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Bank of Japan

The Conduct of Monetary Policy in Japan and Abroad

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

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I. Large-Scale Monetary and Fiscal Policy Measures, and Exit Strategies Therefrom

A. Fragile Economic Recovery Relying on Policy Measures by Governments and Central Banks

After the failure of Lehman Brothers, central banks around the world took all possible measures, including unconventional policies, to address the financial turmoil. Governments also implemented large-scale measures to stabilize the economy and financial system, and the International Monetary Fund (IMF) expanded its loan facilities targeting especially emerging economies. These measures prevented further destabilization of the international financial system as well as further deterioration in market participants' confidence, while contributing to an improvement in the functioning of markets.

The series of measures by governments and central banks may be classified into three main categories: (1) unconventional monetary policies; (2) large-scale fiscal stimulus; and (3) measures to stabilize the financial system implemented in Europe and the United States. Measures that fall into the second category have been taken in many countries including the United States, Germany, China, and Japan. Such measures include, for example, measures to stimulate automobile demand -- such as the cash-for-clunkers program in the United States -- and increased public works projects. The third category comprises measures to provide a financial safety net consisting, in the main, of injections of taxpayers' money into banks and government guarantees for interbank transactions.

To prevent the financial turmoil from developing into a global economic crisis, central banks provided ample liquidity. Major central banks, which had already been aware of the increasingly interdependent nature of global financial markets, were prepared to strengthen cooperation to stop the adverse feedback loop between the real economy and financial systems caused by the bursting of the U.S. credit bubble from spreading worldwide, and to help banks' procurement of U.S. dollar funds and corporate financing. Furthermore, governments of leading nations implemented large-scale fiscal stimulus measures to alleviate the seriousness of the economic recession in the short run. As a result of these measures undertaken by central banks and governments, which so far have placed emphasis on the strengthening of safety nets for the financial sector and employment, the deterioration of the world economy has come to a halt.

B. Exit Strategies from Large-Scale Fiscal Spending and Financial Stabilization Measures

However, global economic and financial conditions continue to be weak, and an autonomous recovery without the help of governments and central banks appears unlikely. This situation applies both to leading and emerging economies. The abundant liquidity resulting from measures in a number of countries has caused a situation where money markets are stable and prices of CP and corporate bonds by issuers of high credit ratings, government bonds, and low credit-risk products are rising. On the other hand, however, the distribution of funds is uneven and the flow of funds in general is not smooth because of the cautious lending attitudes of banks.

The joint communiqué issued after the G8 Finance Ministers meeting in Lecce, Italy, in June stressed the need to prepare exit strategies from measures taken in response to the economic and financial crisis, such as those designed to stimulate the economy and stabilize the financial system. For many countries, now is not the time for action but the time for careful deliberation of such exit strategies. However, there is no denying that exit strategies are indispensable for a sustainable recovery in the long term.

In connection with the measures to stabilize the financial system, the collapse of the credit bubble has triggered a debate over the supervision of financial institutions in the United States and major European nations. In the United Kingdom, the dominant opinion is that the role of the Bank of England (BOE) should be bolstered, with the opposition Conservative Party even proposing abolishing the Financial Services Authority and putting the BOE in full charge of supervision. In the United States, the Treasury Department has proposed entrusting the supervision of systemically important financial institutions to the Federal Reserve. At the Basel Committee on Banking Supervision, active discussions arose concerning capital requirements for large banks. The Bank of Japan is taking part in such discussions with particular interest, as their outcome could materially affect the management of Japanese banks.

II. Policy Measures by Major Central Banks

I will now talk about the policy measures taken by major central banks, including unconventional measures, following the Lehman shock in September 2008. The measures can be classified into four groups.

The first is significant reductions in policy interest rates. Major central banks have all reduced their policy interest rate to 1 percent or lower. At present, the key policy interest rate of the Federal Reserve is 0 to 0.25 percent, that of the European Central Bank (ECB) 1.0 percent, that of the BOE 0.5 percent, and that of the Bank of Japan 0.1 percent. Looking at these extremely low key rates, it is as though a "zero interest rate club" has been formed. However, no central bank has actually set the policy rate at zero. This is due to the shared understanding of the vital need that a balance must be struck between the economic stimulus from lower interest rates and the maintenance of proper market functioning. The reason for this appears to be the shared concern, based on the experience of Japan's zero interest rate and quantitative monetary easing policies, that if the key policy interest rate is lowered to zero, this may impede the functioning of the money market, making it difficult to exit smoothly from unconventional monetary policies.

The second group of measures consists of the provision of ample liquidity to stabilize financial markets. To stabilize the markets through the provision of liquidity, major central banks have taken various steps, including (1) the enhancement of market operations to supply funds, (2) the introduction of new methods to absorb funds from markets, and (3) the improvement of standing facilities. The first point includes increases in the frequency, size, and length of operations, and the expansion of the range of eligible collateral and counterparties. The third point includes the payment of interest on excess reserves held at central banks, and the extension of the terms of loan facilities. It seems that the frameworks of market operations of major countries are becoming increasingly alike. Furthermore, central banks are increasing cooperation for the stabilization of financial markets through, for example, currency swap agreements to provide foreign currency funds, and the introduction and expansion of cross-border collateral schemes.

The third group of measures concerns the expansion of eligible assets to be purchased in

market operations. After the Lehman shock, financial transactions were depressed by severe corporate funding conditions, rising housing loan interest rates, and a decline in the availability of funds. In general, central banks purchase safe short-term government securities in market operations. Following the Lehman shock, however, higher-risk assets were added to the list of eligible instruments for such purchases. To be more precise, the following purchasing schemes were introduced by a number of central banks: (1) purchases of financial assets issued by the private sector such as CP and corporate bonds to revitalize the credit market, which had ceased to function properly (Bank of Japan, Federal Reserve); (2) purchases of long-term government bonds and agency bonds to affect the prices of a wide range of assets or to boost the supply of money and credit (Federal Reserve, BOE); and (3) purchases of stocks held by financial institutions to reduce the equity exposure of banks, thereby helping to stabilize the financial system as a whole (Bank of Japan).

Finally, the fourth group of measures consists of the provision of liquidity to specific financial institutions. Some central banks acted as the "lender of last resort" to maintain the stability of the financial system. Notably, the Federal Reserve injected liquidity into government-sponsored enterprises and a major insurance company, none of which were deposit-taking institutions or primary dealers.

A. Classification of Unconventional Monetary Policies

The "unconventional" monetary policies implemented by the central banks of major economies around the world comprise a large variety of measures, and there is therefore no single definition. To facilitate a better understanding of the transmission mechanisms of, and exit strategies from, unconventional monetary policy measures, I will attempt to provide some classifications.

Conceptually, unconventional monetary policies can be classified into two categories, depending on the risk that the central bank takes on in its own balance sheet and what it does with excess reserves. That is, unconventional monetary policies either take the shape of "credit easing" or of "quantitative easing." In the former case, the size and composition of the central bank's balance sheet changes as it takes on credit and term risks that are above normal levels and, in principle, absorbs excess reserves. On the other hand, in the latter

case, the central bank increases its holdings of assets that are free from credit risk, such as government debt, to expand reserve deposits above what would be necessary to achieve the lowest possible interest rates, and leaves excess reserves as they are.

Based on this distinction, it can be argued that the BOE, as it also says itself, has been pursuing quantitative easing, since it has accepted only a limited degree of credit risk, while the Federal Reserve and the ECB have been pursuing credit easing. The Bank of Japan, which has been purchasing CP and corporate bonds since the beginning of this year, can be said to be pursuing a limited credit easing policy. However, looking at central banks' actual policy conduct, most central banks, to different degrees, pursue policies that blend both approaches in that they purchase assets that entail credit risk and at the same time allow some excess reserves. For example, the Federal Reserve can be said to have adopted a credit easing policy until February this year, but since then has switched to a "hybrid" unconventional monetary policy since the March meeting of the Federal Open Market Committee (FOMC), at which the outright purchase of longer-term Treasury securities was decided.

It is also possible to classify unconventional monetary policies in terms of the transmission mechanism that central banks assume and the riskiness of assets that they purchase. That is to say, it is possible to distinguish three types of policies: (1) asset purchasing policies; (2) credit easing policies; and (3) policies that are a hybrid of these two. The BOE, at its Monetary Policy Committee (MPC) meeting in March, resolved to undertake an "Asset Purchase Program," under which the BOE buys government debt and corporate debt, such as corporate bonds and CP, amounting to 75 billion pounds in total, with the aim of boosting the supply of money and credit and thus raising the rate of growth of nominal spending. At the same time, the BOE announced that it was likely that the majority of the overall purchases by value would be of gilts. At the May MPC meeting, it decided by unanimous vote to expand the size of the program by 50 billion pounds to a total of 125 billion pounds. According to the minutes of this meeting, the decision was made based on the assessment that the current and prospective weakness in nominal demand meant that there remained a substantial risk that inflation would undershoot the target in the medium term, and that further monetary easing was required to meet the inflation target. At the August MPC

meeting, the BOE further increased the size of the program by 50 billion pounds to a total of 175 billion pounds, explaining that "in the United Kingdom, the recession appears to have been deeper than previously thought. . . . the margin of spare capacity in the economy is likely to continue to grow for some while yet, bearing down on inflation in the medium term." In the United States, the Federal Reserve, which had already embarked on a credit easing policy, in March decided to purchase up to an additional 300 billion U.S. dollars of longer-term Treasury securities, bringing its total purchases of financial assets, including agency mortgage-backed securities (MBS) and agency debt, to up to 1.75 trillion U.S. dollars. Later, after the FOMC meeting held on August 11 and 12, the Federal Reserve stated that it had decided to gradually slow the pace of these transactions and anticipated that the full amount would be purchased by the end of October.

B. The Thinking behind the Adoption of Unconventional Monetary Policies

The implementation of unconventional monetary policies is a challenge for any central bank. However, central banks need to consider and implement, within a limited time frame, whatever policies are most appropriate at any particular time. In this process, central banks must decide the size and composition of financial assets they hold with a view to maintaining their financial soundness. Furthermore, central banks are expected to take effective short-term measures that are consistent with their medium- to long-term goals and are justifiable from an external and *ex post* perspective. In view of the severe economic and financial conditions following the bursting of the credit bubble, it was essential, and will remain so in the future, to have in-depth discussions on the following points before embarking on monetary policy that is regarded as unconventional.

The first point concerns the rationale for adopting such a policy. A major precondition is that monetary policy goals cannot be achieved through conventional monetary policies, that is, changes in the policy interest rate. Cases may arise where (1) a sharp deterioration in the functioning of financial markets is expected to continue, (2) the financial system is at risk of facing a crisis, and (3) there is no room left for lowering interest rates further.

I must add that, when implementing unconventional monetary policies, it is important more than ever that appropriate information be provided to the public. Such information

includes (1) a logical explanation of the reasons for adopting unconventional policies, (2) the main objectives of the policies, and (3) the scale and extent of the policies. Issuing detailed information through comments by central bank executives, research papers, and the central bank's web site will increase market participants' understanding of such policy measures and enhance their effectiveness through the efficient formation of market expectations.

The second point such discussions need to address is how to minimize the impairment of market functioning. There has been criticism that central bank purchases of private-sector debt as part of a credit easing policy impair the proper functioning of the market. While the need for such intervention depends on the extent of market dysfunction, the number of markets in which to intervene and the size of interventions should be kept to a minimum.

The third point that needs to be addressed is how to maintain the central bank's financial soundness. When purchasing risk assets or providing liquidity to specific financial institutions, two points are important in upholding the credibility of the central bank: (1) restraining such action to ensure that the central bank's financial soundness will not be severely impaired; and (2) reaching an agreement in advance with the government and private entities on the allocation of possible future losses.

The fourth point concerns ensuring that policy decisions are consistent with the principle of central bank independence, even when implementing unconventional policies. Generally speaking, in times of financial crisis, central bank policies may come close in character to fiscal policy in that the financial burden is eventually passed on to taxpayers and/or that such policies result in a redistribution of resources at the microeconomic level. Therefore, it is important for central banks to explain clearly their thinking behind purchases of risk assets and their liquidity support to specific financial institutions, in order to demonstrate that they maintain a neutral stance with regard to resource allocation at the microeconomic level. Furthermore, central banks should not provide financing support to specific firms or industries that does not fall under their responsibility as "lender of last resort" and that should be provided through the government's fiscal burden or policy-based financing. Due to the need for prompt action, it is generally the case overseas that agreements are in place

beforehand stipulating that the government will shoulder the losses arising from central bank liquidity support to particular firms or industries.

Furthermore, when embarking on a quantitative easing policy that entails purchases of long-term government bonds, it is important that central banks make sure to (1) keep a certain distance from government debt management policy and (2) make clear that the objective of such purchases is not monetization. Financial market participants seem to understand that central banks will not purchase government bonds to support governments' debt financing. However, since there is a deep-rooted view that central banks are aware of the upward pressure on long-term bond yields from fiscal stimulus measures, they need to repeatedly make clear that such purchases never aim at monetization.

The fifth point that needs to be discussed concerns exit strategies: given that unconventional policies are applied only in times of crisis, it is important to discuss them from the moment they are formulated, and to announce in detail how and when such policies will be terminated, before the policies are actually launched. When the Bank of Japan decided to take the extraordinary step of buying CP and corporate bonds, it made public the basic thinking behind its outright purchases of corporate financing instruments, stating that the Bank would conduct such purchases only temporarily and only to the amount deemed necessary. However, the implementation of exit strategies for individual measures needs to be based on a judgment as to whether such temporary measures are still necessary given the state of financial markets and corporate financing.

C. Different Policy Responses Reflecting Different Circumstances

The unconventional policies that major central banks have embarked on differ depending on the situation in which they find themselves. The differing policy responses arise from differences in (1) the state of financial markets, especially the level of development of the credit market and the extent to which the functioning of markets has deteriorated, and (2) whether financial intermediation operates mainly on the basis of direct financing or indirect financing.

Regarding the first point, the extent to which a central bank can conduct market operations

depends on the size of the financial market. The major European countries and the United States all suffered from deterioration in the functioning of credit markets, but the central bank that faced the least risk of causing damage to market functioning through active intervention in various credit markets was the Federal Reserve, because of the large size of capital markets in the United States. I believe the appropriate unconventional policy measure to deal with credit market dysfunction is purchases of credit risk assets.

As for the second point, in Europe borrowing from banks accounts for about 90 percent of funds procurement compared with about 40 percent in the United States. Consequently, the ECB has introduced policy measures to help financial institutions obtain liquidity and to restore their ability to create credit. It is for this reason that ECB President Jean-Claude Trichet called the ECB's covered bond purchase program an enhanced credit support operation. After the ECB announced its plan to purchase covered bonds in May, both the primary and secondary markets for covered bonds recovered to some extent. Although it is still too early to judge the effectiveness of this program in terms of improving the funding of financial institutions in the euro area, it can be said that the scheme at least has produced an announcement effect. Personally, I believe that the ECB's most effective policy tool so far has been liquidity-providing longer-term refinancing operations with a maturity of one year carried out as fixed-rate tender procedures with full allotment, which were introduced in May.

The Bank of Japan, the Federal Reserve, and the BOE all purchase government bonds, but they do so for different ends. For the Bank of Japan, outright purchases of long-term government bonds are a means of liquidity provision. It therefore considers such purchases to fall within the framework of conventional monetary policy.

The BOE, which on March 5 decided to purchase financial assets, mainly focusing on gilts, said in a public statement that its MPC "resolved to undertake further monetary actions, with the aim of boosting the supply of money and credit and thus raising the rate of growth of nominal spending to a level consistent with meeting the inflation target in the medium term." This makes clear that the measure is considered to be a pillar of quantitative easing, that is, an unconventional policy.

The minutes of the FOMC meeting on March 17 and 18, at which the Federal Reserve decided to increase purchases of agency MBS and longer-term Treasury securities, suggest that purchases of the latter were a part of its credit easing policy. It seems likely that the Federal Reserve decided to buy longer-term Treasury securities to complement its purchases of agency MBS that had been expected to bring about low and stable mortgage rates. In fact, the minutes of the FOMC on June 23 and 24 state that "the asset purchase programs were intended to support economic activity by improving market functioning and reducing interest rates on mortgage loans and other long-term credit to households and businesses relative to what they otherwise would have been."

III. Central Banks' Ability to Control Their Balance Sheets and Exit Strategies

A. The Size and Composition of Central Banks' Balance Sheets

In a normal situation, where the financial system is functioning properly, the size of a central bank's balance sheet is determined by its liabilities, which mainly consist of banknotes in circulation and current deposits. When the financial system is under pressure -- that is, in times of financial crisis -- the central bank will conduct market operations that generate excess reserves, resulting in an expansion in its balance sheet by the amount of generated excess reserves.

The composition of the balance sheet also differs between normal times and times of financial crisis. When there are increased concerns over financial system stability, the central bank's policy response will result in the following changes in the composition of its balance sheet. On the liabilities side, excess reserves will increase because the central bank provides ample liquidity in order to support financial institutions facing the risk of liquidity shortage. On the assets side, in addition to the increase in traditional assets in response to the generation of excess reserves, the central bank will also accumulate nontraditional financial assets as a result of its decision to intervene in dysfunctional credit markets and to accept credit assets as eligible instruments for outright purchases or purchases with repurchase agreements.

Given that the major central banks no longer have much room to lower interest rates further,

the ability to control their balance sheet may be taken as one measure of their degree of freedom in the conduct of monetary policy. At this point, all the major central banks, although to varying degrees, are capable of making adjustments to the size and composition of their balance sheets, if deemed necessary from the viewpoint of economic stability.

The Federal Reserve, when exiting from the program of purchases of longer-term Treasury securities and risk assets, will have to tread carefully. However, what it can do at present is to purchase assets with shorter residual maturity, and in this sense, it seems fair to say that the Federal Reserve is capable of reducing the expanded balance sheet.

The Bank of Japan also has adequate ability to control its balance sheet. For example, (1) compared with the other major central banks, the Bank of Japan has at its disposal a large variety of monetary policy tools; (2) as in the case of the Federal Reserve, the framework for the outright purchases of corporate financing instruments, such as CP and corporate bonds, is such that the frequency of financial institutions' participation in such purchasing operations decreases as market conditions improve, and the Bank's balance sheet shrinks accordingly; (3) the Bank has set time limits for the various measures such as its Special Funds-Supplying Operations to Facilitate Corporate Financing; and (4) the Bank has also set a ceiling for the amount outstanding of government bonds it purchases.

B. "Exit Strategy" from Unconventional Monetary Policies

As I mentioned earlier, it is essential for central banks to explain clearly and at as early a stage as possible their exit strategy from unconventional monetary policies. Some market participants argue that it is premature to discuss an exit strategy when the downward spiral between the financial system and the real economy is still operating. However, given that the conduct of unconventional policies is almost unprecedented, unveiling exit strategies only just before such policies are terminated may cause market disruptions, thereby making it more difficult to smoothly phase them out.

Although it becomes a bit technical, I believe that having various operational tools to absorb liquidity from the money market, like the Bank's bill selling operations, is vital to smoothly implement an exit strategy. It can be said that the Bank was able to exit from its

quantitative easing policy relatively smoothly and swiftly for the following reasons. First, when the Bank was conducting quantitative easing, it generated excess reserves mainly by providing short-term funds. Second, when the termination of quantitative easing came in sight, the Bank adjusted the starting and ending dates of its funds-supplying operations so that both did not fall on the same day. This enabled the Bank to avoid the rollover of such operations, thereby allowing it to reduce total assets in its balance sheet quite naturally. And third, the Bank already had a useful operational tool -- bill selling operations.

Meanwhile, many major central banks have already taken measures aimed at a smooth exit from unconventional policies. These include (1) the setting up of schemes that are designed so as to provide a backstop when the functioning of markets has recovered and the need for the scheme has declined automatically, (2) the expansion of schemes for the provision of funds that allow excess liquidity to be absorbed within a short period and also of measures for the absorption of funds, and (3) commenting on the possibility of selling risk assets that have been purchased.

Regarding the third point, I will quote as an example the Federal Reserve's scheme for purchasing longer-term securities. On July 29, William C. Dudley, President of the Federal Reserve Bank of New York, said, "The size of the purchase programs underway makes it likely that balance-sheet growth will resume as assets acquired in conjunction with these programs overwhelm any further declines in the funds advanced via the shorter-term liquidity facilities. The size of the Federal Reserve's balance sheet seems likely to grow to roughly 2.5 trillion dollars, somewhat above the peak reached last December." Regarding the exit strategy from the present unconventional monetary policy, the Federal Reserve has explained that it can dispose of U.S. Treasury securities and agency MBS from its balance sheet by temporarily selling them with reverse repurchase agreements (reverse repos), selling them outright, or redeeming them at maturity. So far, comments by officials of the Federal Reserve on an exit strategy, in terms of the technical details of its money market operations, have not revealed much. However, particularly when the Federal Reserve actually starts to exit from its unconventional policies and begins selling its asset holdings, it will become necessary for it to provide more detailed information to avoid disruptions in financial markets.

On July 21, Federal Reserve Chairman Ben S. Bernanke contributed an article titled "The Fed's Exit Strategy" to the *Wall Street Journal*. Broadly speaking, the article made three points. First, even if its balance sheet remains large for a while, the Federal Reserve has two broad means of tightening monetary policy at the appropriate time: paying interest on reserve balances and taking various actions that reduce the stock of reserves. Second, steps to reduce reserves and drain excess liquidity from markets -- the second means of tightening monetary policy -- include four options: arranging large-scale reverse repos with financial market participants; selling of bills by the Treasury and depositing of the proceeds with the Federal Reserve; offering term deposits to banks; and selling a portion of the Federal Reserve's holdings of long-term securities in the open market. The third point in the article was that the Federal Reserve has many effective tools to tighten monetary policy when the economic outlook requires this, but that economic conditions were "not likely to warrant tighter monetary policy for an extended period," as Chairman Bernanke and his colleagues had stated.

Nevertheless, it is unclear whether the four options mentioned by Chairman Bernanke would indeed ensure a smooth exit from the unconventional monetary policies, and there is also the view that the exit strategy may be affected by "the intermingling of fiscal and monetary policy."[1] Against the backdrop of rapidly changing economic and financial conditions, central banks around the world have adopted unconventional monetary policies of which market participants, too, have no prior experience. It is therefore extremely important for central banks to clearly explain their thinking on the exit strategy from the unconventional monetary policies.

IV. The Shift to Conventional Monetary Policies by the Major Central Banks

As I have already mentioned, following the Lehman shock, the major central banks adopted unconventional policies such as credit easing and quantitative easing. However, broadly speaking, they have come to emphasize the importance of a continuation of the current policy of extremely low interest rates, rather than the addition of further unconventional

[1] See Wolfgang Münchau, "There is no easy way out for central banks," *Financial Times*, July 26, 2009.

policy measures.

For example, officials of the Federal Reserve are increasingly stressing that any rises in the key policy rate still lie in the distant future because of the weakness of the economic recovery and inflationary pressures. Such comments started to emerge from around the end of June when Federal Reserve Bank of San Francisco President Janet L. Yellen stated that she expected the pace of the recovery to be frustratingly slow. She also said that the prospect that the federal funds rate, the benchmark U.S. interest rate, would stay near zero for the next several years was "not outside the realm of possibility."

Emphasis is returning to conventional monetary policy. The reason probably is that although the functioning of U.S. credit markets has not recovered fully, there are some signs that the credit easing has had an effect, as seen, for example, in the narrowing of credit spreads. Since the increase in comments by officials of the Federal Reserve on their intention of maintaining the extremely low interest rate policy, interest rates on term instruments and yields on short-term debt have become stable, resulting in the stabilization of the yield curve of U.S. Treasury securities.

However, given the rise in the unemployment rate and the fall in commercial real estate prices, the burden on U.S. financial institutions from disposing of their bad loans will be large, both time- and cost-wise. It is important to take this point into account when formulating an exit strategy. Regarding the Federal Reserve's planned purchase of 300 billion U.S. dollars of Treasury securities, the statement released after the FOMC meeting in August said that the FOMC "anticipates that the full amount will be purchased by the end of October." However, purchases of agency debt and agency MBS will continue. The tendency for its balance sheet to expand will continue, and it is therefore important for the Federal Reserve to maintain control over its balance sheet.

For central banks implementing unconventional monetary policies, it is important to clearly differentiate between the exit strategy from unconventional or temporary measures and that from the extremely low interest rate policy. Most market participants are increasingly aware of the difference between the two exit policies. As concerns over economic

deterioration and financial system stability recede, talk will turn to the review of unconventional policy measures and means of bringing them to an end. In this situation, in order to avoid any possible misunderstandings, it is important for central banks to explain clearly which exceptional or temporary measure they are referring to when discussing exit strategies.

On the other hand, with regard to conventional monetary policy, the major central banks have maintained low interest rates, and some have even made commitments to continue holding their policy rates at very low levels -- that is, they are embarking on a policy based on the so-called policy duration effect. So far, however, none of these central banks has either adopted such policies additionally or made more decisive commitments. Yet, should the downside risks to the outlook for economic activity and prices increase, committing to a low interest rate policy becomes a possible option.

Meanwhile, major central banks have been providing ample liquidity to money markets, either through conventional or unconventional monetary policies. In addition, given the large-scale fiscal stimulus packages implemented in both advanced and emerging economies, asset prices such as stock, real estate, and natural resource prices may be pushed up beyond economic fundamentals as market participants' risk appetite recovers. Under such circumstances, some may argue that central banks should reduce their liquidity provision, while making sure that such action is not interpreted as a tightening of their policy stance amid the continued financial crisis. The reason behind this argument is the widespread view that, following the collapse of the IT bubble, the central banks of the major economies kept interest rates too low for too long, leading to a global credit bubble and consequently the global financial crisis.

However, it is also true that the policy measures taken by governments and central banks around the world have been contributing to the recovery of the world economy. Moreover, the lending attitudes of U.S. and European financial institutions have not been particularly accommodative. In my view, when discussing the handling of the provision of ample liquidity, the following aspects need to be fully taken into account: (1) the rise in asset prices, rather than being seen as a negative side effect of the ample provision of liquidity,

can be interpreted as a positive factor that will contribute to improvement in corporate and household confidence; (2) the return of various carry trades indicates restoration of market participants' risk appetite; (3) there are concerns over a double dip in the world economy as the effects of fiscal stimulus packages, except for those in the United States and China, will likely expire in 2010; and (4) it will take some time for market participants to fully recognize the difference between the exit from unconventional monetary policies and the exit from extremely low interest rate policies.

V. The Bank's Conduct of Monetary Policy Following the Lehman Shock

I would now like to talk about the Bank's policy response since the failure of Lehman Brothers in September 2008. The policy response can conceptually be divided into three broad areas. The first is significant reductions in the policy interest rate. The second is the provision of ample liquidity to ensure stability in financial markets. And the third is steps to facilitate corporate financing by promoting the recovery of the proper functioning of certain markets, such as credit markets. More specifically, in view of overall tightness in financial markets -- indicated by general rises in interest rates for business and consumer borrowers and limited availability of liquidity -- the Bank has been purchasing private debt and also has expanded the range of eligible collateral for its provision of credit.

A. Seeing the Bank's Policies as a Set

Reflecting the Bank's policy measures, issuance rates on some high-rated CP have fallen below yields on government bills. This phenomenon itself is problematic, but it is also not appropriate to discuss policy effects solely on the basis of distortions in individual markets. Instead, monetary policy effects should be judged based on a comprehensive analysis of corporate financing as a whole. The Bank has communicated its policy response following the Lehman shock by dividing it into the three areas just mentioned, but in reality it is difficult to separate policies clearly in this way, and they should be seen as a comprehensive policy response when evaluating their effects. For instance, the measures aimed at facilitating corporate financing should be seen as contributing to the fact that interest rates on term instruments are currently low and stable.

B. Persistent Severity in Corporate Financing Conditions

Japan's money market, credit markets, and bond markets have been stable, but the corporate financing situation has remained tight. First, firms continue to see their cash flow as weak. The June *Tankan* (Short-Term Economic Survey of Enterprises in Japan) indicates that projections of net income for the first half of fiscal 2009 by all respondents were down by 62.9 percent from the March survey, and that large manufacturers expect that they will register a net loss. Second, although the loan market should again be a borrowers' market as lending to firms declines and lending rates fall, the June *Tankan* indicates that all respondents expect interest rates on loans to increase, as suggested by changes in the diffusion index (the percentage of the number of firms that responded that they expected loan rates to rise minus that of firms that responded that they expected loan rates to fall). More specifically, while the diffusion index for the actual rate change in the March survey was minus 5 and that in the June survey plus 3, the forecast for September is plus 14. Factors behind this include firms' experience during the periods around the end of calendar 2008 and fiscal 2008 (March 2009), when issuance rates on CP and banks' lending rates increased. It is also attributable to firms' concern that lending rates may increase in the future if the ratings of their debt are downgraded or financial institutions' credit standing deteriorate. And third, despite the fact that interest rates on CP and term instruments have been falling recently, many firms still hope that the Bank will continue to implement the policy to facilitate corporate financing.

In light of these conditions, the Bank decided, at its Monetary Policy Meeting (MPM) in July, to extend for three months the effective periods of outright purchases of CP and corporate bonds -- temporary measures that had been due to expire on September 30. It has been suggested that, taking account of the weak bidding in these operations, they are no longer necessary. However, these temporary measures were, from the beginning, designed to provide a backstop and were not intended to be used actively on a regular basis. It was expected that the need for these operations would decline automatically as the functioning of markets recovers, allowing the Bank to smoothly terminate these unconventional policy measures.

The Bank also decided to extend the effective periods of special funds-supplying operations

to facilitate corporate financing for three months with no revisions to the terms and conditions for the facility. In my view, any revisions to this facility at this point might unnecessarily increase volatility in financial markets, as the facility has been influencing interest rates on term instruments. In fact, if financial markets were to become more dependent on this exceptional measure, this could have negative side effects in the longer run. Such potential side effects include the risk that (1) autonomous adjustments in financial markets and the economy may be hampered and (2) there may be disruptions in financial markets when the Bank revises or terminates the measure. The environment surrounding corporate financing remains severe, but it certainly is on the road to recovery. My view at the MPM in July therefore was that it was appropriate to extend the facility, which was due to expire at the end of September, not by six months, as was the case at the MPM in February, but by three months.

Concluding Remarks

Looking at major financial markets, short-term interest rates are stable, although the distribution of funds is uneven and the flow of funds in general is not smooth because of the cautious lending attitudes of banks. Moreover, prices of CP and corporate bonds by issuers of high credit ratings, government bonds, and relatively simple credit products are rising. The underlying factor behind this surface calm of financial markets is the abundant liquidity resulting from measures taken by central banks in a number of countries. However, this calm could be disturbed by (1) macroeconomic indicators dashing hopes for economic recovery and (2) wild speculation over exit strategies. In addition, unconventional monetary policies and large-scale fiscal spending are temporary measures that should not be relied on for long because of their potential negative side effects. Therefore, policymakers in each country need to take great care in their communication with the market.

Since the global financial crisis is widely viewed to reflect "market failure," there are worldwide calls for tighter financial regulation, particularly of investment banks and hedge funds, which have led the financial industry since the 1990s. Meanwhile, in Japan, the significance of financing through government financial institutions recently has attracted renewed attention. However, in my view there are limits to government intervention in the

market, which is what an expansion of policy-based financing represents. This is because the ballooning of policy-based financing tends to be accompanied by some adverse consequences: specifically, growth of efficient capital markets and the appropriate allocation of resources based on market principles may be hindered. Since the prevailing view in countries around the world appears to be in favor of reinforcing financial regulation, financial institutions' capacity to extend loans is unlikely to increase significantly in the medium term. In Japan, procurement of funds by large firms in the previous fiscal year shifted from procurement through the issuance of CP, corporate bonds, and stocks to procurement through indirect financing and policy-based financing. In the current fiscal year, corporate bond issuance is increasing in terms of value, but the number of issuing firms is not necessarily on the rise. If policy-based financing does come to be actively employed, I hope that it will contribute to improving the working of the credit market through the provision of government guarantees and measures that complement the market mechanism.