008 Outlook Report. The forecast by the majority of Policy Board members for the rate of real GDP growth in fiscal 2009 ranged between minus 2.5 percent and minus 1.9 percent, and the median of the forecasts was minus 2.0 percent. Moreover, the large negative output gap is likely to exert strong downward pressure on consumer prices, and in the January interim assessment, Policy Board members' forecast of the year-on-year rate of change in the consumer price index (CPI; excluding fresh food, on a nationwide basis) ranged from minus 1.2 percent to minus 0.9 percent (with a median value of minus 1.1 percent) for fiscal 2009 and from minus 0.6 percent to 0.0 percent (with a median value of minus 0.4 percent) for fiscal 2010.

Given this outlook as well as the rapid deterioration in actual economic indicators, the Bank needs to be prepared to take measures -- including measures that may extend into the realm of fiscal policy -- to (1) provide support to the corporate and household sectors in order to restore confidence, (2) ensure the availability of liquidity in the money market, and (3) ease the tightness of corporate financing.

When attending recent Monetary Policy Meetings, I kept in mind three issues in particular: (1) what types of financial assets the Bank should accept as eligible collateral; (2) to what extent the Bank should expand the range of corporate debt for outright purchases; and (3) how the Bank should bring down interest rates on term instruments.

As for the first issue, the range of eligible collateral, the Bank decided, at the Monetary Policy Meeting held on January 21 and 22, 2009, that it would accept bonds and CP issued by real estate investment corporations (the so-called J-REITs), bills drawn by them, and loans on deeds to them as eligible collateral for the Bank's provision of credit. This decision was made with a view to further facilitating the Bank's money market operations and taking account of the fact that such real estate investment corporations play an important role in the real estate securitization market. It has not been decided yet what other financial instruments will be accepted as collateral, but any such decisions will be made as necessary, based on a close monitoring of developments in financial markets in Japan.

The second issue is to what extent the Bank should expand the range of corporate debt for outright purchases. At the January Monetary Policy Meeting, the Bank revised its economic assessment downward again, to "Japan's economic conditions have been deteriorating significantly." Given the substantial downward revision of the Bank's economic assessment, the next logical step to consider following the commencement of purchases of CP, to my mind, is to consider outright purchases of corporate bonds.

While outright purchases of corporate bonds seem to be justified, I think it is important to provide a clear explanation to the public regarding the aim of such policy action. With regard to purchases of CP, I personally see them as a measure to facilitate the flow of funds and to increase the availability of funds over the calendar and fiscal year-ends. On the other hand, in the case of corporate bonds, although only bonds with a residual maturity of less than one year would be purchased, the purpose would be, first, to address any possible decrease in firms' cash flow and to stabilize financial markets over the fiscal year-end, and second, by purchasing financial products whose markets are not functioning properly, to promote the recovery of the proper functioning of such markets.

In my view, the Fed's "credit easing policy" reflects a similar line of reasoning. The Fed, aiming at restoring the functioning of financial markets, has intervened in various types of credit markets whose functioning is impaired, accepting financial products traded there as collateral and purchasing them as necessary, and has allowed its balance sheet to expand as a result. Moreover, by working toward the restoration of the functioning of credit markets and of the stability of the financial system, the Fed is seeking to lay the foundations for economic recovery.

The last issue is how to bring down interest rates on term instruments. Financial institutions, having booked losses on their stockholdings, are now facing the possibility of having to increase the disposal of loan assets and provisions for possible loan losses as the economy deteriorates, raising concerns about their capital adequacy. The fact that financial institutions' activity is restrained by the state of their balance sheets seems to be a reason for the high Euroyen TIBOR for periods of three months or longer. If this situation does not change, these rates may not decline significantly even if the Bank were to aggressively implement money market operations. Therefore, when examining ways to influence three-month and six-month interest rates, the strategies of financial institutions with regard to managing their capital base need to be taken into account.

Issuance of three-month government bills was raised from 4.5 trillion yen per month until December 2008 to 4.8 trillion yen in January 2009 and 5.1 trillion yen in February. Against this background, bids for new issues have become less strong and the sentiment that there is an oversupply is gradually pushing up issuance rates. This is something that needs to be monitored when considering ways to influence interest rates on term instruments.

Because the economy is like a living organism that changes its behavior constantly, policy action must be flexible. For this reason, except in exceptional cases where a duration effect is intended, such as in the implementation of the quantitative easing policy, it would be inappropriate to express a public commitment to future monetary policy in terms of, for example, policy tools to be used or the basis for deciding on any policy action. Moreover, given that Japan's banking system has been relatively stable compared with its U.S. and European counterparts even following the "Lehman shock" of September last year, it seems reasonable to argue that the Bank should not rush into taking any nonconventional monetary policy steps at this point in time.

However, since the October-December quarter, economic indicators for Japan, especially those for exports, production, and capital spending, have deteriorated rapidly and more than expected due to the global economic downturn and the financial crises in the United States and Europe. While there remains room for debate whether Japan already suffers from an adverse feedback loop between financial and economic activity, it is clear that Japan's economy is severely affected and international organizations such as the IMF forecast that in 2009 Japan's real GDP will contract by more than that of the United States or the euro area.

Looking ahead, the so-called "tail risk" with regard to the following scenarios is not negligible: (1) the possibility that nonfinancial firms' cash flow declines significantly and that reducing excess capacity and employment becomes their top priority; (2) the possibility that the deterioration in the employment and income situation depresses private consumption; (3) the possibility that the worsening of corporate results and a consequent downgrading of firms' ratings increases financial institutions' credit costs more than expected; and (4) the possibility that there is an appreciation in the effective exchange rate of the yen vis-à-vis all other major currencies and that at the same time Japanese stock prices continue to fall. Therefore, I think it is important for the Bank to be prepared to promptly take policy actions, including actions that may be considered exceptional.

As I mentioned earlier, the Bank's current monetary policy does not focus only on the approaching fiscal year-end, but takes a forward-looking perspective, focusing also on the period from the coming fiscal year onward, when severe economic and financial conditions are expected to continue. As the nation's central bank, the Bank will do its utmost in order for Japan's economy to return to a sustainable growth path with price stability.

IV. Indispensable Safety Nets for the Financial System and Employment

Until 2007, exporting firms led the Japanese economy, benefiting from economic globalization and a moderate depreciation of the yen. However, as a result of financial crises in the United States and Europe and the consequent stalling of economies worldwide, exporting firms' cash flow deteriorated substantially and a considerable number of large firms are expecting not only a fall in profits but also losses. Furthermore, business plans that were based on a robust world economic outlook are being overhauled, and some firms are now planning to freeze capital investment for capacity expansion or to consolidate production facilities, including the closure of factories, with drastic cuts in employment also in the pipeline.

Japan experienced an NPL problem in the latter half of the 1990s. The full transcripts of the Monetary Policy Meetings held in 1998, which were made public recently, chronicle the discussions that took place at the Bank at the time. Simply put, the Policy Board members at the time shared the view that, should a major long-term credit bank collapse, the ensuing credit uncertainty could develop into a chain reaction of bankruptcies and job losses among borrowing firms and that the consequent loss of confidence would undermine consumer sentiment and spending and restrain capital spending. That is, Policy Board members agreed that, along with taking measures to revitalize the financial system through the disposal of NPLs, reorganize the financial system, and stimulate the economy, it was important to formulate a medium- to long-term vision focusing on supply-side issues such as taxes and social security to dispel people's anxieties regarding the future of the financial system and the economy.

In government circles, too, the view subsequently gained ground that it was necessary to combine demand-side and supply-side measures and to concurrently regenerate the financial sector and industry as a whole.

Now that an adverse feedback loop between financial and economic activity is rearing its head in Japan, it is vital that all possible measures are taken to ensure the stability of the financial system. Depending on trends in the stock market, there is a risk that the size and quality of the owned capital of major Japanese banks engaged in international operations may compare unfavorably with major U.S. and European banks whose Tier I capital has been increased as a result of recent injections of public funds. Some regional banks in Japan are considering application of the amended Act on Special Measures for Strengthening Financial Functions, which has already been passed by the Diet. A bill designed to allow the government to purchase stocks held by financial institutions and business firms through the Banks' Shareholdings Purchase Corporation is also being discussed in the Diet. Furthermore, the Bank of Japan decided just two days ago to resume purchasing of stocks held by financial institutions with a view to supporting their efforts to reduce the market risk associated with stockholdings. These moves indicate that progress is being made in putting a safety net for the financial system in place. In addition, efforts to strengthen the employment safety net are gathering momentum.

With leading firms around the world experiencing a steep drop in cash flow, it is expected that the automobile, electrical machinery, semiconductor, and pharmaceutical industries will experience consolidation on both a domestic and global basis. Personally, I hope that there will be greater international debate on the concurrent regeneration of the financial sector and industry as a whole reflecting the increase in economic globalization.