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Bank of Japan

Recent Economic and Financial Developments and the Conduct of Monetary Policy

Summary of a Speech at a Meeting with Business Leaders in Okinawa

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Introduction

Today, I would like to talk about developments in overseas economies and in Japan, while touching upon monetary policy measures taken by the Bank of Japan. As all of you may know, the global economy, including that of Japan, has been facing the most severe situation since World War II. I would like to discuss the causes of the current global recession and the outlook for the economy and also talk about my own views as one of the members of the Bank's Policy Board.

I. Overseas Economies

I will first discuss key factors affecting overseas economies, with particular focus on the United States, the starting point of the current global recession.

A. Global Imbalances

Beginning with the turmoil in global financial markets in the summer of 2007, the world economy slowed markedly and decelerated further following the failure of Lehman Brothers in September 2008. At present, the simultaneous downturn in economies around the world is deepening. Regarding the outlook, although many expect a moderate recovery following a few more quarters of deceleration, there is a growing view that the slowdown is more serious and that it will take more time until recovery sets in. The International Monetary Fund (IMF), in its *World Economic Outlook* released in January 2009, estimates that world economic growth slowed to 3.4 percent in 2008, down from the high growth of around 5 percent from 2002 to 2007. World growth is projected to fall to 0.5 percent in 2009, the lowest rate since World War II, while output in the advanced economies is expected to contract in 2009.

Underlying the outlook I have just mentioned are the various imbalances accumulated during the period of simultaneous growth of economies around the world from 2002 onward, such as (1) the excessive consumption and accumulation of debt in the United States; (2) the excessive leverage[1] in the financial sector overall, including hedge funds and structured investment vehicles (SIVs);[2] and (3) the overshooting of home and real estate prices in

[1] Leverage refers to the attempt to raise the return on equity through the issuance of bonds or the use of loans.

[2] Entities established for a special purpose, such as securitization (special purpose vehicles).

many countries. These imbalances emerged gradually over time and appear to be greater than expected.

These imbalances were, in a way, supported by increases in global current account imbalances. Having experienced the 1997 Asian financial crisis as a result of large current account deficits, emerging economies in East Asia turned their current account deficits into surpluses and increased their foreign reserves. The surplus savings of emerging economies and Japan financed the U.S. current account deficit and supported excessive spending in the United States. These imbalances ballooned to an unsustainable level and are presently undergoing adjustment. It is important to understand this larger picture in order to predict the future direction of the United States and the world economy as a whole.

Global imbalances can be gauged in many ways. For example, the ratio of households' financial debt to disposable income increased sharply in the United States from around 2000 due to a surge in mortgage loans.[3] The ratio of outstanding external debt to world GDP increased significantly from around 2002, indicating a sharp rise in international funds transactions and market liquidity relative to economic growth. Furthermore, indicators of home prices in the United States and Europe show that prices rose sharply in tandem with the global credit expansion that lasted until around 2007, but subsequently tumbled, and further steep falls seem to be in store as the rise has been greater than that experienced in Japan during the bubble economy in the latter half of the 1980s.[4]

The current global recession is more likely to be a global structural adjustment rather than a passing phase of a cyclical pattern. During the 1990s, Japanese firms and financial institutions were forced to implement balance-sheet adjustments, and these adjustments took a long time to complete. This experience taught the lesson of the need to monitor the

[3] In the United States, households have increased leverage through (1) the continuation of an accommodative financial environment, (2) the formation of expectations for a continued rise in home prices, and (3) the accommodative lending attitude of banks leading to the extension of loans to individuals with a poor credit standing. Furthermore, personal saving rates fell to almost 0 percent while consumers continued their excessive spending.

[4] U.S. home price index futures -- although not an entirely reliable indicator because markets are thin -- suggest that after a fall of less than 30 percent from the peak recorded in the middle of 2006, home prices may decline further by more than 10 percent by November 2010.

degree of progress in correcting imbalances to gain insight into the possible length and severity of the downturn and also the expected timing of a recovery.[5]

B. Balance-Sheet Problems of U.S. and European Financial Institutions

From a financial perspective, the underlying cause of the current financial instability is that the successive injections of public funds into financial institutions by authorities around the world have not succeeded in dispelling anxiety over the balance sheets of U.S. and European financial institutions, that is, concerns about whether financial institutions have sufficient capital to cover the impairment of assets.[6] Furthermore, the balance-sheet adjustment in the financial sector is exerting downward pressure on economic activity through a tighter lending stance, and the resulting fall in the value of financial assets and rise in credit costs is leading to an increase in losses at financial institutions and a further tightening in their lending stance, causing an intensifying adverse feedback loop between financial and economic activity. Trapped in this feedback loop, losses of financial institutions worldwide have been expanding: at the end of January 2009, the IMF raised its estimate of combined losses of financial institutions to 2.2 trillion U.S. dollars, up from its October 2008 estimate of 1.4 trillion dollars and its April 2008 estimate of 940 billion dollars.

Based on Japan's experience since 1998 in working to stabilize the financial system through the injection of public funds, in which I was personally involved, it would seem that U.S. and European financial institutions need to take three measures consecutively in order to fundamentally resolve their balance-sheet problems: (1) grasp the extent of losses through the strict assessment of assets; (2) dispose of legacy assets; and (3) obtain new funding to cover capital shortfalls. In this sense, the U.S. government's new Financial Stability Plan announced on February 10, 2009 is a step forward, as it listed measures such as the establishment of a Public-Private Investment Fund to purchase legacy loans and assets

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[5] For more details on the accumulation and adjustment of imbalances, refer to *Financial Markets Report*, January 2009, pp. 5-16.

[6] There is a growing view that the securitized products and other assets of U.S. financial institutions are overvalued and that given the magnitude of potential losses, their capital base has been impaired substantially. It has been said of the problem with financial institution balance sheets that "on the left-hand side nothing is right and on the right-hand side nothing is left."

while calling for the strict assessment of assets.[7] However, since it is not clear how the establishment of the fund will lead to the resolution of the thorny issue of how to price the legacy assets, it is likely to take some time before concrete measures are introduced. Already, concerns have been voiced that the amount set aside for the purchase of legacy assets is too small compared to the estimated total of legacy assets.

A central issue is how to price legacy assets. If the price is high, the burden on the government will rise, while a low price will impede sales by financial institutions. There is no doubt that it will be difficult to set a price -- a fair price -- to which both parties will agree. In this connection, it should be remembered that disposal of legacy assets -- other than by defunct institutions -- in Japan in the 1990s was slow due to difficulties in agreeing on a fair price. Since securitized products, which account for a large portion of the legacy assets, involve greater difficulties in pricing, U.S. and European financial institutions are faced with more complex problems than their Japanese counterparts in the 1990s. The issue of pricing legacy assets has been outstanding since October 2008, when the Emergency Economic Stabilization Act was enacted, and markets have been extremely disappointed that a solution has yet to be found. It is important, therefore, to keep watch on the pace of progress in the disposal of legacy assets with particular emphasis on the practical side of this issue, including pricing.

C. Inter-Regional Adverse Feedback Loop

In the past, economic downturns in the United States and Europe adversely affected emerging economies, but not vice versa. This time, however, an inter-regional adverse feedback loop between industrialized and emerging economies is operating: the quicker-than-expected slowdown in emerging economies is reducing exports to them from industrialized economies, thereby depressing the latter in turn.

China, which replaced the United States in 2007 as Japan's largest trading partner, saw its

[7] The principal elements of the Financial Stability Plan are (1) a comprehensive stress test for major banks and a capital assistance program, (2) the purchase of legacy assets by a Public-Private Investment Fund, (3) the expansion of the size and scope of the Term Asset-Backed Securities Loan Facility, and (4) the launch of a comprehensive housing program.

real GDP growth[8] fall sharply to 6.8 percent in the October-December quarter of 2008 from 9.0 percent in the previous quarter. In January, the year-on-year rate of change in exports was down significantly by 17.5 percent, marking a decline for the third consecutive month. Imports, on the other hand, tumbled by 43.1 percent from the same period a year earlier.[9] This reflects a sharp decline in exports from Japan and other industrialized economies. Before the U.S. economic slowdown became more pronounced, there was much talk about the so-called "decoupling theory" and the extent to which high growth in emerging economies, particularly in China, would offset any adverse impact of a slowdown in the U.S. economy.[10] However, it is now clear that this theory was illusory and a "recoupling" of economies is growing rather evident.

Furthermore, the World Bank expects world trade volumes to contract in 2009 for the first time since 1982.[11] Against this background, protectionist measures, such as restrictions on imports, are emerging.[12] As I will touch upon later, the United States has included in its stimulus package a "Buy American" clause that requires government procurement and

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[8] The figures are in comparison with the same period a year earlier, as China does not release real GDP growth on a quarter-on-quarter basis (the United States, Europe, and Japan announce GDP growth in comparison with both the same period of the previous year and the previous quarter).

[9] The degree of the drop in both China's exports and imports has expanded on a year-on-year basis since November 2008. The decline in January 2009 was particularly large, partly because of the Chinese New Year holidays, which in 2008 fell in February.

[10] I presented my view on the "decoupling theory" in a speech on "Recent Economic and Financial Developments and the Conduct of Monetary Policy" delivered at a meeting with business leaders in Gunma in March 2008, a summary of which is available from the Bank's web site. In the speech, I argued that "the impact on Japan's exports of falls in the exports of other East Asian countries including China to the United States requires monitoring, given the international division of the production process -- that is, the process by which Japan makes intermediate goods, or more specifically parts, that are exported to other East Asian countries, where they are assembled into final consumer goods and subsequently exported to the United States."

[11] According to a report released in December 2008 by the World Bank, world trade volumes are estimated to have increased by 6.2 percent in 2008 after growth of 7.5 percent in 2007, and are expected to contract by 2.1 percent in 2009.

[12] According to a World Trade Organization (WTO) report in January 2009 presented by the Director-General to the Trade Policy Review Body on the financial and economic crisis and trade-related developments, protectionist measures are increasingly being adopted. For example, Russia raised import duties on cars and trucks, and India raised tariffs on some steel products and issued notifications restricting imports on some steel products.

public works funded by the package to give preference to U.S. products. I am deeply concerned that such protectionist pressures could accelerate the downward trend in international trade.[13]

D. Policy Measures

Confronted with a sharp global deterioration in financial and economic conditions, governments and central banks have taken various measures. To alleviate the financial crisis, central banks in various countries are acting together to provide funds not only in their own currency but also in U.S. dollars. Governments are injecting public funds into troubled financial institutions, expanding their deposit insurance schemes, and insuring the liabilities of financial institutions.

In response to the contraction in demand, considerable monetary easing and fiscal stimulus measures have been enacted in many countries. Notable among the various measures is the American Recovery and Reinvestment Act of 2009 that was signed into law on February 17, 2009.[14] The 787 billion U.S. dollar stimulus package, unprecedented in size, consists of two main pillars: major tax cuts and public works projects. Similarly, China is in the process of implementing a 4 trillion yuan stimulus package, and since the end of 2008 bright signs have emerged in areas related to domestic demand: bank lending has increased,[15] inventory adjustment is making progress, industrial output has bottomed out, the Purchasing Managers' Index (PMI) has improved,[16] and stock prices have rebounded.[17]

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[13] The protectionist measures taken by the United States (the Smoot-Hawley Tariff Act) during the Great Depression of the 1930s provoked a storm of retaliatory measures by European and other countries. As a result, world trade declined by almost 70 percent in value between 1929 and 1933.

[14] The American Recovery and Reinvestment Act of 2009 includes the following stimulus measures: (1) investments to save energy and use renewable energy; (2) investments for highway construction and other infrastructure; (3) expansion of aid to the unemployed and job training; and (4) financial support to state and local entities.

[15] Measures by the Chinese government to increase bank lending induced a 20 percent increase in credit extension on a year-on-year basis. In January, lending increased by 1.6 trillion yuan, or four times the average monthly increase in loans in 2008.

[16] The PMI is compiled by the China's Federation of Logistics and Purchasing on behalf of China's National Bureau of Statistics. A reading above 50 suggests expansion, while one below 50 indicates contraction. After falling to 38.8 in November 2008, the PMI rose for the second consecutive month, reaching 41.2 in December and 45.3 in January 2009.

It is no exaggeration to say that the prospect and timing of a global economic recovery hinge on the actual implementation and force of various policy measures designed to repair the large imbalances I mentioned earlier. Global financial markets are already factoring such policy measures into their expectations, which provides a potential risk factor that may bring new uncertainty and needs to be carefully watched.

II. Japan's Economy

Next, I will talk about the current situation of and the outlook for Japan's economic activity and prices.

A. Economic Activity

Between fiscal 2003 and 2006, Japan's economy grew at annual rates of around 2.0 to 3.0 percent. Economic growth subsequently slowed to 1.9 percent in fiscal 2007, continued to decelerate at the beginning of fiscal 2008, and has further significantly deteriorated most recently. According to the first preliminary estimate for the October-December quarter of 2008, real GDP fell for the third consecutive quarter on an annualized quarter-on-quarter basis, declining sharply by 12.7 percent. The drop is the largest in 35 years since a decline of 13.1 percent in the January-March quarter of 1974 at the time of the first oil crisis. The contraction in Japan's GDP exceeded by far that of 3.8 percent in the United States and that of 5.8 percent in the euro area in the same period.[18]

The main reason for the deterioration in Japan's economy is the overseas economic slowdown caused by the global structural adjustment I have just talked about. Japan's

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[17] If China's economy rebounds due to public investment, exports of materials to China may recover. The effect on the Japanese economy as a whole, however, should be measured with prudence. In recent years, the increase in Japan's exports to China had been supported by capital goods, parts, and other intermediate goods. These were then assembled in China for export to the United States and Europe for final consumption. Japanese exports for final consumption in China have not been particularly large.

[18] The drop in output in Japan has become much larger than that in the United States, the origin of the global economic adjustment, due largely to structural differences in the manufacturing sectors of the two countries in terms of (1) the relative weight of different industries in overall industrial output, (2) the impact of exports on production, and (3) the spillover effects of demand shocks. For more details, refer to "BOX: Recent Substantial Decrease in Industrial Production," *Monthly Report of Recent Economic and Financial Developments*, February 2009, pp. 15-16.

economic downturn is conspicuously large because the recovery and expansion since fiscal 2002 have been largely sustained by an increase in exports reflecting growing global demand. In the period up to fiscal 2007, exports had increased by about 80 percent, and the cumulative contribution of net exports to economic growth exceeded that of private consumption and business fixed investment.[19] Exports increased sharply due to increases in global demand and were further helped by a weaker yen, while at the same time export-oriented manufacturers increased their fixed investment. These developments set off a virtuous cycle, which suddenly reversed with the plunge in global demand.[20] Furthermore, the sharp appreciation of the yen, at a time when the global imbalances mentioned earlier were in an adjustment phase, further reduced final demand from overseas, adding to the negative effect on Japan's exports.

Tightening in corporate financing, which I will discuss later, has started to negatively influence economic activity since autumn 2008. Looking ahead, economic conditions are likely to increase in severity for the immediate future. This is because domestic private demand is likely to weaken further as corporate profits decline, firms' funding conditions deteriorate, and employment and income conditions in the household sector worsen, and also because exports are expected to decrease due to the further slowdown in overseas economies.

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[19] A breakdown of the contribution to Japan's GDP growth by demand component for the six years from fiscal 2002 to 2007 shows that net exports accounted for 40 percent, while private consumption and business fixed investment each accounted for 30 percent. Thus, the increase in net exports made the largest contribution. Considering the effects on fixed investment among export-oriented manufacturers, growth until the end of fiscal 2007 relied heavily on exports backed by increases in global demand.

[20] Production in the January-March quarter of 2009 is projected to register a significant decline that will be larger than the 11.9 percent fall in the October-December quarter of 2008. Assuming that the level of production in March 2009 corresponds to that suggested by the production forecast index of February, production in the January-March quarter of 2009 is expected to decrease by 20.4 percent from the previous quarter. In this case, the level of the production index will be 74.3, down by 32.0 percent from the October-December 2007 peak of 109.2. This would be the lowest level since the October-December quarter of 1983, when it registered 72.5. The figures indicate a sharp reduction in production over a short period of time. Moreover, this reduction will be even greater in industries that are heavily dependent on exports, such as the electronic parts and transport equipment industries, which have export ratios of about 70 percent and 50 percent, respectively.

Every April and October, the Bank releases its *Outlook for Economic Activity and Prices*, or the Outlook Report, and in the intervening period makes interim assessments in January and July of the outlook laid out in the Outlook Report. In these months -- that is, on a quarterly basis -- each Policy Board member (of whom there are eight at present) prepares a forecast for Japan's economy and prices, and then the Bank makes a summary and releases the range of all members' forecasts for GDP and prices, in table format and also in Risk Balance Charts based on probability distributions. As of January 2009, the median of the eight Policy Board members' forecasts for real GDP growth was minus 1.8 percent for fiscal 2008, minus 2.0 percent for fiscal 2009, and 1.5 percent for fiscal 2010. In other words, the Bank's baseline scenario projects that real GDP growth will return to its potential in fiscal 2010 after two consecutive years of negative growth. The Risk Balance Charts show that the probability distribution is skewed to the left, indicating that Policy Board members as a whole are strongly conscious of the downside risks. Barely a month or so has passed since the release of the latest interim assessment in January, but I am of the opinion that recent data indicate the economy has weakened even further.

B. Prices

Moving on to prices, the year-on-year rate of increase in the consumer price index excluding fresh food, or the core CPI, for December 2008 had moderated substantially to 0.2 percent. The moderation mainly reflects the decline in and stabilization of energy and food prices. With energy and food prices, which caused prices to rise in fiscal 2007, no longer likely to cause increases for the time being, the core CPI is expected to fall by considerably more than 1 percent on a year-on-year basis around the middle of 2009 reflecting price rises last year, but the extent of the decline in prices is expected to diminish thereafter.

Regarding future developments in prices, it is important to carefully monitor (1) the possible effect of the current sharp deterioration in supply and demand conditions on the dynamics of price formation,[21] and (2) the effect of the sharp fall in prices on medium- to long-term inflation expectations, which remained more or less stable during the period of price increases.[22] Thus movements in price-related indicators for the next few quarters warrant close attention.

C. Risk Factors

For the time being, the Bank's baseline scenario projects that the economy will start recovering from the latter half of fiscal 2009 at the earliest, with price declines abating. I said "for the time being" because, as you will have gathered from what I have said so far, the assumption is that overseas economies will move out of their deceleration phase. In other words, the largest risk concerns the recovery of overseas economies, especially the U.S. economy. In addition, there are countless other risk factors,[23] but the one I would like to discuss now is the risk that Japan's financial markets seize up.

Japan's financial markets remained relatively stable compared to those in the United States and Europe until the first half of 2008, but were subsequently affected by the strains in global financial markets.

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[21] Regarding (1), it is of concern that in January 2009 the CPI excluding food and energy for central Tokyo (23 wards) fell 0.3 percent from the same period a year earlier (down 1.1 percent from the previous month). With regard to the core CPI for central Tokyo, the difference between the number of items whose prices rose or fell was plus 60 in January, about half of the peak in September 2008 of plus 116, indicating a change in the trend. There is a possibility that the increase in prices has halted, reflecting changes in, for example, the output gap, and prices for goods and services are being lowered in addition to energy and food prices.

[22] Households' inflation expectations for the next 12 months, estimated from the Bank's *Opinion Survey on the General Public's Views and Behavior*, were about 1 percent in summer 2008, but eased to 0.5 percent in December 2008, reflecting a fall, or a leveling-off of increases, in the prices of frequently purchased items such as petroleum products and food. In contrast, inflation expectations for the next five years have been stable at around 1 percent for the past few years. This phenomenon in which the short-term inflation expectations of households are falling in contrast to stable medium- to long-term expectations is also evident in the United States.

[23] One of the risk factors assumed in the scenario is a rise in pressures to adjust capital stocks and employment due to a decline in firms' medium- to long-term growth expectations. I have been paying attention to this risk factor and presented my view on this in a speech on "Recent Economic and Financial Developments and the Conduct of Monetary Policy" delivered at a meeting with business leaders in Kushiro in September 2008, a summary of which is available from the Bank's web site.

Financial conditions in Japan can be summarized as follows. The CP market remains tight on the whole. In response to the Bank's various policy measures, such as outright purchases of CP that I will touch on later, interest rates on CP have declined, and some signs of improvement have been seen. However, the amount outstanding of CP has been below the previous year's level. In the corporate bond market, reflecting strong risk aversion among investors, issuance conditions have become severe to an extent that cannot be explained by a deterioration in the terms and conditions of loans to particular firms. Moreover, there is growing evidence that indirect financing which would be expected to make up for the shortfall in direct financing is also becoming more difficult to obtain as financial institutions as a whole have become more conscious of their capital constraints when managing risk assets as a result of the recent increase in the number of corporate bankruptcies and fall in stock prices, and an increasing number of firms have found it difficult to raise funds. Some large firms have reported that they have revised their business fixed investment plans downward due to the deterioration in funding conditions. Careful attention should therefore be paid to the risk that the adverse feedback loop between financial and economic activity might further intensify.

III. Conduct of Monetary Policy

Having discussed the current situation of, and the outlook for, Japan's economy, I will now turn to the Bank's conduct of monetary policy. Since September 2008, when the turmoil in global financial markets and in the U.S. and European financial systems increased in severity, the Bank has promptly undertaken various measures. These fall into three main categories: (1) reductions in the policy interest rate; (2) measures to stabilize financial markets; and (3) measures to facilitate corporate financing. In what follows, I would like to explain the thinking behind these policy measures, including those decided last week.

A. Reductions in the Policy Interest Rate

In considering the different measures, let me begin with interest rate policy. Since February 2007, the Bank had maintained its target for the uncollateralized overnight call rate, the Bank's policy interest rate, at 0.5 percent. The Bank lowered the target rate by 0.2

percentage point both in October and December 2008, to 0.1percent.[24]

B. Measures to Stabilize Financial Markets

The second set of measures is aimed at ensuring stability in financial markets. To stabilize financial markets amid the financial crisis, the provision of substantial liquidity by the central bank is extremely important.

With regard to yen funds, the Bank introduced a complementary deposit facility in order to further facilitate the provision of sufficient liquidity and provided ample funds maturing over the 2008 year-end exceeding the previous year's level by about 20 percent. Furthermore, the Bank increased the amount of outright purchases of Japanese government bonds from 14.4 trillion yen per year to 16.8 trillion yen per year. This is to supply longer-term funds and resolve the problem of having to conduct frequent short-term funds-supplying operations, thereby facilitating smooth money market operations.

The Bank implemented U.S. dollar funds-supplying operations immediately after the failure of Lehman Brothers in September 2008, as part of coordinated measures by the central banks of major economies, and has been supplying ample dollar funds ever since. These operations are supporting economic activity by relieving the funding concerns of Japanese firms through reducing the dollar funding pressures among financial institutions. As a result, dollar funding rates have declined, mainly for shorter terms.

C. Measures to Facilitate Corporate Financing

The third set of measures is aimed at facilitating corporate financing, in other words, at reducing the risk factor for financial conditions that I mentioned earlier. Specifically, the Bank expanded the range of corporate debt eligible as collateral for the Bank's provision of

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[24] At the Monetary Policy Meeting held on February 18 and 19, 2009, the eight Policy Board members decided, by unanimous vote, to maintain the target of the policy interest rate at 0.1 percent. At Monetary Policy Meetings, decisions are taken by a simple majority vote of Policy Board members, who consist of the Governor, the Deputy Governors, and members of the Policy Board, following the principle of "one person, one vote."

credit[25] and introduced special funds-supplying operations to facilitate corporate financing, which provide funds at a low interest rate with no explicit ceiling on the total funds available, although the maximum amount of loans available to an individual financial institution will not exceed the value of the corporate debt it has pledged as collateral. Market participants have found the special operations attractive, as they enable participants to obtain longer-term funds at a low fixed rate of 0.1 percent. As a result, the amount of funds provided by the Bank has already reached 4.5 trillion yen, which exceeds the initially anticipated amount of 3.0 trillion yen. Moreover, given that the uncollateralized overnight call rate, the policy interest rate, was very close to zero at 0.1 percent, at the Monetary Policy Meeting held on February 18 and 19, 2009 the Bank decided to expand special funds-supplying operations to facilitate corporate financing, with a view to encouraging a decline in longer-term interest rates, which firms pay when they borrow -- that is, interest rates on term instruments. To further relieve firms' funding concerns, it was decided, first, that loans will be offered through the end of September 2009. Second, the frequency of the special operations, which was previously twice a month, will be increased to once a week. And third, the special operations will be expanded to ensure stable provision at a low interest rate for funds with the somewhat longer duration of three months.

Given the considerable decline in the functioning of the CP market, the Bank has increased the frequency and size of CP repo operations. It also began outright purchases of CP at the end of January 2009 and has bought 1.3 trillion yen worth of CP as of today. Some positive effects, such as a significant decline in interest rates on CP, have been seen in the CP market. In addition, given funding difficulties in the corporate bond market, the Bank decided at the Monetary Policy Meeting held on February 18 and 19, 2009 to commence in March outright purchases of corporate bonds with a residual maturity of up to one year. Outright purchases of corporate financing instruments such as CP and corporate bonds to facilitate corporate financing should be regarded as an exceptional measure for a central bank for the following reasons. First, they involve taking on a greater degree of individual private firms' credit risk and consequently a relatively high probability of incurring losses

[25] In order to facilitate corporate financing, the Bank eased the eligibility criteria for corporate debt to be accepted as collateral from a credit rating of "A-rated or higher" to "BBB-rated or higher," and decided to accept debt instruments issued by real estate investment corporations as eligible collateral.

that will ultimately be borne by the taxpayer. And second, they carry the risk of damaging the financial health of the Bank and ultimately undermining confidence in the currency and monetary policy.

The basic principles for a central bank to take such an exceptional measure can be summarized as follows.

The premise of a free market economy is that central banks provide liquidity at large, and private financial institutions and financial markets perform the function of allocating individual resources and credit. It is therefore important to explain the role of this measure. The Bank has made clear the criteria for the adoption of exceptional measures. The first criterion is that a significant decline is observed in the functioning of the corporate financing market, leading to tight corporate financing conditions overall. The second criterion is that outright purchases of corporate financing instruments are judged necessary to fulfill the Bank's mission to ensure price stability and financial system stability.

In addition, great care is required regarding the institutional arrangements for the implementation of outright purchases of corporate financing instruments. The Bank has laid out three elements to be considered. The first is the need for neutrality, that is, the need to prevent the discretionary allocation of credit to individual firms. The second element is to conduct the purchases only for the period necessary and on an appropriate scale. The aim is to ensure that the purchases are a bridging measure until the market functions again. Concretely, this means that outright purchases of corporate financing instruments are a temporary measure,[26] and the upper limits to total CP and corporate bond purchases are set to 3 trillion and 1 trillion yen, respectively. The third element is to ensure that the Bank's financial soundness is maintained. Since any losses resulting from purchases of corporate financing instruments are borne by taxpayers, it is important to avoid the concentration of credit risk associated with holding the instruments of specific firms.

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[26] When the outline of the CP purchasing scheme was released in January 2009, a time limit on such purchases until the end of March 2009 was set. However, at the Monetary Policy Meeting held on February 18 and 19, 2009, the Bank decided to extend the duration of purchases of CP to the end of September 2009. Outright purchases of corporate bonds will be conducted until the end of September 2009.

The Bank will purchase CP rated a-1 that is eligible as collateral with the Bank, with an upper limit set for each individual firm.

D. The Importance of Keeping a Balance between Facilitating Corporate Financing and Restoring Market Functioning

As outlined, the Bank decided on and implemented various policy measures in swift succession following the failure of Lehman Brothers. In this context, what I think is important is the choice of appropriate policies to maintain accommodative financial conditions and provide support for Japan's economy. As I said earlier, under the current severe economic conditions, central banks have no choice but to intervene in individual financial markets. However, if such intervention is excessive, central banks' purchases of corporate financing instruments themselves may impair the functioning of markets that at present are operating reasonably well, thus defeating the whole purpose of such intervention. For this reason, I do not think that the larger the amount of purchases of corporate financing instruments or the lower interest rates to be applied to such purchases, the greater the positive effect of these measures. For example, in outright purchases of CP and corporate bonds, the Bank uses an auction in which a minimum bid rate is set. The minimum bid rate is set to be more favorable than the market rate when the market is malfunctioning, but not more favorable than the market rate in normal times. With this setting, bids will naturally decrease in number as the functioning of the market recovers. Thus, I am strongly aware that in conducting outright purchases of credit market instruments to facilitate corporate financing, it is important to strike a balance between using such purchases to facilitate corporate financing to the fullest extent possible while at the same time aiming to restore the functioning of markets.