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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 Nagano Prefecture
(Held in Matsumoto)

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Introduction

Today, I would like to talk about developments in overseas economies and in Japan, while also touching upon monetary policy measures taken by the Bank of Japan. Economies around the world have experienced the most severe simultaneous downturn since World War II, although, in the view of most, the worst is now behind us. I would like to discuss the causes of the current global economic downturn, whether they have been resolved, and the outlook for the world economy.

I. Overseas Economies

I will first discuss key factors affecting overseas economies.

A. Adjustments of "Imbalances": More Time Will Be Needed

Beginning with the global financial market turmoil in the summer of 2007, the world economy slowed at an increasingly faster pace and decelerated further following the failure of Lehman Brothers in September 2008. Currently, however, economic conditions around the world have generally stopped worsening. As for the outlook, against the background of further progress in inventory adjustments, the world economy, which has stopped worsening, is likely to start recovering, supported by monetary policy measures and governments' various economic measures. Nevertheless, the prevailing view is that the pace of the recovery will be moderate.[1]

Behind the current global economic downturn lie global structural adjustments rather than a passing phase of a normal business cycle. In the 1990s after the bursting of the bubble economy in Japan, Japanese firms and financial institutions were forced to make balance-sheet adjustments, which took a very long time. Similarly, in the world economy,

[1] According to the *World Economic Outlook* released by the International Monetary Fund (IMF) in July 2009, the year-on-year growth rate of the world economy decelerated to 3.1 percent in 2008, from much higher rates of around 5 percent a year between 2002 and 2007. The growth rate is projected to plunge to minus 1.4 percent in 2009, the largest negative growth since World War II, and to recover to a positive rate of 2.5 percent in 2010.

during its simultaneous boom after 2002, various imbalances[2] or excesses were accumulated on a global scale, namely, (1) excessive consumption in the United States and excessive debt that supported it; (2) excessive leveraging (balance-sheet expansion) in the financial sector as a whole, including insurance companies and hedge funds; and (3) excessive increases in home and real estate prices in many countries. The difficulties in adjusting these imbalances are currently stifling the global economic recovery.

Let me move now to the question of how much progress has been made in adjustments of the imbalances accumulated. In the United States, relatively rapid progress has been made in home price adjustments; however, there still remains substantial room for adjustments of excessive consumption and debt. Excessive leveraging of financial institutions has been evident around the world.[3]

Adjustments of these imbalances will require considerable time, and therefore the momentum of global economic recovery is likely to remain weak for the time being. In

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[2] I discussed "global imbalances" in depth in a speech, "Recent Economic and Financial Developments and the Conduct of Monetary Policy" delivered at a meeting with business leaders in Okinawa in February 2009, a summary of which is available from the Bank's web site. In the speech, I summarize the gist of the course of events as follows. First, these imbalances were, in a way, supported by increases in global current account imbalances: in other words, since the 1997 Asian financial crisis, emerging economies turned their current account deficits into surpluses and increased their foreign reserves, and their surplus savings -- combined with surplus savings in Japan -- eventually financed the U.S. current account deficit and supported excessive spending in the United States. And second, these imbalances ballooned to an unsustainable level on a global scale and are presently undergoing adjustment.

[3] One element of these various imbalances is global current account imbalances, and unwinding these will not be easy. Following the meeting of the Leaders of the Group of Eight (G8) in L'Aquila on July 8, 2009, it was stated in the G8 Leaders Declaration that "stable and sustained long-term growth will require a smooth unwinding of the existing imbalances in current accounts." On this point, Governor Zhou Xiaochuan of the People's Bank of China, the central bank of the country with the world's largest current account surplus, referred to the difficulties of solving this problem in his speech on July 3, 2009, stating that "in China's structural adjustments, the optimal choice is to expand household consumption, which will directly enhance the domestic demand and lower the savings rate. This is, however, easier said than done." He added that "a practical way forward . . . may be that continued reform leads to stronger consumption and significant progress of urbanization in China. In this case, given the high savings rate in China, we may still maintain residual savings."

assessing the momentum of global economic recovery and the time required for the world economy to return to a sustainable growth path, it is important to confirm frequently the progress in the adjustment of the imbalances.

B. Financial Systems and Markets in the United States and Europe: Halfway to Recovery

Global financial markets have shown relatively clear signs of improvement, owing largely to the receding of excessive concerns over the U.S. and European financial systems. However, market participants remain very cautious about the outlook for economic activity and the performance of firms, including financial institutions. Hence, the functioning of markets, particularly of credit markets, has recovered only halfway.

Turning to the financial system and financial markets in the United States, which underlie the current global economic downturn, I will discuss the problem of the "adverse feedback loop between financial and economic activity." I have been watching the development of this feedback loop with great interest from relatively early on, as I was directly involved in the resolution of the nonperforming-loan problem in the Japanese banking system in the 1990s.

My assessment of the current state of the U.S. financial system is as follows. Following the U.S. government's release in May 2009 of the results of the stress test[4] for the 19 major U.S. bank holding companies, overly pessimistic views in the market on the soundness of financial institutions have receded. Market sentiment has improved to an extent that has allowed many financial institutions to raise funds in the markets on their own. Nevertheless, the resolution of the problem is still far from complete.

I am particularly concerned over the possibility that the scale of the Public-Private Investment Program (PPIP) designed to purchase financial institutions' impaired assets will

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[4] Officially, it is called the Supervisory Capital Assessment Program (SCAP). It is a stress test of U.S. bank holding companies' soundness under two alternative economic scenarios, namely, a baseline scenario and a more adverse scenario of the depth and duration of the downturn. The firms were asked to project their credit losses as well as the level of reserves that would be needed at the end of 2010 to cover expected losses.

contract significantly. Originally, the U.S. government had announced that it would purchase impaired assets up to a maximum of 1 trillion U.S. dollars. On July 8, 2009, however, it announced that for the time being the program would be narrowed to the purchase of securitized products and would start on a scale of 40 billion U.S. dollars, or only one-twenty-fifth of the potential maximum amount. It appears that U.S. financial institutions are less willing to make use of the PPIP for the following reasons. First, they have already managed to raise substantial amounts of capital. Second, under the program, they might have to sell their impaired assets for a lower price than the value they initially carried. And third, they appear to be concerned over the risk of having new conditions imposed on them after they decide to participate in the program.

However, there are two significant risks that may arise through the lack of participation by financial institutions in the PPIP. First, if the PPIP is not fully made use of, impaired assets will not be removed from financial institutions' balance sheets, and if the recovery in economic activity is slower than assumed in the scenarios used in the stress test, then these impaired assets can increase the financial institutions' losses, rekindling the problem of capital shortages. And second, in such an event, financial institutions will give priority to repaying public funds to prevent government intervention in management of their business, and the provision of credit for economic activity, which is supposed to be their primary function, will be impaired, increasing the risk of a return of the adverse feedback loop between financial and economic activity. I will continue to observe carefully to see if all the important processes for resolving the adverse feedback loop are achieving steady progress.[5]

C. Developments by Region: Regional Disparities Becoming More Pronounced

I will now discuss developments in overseas economies by region. Looking at developments in the United States, Europe, and Asia, disparities in the timing of the bottoming out of economic activity and the pace of recovery are becoming more

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[5] Financial statements of major U.S. banks for the April-June quarter of 2009 show further deterioration of assets, centering on commercial real estate loans and personal loans, such as mortgage loans. Allowances for loan losses increased substantially from the same period of the previous year, increasing by approximately 80 percent at Citigroup Inc. and 2.3-fold at JPMorgan Chase & Co. and Bank of America.

pronounced.

1. The United States

In the United States, the pace of deterioration in economic conditions has been moderating, as suggested by the recovery in various indicators of business and household confidence, which are considered to be leading indicators of economic activity. It is increasingly believed that the U.S. economy will return to positive growth in the July-September quarter of 2009 and remain on the road to recovery. At the same time, given that -- for example -- the pace of decline in the number of employees is accelerating again, improvements in the economy will not follow a smooth trend. The pace of recovery is likely to be quite moderate, for the following reasons.

As I explained earlier, adjustments of excessive household consumption and debt have started only recently. Such adjustments exert pressures to repay debts and reduce liabilities. Meanwhile, the asset side is affected significantly by the so-called negative wealth effects -- the substantial drop in the value of wealth, particularly of housing and financial assets -- due to falls in home prices and stagnant stock prices. Furthermore, factors that adversely affect personal consumption, the main engine of the U.S. economy, are too many to enumerate. For example, the unemployment rate, which is already only a notch below 10 percent, is forecasted to rise further and is heightening anxiety over the employment and income situation, and consumer credit remains tight. In fact, the monthly average of real personal consumption expenditures for the April-May period of 2009 fell below that for the January-March quarter. The increase in disposable income due to government stimulus measures is not contributing fully to an increase in consumption, and the savings rate, which at one time had fallen to almost 0 percent, rose to 6.9 percent in May 2009. The important point is that none of these factors weighing on personal consumption is temporary in nature, and resolving them will require considerable time.

There are signs of a bottoming out in housing investment, the major cause of the current contraction of the U.S. economy. However, given the fact that housing inventory is still at a high level, it will still take a considerable amount of time before housing investment recovers fully. On the risk side, while no fundamental change is anticipated in the situation in which impaired assets remain on financial institutions' balance sheets as described earlier, prices of not only homes but also commercial real estate are continuing to fall and the delinquency rate on loans has risen sharply. This could again intensify the adverse feedback loop between financial and economic activity. Thus, downside risks to the U.S. economy continue to warrant attention.

2. The euro area

The economy of the euro area is also moving out of its worst phase; however, staff members of the European Central Bank (ECB) and the International Monetary Fund (IMF), for example, forecast that growth will be negative both in 2009 and 2010, suggesting that the pace of economic recovery is slower than in Asia and the United States. This can largely be attributed to the following factors: the rigidity of labor markets; the vulnerability of Central and Eastern European economies; the cautious lending stance of financial institutions; and the smaller scale of fiscal measures relative to those in other regions. These factors are at the same time downside risk factors to the outlook for the economy of the euro area.

3. Asia

The year-on-year growth rate of China's real GDP accelerated to 7.9 percent in the April-June quarter of 2009 from 6.1 percent in the January-March quarter, suggesting that the Chinese economy has bottomed out well ahead of other regions. Owing to a series of economic stimulus measures by the government, which include aggressive fiscal policy measures and monetary easing, fixed asset investment, primarily public investment, is up almost 40 percent year on year, while private consumption has remained firm. It is becoming more evident that the strong growth in China's domestic demand is offsetting the decline in its exports, which still have not recovered.[6,7] In response to the aggressive government policies, the amount outstanding of lending in renminbi by Chinese banks

[6] China's economic growth rate in the first half of 2009 was 7.1 percent year on year. Decomposing this shows that aggregate capital formation (including inventories) contributed 6.2 percentage points and final consumption expenditure 3.8 percentage points, while the contribution of external demand was negative at minus 2.9 percentage points.

[7] China is contributing to the world economy by being one of the few regions that is propping up global final demand, as indicated by the fact that exports from Japan and elsewhere to China have increased from their levels at the beginning of 2009.

increased by more than 7 trillion yuan during the January-June 2009 period, or 1.5 times the increase for the whole of 2008. However, it has become evident that such a sharp increase in lending in renminbi has both upside and downside risks. As China waits for the recovery in exports, one of the former pillars of growth, the question arises whether such policies are sustainable and should be continued, given that, in the view of some, its economy may already be overheating. If the policies are continued, this involves the risk of increases in asset prices as well as a further increase in excess production capacity. On the other hand, if they are not continued, there is the risk that the recovery may stall.

Elsewhere in Asia, India and Indonesia, which have large populations and are less dependent on exports, continue to grow relatively strongly owing largely to the firm expansion of domestic demand, particularly private consumption. On the other hand, the highly export-dependent economies of South Korea, Taiwan, Thailand, and Malaysia have generally stopped deteriorating, but levels of economic activity in these countries remain substantially below those prevailing prior to the failure of Lehman Brothers in September 2008.

II. Japan's Economy

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

A. Economic Activity: Has Bottomed Out, but Recovery in Demand Still Uncertain

Japan's economic growth rate was in the range of 2-3 percent from fiscal 2003 to fiscal 2006, but dropped to 1.8 percent in fiscal 2007. In fiscal 2008, economic conditions deteriorated substantially and the economy registered negative growth of 3.3 percent. In the two most recent quarters, the economy exhibited particularly sharp declines, almost verging on a free fall: on an annualized quarter-on-quarter basis, real GDP fell by 13.5 percent in the October-December quarter of 2008 and by 14.2 percent in the January-March quarter of 2009.[8]

Since then, however, Japan's economy has escaped further rapid and large-scale deterioration and has generally stopped worsening. As corporate profits are extremely weak, business fixed investment has declined substantially. Amid the worsening employment and income situation, private consumption has generally remained weak, except for sales of energy-efficient electrical appliances and motor vehicles. Meanwhile, exports and production have picked up, and public investment has increased.

As you may know, the Bank conducts and releases its *Tankan*[9] every three months. The findings of the *Tankan* confirm these improvements in the economy. The June *Tankan*, released on July 1, 2009, shows that compared with the March survey, the diffusion index (DI) of business conditions for large firms -- the percentage of firms responding that business conditions are "favorable" minus that of firms responding they are "unfavorable" -- has improved, although the figure is still in negative territory, both for the manufacturing and the nonmanufacturing sector. This was the first improvement in the DI in the past 10 quarters since December 2006.

Other economic indicators also show improvements. Indicators of exports, production, and public investment for the April-June quarter of 2009 marked relatively large increases on a quarter-on-quarter basis. These developments form a strong basis to expect that the economic growth rate for the April-June quarter will turn out to have improved substantially

[8] These were the sharpest falls in 35 years, in other words, since the annualized quarter-on-quarter rate of decrease of 13.1 percent in the January-March quarter of 1974, when Japan's economy was hit by the first oil crisis. Other countries registering large declines in output include Germany among industrialized economies and South Korea and Singapore among emerging economies. These declines can be attributed to the fact that the weight of the manufacturing sector in these economies is large and that the downturn of the world economy hit economic activity in these countries hard through falls in exports of manufactured goods. In Japan, exports of manufactured goods, particularly of transport machinery, electrical machinery, and general machinery, plunged, causing a sharp reduction in production and a substantial decline in economic output overall.

[9] "*Tankan*" is an abbreviation for *Tanki Keizai Kansoku Chousa* (Short-Term Economic Survey of Enterprises in Japan). The survey is carried out four times a year. The June 2009 *Tankan* covered approximately 10,000 firms, including slightly more than 5,000 small firms, and received responses from 99 percent of the firms surveyed.

compared with the previous quarter.

As I mentioned, the tide of the economy has turned. Looking ahead, Japan's economic conditions are likely to turn upward over time owing to the positive effects of fiscal and monetary policy measures -- I will discuss the latter below -- in addition to the recovery in overseas economies and global financial markets mentioned earlier. It should be remembered, however, that the situation provides little grounds for optimism, for the following reasons. First, the pickup in exports and production is an autonomous rebound following the earlier sharp and massive falls to levels substantially below the level of final demand. An illustration of this point is that exports and production in the April-June quarter of 2009 were still about 30 percent below their peak levels reached in the January-March quarter of 2008. Normally, economic indicators are viewed in terms of the rate of change on a year-on-year or quarter-on-quarter basis. However, in cases in which there has been a disruptive change, as in the current episode, it is more appropriate to also examine the levels of economic activity. And second, signs of a full-fledged and sustainable recovery in final demand, including domestic demand, are still scarce, and uncertainties regarding developments in final demand remain high. Exports, however, are highly likely to continue recovering,[10] mainly due to progress in inventory adjustments both at home and abroad, and public investment is also likely to continue increasing. On the other hand, domestic private demand is likely to remain relatively weak with the corporate profit situation remaining severe and the employment and income situation worsening.[11] Furthermore, given that firms consider their capital stock and employment to be greatly excessive, even if production recovers to some extent, this is unlikely to lead to increases in business fixed investment and employment. Thus, Japan's economy will

[10] Given that Japan's exports depend on the situation in overseas economies, there are uncertainties as to whether they will continue recovering. I think it is important to note, however, that in the Manufacturing ISM *Report On Business* released by the Institute for Supply Management in the United States, the New Orders Index, which is regarded as a leading indicator of Japan's exports, showed a marked improvement from 23.1 in December 2008 to 49.2 in June 2009.

[11] The ratio of job offers to applicants in May 2009 continued to decline for the 12th consecutive month and stood at 0.44, which is below even the previous record low of 0.46 marked in May and June 1999.

require more time to recover.[12]

Let me explain the view of the Bank's Policy Board regarding the economic outlook, namely, the median and the range of Policy Board members' forecasts for real GDP growth, and the Risk Balance Charts, which are probability distributions of the forecasts,[13] as of July 2009. The median of the eight Policy Board members' forecasts for real GDP growth was minus 3.4 percent[14] for fiscal 2009, and 1.0 percent for fiscal 2010. In other words, the Bank's baseline scenario projects that after two consecutive years of negative growth in fiscal 2008 and 2009, the economy will return to positive growth in fiscal 2010. However, if we regard the level of GDP at its most recent peak marked in fiscal 2007 as 100, the level of GDP is likely to be 93 in fiscal 2009 and still only 94 in fiscal 2010. 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. Later, I will discuss the risks in detail.

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[12] As mentioned earlier, in the June *Tankan*, the DI for business conditions for large manufacturing firms has improved. However, that for large nonmanufacturing firms and small firms has remained more or less flat or deteriorated. As a result, based on data for firms of all sizes in all industries, there was only an improvement of a mere 1 percentage point. The DI for the outlook of business conditions three months ahead improved by 18 percentage points for large manufacturing firms and by 8 percentage points for large nonmanufacturing firms, but by only 1 percentage point for small firms. These results indicate that the economy has stopped worsening largely due to a pickup in exports and that the benefits are unlikely to spread to small firms for the time being, or if they do, this could well be offset by the weakness in domestic private demand.

[13] 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 the Risk Balance Charts based on probability distributions.

[14] The sharp drop in real GDP in the second half of fiscal 2008 has exerted a large carry-over effect on the fiscal 2009 growth rate. This means that even if quarter-on-quarter growth in fiscal 2009 from the fourth quarter of fiscal 2008 onward were 0 percent, the annualized rate of growth for fiscal 2009 would be minus 4.6 percent. The median of Policy Board members' forecasts of minus 3.4 percent means that Policy Board members actually expect real GDP to increase at an average rate of 0.5 percent quarter on quarter (or an annualized rate of 2 percent) over the period.

B. Prices: Declines Evident in a Wider Range of Items

Let us now move on to developments in prices. The consumer price index (CPI; excluding fresh food), or the core CPI, in May 2009 showed a year-on-year decrease of 1.1 percent, a faster rate of decline than in April. The downward trend in the inflation rate so far is largely explained by the declines in the prices of petroleum products and the stabilization of food prices. More recently, however, it has become evident that prices of a wider range of goods and services are falling against the background of the deterioration in the supply-demand balance in the overall economy. The contribution of factors other than energy and food prices to the year-on-year rate of change in the core CPI has gradually increased. The year-on-year rate of decline in the CPI (excluding fresh food and energy) has been accelerating gradually, while the percentage share of items showing a price decline has been rising steadily.[15]

The year-on-year rate of change in the core CPI is likely to fall to somewhere around minus 2 percent in the July-September quarter of 2009, mainly reflecting the surge in petroleum prices a year earlier. Thereafter, however, the fall in the core CPI is expected to moderate as the effects of the developments in prices of petroleum products abate and -- as is likely -- economic conditions turn upward over time.

Regarding future developments in prices, I am carefully monitoring the extent to which the current deterioration in supply and demand conditions in the overall economy affects the dynamics of price formation. I do not believe that medium- to long-term inflation expectations, which have remained more or less stable so far, will diverge significantly from their trend and increase the risk of a deflationary spiral, that is, a vicious cycle of falling prices and deteriorating economic activity. In any event, developments in price-related indicators warrant close attention.

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[15] On a nationwide basis, out of the 521 items whose prices comprise the CPI (excluding fresh food), the percentage share of items whose prices declined has risen since October 2008. As of May 2009, the difference between the percentage of items showing a price rise and that of items showing a decline narrowed to approximately 11.6 percentage points, as the former accounted for 50.8 percent and the latter for 39.1 percent. The CPI in the Tokyo metropolitan area shows that the percentage of items whose prices declined has already exceeded that of items whose prices rose.

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 moderating. 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 start recovering. In other words, the largest risk factor is whether overseas economies, especially the U.S. economy, will recover. I explained this point in greater detail earlier.

There are countless other risk factors,[16] but here I will focus on three in particular, namely, financial conditions, commodity prices, and long-term interest rates. All three factors could cause economic growth to fall below the Bank's baseline scenario.

1. Financial conditions

I will start by explaining the first risk factor, the current financial conditions in Japan. To summarize, financial conditions, while remaining generally tight, have continued to show signs of improvement. As suggested by the *Tankan*, many firms have continued to regard their financial position as weak and lending attitudes of financial institutions as severe. Issuance of corporate bonds by firms with low credit ratings has remained difficult. Nevertheless, funding conditions for firms as a whole have been improving, as seen in the fact that issuance rates on CP have declined, issuance rates on corporate bonds, along with the increase in the number of issuing firms, have also declined, and the amount outstanding of bank lending, particularly to large firms, has continued to increase at a relatively fast pace. Moreover, firms' demand for loans both to secure equipment funds and to raise working capital has been declining recently.

As for the outlook, uncertainty regarding the prospects for a full-fledged recovery in final demand is extremely high. In this situation, firms' demand might increase for liquidity for defensive purposes, such as funds for restructuring due to sluggishness in corporate

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[16] Another important risk factor assumed in the scenario is a rise in pressures to adjust production capacity and employment due to a decline in firms' medium- to long-term growth expectations. I have presented my view on this in a speech, "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.

performance. I therefore believe that the environment for corporate financing for the time being will likely continue to provide little ground for optimism. I will monitor closely whether the aforementioned signs of improvement in financial conditions continue and examine future developments in corporate financing and financial markets.

2. Commodity prices

The second risk factor is a possible rise in commodity prices. Commodity prices have shown unexpectedly high increases. For example, at one point in June 2009, crude oil prices rose to over 70 U.S. dollars per barrel from around 30-40 U.S. dollars per barrel at the beginning of the year. This provides an illustration of how investors adopt a more risk-taking stance and become more inclined to allocate funds to commodity markets when expectations of a continuation of economic recovery rise.

The general view, however, is that a steady rise in crude oil prices is unlikely, given supply and demand conditions. Although in China, for example, the number of car sales is increasing rapidly and consequently that country's imports of crude oil have started to increase, global supply and demand conditions for crude oil remain slack. However, while central banks around the world have been providing ample liquidity and investors remain cautious about investing in complicated structured credit assets, the possibility cannot be entirely ruled out that commodity prices might rise further due to a greater tendency toward a "flight to simplicity," as had been observed until summer 2008. Since a recovery in domestic demand cannot be expected with confidence at this point, deterioration in the terms of trade through a rise in commodity prices would pose a heavy burden on Japan's economy, and therefore it is necessary to pay attention to future developments in commodity prices.

3. Long-term interest rates

Lastly, the third risk is a possible rise in long-term interest rates that is too fast relative to the pace of economic recovery. U.S. and European long-term interest rates continued to trend upward during the first half of 2009. The reasons include expectations for economic activity to bottom out and a consequent recovery in various financial asset prices, primarily stock prices; the rise in commodity prices mentioned earlier; and concerns about a possible deterioration in the supply-demand balance of government bonds due to fiscal expansion. Long-term interest rates in Japan have also increased, although the increase has been moderate when compared with that in the United States and Europe. Yields on Japanese government bonds (JGBs) with a maturity of ten years, the benchmark rate of long-term interest rates in Japan, temporarily increased to the 1.5-1.6 percent range in June 2009 from the 1.1-1.2 percent range at the end of 2008.

In order to prevent large falls in government bond prices, it is crucial to ensure that the government maintains fiscal discipline. Put differently, a clear path toward fiscal consolidation should be presented. If such a path is not made clear, I believe, the Bank's outright purchases of JGBs might be misinterpreted as a means to facilitate government financing, and in this situation the potential danger that risk premiums might rise, causing long-term interest rates to rise, warrants due attention.[17]

A potential rise in long-term interest rates that is too fast relative to the pace of economic recovery would make the momentum of economic recovery even weaker than it already is. Therefore, I believe that developments in long-term interest rates also warrant vigilant monitoring.

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[17] Empirical studies on, and overseas examples of, the effects of outright central bank purchases of government bonds on long-term interest rates seem to arrive at a consensus that such purchases temporarily produce a perceptible announcement effect but do not have any longer-term effects in terms of keeping long-term interest rates at a certain level. In fact, following outright purchases of government bonds by the Federal Reserve and the Bank of England, long-term interest rates in both economies increased, giving rise to concerns that the purchase of government bonds involved the risk of actually increasing long-term interest rates, as such a step was misinterpreted as a means of government financing. In relation to this point, Federal Reserve Chairman Ben S. Bernanke made the following remarks at the Congressional testimonies on May 5, June 3, and July 21, 2009: while he stated that "we are not trying to target a particular interest rate" and "the Federal Reserve will not monetize its debt," he also explained that "prompt attention to questions of fiscal sustainability is particularly critical" and "agreeing on a sustainable long-run fiscal path now could yield considerable near-term economic benefits in the form of lower long-term interest rates and increased consumer and business confidence."

III. Conduct of Monetary Policy

A. Policy Responses by the Bank

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 undertaken various policy measures. These measures 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 mainly the Bank's thinking behind these policy measures, including those discussed and decided at the Monetary Policy Meeting on July 14 and 15, 2009.

1. 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 0.1 percent.

2. 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 while maintaining the policy interest rate at around its targeted level, and provided ample funds maturing over the fiscal year-end in March 2009, exceeding the previous year's level by about 20 percent. Furthermore, the Bank increased the amount of outright purchases of JGBs from 14.4 trillion yen per year to 21.6 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 have been 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.

Moreover, in May 2009, the Bank announced that it would accept from financial institutions bonds issued by the governments of the United States, the United Kingdom, Germany, and France -- so-called cross-border collateral -- as eligible collateral with a view to ensuring stability in financial markets by further facilitating the Bank's money market operations. This measure has expanded the range of eligible collateral, which was previously restricted to instruments denominated in yen, issued in Japan, and governed by the laws of Japan, to instruments denominated in foreign currencies, issued overseas, and governed by the laws of foreign countries.

3. Measures to facilitate corporate financing

The third set of measures is aimed at facilitating corporate financing, in other words, at reducing the risk factors related to financial conditions that I mentioned earlier.

Specifically, the Bank took the following measures. First, the Bank expanded the range of corporate debt it accepted as eligible collateral for the provision of credit.[18] Second, the Bank 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. This measure had been introduced to encourage a decline in longer-term interest rates, which firms pay when they borrow -- that is, interest rates on term instruments -- in a situation where the uncollateralized overnight call rate, the policy interest rate, was already very close to zero at 0.1 percent, and also to further relieve firms' funding concerns.

[18] In order to facilitate corporate financing, the Bank eased the eligibility criteria for corporate debt for acceptance 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.

Third, in view of the considerable decline in the functioning of the CP market, the Bank has increased the frequency and size of CP repo operations, and began outright purchases of CP from January 2009. And fourth, given funding difficulties in the corporate bond market, the Bank commenced 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 exceptional measures for a central bank for the following reasons. First, they involve directly shouldering a greater degree of individual private firms' credit risk and consequently a relatively high probability of incurring losses 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 Bank nevertheless decided to introduce such exceptional measures,[19] with the conditions that the measures be temporary until the market functions again and that upper limits to total purchases be set.[20]

B. Discussion and Assessment of the Various Measures

As I have explained, while Japan's economy has been facing the most severe situation since World War II, the Bank has employed not only traditional measures in the policy tool-kit, primarily interest rate policy, but also unconventional policy measures such as outright purchases of corporate financing instruments. It is true with central banks just as with firms that, when endeavoring in new fields, it is necessary to make a thorough analysis and a balanced assessment of the situation. When the Bank introduced the unconventional policy measures, it did so on the basis of careful deliberations and extensive discussions.

In considering the introduction of new policy measures, it is necessary to spell out policy prescriptions that match the structure and problems of Japan's financial markets. In the case of Japan, bank lending plays a large role, and the Bank has consequently pursued policies aimed at two objectives: achieving a recovery in the functioning of markets, and

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[19] For more details on the series of recent exceptional measures, see *The Bank of Japan's Policy Measures in the Current Financial Crisis*, which is available from the Bank's web site.

[20] For details, see *Outright Purchases of Corporate Financing Instruments*, which is available from the Bank's web site.

strengthening the credit intermediation function of banks and other financial institutions.[21] It is possible to categorize the unconventional policy measures taken by the Bank in terms of these two objectives. Measures to achieve a recovery in the functioning of financial markets include outright purchases of CP and corporate bonds through financial institutions. Measures to strengthen the credit intermediation function of financial institutions include the expansion of the range of collateral eligible for the Bank's operations and the introduction of special funds-supplying operations to facilitate corporate financing, which provide longer-term funds at a low interest rate against the value of corporate debt financial institutions pledged as collateral.

Developments in Japan since the introduction of the various measures indicate that economic and financial conditions have improved on the whole, suggesting that these measures have been effective to a certain extent.[22]

C. Thinking on Temporary Measures

Greater attention is now being paid to the so-called "exit policy," that is, the Bank's decision when these temporary policies should be withdrawn. The most important element of the exit policy is timing. Maintaining the exceptional policies for too long may obstruct continuous and autonomous adjustments in financial markets and economic activity and, as a result, cause large fluctuations in economic conditions and prices. On the other hand, a change in policy at too early a stage could cause the reemergence of problems, which we

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[21] In contrast, in the United States, it is the functioning of private credit markets that had deteriorated markedly, and the Federal Reserve has taken various measures aimed at restoring the functioning of such markets. Since financial intermediation in the United States takes place mainly in the capital markets, the Federal Reserve has purchased large amounts of CP, mortgage-backed securities (MBSs), agency debt, and Treasury securities from the market. This provides an illustration of the fact that central banks around the world have been implementing measures that are appropriate to the economic and financial situation in each country.

[22] The amount outstanding of funds provided by U.S. dollar funds-supplying operations and outright purchases of CP and corporate bonds has been on a decreasing trend. This is one indication that the proper functioning of the market is being restored. The various unconventional measures taken by the Bank that I mentioned act as backstop facilities that can be used when the market is under a severe stress. Once the market starts to function properly, market rates will be more attractive for market participants than the rates offered by the Bank. Therefore, with the Bank's unconventional policy measures, it is not the case that the larger the amount outstanding of funds provided, the more accommodative are the Bank's policies.

must of course prevent.

At the Monetary Policy Meeting on July 14 and 15, 2009, the Policy Board members discussed these issues and decided to extend the temporary measures by three months.

Specifically, given current financial conditions, the Bank decided to extend outright purchases of CP and corporate bonds and special funds-supplying operations to facilitate corporate financing to the end of December 2009.[23] As I have explained earlier, financial conditions in Japan remain generally tight. It seems that firms' concerns about future funding conditions have not been dispelled, since corporate profits have been weak and future developments in final demand after the completion of inventory adjustments are highly uncertain. Under these circumstances, the Bank judged that facilitating corporate financing was still necessary and extended the effective periods of the measures.[24]

As I have previously stated, unlike in the period up to the end of fiscal 2008, financial conditions have continued to show signs of improvement. Taking careful account of developments in financial conditions, the Bank will reevaluate by the year-end whether financial conditions continue to warrant the support provided by the various temporary

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[23] In line with this decision, the Bank also extended the expansion in the range of corporate debt eligible as collateral to the end of March 2010 to facilitate the provision of three-month liquidity until the end of December 2009. In addition, in order to maintain the policy interest rate -- the uncollateralized overnight call rate -- at around its targeted level, the Bank extended the effective period of the complementary deposit facility so that the payment of interest would continue through the reserve maintenance period from December 16, 2009, to January 15, 2010, thus including the end of December. As for U.S. dollar funds-supplying operations against pooled collateral, in a situation where market participants' concerns over dollar funding remain strong, the Bank, taking account of the fact that the Federal Reserve and other central banks extended the end of the U.S. dollar swap arrangements to February 1, 2010, extended the end of the arrangements to the same date.

[24] On this point, I am aware of the fact that these temporary measures, for example special funds-supplying operations to facilitate corporate financing, might give rise to the side effect of a fall in issuance rates on some CP below yields on government bills; in other words, to a partial deterioration in the functioning of the markets. However, I think that at present the potential costs of ending these measures, which provide an important safety net, would be greater than the cost of the side effect associated with the measures. Therefore, I believe it remains important to continue alleviating any market concerns with regard to funding.

measures, and decide whether to terminate, alter, or further extend each one of them.