December 2, 2009

Bank of Japan

The Current Situation of and Outlook for Japan's Economy and the Conduct of Monetary Policy

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

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I. The Current Situation of and Outlook for Japan's Economy

A. The Current Situation in Financial Markets

The topic I would like to discuss today is the current situation of, and outlook for, Japan's economy and the Bank of Japan's conduct of monetary policy. Let me begin by looking at developments in global financial markets, which experienced the unprecedented turmoil triggered by the failure of Lehman Brothers in autumn last year.

Owing to the aggressive measures taken by governments and central banks around the world since last year, global financial markets have increasingly been showing signs of improvement. Some concerns over the vulnerability of financial markets remain, partly because some financial institutions have sustained losses and some have even gone bankrupt. Nevertheless, credit spreads in many countries, including Japan, have returned to levels seen just before the failure of Lehman Brothers due to a recovery in investors' risk appetite. In what follows, I would like to review the developments in global financial markets to date and discuss the Bank's responses in some detail, before briefly explaining current conditions for corporate financing in Japan.

A key characteristic of the recent global financial crisis is that it originated from a credit bubble in certain countries that spread to other countries via securitized products, and the impact of the bursting of the bubble was quickly felt around the world in the form of liquidity disruptions. Until the BNP Paribas shock in August 2007, the general view, including among market participants, was that the decline in home prices and prices of securitized products in the United States and Europe was a healthy correction to previous excesses and would not have any significant impact on the growth of the global economy. However, as a result of the BNP Paribas shock, the realization grew that the subprime mortgage problem would not be confined to a simple adjustment in asset prices, but was beginning to pose liquidity problems for financial institutions. The Paribas shock was followed by a series of reports on losses incurred by financial institutions and the failure of large hedge funds due to the decline in home prices and prices of securitized products. However, as a result of the bailout of Bear Stearns in March 2008, there was a growing perception that the U.S. authorities would not let large financial institutions -- which were "too big to fail" -- go under. Supported by this perception, it was the surge in the prices of

materials, particularly crude oil, instead of the subprime mortgage problem that attracted more attention in summer 2008. Against this background, some central banks, such as the European Central Bank (ECB) and Sveriges Riksbank, continued to raise their policy rates. In this situation, Lehman Brothers failed in September 2008, triggering a rapid spread of extreme cautiousness regarding the creditworthiness of U.S. and European financial institutions among market participants and a rapid decline in investors' risk appetite. There was an accelerating flight to quality, that is, moves to sell risk assets and obtain safer financial assets such as government debt and cash, leading to a plunge in stock prices not only in the United States and Europe but also in Japan, as well as a rapid widening of spreads on CP and corporate bonds. In money markets, lenders became more cautious about lending and liquidity risk premiums consequently widened.

To address this situation, governments and central banks took prompt and decisive policy actions such as the implementation of large-scale fiscal measures, the significant lowering of policy interest rates, and the purchase of risk assets. The Bank, in addition to lowering its target for the uncollateralized overnight call rate to 0.1 percent, provided ample liquidity by actively conducting funds-supplying operations and increasing the amount of outright purchases of Japanese government bonds (JGBs) in order to ensure the stability of financial markets. Moreover, for the purpose of facilitating corporate financing, the Bank introduced a special funds-supplying operation, started purchasing CP and corporate bonds outright, and expanded the range of collateral it accepted by easing eligibility criteria. Since these steps expose the central bank to a high degree of credit risk and involve a high risk of impairing the market's natural formation of interest rates, they represent exceptional measures in terms of the money market operation tools normally used by central banks and therefore were introduced only on a temporary basis.

Owing to such aggressive measures, the financial environment in Japan improved greatly during the first half of fiscal 2009. Most markets have now returned to the level of calm observed before the failure of Lehman Brothers. Specifically, in the money market, with the uncollateralized overnight call rate remaining stable at around 0.1 percent, interbank rates on term instruments have been edging lower, and the liquidity risk premium has declined to a level below that seen just before the failure of Lehman Brothers. Moreover,

at present there are no signs of the premium on term instruments maturing beyond the end of the calendar year and the end of the fiscal year (March) rising significantly, and the environment for corporate financing has also continued to improve. Corporate demand for external funds has decreased, reflecting the fact that (1) the fall in firms' cash inflow is coming to an end as exports and production recover; (2) the demand for liquidity to fund working capital is declining as progress is being made in inventory adjustments; and (3) the demand for back-up funds is also falling as a result of improvements in business confidence. Regarding firms' funding conditions, in the CP market, issuing conditions have improved significantly, as evidenced by the significant narrowing of issuing spreads even on low-rated CP. In the corporate bond market, issuing conditions as a whole have also improved and become favorable again, with the credit spread on corporate bonds with a credit rating of "BBB or higher" narrowing to levels comparable to those seen before the failure of Lehman Brothers, and the amount of bond issuance in the first half of fiscal 2009 reaching a historical high (Chart 1). As for cash availability for small firms, various survey results, including the *Tankan* (Short-Term Economic Survey of Enterprises in Japan), indicate that although small firms still face some difficulties, there are signs of a gradual improvement (Chart 2).

B. The Current Situation of the Economy and Prices

1. Economic activity

I would now like to discuss developments in the real economy. While Japan's economy is picking up, there is not yet sufficient momentum to support a self-sustaining recovery in domestic private demand. Let us take a closer look at recent developments in each demand component.

First, exports, the main engine of Japan's economic growth, have been rising due to the improvement in overseas economic conditions. Examining developments in overseas economies in more detail, the economy of the United States is experiencing a so-called jobless recovery, in which output is growing but employment fails to increase. In a situation where the unemployment rate has risen to 10.2 percent, corporate profits have been recovering on the back of rapid growth in labor productivity and substantial declines in unit labor costs. With the effects of government stimulus measures such as the car

allowance rebate system and the tax credit for first-time homebuyers taking hold, there are signs that production is picking up and the decline in business fixed investment is coming to a halt. Nevertheless, the pace with which improvements in the corporate sector are feeding through to the household sector remains moderate. Although financial institutions' lending attitudes have eased somewhat, they continue to be tight. The severe employment situation and pressure on households to adjust their balance sheets have also been weighing on growth in private consumption. However, indicators relating to private consumption have been unexpectedly firm, partly due to wealth effects resulting from the rise in stock prices. For example, car sales, which fell in September, reflecting the end of the car allowance rebate system, regained sales of over ten million units in October. Retail sales excluding car sales also increased for the third consecutive month. At the same time, these developments do not appear to possess great strength. In Europe, economies are continuing to pick up, partly due to the effects of demand-boosting policy measures. However, just as in the United States, the pace of recovery remains moderate reflecting the vulnerability of the financial sector and adjustments in households' balance sheets. By contrast, the strength of economic growth in emerging and commodity-exporting economies is conspicuous. In China, the economy has continued to grow at a rapid pace, supported by large-scale government stimulus measures such as measures to promote the sale of cars and electrical appliances. Specifically, retail sales increased by around 15 percent on a year-on-year basis, and industrial production and fixed asset investment both continued to increase significantly on the back of an increase in bank lending by more than 30 percent from a year earlier. The strong domestic demand in China is having a positive effect on other Asian economies such as the NIEs and the ASEAN countries. In these economies, there are signs of recovery not only in exports and production but also in domestic demand components.

Turning to domestic demand in Japan, public investment has been increasing, albeit with some fluctuations. Private consumption, notably durable goods consumption, has picked up due to the effects of policy measures, such as tax reductions on purchases of environmentally friendly cars and the introduction of the eco-point system, which favors energy-efficient products. The substantial decline in business fixed investment, which has continued reflecting weak corporate profits and a sense of excessive capital stock among

firms, seems to be finally coming to a halt, as suggested by the pick-up in shipments of capital goods, a coincident indicator of machinery investment. On the other hand, housing investment continues to decline. The number of housing starts decreased significantly to an annual rate of 707,000 units in the July-September quarter, the lowest level since the data began to be compiled.

Reflecting the situation in domestic and overseas demand I just described, production has been rising. Looking at developments in the industrial production index on a quarterly basis, following a substantial decline of 22.1 percent in the January-March quarter, production has shown a clear rebound, increasing by 8.3 percent in the April-June quarter and 7.4 percent in the July-September quarter. With regard to the shipment-inventory balance, while inventory adjustment pressures have remained strong for construction goods, inventory adjustments for durable goods and electronic parts and devices have almost come to an end. The shipment-inventory balance is also improving gradually in capital goods and producer goods.

2. Prices

Let me now take a look at developments in prices. The year-on-year decline in the consumer price index (CPI; excluding fresh food) accelerated from the beginning of this fiscal year, mainly due to the drop in the prices of petroleum products following their surge a year ago and the deterioration in the supply-demand balance, but since registering a decline of 2.4 percent in August 2009, the pace of decline has started to slow. The absolute value of the year-on-year rate of change in the CPI in August this year is exactly the same as that in August last year, when the CPI registered a year-on-year increase of 2.4 percent. The word "deflation" has been used frequently in the media recently (Chart 3 [1]), and for this reason people may think that there is a sustained fall in prices. In truth, however, the CPI is currently at almost exactly the same level as before the surge in prices of petroleum products (Chart 3 [2]).

C. Outlook for the Economy and Prices

Recent economic indicators suggest that Japan's economy has generally been moving in line with the Bank's baseline scenario, which forecasts that the economy will start recovering

from the latter half of the current fiscal year. As for the outlook, it is likely that the pace of economic improvement will remain moderate until around the middle of fiscal 2010 and that the growth rate will start to rise thereafter through fiscal 2011 as the pace of recovery in overseas economies accelerates. At the same time, although the uncertainty surrounding this outlook has moderated somewhat, it remains considerable.

I would now like to address the outlook for demand components in more detail. Starting with real exports, these are expected to continue increasing. A closer look at the prospects for the global economy, on which developments in Japan's exports depend, suggests that, until around the middle of fiscal 2010, the recovery in advanced economies such as the United States and Europe will inevitably be moderate given the lingering vulnerability in the financial sector and effects of adjustments in households' balance sheets; on the other hand, emerging and commodity-exporting economies are likely to keep expanding at a relatively fast pace. Thereafter, however, upward momentum in private demand in the United States and Europe is likely to increase gradually as pressures for balance sheet adjustments abate owing to the support provided by government policies. Consequently, the rate of growth in overseas economies as a whole is expected to rise gradually.

With regard to domestic demand components, private consumption is likely to continue to pick up, led mainly by demand for durable consumer goods as a result of the positive effects of various policy measures. Business fixed investment, which is bottoming out, is likely to start rising gradually, reflecting improvements in corporate profits. In fact, machinery orders (private demand, excluding orders of shipbuilding and orders from electric power companies) -- a leading indicator of machinery investment -- are expected to increase, albeit only marginally, in the October-December quarter for the first time in seven quarters. Production is also expected to continue increasing for the time being, with the forecast index suggesting quarter-on-quarter growth in the October-December quarter may come in at 5 percent. However, given the bleak outlook for winter bonuses, confidence indicators, such as those in the Economy Watchers Survey and the consumer confidence index of the Consumer Confidence Survey, have recently stopped improving. Going forward, should the positive effects of various policy measures taken by the government wane, growth in Japan's real GDP, which increased at a relatively rapid pace in the first half of the current

fiscal year, may decelerate and could even temporarily fall into negative territory. Having said that, it is likely that the improvements in the corporate sector originating from exports will feed through to the household sector and that the growth rate of Japan's economy will start to rise gradually in fiscal 2011 on the back of accelerating global economic growth.

As for prices, it is expected that the pace of the year-on-year decline in the CPI (excluding fresh food) will decelerate relatively rapidly as the effects of the previous year's surge in the prices of petroleum products abate, and that the year-on-year rate of change in the CPI will register approximately minus 1 percent toward the end of this year.[1] Nevertheless, beyond that point, the pace of decline in the CPI is likely to moderate only gradually, as the economic slack, which emerged in the second half of 2008 due to the sharp deterioration of the economy, is expected to continue to exert downward pressure on prices.

D. Risk Factors

Next, I will review the risk factors that could affect the outlook I have just presented. I believe that in the period up to the end of fiscal 2011, which is the projection period covered in the October issue of the Bank's *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), risks to both economic activity and prices are likely to be more balanced given that emerging and commodity-exporting economies are continuing to grow at a high pace and that global financial markets, although still vulnerable, have been improving. In the short term, however, the risk seems to be rising that recent developments in international financial markets, including instability in foreign exchange markets, through their impact on firm and household sentiment, will have a negative effect on economic activity. Potential risks that warrant attention are discussed in detail in the October Outlook Report, and I will not go through them all today. Instead, I would like to elaborate on the risks that I pay particular attention to.

1. Risks associated with expansionary macroeconomic policies

The first of these risks concerns the expansionary macroeconomic policies conducted around the world. These policies entail the upside risk of stimulating economic activity

[1] If the CPI were to remain at its current level, the year-on-year rate of decline in the index would be approximately minus 1 percent at the end of 2009 (Chart 3 [2]).

more than intended as well as the downside risk of causing a subsequent economic contraction. The probability of the latter risk materializing seems to be increasing, particularly in emerging and commodity-exporting economies. These economies -- which have high growth potential and face no balance-sheet adjustment problems -- also have introduced aggressive stimulus measures in the wake of the global financial crisis. Furthermore, economies that have pegged their currency to the U.S. dollar may have "imported" the monetary easing of the United States and the extent of this easing may have become excessive. In addition, there continue to be comments from market participants that funds are flowing into emerging and commodity-exporting economies as well as commodity markets as a result of the dollar carry trade. It is therefore necessary to carefully monitor whether the aforementioned developments lead to excessive investment and the taking of extreme positions by market participants, paving the way for a sudden unwinding of such positions. It is also necessary to continue to pay attention to the upside risk to long-term interest rates as a result of growing concerns regarding fiscal discipline. Easy resort to monetization by central banks would add to such concerns.

2. Risks related to prices

I will next talk about risks to prices, on both the upside and the downside. From a longer-term perspective, we should remain aware of the risk that against the background of continuing accommodative global financial conditions, a return of funds to commodity markets may cause another surge in primary product prices, eventually leading to higher than expected inflation.

In the short run, however, it needs to be borne in mind that -- along with the potential impact on the economy of the recent sharp appreciation of the yen -- there is the downside risk of an economic slowdown at home and abroad and a decline in inflation expectations resulting therefrom. In this regard, developments in wages hold an important key to the future direction in prices. Recent trends highlight once again that Japanese firms tend to restrain labor costs through wage cuts rather than through job cuts: while the unemployment rate in Japan has not increased as sharply as in other advanced economies, the decline in wages has been relatively steep. Especially in recent years, this pattern may have become more pronounced, partly as a result of government policies such as the provision of

employment adjustment subsidies. This situation is in sharp contrast with that in the United States, where large employment cuts are implemented while wage levels are maintained, helping to achieve a rapid recovery in labor productivity. The Japanese case, where wages are adjusted and employment is maintained, has the advantage of avoiding any sharp deterioration in consumer confidence through employment insecurity, but carries the risk of putting downward pressure on prices through a decline in services prices. So far, the fall in services prices has not been particularly pronounced as wage cuts have been made mainly through the shortening of working hours rather than reductions in hourly wages, and also because housing rents, a major component of services prices, have remained relatively stable (Chart 4). However, services prices could fall further if adjustments extend to scheduled hourly wages.

Historically, services prices in Japan have tended to rise more slowly than those in the United States and Europe. This is largely due to the generally slow growth in wages, especially in the service sector in Japan. Unless wages increase, a virtuous cycle in which improvements in the corporate sector feed through to the household sector may not arise and operate smoothly. Ultimately, the aim must be to achieve a medium- to long-term rise in wages through increases in productivity.

3. Deflation

The aforementioned decline in inflation expectations increases the risk of a further decline in prices. I just mentioned that recently there have been an increasing number of media reports about "deflation," and I would now like to say a few words about this term.

The textbook definition of "deflation" is that it is a continuous decline in general prices. Based on this definition, it could be said that the Japanese economy is currently in a deflationary phase. In this regard, there are two important points for the conduct of monetary policy: which data should be used to grasp price developments, and what is causing the deflation.

I will start with the first point -- which price data should be used. There are various price indicators such as the CPI, the corporate goods price index (CGPI), and the GDP deflator.

The Bank monitors these and other indicators comprehensively when it assesses the price situation. Nevertheless, when explaining its conduct of monetary policy, the Bank places special emphasis on the CPI. The CPI has the advantage that it provides information in a timely manner as it is released on a monthly basis and, moreover, corresponds to people's perceptions of the price situation since it reflects prices of goods and services consumed by households. Other central banks share this emphasis on developments in consumer prices.

As for the second point, the causes of deflation, we can cite (1) changes in the prices of imports such as resources, (2) the deterioration in the supply and demand balance of the overall economy, and (3) improvements in productivity. While the main cause for the current continued decline in prices is the drop in resource prices following their surge a year ago, given the substantial slack in the economy mentioned earlier, the deterioration in the supply and demand balance of the economy overall also appears to be responsible. In fact, discussions with regard to the current deflationary phase generally focus not solely on the continuous decline in prices but instead mention it in the context of insufficient demand. Going forward, whereas the impact of the drop in resource prices is expected to abate, the effect of the deterioration in the supply and demand balance is likely to become relatively more important. If, in this situation, prices were to continue falling longer than expected, this could increase the risk of a deflationary spiral, where price declines lead consumers to postpone purchases, weaken business performance, and thereby put downward pressure on the real economy, lowering inflation expectations and in turn causing further price declines.

E. Conduct of Monetary Policy in the Near Future

So far, I have commented on developments in global financial markets, the situation of the economy and prices at home and abroad, and risk factors to the outlook for these. I would now like to talk about the Bank's conduct of monetary policy, which takes these points into consideration.

The Bank intends to maintain the extremely accommodative financial environment and thereby provide steady support for Japan's economy to return to a sustainable growth path with price stability. On this basis, at the Monetary Policy Meeting on October 30, 2009, the Bank made the following decisions concerning various temporary measures introduced

with a view to facilitating corporate financing since last year.

First, the Bank decided to complete the outright purchase of CP and corporate bonds at the end of December 2009 as scheduled. Let me explain the reasons for this decision. One reason is that, based on recent auction outcomes, the Bank concluded that the intended purpose of the measures -- the restoring of market functioning -- had been fully achieved: by the time of the Monetary Policy Meeting at the end of October, there had been three auctions for outright purchases of CP in a row in which no bids were submitted (this has now risen to eight auctions in a row), and in auctions for the outright purchase of corporate bonds, bids continued to fall well short of the Bank's offer. Another important reason was that the Bank felt that negative side effects of outright purchases of CP and corporate bonds in the respective markets were becoming increasingly evident. More specifically, in the CP market, issuance rates on some high-rated CP continued to be below yields on government bills, and in the corporate bond market demand for some high-rated bonds was overheated. In addition, there has been a growing trend in which differences in CP rates are diminishing. This trend is attributable to the fact that CP is issued based on the premise that the Bank conducts outright purchases of CP, and therefore, even in a situation where there are no bids in auctions for outright purchases of CP, issuance rates increasingly tend to converge to the minimum yields determined by the Bank for its outright purchases of CP, rather than reflect issuers' credit risk. If these negative side effects in the CP and corporate bond markets were to continue, investors could leave these markets and the measures could hamper, rather than encourage, active trading and the smooth flow of funds to firms.

On the other hand, the Bank decided to extend special funds-supplying operations to facilitate corporate financing until the end of March 2010, at which point they will be terminated. A number of corporate managers had expressed concern that it was difficult to determine the extent of the future impact of the termination of this measure, which continues to be used to a considerable extent, especially during the period leading up to the fiscal year-end (March), when demand for funds increases. Taking such concerns into account, the Bank decided to extend the effective period of this special measure to March 2010 so that firms' procurement of funds beyond the fiscal year-end would be ensured.

Some market participants have asked why the Bank needed to make these decisions at such an early stage. Let me give you my own view on this issue. First of all, given that there were a variety of speculative views in the market regarding the Bank's manner of handling the various temporary measures, I felt that it was beneficial for the market if the Bank announced its policy stance going forward as soon as possible, thereby reducing uncertainty about its future conduct of monetary policy. Moreover, in my view, by making its future policy stance clear at an early stage, the Bank gives markets ample time to respond to its policy decisions and thereby provides a certain sense of security.

Now I would like to emphasize two points.

The first is that, in seeking to ensure market stability and thereby facilitate corporate financing, the Bank should take measures that would be most appropriate on each occasion, in response to changes in financial market conditions. On this basis, the Bank at the end of October judged that, from the perspective of ensuring market stability and facilitating corporate financing, the most desirable response was to continue with the ample provision of funds by, from April 2010, making full use of funds-supplying operations against pooled collateral, for which a wider range of collateral was eligible and the maturity could be changed more flexibly to meet liquidity demand in financial markets than for the special operations to facilitate corporate financing.

At the unscheduled Monetary Policy Meeting held yesterday, the Bank decided to introduce a new type of funds-supplying operation against pooled collateral, with funds provided at a fixed rate of 0.1 percent for a period of three months. Underlying this decision is the Bank's assessment that -- at a time that the risk that recent developments in international financial markets and instability in foreign exchange markets, through their impact on firm and household sentiment, have a negative effect on economic activity is rising -- the most effective means to support economic recovery from the financial side is to further enhance the extremely easy monetary conditions and encourage a further decline in longer-term interest rates in the money market through the provision of ample longer-term funds at an extremely low interest rate. The Bank will continue to adopt the most effective method for money market operations, carefully taking the advantages and disadvantages of various

alternatives into account.

The second point I would like to stress is that the size of the Bank's balance sheet does not necessarily indicate the degree of monetary easing. In Japan, fluctuations in factors that induce changes in current accounts at the Bank, such as payments/receipts of government funds and the issuance/withdrawal of banknotes, are substantial. As a result, to guide the policy interest rate -- the uncollateralized overnight call rate -- to the target level, the Bank needs to provide or absorb relatively large amounts of funds in a flexible manner in response to changes in the supply of and demand for funds. In addition, when, as in the recent financial crisis, market functioning decreases significantly and the supply of funds falls substantially short of demand, the Bank needs to provide ample funds. Conversely, once the market functions again and providers of funds return to the market, the need for the Bank to provide short-term funds declines accordingly. Consequently, even if hereafter the Bank's balance sheet were to contract, this does not automatically imply a change in the Bank's policy stance and a decrease in the degree of monetary easing. I would now like to consider the relationship between the Bank's balance sheet and its monetary policy in more detail, touching also on recent events in this regard.

II. Central Banks' Balance Sheets and Monetary Policy

A. The Bank's Balance Sheet

Since the BNP Paribas shock in August 2007, major central banks have taken various steps, including unconventional policy measures, reflecting the specific circumstances of the different economies. As a result of these steps, the balance sheets of the Federal Reserve, the Bank of England (BOE), and the ECB have expanded rapidly (Chart 5). Reserves increased sharply on the liabilities side of the balance sheets of the Federal Reserve and the BOE, with the former introducing a lending facility following the failure of Lehman Brothers and the latter starting in March 2009 a program to purchase gilts. Similarly, reserves of the ECB increased after it decided in October 2008 to provide banks with unlimited funds at fixed interest rates. In contrast, increases in the size of the Bank of Japan's balance sheet and its reserves have been relatively small in comparison to the other three central banks. For this reason, some have argued that the Bank's policy measures are inadequate. I would therefore like to talk now about three reasons why the expansion of

the Bank's balance sheet has been modest.

First, the size of a central bank's balance sheet is significantly affected by the private-sector demand for funds. Regardless of the frequency of market operations, a central bank cannot increase the provision of funds if financial institutions' demand for funds is weak. Conversely, when the demand for funds is very strong, a central bank will need to provide large amounts of funds through market operations. The increase in the size of the balance sheets and reserves of the Federal Reserve, the BOE, and the ECB following the failure of Lehman Brothers was largely due to the sudden increase in all markets in the precautionary demand for liquidity to prepare for future payments, against the background of rising counterparty risk. In addition, households' demand for cash also tends to increase when the soundness of financial institutions is in doubt. This was indeed the case after the failure of Lehman Brothers, as evidenced by the large increase in the amount of banknotes issued by the ECB and the Federal Reserve. In Japan, counterparty risk did not rise as much as it did in the United States and Europe. As a result, the increase in Japanese financial institutions' precautionary demand for liquidity was relatively small. The amount of banknotes issued by the Bank, which had surged during the late 1990s, did not increase noticeably this time around.

The second reason concerns differences in the way firms procure funds, which affect the extent to which a central bank's balance sheet expands as a result of exceptional policy measures to facilitate corporate financing. In Japan, the share of funds procurement through the issuance of CP and corporate bonds has been relatively small (Chart 6), and at times when the functioning of CP and corporate bond markets was impaired or when demand for funds surged due to an expected fall in cash inflow, firms were able to respond by increasing their borrowing from banks. Moreover, developments in credit spreads on CP and corporate bonds indicate that the malfunctioning of these markets in Japan has been less pronounced than in the United States and Europe (Chart 7). In addition, the Bank had already been purchasing CP under repurchase agreements. For these reasons, compared with the Federal Reserve, the BOE, and the ECB, the scale of intervention by the Bank of Japan in the CP and corporate bond markets and the additional expansion of its balance sheet have been relatively small.

Third, Japanese financial institutions and the Bank have been highly conscious of liquidity risk to start with, and precautions had already been put in place against such risks. Since the main funding source of Japanese banks is deposits, they did not, unlike their U.S. and European counterparts, depend much on short-term borrowing from money markets and thus were relatively well equipped to deal with liquidity risk. Furthermore, based on Japan's experience with the financial crisis in the 1990s, the Bank has remained particularly aware of the cardinal importance of liquidity. Illustrations of this are the Bank's daily monitoring of the cash position of all counterparty financial institutions and frequent exchange of information with their financial officers. Such thorough liquidity monitoring by the Bank has made possible the flexible provision of liquidity at all times, and has instilled a sense of confidence and trust among financial institutions that the Bank stands ready to provide liquidity whenever necessary. I believe it was partly due to such practices that the need to introduce new types of market operations during the recent financial crisis was limited. In contrast, mechanisms of liquidity monitoring by the Federal Reserve, the BOE, and the ECB seem to differ from those in Japan. Moreover, the existing lending facilities of the Federal Reserve and the BOE were not actively used by financial institutions during the recent financial crisis because of the so-called stigma problem -- concerns over negative reputation effects -- giving rise to the need for new types of operations.

Let me also add that, although it has been said that the size of the Bank's balance sheet has not expanded significantly during the recent financial crisis, as a ratio of nominal GDP, the Bank's balance sheet is relatively large (Chart 8).

This is a brief explanation of why, compared with the Federal Reserve, the BOE, and the ECB, the expansion of the Bank's balance sheet has been modest. However, regardless of the issues I have pointed out, there have been calls in the market for the Bank to expand its balance sheet by increasing the amount of outright purchases of government bonds in order to end deflation. The Bank considers that it should take measures that would be most appropriate on each occasion, in response to changes in financial market conditions: it does not rule out any policy options and carefully examines the advantages and disadvantages of

various alternatives, taking also into account lessons learned from the past and policy measures implemented by other central banks. Put another way, since the advantages and disadvantages of a policy option vary depending on financial market conditions and other variables, the most suitable policy is not predetermined, and the Bank keeps an open mind. From this perspective, I would now like to go on to some issues regarding the holding of long-term assets by central banks.

B. Central Banks' Holding of Long-Term Assets

Central banks supply long-term funds on the basis of certain rules. The reason is as follows. The provision of long-term funds, which partly replaces massive provision of short-term funds, mitigates distortions in the formation of short-term interest rates and reduces the administrative burden on the central bank. At the same time, however, it reduces the liquidity of the central bank's assets and as a result inhibits the flexible conduct of money market operations in line with the market's liquidity conditions. The Bank has a policy of limiting its holdings of long-term government bonds to the outstanding amount of banknotes issued. The Federal Reserve and the BOE have similar views on purchases of government bonds. In general, the Federal Reserve keeps any increase in the amount of its holdings of Treasuries, both short and long term, in line with the increase in the outstanding amount of banknotes issued, while the BOE adjusts the outstanding amount of gilts purchased in line with the outstanding amount of banknotes issued. Needless to say, these rules aim to achieve smooth provision of funds and are not necessarily applicable to purchases of government bonds, or other long-term assets, conducted as unconventional policy measures. In fact, the Federal Reserve and the BOE both decided to introduce outright purchases of long-term assets, including government bonds, as part of their unconventional policy measures. In such cases, once economic recovery is on a sure footing, it will become necessary to scale down the size of accumulated reserves, giving rise to the issue of how to decrease asset holdings, a significant amount of which consists of long-term assets, at an appropriate pace without causing disruptions in financial markets.

Another reason for the Bank's setting of a limit to its holdings of long-term government bonds equivalent to the outstanding amount of banknotes issued is to ensure the credibility of its monetary policy; setting such a limit makes clear that the Bank's purchases of

government bonds are not intended to support government bond prices or to accommodate fiscal financing needs. Indeed, there have also been discussions regarding such issues within the Federal Reserve and the BOE. At the Federal Reserve's Federal Open Market Committee (FOMC) meeting in June, for example, the point was raised that "announcements of substantial additional purchases could add to perceptions that the federal debt was being monetized," and that "public concern about monetization could have adverse implications for inflation expectations." Similarly, at the Monetary Policy Roundtable held at the BOE in June, the risk was noted that "the programme [of large-scale asset purchases] strayed too close to fiscal policy issues and so might lead to concerns that the [Monetary Policy Committee] was not independent of the government."

Regarding the effects of the accumulation of reserves resulting from purchases of long-term assets, there are various views, including on the quantitative easing policy of the Bank in the past. For instance, the Federal Reserve currently holds excess reserves of one trillion U.S. dollars, and the effects of this are still unclear. At the FOMC meeting in November, most members projected that over the next couple of years the unemployment rate would stay quite elevated and the level of inflation would remain below rates consistent over the longer run with the Federal Reserve's objectives. Likewise, Adam S. Posen, a member of the BOE's Monetary Policy Committee, stated in a speech that "high inflation threats from large-scale creation of bank reserves in response to a deflationary financial crisis seem rather dubious," and that "there is no evidence from relevant periods of UK or other major economies' economic history that [quantitative easing] will result in high or sustained inflation."[2]

The point I am trying to make is that the conduct of monetary policy requires careful consideration from a variety of angles and a medium- to long-term perspective. This also applies to unconventional policies, the actual effects of which remain uncertain. With the experience of the economic bubble in mind, the monetary policy framework of the Bank now places more importance on a medium- to long-term perspective, although this in no way means that the Bank has sacrificed timeliness and flexibility in its conduct of monetary

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[2] Adam S. Posen, "Getting Credit Flowing: A Non-Monetarist Approach to Quantitative Easing," speech presented at the Dean's Lecture Series, Cass Business School, in London on October 26, 2009.

policy. The Bank's current policy is based on careful deliberations, which take into account various issues such as opinions of market participants and corporate managers, the state of and outlook for economic activity and prices, the financial environment including corporate financing, and the feasibility of other possible policy measures. The Bank intends to maintain this attitude and will continue to make every effort to implement the appropriate monetary policy.