Opening Speech

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I. Introduction

Good morning, ladies and gentlemen. I am very pleased to address the 13th international conference hosted by the Institute for Monetary and Economic Studies. On behalf of my colleagues at the Bank of Japan, I welcome all the participants from all over the world.

II. Theme of this Year's Conference

The theme of this year's conference is "Financial Markets and the Real Economy in a Low Interest Rate Environment." I am sure that this theme is timely for all of us, considering the financial and real economic conditions we have faced since the 1990s. Let me elaborate on this point, focusing on Japan's experience with quantitative easing.

III. Japan's Experience with Quantitative Easing

Since the 1990s, Japanese firms and banks have continued their adjustment efforts. Specifically, Japanese firms have tackled the so-called "three excesses," that is, the excesses of debt, employment, and production capacity, since the bursting of the economic bubble in the early 1990s. Japanese banks suffered from a massive nonperforming-loan problem, which plagued the stability of the financial system.

In addition, around 2000, the collapse of the so-called IT bubble around the globe placed Japan's economy once more in a recessionary phase. In these circumstances, the economy faced the risk of falling into a deflationary spiral. Once the economy falls into such a vicious spiral, it is very hard to get out of it, since expectations of continuing deflation can be self-reinforcing.

To prevent the vicious spiral, the Bank acted decisively by introducing the quantitative easing policy. The quantitative easing policy had two pillars: (1) provision of ample liquidity by the Bank with the adoption of the outstanding balance of current accounts at the Bank as the operating target for money market operations; and (2) a commitment by the Bank to continue to provide ample liquidity "until the consumer price index (CPI, excluding fresh food) registers stably a zero percent or an increase year on year."

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This policy package exerted significant influences on the overall interest rate environment. Specifically, the provision of ample liquidity drove the uncollateralized overnight call rate, which should reflect credit risks of borrower financial institutions, lower to 0.001 percent under the quantitative easing. In addition, the commitment to continue zero interest rates substantially flattened the yield curve.

The strong effects of the quantitative easing policy on financial markets are very clear if we compare them with the U.S. situation in the 1930s. During the 1930s, although the U.S. Treasury bill rate declined to approximately zero percent, the federal funds rate, the rate at which financial institutions lend and borrow short-term funds, declined only to 0.25 percent. Moreover, the yields on government bonds have been much lower in Japan from the mid-1990s onward than they were in the United States of the 1930s. Thus, we can infer that the quantitative easing policy was one of the most decisive policy challenges for central banks from a historical perspective.

In retrospect, Japan's economy finally started recovering in January 2002 after the strenuous efforts by firms and banks to resolve their problems that I have mentioned. As an aside, it was on March 20, 2003 that I assumed the office of Governor. At that time, the fact that Japan's economy had already started recovering was beyond my widest dreams. In my inaugural address, I mentioned that Japan's economy was still on shaky ground.

Subsequently, the Bank stepped up the quantitative easing further by increasing the current account balances at the Bank far above the required reserves, as well as abiding by the CPI commitment. Also, in October 2003, the Bank provided a more detailed description of the commitment to maintain the quantitative easing policy from the perspective of enhancing the transparency of monetary policy. During this, we always kept in mind that we should carefully nurture the budding economic recovery.

The quantitative easing policy showed visible effects on two fronts. First, the policy, particularly through the ample liquidity provision, stabilized the financial system, at a time when there were strong concerns over its stability. The ample liquidity the Bank supplied met the surges in financial institutions' liquidity demand, and thus successfully avoided a repetition of the large-scale credit crunch that was observed in 1997 and 1998.

Second, the quantitative easing policy created and maintained a very accommodative environment that supported the recovery of Japanese firms, through the commitment to continue zero interest rates. In particular, bank lending rates and interest rates on corporate bonds continued to decline as a result of the flattening of the yield curve, as well as the gradual decline in credit risk premiums.

Various potential transmission channels of the quantitative easing were discussed among economists at the time the Bank introduced the policy. One of these channels is the portfolio rebalance channel: as the proportion of safe assets such as the current account balances at the Bank increases in the asset portfolios of financial institutions, they are expected to adjust their portfolios, typically by increasing holdings of riskier assets such as loans. Looking back on the period under the quantitative easing policy, we are not yet sure whether this channel actually worked or not.

The accommodative environment contributed finally to putting the economy back onto a solid recovery path. The year-on-year rate of change in the core CPI rose to the surface in October 2005 and turned positive the following month.

Under these circumstances, the Bank decided to terminate the quantitative easing policy in March 2006. More specifically, the Bank decided to change the operating target for money market operations from the outstanding balance of current accounts at the Bank to the uncollateralized overnight call rate. Under the new scheme, the Bank currently encourages the uncollateralized overnight call rate to remain at effectively zero percent.

During the period of the adjustment process, Japanese firms have been innovating continuously to strengthen their competitiveness. They have also expanded the global supply-chain network with a particular emphasis on developing their strategic linkages with Asian counterparts. Meanwhile, the Japanese banks have overcome the nonperforming-loan problem and are currently better positioned to respond to the demands for sophisticated financial services of the times. Such revitalization of both firms and banks should improve the efficiency of the market mechanism, thereby enabling a better allocation of resources.

IV. Several Questions to Be Discussed

In what follows, let me raise several questions that I hope are discussed at this conference.

First, how have financial markets functioned in the historically low interest rate environment? Have any unexpected effects of the low interest rate policy been detected in the financial markets?

Second, has the interaction between financial markets and the real economy changed in a low interest rate environment? For instance, have the roles played by financial markets and asset prices in the transmission mechanism of monetary policy changed?

Third, what are the consequences of a prolonged low interest rate environment? In particular, does the low interest rate policy pose potential risks to both financial markets and the real economy?

Fourth, how can we evaluate the recent low interest rate policy from historical and international perspectives? For instance, can we derive policy implications by comparing our recent policy experiences with the past episodes of combating deflation such as the 1930s in the United States?

V. Final Words

There are no easy answers to these questions. During the next two days, I am looking forward to learning from both prominent scholars in this field and central bankers their analyses and perspectives on the “Financial Markets and the Real Economy in a Low Interest Rate Environment.” I also hope the insights gained at the conference will be of some help to the future generations of central bankers. It would be our utmost pleasure if every one of you could obtain some insights from the discussions that follow. Thank you.