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Monetary Policy in the 1990s: Bank of Japan's Views Summarized Based on the Archives and Other Materials

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Discussion Paper No. 2020-E-6

IMES

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Masanao Itoh*, Yasuko Morita, and Mari Ohnuki*****

Abstract

This monographic paper summarizes views held by the Bank of Japan (hereafter BOJ or the Bank) in the 1990s regarding economic and financial conditions as well as the conduct of monetary policy, based on materials compiled during the period mainly in its Archives.

The following points were confirmed in writing this paper. First, throughout the 1990s, the Bank's thinking behind the conduct of monetary policy had shifted toward emphasizing the transparency of its policy management. The basic background to this seemed to be the growing importance of dialogue with market participants, reflecting a change in the target for money market operations from official discount rate changes to the guiding of money market rates. In addition, the fact that the revised Bank of Japan Act (hereafter the Bank of Japan Act of 1997) came into effect in April 1998 under the two principles of independence and transparency accelerated the trend of attaching importance to transparency. Second, on the back of the emphasis on transparency, the Bank enhanced its communication by increasing its releases in the second half of the 1990s, particularly after the enforcement of the Bank of Japan Act of 1997. Thus, the materials, especially those referred to in the latter half of this paper, consist mainly of the Bank's releases. And third, in the 1990s, the Bank faced a critical situation in which it needed to conduct monetary policy while paying due attention to the functioning of the financial system. Therefore, this paper includes numerous references to the issues regarding the financial system, mainly the disposal of nonperforming loans.

Keywords: Monetary policy conduct; Disposal of nonperforming loans; Financial system crisis; Bank of Japan Act of 1997; Zero interest rate policy

JEL classification: E52, E58, N15, N25

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The authors would like to thank referees and the BOJ staff for their helpful comments. The views expressed in this paper are those of the authors and do not necessarily reflect the official views of the BOJ.

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I. Summary

This monographic paper summarizes views held by the Bank of Japan (hereafter BOJ or the Bank) in the 1990s regarding economic and financial conditions as well as the conduct of monetary policy based on the materials stored in the Archives of the Institute for Monetary and Economic Studies (IMES) (hereafter BOJ Archives) and other contemporary materials. One of the authors was involved in the compilation of a similar paper covering the 1980s,¹ and this paper may be regarded as a sequel to the previous one. However, the BOJ Archives regarding the 1980s are more extensive in volume than those regarding the 1990s, mainly reflecting the longer lapse of time since the 1980s. On the other hand, with respect to the Bank's releases, there are more materials for the 1990s than those for the 1980s since the Bank changed its stance to putting an emphasis on transparency in the Bank's thinking behind its monetary policy conduct. Therefore, many parts of this paper, particularly its second half, are based on these releases.²

Like Ito, Koike, and Shizume (2015), this paper puts the focus of attention on (1) the Bank's thinking behind the conduct of monetary policy and (2) the Bank's assessment of economic conditions at home and abroad, as well as other factors that potentially affect the Bank's conduct of monetary policy. In addition, this paper includes references to (3) how the occurrence of the nonperforming-loan (NPL) problem in the financial sector and the resulting failure of financial institutions affected the Bank's conduct of monetary policy, and (4) how the enactment of the revised Bank of Japan Act (Bank of Japan Act of 1997) affected the Bank's formulation and conduct of monetary policy.

Looking back at the overall economic picture of Japan in the 1990s, the period was a decade of protracted economic stagnation -- as exemplified by the bursting of the bubble economy and the emergence of deflation -- that had started with a plunge from the peak of the bubble economy. In terms of financial conditions, the following four points can be identified: (1) a sharp and continuous decline in asset prices, (2) protracted stagnation of economic growth, (3) a slowdown in growth of monetary aggregates, and (4) deterioration in assets held by the corporate sector and the occurrence of the NPL problem facing financial institutions.

Looking at the Bank's conduct of monetary policy under these conditions from the historical perspective, the following points can be noted. First, the shift to the conduct of monetary policy using short-term market interest rates as the target of control, which started

¹ Itoh, Koike, and Shizume (2015).

² The period for the disclosed BOJ Archives used for compiling this paper is through 2017.

in the second half of the 1980s, was almost completed by the mid-1990s. The previous conduct of monetary policy, which used the official discount rate as the benchmark, changed in nature due to the completion of deregulation of deposit interest rates in October 1994. In March 1995, the Bank introduced a new system under which the guidance of market interest rates was defined as a monetary policy tool. In this system, the Bank releases a public statement regarding the guideline for market operations. As a result, the direct linkage of the official discount rate with deposit and loan interest rates that had until then been assumed was lost.

Second, in accordance with the above change, with respect to money market operations, the shift from Bank of Japan loans to monetary control mainly based on money market operations was completed in the second half of the 1990s. In January 1996, the credit line system intended for nine city banks that continued after the abolition of window guidance in June 1991 was abolished, and since then, monetary policy has been conducted mainly through various money market operations. Although the announcement effect (the effect of explicitly indicating the general framework of a central bank's policy stance) of the official discount rate was still widely acknowledged, the rate virtually became nothing more than a loan interest rate applicable to the Bank's provision of liquidity to individual financial institutions.³

Third, during this period, the NPL problem induced by the bursting of the bubble economy occurred and became serious, and the subsequent failures of financial institutions forced the Bank to continue to conduct prudential policy. The cumulative amount of losses from the disposal of NPLs between fiscal 1992 and 1999 was 54.7 trillion yen.⁴ Prudential policy, which was conducted under cooperation between the banking supervisory authority and the Bank, played a role in preventing the materialization of systemic risk. On the other

³ Later, the complementary lending facility was established in March 2001, and through June 2006, the Bank announced the interest rate applied to complementary lending as the "official discount rate." However, at the Monetary Policy Meeting (MPM) in July 2006, members of the Policy Board agreed that, given that the interest rate applied to complementary lending did not have the function of indicating the Bank's basic stance on monetary policy, it was appropriate to use the term "basic loan rate" instead of the "official discount rate," which tended to give the impression that this was a policy interest rate. Thereafter, the Bank announced the interest rate applied to complementary lending as the "basic loan rate" (BOJ [2006], pp. 8-9 and 15).

⁴ Financial Services Agency (2000). The cumulative amount of losses from the disposal of NPLs is comprised only of losses incurred by major banks, including city banks, long-term credit banks, and trust banks (data on the cumulative amount of such losses incurred by all banks can be traced back only up to fiscal 1995).

hand, due to the delay in developing the failure resolution legislation and a comprehensive safety net, the disposal of NPLs became prolonged, weighing on the macroeconomy, and it also affected the Bank's conduct of monetary policy at the time. Under these circumstances, from February 1999, the Bank adopted the so-called zero interest rate policy to be the forerunner among the central banks.

Fourth, in this situation, the Bank of Japan Act of 1997 was put into force in April 1998. The move to enact this Act started in 1996, and it was enacted after active discussions involving academics and former monetary policymakers as well as deliberations at the Central Bank Study Group, an advisory panel to the Prime Minister, and the Financial System Research Council, an advisory committee to the Minister of Finance. During the process of enactment of the Act of 1997, deliberations were made regarding drastic revision of the central bank system in light of the progress in globalization in the fields of economy and finance and in marketization, and a new framework based on the principles of independence and transparency became the pillar of the new Act. Under the Act of 1997, the Policy Board has been set as the only decision-making body, putting in place a legal and institutional framework for ensuring independence and transparency of monetary policy. Since then, the Policy Board has virtually assumed the responsibility for determining the Bank's monetary policy. The monetary policy centering on monetary control through various money market operations, which was established in the mid-1990s, was conducted based on deliberations and decisions by the Policy Board.⁵

With the aforementioned four points in mind, this paper summarizes the Bank's conduct of monetary policy in the 1990s.

This paper is structured as follows. The main text summarizes the conduct of monetary policy during the period as divided into the following phases in chronological sequence: (1) rapid monetary tightening (spring 1989 through spring 1991); (2) shift to monetary easing and protracted economic downturn (summer 1991 through the end of 1993); (3) changes in financial conditions and monetary policy response (early 1994 through summer 1995); (4) materialization of a financial system crisis in Japan (autumn 1995 through summer 1998); and (5) monetary policy under the Bank of Japan Act of 1997 (autumn 1998 through summer 2000). This paper also discusses in appendixes three points among important themes that should be considered in summarizing the conduct of monetary policy

⁵ As a result, the executives' meetings that had been held until then was abolished. For details, see Appendix 3.

in the 1990s -- monetary policy rules, special loans extended by the Bank (*Nichigin Tokuyu*), and the revised Bank of Japan Act (Bank of Japan Act of 1997).

II. Rapid Monetary Tightening (Spring 1989 through Spring 1991)

A. Shift to Monetary Tightening (Spring 1989 through Summer 1990)

1. Economic developments at home and abroad

With monetary easing continuing throughout the second half of the 1980s, Japan's economy kept expanding against the backdrop of favorable domestic private demand; and in this situation, the correction of the current account imbalance proceeded. The improvement in the macroeconomic external imbalance shifted the focus of the Japan-U.S. economic friction to structural issues such as trade barriers in the specific sectors and poor market access for foreign suppliers. Accordingly, the negotiation table changed to bilateral negotiations from multilateral negotiations, such as the Group of Five (G5) and the Group of Seven (G7).

The deregulation and globalization of financial and capital markets, an initiative launched by the Japan-U.S. Yen-Dollar Committee in 1984, was gradually implemented from 1985. In June 1987, the Ministry of Finance (MOF) released the "Immediate Outlook for Deregulation and Globalization of Financial and Capital Markets," which contained the schedule of deregulation for the time being. In this report, deregulation of deposit interest rates was identified as an urgent task. Meanwhile, based on this report, the CP market and the stock index futures market were established; in April 1989, a financial futures exchange was established, and transactions of financial futures started in June. As the deregulation of deposit interest rates made steady progress, the small-lot money market certificates (MMCs) were introduced and the lower limit on large-lot time deposits, for which interest rates had already been deregulated, was further reduced. Consequently, as of the end of 1989, deposits with deregulated interest rates and those with interest rates that were linked to market interest rates constituted a large proportion of deposits in Japan: the amount of ordinary time deposits with regulated interest rates was 44.5 trillion yen, whereas that for time deposits with deregulated interest rates was 151.0 trillion yen, 11.2 trillion yen for MMCs, and 19.3 trillion yen for small-lot MMCs.⁶

Against this backdrop, financial institutions' activity became aggressive, leading to the

⁶ Editorial Committee on the Annual Report of Financial Institutions, Banking Bureau, MOF (1989), pp. 12-19.

emergence of financial imbalances, such as rapid growth in money stock, a sharp increase in equity finance as part of corporate financing, and surges in stock and land prices. Financial institutions' increased proactiveness, which had been observed since the mid-1980s, escalated rapidly, partly because they were permitted to include 45 percent of their unrealized profits on securities holdings in their capital base under the minimum capital requirement (Basel standards) in 1987-1988.⁷ The long period of monetary easing following the Plaza Accord also made it easier for investors to raise funds by reducing the funding cost. Moreover, the land taxation system, which imposed a relatively low tax on land holdings and a relatively high tax on capital gains, also had the effect of curbing the supply of land. This, coupled with speculative demand for land, triggered a sharp rise in land prices. Specifically, following the enactment of the Temporary Act for Promoting the Strengthening of Specific Facilities by Utilizing Private Sector Business Capabilities in May 1986, Japan witnessed an asset price spiral in which numerous development projects and the ensuing speculative demand for land triggered a rise in land prices, thereby inducing a surge in stock prices, which in turn increased demand for land by facilitating fund-raising.⁸

In response to the land price surge, in October 1987, the MOF issued to financial institutions a directive requiring the adoption of more stringent conditions for providing land-related loans and called on them to refrain from extending loans for speculative land transactions. In addition, the Cabinet decided on the Outline of Comprehensive Measures

⁷ The capital adequacy ratio set for private banks in 1988 upon a proposal from the United States, supported by the United Kingdom and Japan, among other countries (Basel Committee on Banking Supervision [1988]). Private banks were required to keep their capital adequacy ratio -- calculated by dividing the capital amount by the amount of weighted risk assets -- at or above 8 percent, which was known as Basel I. This was intended to enhance the soundness of the global banking system and reduce competitive inequality between banks with respect to international operations. In response to a proposal from the United Kingdom and the United States to count only paid-in capital and disclosed reserves as capital, requests for improvement were made by other countries. As a result, it was permitted to set various categories of supplementary capital, and Japan decided to allow financial institutions to set the total amount of Tier 1 (equity capital) and Tier 2 (subordinated loans and 45 percent of the amount of unrealized profits on securities) as part of their capital. Therefore, it was presumed that this regulation, which was originally intended to strengthen the soundness of the banking system, became one of the background factors of the excessive lending due to a surge in stock prices during the bubble period (financial institutions were permitted to increase the total amount of loans by a margin 12.5 times as large as the increase in the amount of their Tier 2 capital).

⁸ Komine (2011), pp. 284-286.

Related to Land in June 1988, and the government sought to contain speculative land transactions by putting into force the Basic Act for Land as well as implementing other measures in December 1989.

2. Monetary policy response

Under these circumstances, the Bank judged that, in addition to the narrowing of slack in domestic supply and demand conditions and a wage rise, the yen's depreciation and an increase in crude oil prices were also gradually exerting upward pressure on prices, as monetary easing continued for a protracted period.⁹ The Bank also judged that it was necessary to revise the conventional monetary policy conduct, as the linkage between various markets was expanding due to active interest rate arbitrage trade between various domestic financial markets as well as between financial markets at home and abroad, with the progress of financial deregulation and globalization. Therefore, in November 1988, the Bank changed the framework for money market operations. In line with this change, the new short-term prime lending rate, which was linked to market interest rates, was introduced in place of the existing short-term prime lending rate, which had been linked to the official discount rate, and this led to free interest rate formation based on market conditions.

As the interest rate formation came to reflect market conditions, a sustained economic expansion and rising pressure on prices further heightened anticipation for higher interest rates from spring 1989, resulting in an uptrend in both short- and long-term interest rates. In response, in May 1989, the Bank raised the official discount rate (from 2.5 percent to 3.25 percent), marking a shift to monetary tightening. Subsequently, the Bank implemented additional hikes in the rate in October 1989 (to 3.75 percent) and in December of the same year (to 4.25 percent), in light of the growing upward pressure on prices due to the narrowing slack in supply and demand conditions and rising import costs. As to the reason why the Bank implemented a series of interest rate hikes despite the lack of a notable change in either consumer prices or wholesale prices -- when the effects of the introduction of the 3 percent consumption tax were excluded -- compared with their trends before the

⁹ "Governor's Opening Speech at the General Managers' Meeting of the Bank of Japan's Branches on April 24, 1990," BOJ Archives "General Managers' Meetings (including Deputy General Managers' Meetings) of the Bank of Japan's Branches from April 23, 1990, to December 1991," No. 41807 (hereafter "No." after a document name indicates a Bank of Japan Archive Reference number corresponding to a folder with documents in the Archives).

introduction of consumption tax in April 1989,¹⁰ the Bank described these policy actions

¹⁰ The Research and Statistics Department of the Bank was cautious about using price statistics to assess developments in prices in this period because it became difficult to capture the actual price trend due to the introduction of the consumption tax and the abolition of various commodity taxes.

The *Quarterly Economic Outlook* (Spring 1989), which was published on April 28, 1989, noted as follows: "Domestic wholesale prices for early April increased by 1.7 percent compared with late March (2.1 percent on a year-on-year basis) and consumer prices (in Tokyo, excluding fresh food) for April increased by 1.5 percent month on month (2.8 percent on a year-on-year basis), following the introduction of the consumption tax." However, it did not mention how much of those increases was attributable to the impact of the consumption tax (Research and Statistics Department, BOJ [1989a], p. 6). When asked at a media briefing held at the time of the release of the report "whether the impact of the tax system reform on consumer prices could be considered to be 1.2 percent," Director Akira Nambara of the Research and Statistics Department replied, "The figure 1.2 percent is a theoretical figure calculated by the Economic Planning Agency (EPA), so I assume that we should look at it with a certain margin of error" ("Document for a Media Briefing on the *Quarterly Economic Outlook* [Spring 1989], Price Statistics Division, Research and Statistics Department, May 1, 1989," BOJ Archives "Documents for Media Briefings [Part 9] from April to June 1989," No. 27915). In addition, at a media briefing held on April 24 in relation to wholesale prices, Mr. Shigeru Hikuma, Head of Price Statistics Division, Research and Statistics Department, stated as follows with respect to the impact of the tax system reform, including the introduction of the consumption tax, on wholesale prices: "It is impossible to accurately identify the impact or express it as a precise numerical value because (1) prices covered by the wholesale price survey are sales prices set by primary wholesalers and are different from ex-factory prices, which are subject to the consumption tax, and (2) it is difficult to specify the impact of other taxes that have been abolished or revised at this time, such as commodity and liquor taxes" ("Document for a Media Briefing on Wholesale Prices [Early April], Price Statistics Division, Research and Statistics Department, April 24, 1989, BOJ Archives "Documents for Media Briefings [Part 9] from April to June 1989," No. 27915). Subsequently, the summer and autumn 1989 issues of the *Quarterly Economic Outlook* noted, "Although the price levels rose in April in terms of both wholesale and consumer prices following the introduction of the consumption tax, assessment will be conducted conceptually excluding the impact of the tax." However, the reports did not quantitatively indicate the scale of the impact (Research and Statistics Department, BOJ [1989b], p. 7, and Research and Statistics Department, BOJ [1989c], p. 7).

At that time, the Research and Statistics Department bore in mind the risk that, as a result of the shift to a service economy, the function of wholesale prices as a barometer of economic activity to which importance should be attached in the conduct of monetary policy might be declining ("Issues Facing Japan's Economy, Document for General Managers' Meeting of the Bank of Japan's Branches on January 19, 1989," Research and Statistics Department, BOJ Archives "Special Report: Documents for General Managers' Meetings of the Bank of Japan's Branches 1/2," No. 28822). Based on the recognition of this risk, the Bank developed the Services Producer Price Index (SPPI), which complements the wholesale price index, and started to release the SPPI in 1991 (Research and Statistics Department, BOJ [1991b], "Details of the Corporate Service Price Index and Its Recent Trend Since 1985, Document Distributed at a Media Briefing, January 9, 1991," BOJ

as "preemptive measures" in the sense that "inflationary expectations should be contained in advance to continue to ensure price stability."¹¹

As for window guidance, since spring 1981, the Bank had maintained the basic stance of respecting individual banks' lending plans. However, when the Bank started monetary tightening in May 1989, the Bank changed the existing stance and enhanced window guidance through measures such as making restrictive adjustments to the planned loan amounts of individual financial institutions based on the assessment that "it was necessary to encourage the growth rate of bank loans to decline at a faster pace" in order to curb inflationary pressure because "the level of overall liquidity accumulated thus far during the long period of monetary easing remained fairly high in relation to economic activity."¹²

On the Bank's rate hike in December 1989, a news article reported a possible rate hike before the official release, and other articles reported that Minister of Finance Ryutaro Hashimoto "said that the rate hike would be called off." Director Tatsuya Tamura of the Policy Planning Department of the Bank issued a statement saying that "the news reports stating that the Bank had already decided to raise the rate are not factual."¹³ Nevertheless,

Archives "Documents for Media Briefings [Part 17] from January to February 1991," No. 27923).

¹¹ "Raising of the Official Discount Rate," a private note by the Director of the Policy Planning Department, October 11, 1989, BOJ Archives "Private Notes by Directors from 1987 to 1990," No. 40050. At the opening speech of an international conference titled "The Role of Monetary Policy under Low Inflation: Deflationary Shocks and Policy Responses," which was held in July 2000 by the Institute for Monetary and Economic Studies (IMES), Governor Masaru Hayami pointed out that the Bank was responsible for its monetary policy regarding the generation and expansion of the bubble economy, in that the Bank let expectations for the perpetuation of low interest rates take hold by maintaining low interest rates for a relatively long period even after summer 1988, when the economic recovery became clear. Governor Hayami stated as follows: "This suggests that a central bank should aim at sustainable price stability necessary for supporting economic growth over the medium to long term, not over a temporary period"; and "therefore, even if the statistically observed inflation rate is stable, it is necessary to secure sustainable price stability by swiftly adjusting interest rates when it can be judged that the risk of sustainable price stability being undermined is increasing. Regrettably, according to this standard, it is difficult to say that price stability has been sufficiently secured in Japan's economy since the bubble economy." His remarks indicated the view that ultimately the Bank lagged behind in shifting to monetary tightening (Hayami [2000b]).

¹² "Lending Plans of City Banks, Long-Term Credit Banks, and *Shinkin* Banks, for the July-September Quarter of 1989," a private note by the Director of the Credit and Market Management Department, June 29, 1989, BOJ Archives "Private Notes by Directors," No. 10610.

¹³ "On the News Reports of the Official Discount Rate," a private note by the Director of the Policy Planning Department, December 19, 1989, BOJ Archives "Private Notes by Directors from 1987 to

the Bank raised the official discount rate six days after the first news article was published.

After the turn of 1990, economic activity remained firm due to high growth in business fixed investment and the expansion of private consumption, mainly due to a favorable employment and income environment (Chart 1). As the land price rise continued in 1990 (Chart 6), upward pressure on prices began to grow, mainly due to the accelerated growth rate of money stock (Chart 5) caused by front-loaded funding reflecting heightened expectations for higher interest rates. From late February, market interest rates rose, factoring in a subsequent hike in the official discount rate. On the other hand, turmoil spread through financial markets, as exemplified by a sharp drop in stock prices on February 26. In this situation, market participants strongly called for the Bank to "give a hint to the market that there will be no more rate hikes."¹⁴

Under these economic and financial conditions, in March 1990, the Bank raised the official discount rate for the fourth time (from 4.25 percent to 5.25 percent) as "the final preemptive measure to forestall price increases in advance." The margin of the rate hike was 1 percentage point.¹⁵ As for window guidance, the Bank tried to strengthen the restraint on bank loans, especially those provided by regional banks and regional banks II that had been increasing their loan provision, while maintaining the same degree of restraint on loans provided by, for example, city banks. The lending stance of regional banks and regional banks II was becoming rather aggressive, reflecting the spread of a rise in land prices from the Tokyo and Chubu/Kinki metropolitan areas to across the country. In this situation, at end-March 1990, the MOF imposed restriction on the amount of overall real estate-related loans and also required banks to report their current status of lending for the real estate industry, the construction industry, and nonbanks.

After the rate hike in March 1990, the Bank basically considered the rise in interest rates and a drop in stock prices observed after the turn of 1990 to be a "contraction of the bubble economy," owing to "the deeper penetration of the lagged effect of the rate hikes conducted thus far." The Bank therefore judged that "the top-priority challenge was

1990," No. 40050.

¹⁴ "Raising of the Official Discount Rate," a private note by the Director of the Policy Planning Department, March 20, 1990, BOJ Archives "Private Notes by Directors from 1987 to 1990," No. 40050.

¹⁵ "Raising of the Official Discount Rate," a private note by the Director of the Policy Planning Department, March 20, 1990, BOJ Archives "Private Notes by Directors from 1987 to 1990," No. 40050.

still prevention of inflation" as "entrepreneurship remained active and economic dynamism continued to be intact." At the same time, the Bank also started to pay attention at this point to downside risks to the economic outlook that "closer attention should be paid to whether economic activity could worsen sharply in the face of rapid changes in financial conditions."¹⁶

In response to these circumstances, from April to May 1990, the Bank started to deliberate on its function as the lender of last resort (LLR) and measures to deal with financial institutions facing problems, from the viewpoint of reviewing the Bank's credit provision policy.¹⁷ As a result of the deliberations, the Bank judged as follows: "The most important challenge for the Bank and other relevant parties used to be preventing financial institutions from failing, regardless of the scale or specifics of their business operations; in a situation where such idea had been supported by the general public, it had been appropriate to use the Bank of Japan loans as leverage to support financial institutions' liquidity and profits when addressing problems facing financial institutions in an indiscernible manner before the failure of financial institutions, or in other words, the ensuing use of the deposit insurance system." However, the Bank assessed that "now that the Bank has basically taken a step toward promoting financial deregulation and globalization, as well as strengthening the principle of self-responsibility, the conventional approach is not always effective." As for the points that needed to be addressed over the medium to long term, the Bank raised "(1) the explicit development of a scheme for special

¹⁶ "Governor's Opening Speech at the General Managers' Meeting of the Bank of Japan's Branches on April 24, 1990," BOJ Archives "General Managers' Meetings (including Deputy General Managers' Meetings) of the Bank of Japan's Branches from April 23, 1990, to December 1991," No. 41807. In this speech, the Governor referred to developments in land prices as follows: "If a partial repercussion of asset prices spilled over to land prices, then a further spread of detrimental impact would be inevitable." On May 8, the Research and Statistics Department released a paper titled "Background to and Impact of a Rise in Land Prices in Japan in Recent Years" (Research and Statistics Department, BOJ [1990]), which summarized the macroeconomic and financial impact of developments in land prices. ("Document for a Media Briefing on the *Bank of Japan Monthly Bulletin*, April issue, 'Research,'" BOJ Archives "Documents for Media Briefings [Part 13] from April to June 1990," No. 27919).

¹⁷ "The Bank of Japan's Function as the Lender of Last Resort -- From the Viewpoint of Reviewing the Bank's Credit Policy, Policy Planning Department, April 1990" and "Measures to Deal with Financial Institutions Facing Problems -- Points to Be Considered, Policy Planning Department, May 1990," BOJ Archives "Reference Materials for Policy Planning Affairs (June 1990)," No. 28108.

bailout loans by the Bank based on the consensus not only among the MOF and private financial institutions but also from the general public and (2) drastic revision of the deposit insurance system to enhance its feasibility." At a press conference in November 1990, Governor Yasushi Mieno stated that the Bank was exploring the possibility of taking new measures and made the following comments: "Mergers intended to bail out financial institutions through absorption may occur in the future"; and "the Bank is conducting research, led by the Financial and Payment System Department, on what measures it could take in order to make the safety net, including the settlement system, a more satisfactory one."¹⁸

B. Further Monetary Tightening and Continuation of Tight Monetary Policy (Summer 1990 through around May 1991)

1. The Gulf Crisis and economic conditions at home and abroad

Following the onset of the Gulf Crisis in August 1990, crude oil prices showed sharp volatile movements; they rose from 18.6 U.S. dollars per barrel in July to 35.9 dollars in October, and fell back to 19.9 dollars in March 1991 (Chart 2). During the Gulf Crisis, the United States, which had been in a mature stage of an economic expansion, was hit by a severe recession through summer 1991. In contrast, Germany maintained an economic expansion led by the impact of the German Currency Union in July 1990 (Chart 7). Amid the growing uncertainty about the global economic situation, the majority view in Japan was that Japan's economy was on an expansionary trend led mainly by domestic demand

¹⁸ "Summary of the Governor's Press Conference on November 14, 1990," BOJ Archives "Summary of the Governor's Press Conferences (1990)," No. 28015.

In order to streamline and facilitate its operations in response to changes in economic and financial conditions at home and abroad, in May 1990, the Bank implemented a large-scale reorganization that transformed a structure comprised of 18 internal units, including a research institution, to one comprised of 16 units, including a research institution. As part of the reorganization, the Financial and Payment System Department was established. This department was created by integrating part of business operations of the Policy Planning Department and the Bank Supervision Department, so as to plan and formulate policy measures necessary for maintaining and fostering a safe and sound financial system, and was in charge of conducting research and deliberations related to the assessment of individual financial institutions' activity and measures for ensuring the efficiency and stability of the payment and settlement systems. As a result, the Policy Planning Department was put in charge of monetary policy planning. See "Reorganization of the Bank of Japan, May 1, 1990," BOJ Archives "Documents for Media Briefings (Part 13) from April to June 1990," No. 27919.

from summer through autumn 1990.

On Japan's economic conditions, the Bank also recognized that "economic activity is very strong, the supply and demand conditions for products and labor have tightened further, and wages are rising prominently." On the other hand, it recognized that "since the slack in monetary conditions has not fully been diminished as shown, for example, by the fact that growth in money supply is still relatively high, the Bank should immediately address the situation in view of preventing inflation."¹⁹ Under these circumstances, the Gulf Crisis was recognized as an additional inflationary shock because its nature was similar to the earlier two oil crises, albeit on a smaller scale. In light of the experiences of the earlier two oil crises, the Bank assessed that "inflation in import prices and a decline in real economic growth are unavoidable" as the primary effect of a rise in crude oil prices, and that the issue was "how to prevent inflation in domestic prices caused as the secondary effect." The Bank judged that "preventing inflation in domestic prices through a swift policy action" was the best option.²⁰

2. Monetary tightening and its continuation after the onset of the Gulf Crisis

Based on the aforementioned judgment, the Bank decided on August 30, 1990, to raise the official discount rate for the fifth time from 5.25 percent to 6.0 percent. On this occasion, the Bank internally recognized this rate hike as an "action intended to adjust aggregate demand, going beyond the earlier raises that were implemented as preemptive measures," and particularly focused on containing inflationary pressure by weakening economic growth with monetary tightening.²¹ Regarding window guidance, the Bank requested private banks to "considerably restrain loan plans in accordance with the tightened monetary policy stance." Bearing in mind the possibility of abolishing window guidance in the future, the Bank also strongly encouraged these banks to "establish a framework to strengthen the financial base proactively and drastically" as it considered that ensuring a

¹⁹ "Raising of the Official Discount Rate," a private note by the Director of the Policy Planning Department, August 30, 1990, BOJ Archives "Private Notes by Directors from 1987 to 1990," No. 40050.

²⁰ "Governor's Opening Speech at the General Managers' Meeting of the Bank of Japan's Branches on October 23, 1990," BOJ Archives "General Managers' Meetings (including Deputy General Managers' Meetings) of the Bank of Japan's Branches from April 23, 1990, to December 1991," No. 41807.

²¹ "Raising of the Official Discount Rate," a private note by the Director of the Policy Planning Department, August 30, 1990, BOJ Archives "Private Notes by Directors from 1987 to 1990," No. 40050.

"stronger capital base and higher profitability" was an "urgent necessity" for these banks.²²

The official discount rate was kept unchanged at 6.0 percent through June 1991. This decision was made based on the following assessment: "Although the economy has started decelerating, overall economic activity is still at a fairly high level"; "market conditions in demand and supply, which are the major key to future developments in prices, have remained tight"; "in the current situation, the Bank should continue with its efforts to stabilize land prices instead of worrying about a possible plunge in these prices"; the Bank regarded it essential to "ensure price stability by maintaining stability in inflationary expectations"; and the Bank judged that it was necessary to "pursue prudent policy management with price stability as its prime objective, while keeping a close eye on how the effects of interest rate increases conducted thus far are permeating through the economy."²³

The Bank maintained the monetary tightening until mid-1991 based on the thinking that normalization of the bubble economy would lead to a sound development of Japan's economy. In July 1991, the Bank changed its stance to monetary easing, but the subsequent balance-sheet adjustments continued for more than 10 years from the 1990s to the early 2000s. With the benefit of hindsight, the Bank's assessment of the impact of financial imbalances on overall economic activity in the medium to long term -- as represented by large fluctuations in asset prices and money supply -- and the resultant balance-sheet adjustments was not necessarily adequate. The Bank later chose to conduct monetary policy under the framework in which it gave consideration to financial imbalances when seeking to achieve price stability in the medium to long term, based on the lesson drawn from the experience during this period when the conduct of monetary policy was not sufficient.²⁴

²² "Lending Plans of City Banks, Long-Term Credit Banks, and Trust Banks for the October-December Quarter of 1990," Credit and Market Management Department, September 27, 1990, BOJ Archives "Private Notes by Directors and Deputy Directors," No. 28326.

²³ "Governor's Opening Speech at the General Managers' Meeting of the Bank of Japan's Branches on April 2, 1991," BOJ Archives "General Managers' Meetings (including Deputy General Managers' Meetings) of the Bank of Japan's Branches from April 23, 1990, to December 1991," No. 41807, "Governor's Opening Speech at the General Managers' Meeting of the Bank of Japan's Branches on October 23, 1990," BOJ Archives "General Managers' Meetings (including Deputy General Managers' Meetings) of the Bank of Japan's Branches from April 23, 1990, to December 1991," No. 41807, and Research and Statistics Department, BOJ (1991a).

²⁴ Okina, Shirakawa, and Shiratsuka (2000), pp. 315-319. The relationship between asset price fluctuations and the monetary policy conduct was also discussed at the meeting of the Study Group on Monetary and Economic Issues held with the theme "Fluctuations in Asset Prices and Japan's

III. Shift to Monetary Easing and Protracted Economic Downturn (Summer 1991 through the End of 1993)

A. Shift to Monetary Easing

1. Global economic environment and economic conditions in major countries

The revolutions of 1989 in Eastern and Middle Europe and advances in *perestroika* and *glasnost* policies in the Soviet Union -- which had started in the second half of the 1980s - led to the collapse of socialist governments in Eastern and Middle Europe, the dissolution of the Soviet Union, the fall of the Berlin Wall, and the reunification of East and West Germany. As a result of the revolutions of 1989 and the dissolution of the Soviet Union, the economic reconstruction of the countries concerned immediately emerged as the most pressing challenge. Therefore, the International Monetary Fund (IMF) and the G5 countries started to provide support to Russia and countries in Eastern and Middle Europe, with the market-oriented reform as their imperative. In addition, the end of the Cold War directly induced a change in the United States' global strategy, and brought about the first Democratic administration in 12 years in the United States as a result of the presidential election in 1992. The William J. Clinton administration tried to revive the U.S. economy by shifting the focus of the global strategy from political issues to economic issues. Such move was exemplified by the tough stance of the United States in the Japan-U.S. Framework for a New Economic Partnership and the Japan-U.S. Financial Negotiations, as well as the revival of the Super 301 provision of the Omnibus Trade and Competitiveness Act of 1988 (Super 301).

At that time, the European integration made significant progress as well. The Commission of the European Communities advocated the goal of achieving the integration of the European Community (EC) by the end of 1992, serving as the driving force for promoting the integration of European markets from the late 1980s through the mid-1990s, despite some setbacks. As the market integration progressed, new challenges emerged, namely, realizing a single currency and political union.

Regarding monetary union, the "Report on Economic and Monetary Union in the European Community" (the so-called Delors Report) was released in April 1989. This report presented a three-stage plan for establishing the Economic and Monetary Union (EMU). Accordingly, the Maastricht Treaty was put into effect in December 1991, and the EC

Economy" by the IMES on November 30, 1989 (IMES, BOJ [1990], pp. 1-8).

member countries, except for the United Kingdom and Denmark, assumed the obligation for the realization of EMU under the treaty. However, the road to realizing the union was not very smooth. As a result of speculative capital transactions, a series of currency crises occurred in Europe in September 1992 and July-August 1993. Italy and the United Kingdom withdrew from the European Exchange Rate Mechanism (ERM), while Finland, Sweden, and Norway, which were hit by the Nordic financial crisis, abandoned their currencies' peg to the European Currency Unit (ECU). In this situation, Germany played a decisive role in resolving those currency crises. The turmoil was finally contained, due to the fact that the Deutsche Bundesbank provided loans to the member countries of EC and conducted currency interventions, and to the subsequent widening of the ERM range of plus or minus 15 percent.

Meanwhile, Asian economies also expanded steadily. Following the high growth of NIEs, the ASEAN countries stood in the vanguard of high growth. In the 1990s, they were joined by China, which was accelerating its shift to a market economy after Chinese leader Deng Xiaoping advocated economic reform in his speeches during his tour of southern China, and by Vietnam, which was promoting the Doi Moi reform policy. Eastern Asia then became the largest area with high growth, as it gained prominence as a global production site. In contrast, Japan entered the "lost decade," following the bursting of the bubble economy in the second half of the 1980s. The accumulation of NPLs due to persistent declines in asset prices and their disposal weighed heavily on Japan's economy, and this led to a financial system crisis in the second half of the 1990s.

Turning to the economic conditions in major countries in the first half of the 1990s under such global economic environment, the 24 member countries of the Organisation for Economic Co-operation and Development (OECD) recorded an average real GDP growth of 3.9 percent in 1989, 3.2 percent in 1990, and 1.5 percent in 1991, falling short of the 4.6 percent growth registered in 1988 for three consecutive years.²⁵ In 1992, the real GDP growth rate finally recovered to 2.3 percent, but in 1993, it slowed again to 1.5 percent. In 1994, economic activity in the member countries clearly turned upward, with the real GDP growth rate rising to 3.0 percent from 1.5 percent in the previous year. However, the upturn was not universal across advanced countries. Among the G7 countries, economic conditions recovered moderately in the United States, Canada, and the United Kingdom from 1992 onward, but remained stagnant in Japan, Germany, France, and

²⁵ IMF, *World Economic Outlook Database*, October 2016.

Italy. In 1994, the U.S. economy continued to expand despite signs of a slowdown observed in part, and European economies resumed their growth as they showed signs of a recovery on the whole (Chart 7).

Turning to real GDP growth for G5 countries by country in more details, the growth rate for the United States was 4.2 percent in 1988, 1.9 percent in 1990, 3.6 percent in 1992, and 4.0 percent in 1994. In other G5 countries, the rates over the same period were as follows: for the United Kingdom, 5.8 percent, 0.7 percent, minus 0.4 percent, and 3.9 percent; for France, 4.7 percent, 2.9 percent, 1.6 percent, and 2.3 percent; for Germany, 3.7 percent, 5.3 percent, 1.9 percent, and 2.5 percent; and for Japan, 7.1 percent, 5.6 percent, 0.8 percent, and 0.9 percent. As is clear from these figures, the economic stagnation in Japan was conspicuous from the 1990s.

2. Economic conditions in Japan

Amid the aforementioned developments in the global economy, the deceleration in Japan's economy rapidly gained speed. After the turn of fiscal 1991, signs of economic adjustments became clearer toward the fiscal year-end, with the emergence of inventory adjustments amid the slowdown in final demand (Chart 1). From 1992, industrial production declined substantially, reflecting full-scale inventory adjustments. Moreover, the economic deceleration was aggravated by the enforcement in January 1992 of the land value tax, which was established in May 1991 with the aim of curbing a surge in land prices due to excessively speculative land transactions. On the financial front, both short- and long-term market interest rates declined (Chart 4), and growth in money stock generally showed a downtrend (Chart 5). Under these circumstances, on July 1, 1991, the Bank lowered the official discount rate by 0.5 percentage point for the first time in four and a half years, and implemented two additional reductions of 0.5 percentage point before the end of the year, on November 14 and December 30. These successive reductions were implemented against the following background: efforts to accelerate financial deregulation advanced, as exemplified by the progress in the deregulation of interest rates and the submission to the Diet of the bill for the Act on Preparation, etc. of Related Acts for Reform of Finance System and Security Exchange System; meanwhile, there were incidents that could undermine confidence in Japan's overall financial system, including a series of financial misconduct that followed an accumulation of financial institutions' impaired assets due to a decline in asset prices.²⁶

²⁶ Research and Statistics Department, BOJ (1992), pp. 1-3.

3. Reduction of the official discount rate and abolition of window guidance (summer through winter 1991)

a. Abolition of window guidance

In June 1991, the Bank decided to abolish window guidance, a practice that had been conducted for a long period of time, and fully abolished it in the July-September quarter of 1991. The Bank stated the following points as factors that led to this decision.²⁷ First, due to the progress in financial deregulation and severe business conditions at financial institutions, a herd instinct among financial institutions in terms of the amount of loan extension weakened, and managerial decisions made based on their respective circumstances came to be sufficiently reflected in their lending activity. As a result, the functioning of interest rates operated more effectively in the long run. Second, in light of the recent materialization of credit risk, financial institutions had changed their easy lending attitudes toward individual loan provision and began to take a more prudent lending stance. And third, the growth in financial institutions' loans was expected to be moderate even if financial institutions were allowed to formulate loan extension plans without any restrictions, given the constraint imposed by the Basel standards as well as the effects of the interest rate policy conducted thus far that had been steadily spreading through the economy.

The Bank provided the following additional explanation: "Needless to say, this policy change is not intended to promote monetary easing, and in fact, the Bank believes that the recent tightness in the loan market will be maintained." In response to a question asking whether the Bank would not comment on a financial institution's loan extension plan even if it was overly ambitious compared with other financial institutions' plans, the Bank stated as follows: "While the Bank does not make comments on individual loan plans, it intends to accurately grasp financial developments by closely monitoring credit extension on an *ex-post* basis." The Bank also stated, "Although the Bank does not conduct moral suasion to suppress lending, it will continue to devote sufficient efforts to give daily routine guidance in a broad sense to individual financial institutions." However, while following the aforementioned policy, the Bank decided to present guidelines, noting that for major city banks, "it would perform the role of an intermediary as well as a coordinator for the

²⁷ "Abolition of Window Guidance," a private note by the Director of the Credit and Market Management Department, June 27, 1991, BOJ Archives "Explanatory Documents (Others [Part 1])," No. 40318.

formulation of loan plans of individual banks by providing internal guidance" for the time being as a transitional measure, although it would not provide restrictive guidance.²⁸

Upon the abolition of window guidance, the Director of the Credit and Market Management Department indicated the following policy regarding the future scheme for providing guidance for financial institutions, at a liaison meeting of the Bank's Head Office and branches in May 1991.²⁹ First, the Director pointed to a rapid slowdown in growth of bank loans and money supply as well as a surge in the amount of NPLs as "two extremely important changes in the environment surrounding the Bank," and noted that, amid these changes, the Bank's guidance for financial institutions would transform as follows: "First, the mission of window guidance in terms of seeking policy cooperation for constraining an increase in money supply is coming to an end. . . . And second, while the Bank will continue with its task of monitoring permeation of monetary policy effects as an authority in charge of credit and market management, the principle for providing guidance for financial institutions will be focused on prudential matters." The Director then revealed the main points regarding guidance for financial institutions as follows: "In this situation, the Bank's task will be to pursue two policy objectives that are sometimes contradictory: (1) ensuring that individual financial institutions maintain a strict stance in their management based on market discipline and secure their soundness under the recent environment in which the growth in the amount of loans is slowing while that of impaired assets is increasing rapidly; and (2) leading the economy to a soft landing without giving a significant shock to the financial system during the process of resolving financial imbalances caused by the bubble economy."

b. First reduction of the official discount rate (July 1991)

On July 1, 1991, the Bank lowered the official discount rate from 6.0 percent to 5.5 percent.³⁰ After the rate reduction, Governor Mieno stated at a press conference as

²⁸ "Recent Trend in Financial Institutions' Loans," Credit and Market Management Department, June 1991," BOJ Archives "Explanatory Documents (Others [Part 1])," No. 40318.

²⁹ "Statement at the Liaison Meeting of the Head Office and Branches, Credit and Market Management Department, May 20, 1991," BOJ Archives "Explanatory Documents (Others [Part 1])," No. 40318.

³⁰ Regarding the shift to monetary easing that started with this reduction of the official discount rate, there was criticism that the pace of monetary easing was too slow and failed to prevent an "overkill" of the economy, or that the magnitude of easing was too small. In this respect, Shiratsuka, Taguchi, and Mori (2000), an interim summary by the staff of the IMES, offered the assessment that "the monetary easing that was implemented in the aftermath of the bursting of the bubble

follows:³¹ "The Bank reduced the official discount rate for the purpose of adjusting the interest rate levels -- to be more specific, slightly lowering the interest rate levels -- in light of the fact that short- and long-term interest rates have fallen slightly compared with their peak levels, as a slight upturn has been observed in developments surrounding prices. Through this rate reduction, 'the Bank aims to maintain growth led by domestic demand over the long term by focusing on price stability,' as is stated in today's statement." Governor Mieno also stated, "From the viewpoint of international economic policy coordination, as is released in the statements at the G7 meetings in April and late June, there is the basic understanding that ultimately, the achievement of sustainable growth with price stability by individual countries is essential for the development of the global economy. Furthermore, in order to achieve such growth, it is necessary for individual countries to implement appropriate measures suited to their respective economic conditions, in a situation where economic conditions began to vary somewhat by country, as was clearly indicated in the latest statement for the G7 meeting. The Bank's latest reduction of the official discount rate is also a measure intended for the recent favorable economic conditions to take hold in Japan, as I mentioned earlier. In that sense, I believe that this measure is in line with the international economic policy cooperation." In response to a question by a reporter "whether simply adjusting market interest rates, for example, would have been sufficient, considering that the degree of reduction was very small, because the Bank had been working on the reform of the short-term money market since 1988 and city banks were providing market interest rate-linked loans," Governor Mieno stated as follows: "As you pointed out, I assume that it is possible to make a policy response by only adjusting market interest rates, but in some cases, it is more appropriate to clarify the Bank's intention through changing the official discount rate. This time, the Bank judged it appropriate to clearly announce the Bank's stance by changing the official discount rate."

economy should be assessed as broadly adequate as a response to the economic setback in a normal stock adjustment cycle." However, with the benefit of hindsight, the negative effects of the bursting of the bubble economy might have been underestimated, as the degree of monetary easing that was implemented after policy decisions made based on real-time information corresponded to the economic setback in an ordinary stock adjustment phase (Itoh, Koike, and Shizume [2015], p. 133).

³¹ "Summary of the Press Conference by the Chairman of the Policy Board on July 1, 1991," BOJ Archives "Summary of the Governor's Press Conferences," No. 39268. The Bank of Japan Act stipulates that the Chairman shall be elected by Policy Board members from among themselves, but between 1989 and 2000, the Governor served as the Chairman.

c. Decline in market interest rates

Against the background of the reduction of the official discount rate, market interest rates declined on the whole (Chart 4). At the press conference held on September 25, 1991, Governor Mieno, citing the short-term prime lending rates as an example, stated, "It seems that some people do not understand such market movements well. Specifically, before the current market infrastructure was established, deposit interest rates moved only when the official discount rate was changed, resulting in changes in private financial institutions' lending rates. However, over the past several years, market movements have been unconstrained in various respects, with market interest rates assuming an intermediate role between the official discount rate and private lending rates. Therefore, as I mentioned earlier, I believe that it is quite natural that both short- and long-term prime lending rates have been lowered, reflecting movements in market interest rates after the reduction of the official discount rate on July 1."³²

In the meantime, the Bank continued to call for the need to revise the advantageous characteristics of fixed-amount postal savings on various occasions, including meetings of the Financial System Research Council, in preparation for smooth implementation of full deregulation of market interest rates. Private financial institutions had also been making a similar appeal. Nevertheless, the upper limit on the amount of postal savings per account, which was 3 million yen through March 1988, was successively raised in April 1988, January 1990, and November 1991 -- the limit being raised to 10 million yen in the end. This rise in the upper limit combined with a stock price fallback triggered a massive shift of funds from bank deposits to fixed-amount postal savings. Confronted with this situation, the MOF and the Bank repeatedly held informal negotiations with the Ministry of Posts and Telecommunications on the issue of the revision of the advantageous characteristics of fixed-amount postal savings, but this issue was not settled. Therefore, the MOF and the Bank decided to seek to exclude postal savings from the interest rate control, aiming to link interest rates on fixed-amount postal savings to market interest rates as an objective to be achieved in the immediate future.³³

³² "Summary of the Governor's Press Conference on September 25, 1991," BOJ Archives "Summary of the Governor's Press Conferences," No. 39268.

³³ "Developments concerning Fixed-Amount Postal Savings," a private note by the Director of the Policy Planning Department, December 27, 1991, BOJ Archives "Private Notes by Directors from 1991 to 1993," No. 39500. This objective was achieved later, when an agreement was reached between the MOF and the Ministry of Posts and Telecommunications in December 1992 that interest

d. Reduction of the reserve requirement ratio

The Bank lowered the reserve requirement ratio in October 1991 for the first time in 10 years. As for the basic thinking behind this reduction, the Bank noted, "It aimed to mitigate financial institutions' burden of the reserve requirement, thereby developing an environment that enabled the Bank to manage smoother money market operations" and "If this measure was taken as an attempt to directly promote monetary easing, that is different from the Bank's true intention given its recognition of current economic and price developments in Japan." In addition, the Bank argued that the role of the reserve requirement had changed, stating as follows: "As is indicated by the fact that the recent change in the reserve requirement ratio was the first change in 10 years, it seems difficult to deny that the Bank is impelled to make slight changes to the significance of the reserve requirement as a policy tool, in light of the ongoing major changes in the policy environment such as the progress in financial deregulation and globalization."³⁴

At a press conference, Governor Mieno explained as follows: "Concerning money market operations, the Bank has continued to regard it important that appropriate market rates suited to actual economic conditions be formed. In light of the fact that the burden of the reserve requirement is imposing some constraints on smooth implementation of money market operations, the Bank judged that it was necessary to mitigate the burden to a certain degree by lowering the reserve requirement ratio and thereby create an environment in which the Bank could continue to manage smooth money market operations."³⁵

e. Second reduction of the official discount rate (November 1991)

On November 14, 1991, the Bank lowered the official discount rate from 5.5 percent to 5.0 percent. The reduction was based on the Bank's judgment that "in a situation where short- and long-term market interest rates are falling further, it is appropriate, at this stage, to

rates on postal savings should be linked to deposit interest rates at private financial institutions in principle.

³⁴ "Reduction of the Reserve Requirement Ratio," a private note by the Director of the Policy Planning Department, October 1, 1991, BOJ Archives, "Private Notes by Directors from 1991 to 1993," No. 39500.

³⁵ "Summary of the Governor's Press Conference on October 9, 1991," BOJ Archives "Governor's Press Conferences," No. 39268. In addition, Director Kunio Kojima of the Policy Planning Department stated on October 1, 1991, that the magnitude of the latest reduction was around 40 percent, and the amount of funds to be released in the money market as a result of this reduction was estimated to be approximately 2 trillion yen (the amount of the remaining reserves estimated to be 3 trillion yen)" (the evening edition of *The Nikkei* on October 1, 1991).

lower the official discount rate further, as part of the series of monetary easing measures the Bank had implemented thus far," while monitoring overall economic conditions since July.³⁶ Other grounds for the reduction included the following: "Over the past few months or so, the Bank has been conducting monetary policy that aimed at adjusting the overall level of interest rates flexibly by immediately responding to changes in economic activity -- specifically, through promoting a decline in market interest rates -- and the intended effects of such policy conduct have been produced"; and "the Bank considered that it was one of its responsibilities, as a central bank, to clearly respond to market expectations for a decline in interest rates on important occasions." However, as points for future reflection, the Bank stated the following: "The latest reduction of the official discount rate has repeatedly been exposed to incorrect press coverage as the media were overly intent with the timing of a reduction"; and in terms of communication with the media, "it cannot be denied that both the Bank and the MOF were responsible for some mishandling." The Bank then noted as follows: "Taking this opportunity, the Bank would like to emphasize that, from the very beginning, the Bank has never thought of lowering the official discount rate in 'the week of November 5,' contrary to reports by newspapers and other media. The Bank decided to lower the rate today because it was not appropriate to decide on the rate before confirming the October figures for financial institutions' loans and the wholesale price index (WPI), as these were more or less expected to factor in the sharp decline in short- and long-term prime lending rates. The issue associated with regulated deposit interest rates, which has been widely discussed among the public, was also of concern. While this issue itself did not serve as the major reason for the reduction, the Bank judged that there were sufficient reasons for deciding on the reduction at this time." With these remarks, the Bank emphasized the appropriateness of the timing of the reduction.³⁷

f. Third reduction of the official discount rate (December 1991)

For the third time in 1991, the Bank lowered the official discount rate on December 30 from 5.0 percent to 4.5 percent. When the rate reduction was decided, Governor Mieno stated at a press conference as follows: "While comprehensively taking account of

³⁶ "Summary of the Press Conference by the Chairman of the Policy Board on November 14, 1991," BOJ Archives "Summary of the Governor's Press Conferences," No. 39268.

³⁷ "Reduction of the Official Discount Rate," a private note by the Director of the Policy Planning Department, November 14, 1991, BOJ Archives "Private Notes by Directors from 1991 to 1993," No. 39500.

various recent developments in economic activity and financial conditions and bearing in mind the fact that the January-March quarter is the period for which firms formulate their business plans for the next fiscal year, the purpose of the rate reduction this time round (from 5.0 percent to 4.5 percent) is to further facilitate and secure a shift from an economy with excessively high growth to a better-balanced one with price stability, which represents the Bank's current basic stance on monetary policy."³⁸ It is worth noting that the Governor explicitly emphasized such shift at this point.

However, according to a private note by the Director of the Policy Planning Department,³⁹ after the previous reduction of the official discount rate in November, "the Bank was informally finalizing the judgment that it was necessary to implement the next rate reduction sometime around the turn of 1992," and "regarding the specific timing, one idea initially held by the Bank was to implement the rate reduction around the time of the January meeting of General Managers of the Bank's branches, from the viewpoint of taking a little while longer to assess developments in land transactions and land prices after the removal of the restriction imposed on overall real estate-related lending." The note, however, continued to state that "the Bank abruptly decided on the implementation before the turn of 1992 . . . due to recent developments, including (1) the heightened risk that President George H. W. Bush would cite a reduction of the official discount rate as part of his request for Japan to expand domestic demand at the time of his visit to the country and (2) the call from the United States for holding a G7 meeting with the aim of enhancing economic expansions in advanced countries, including Japan. In that sense, some political considerations have played a role." The note stated that the timing of the rate reduction was determined by the combination of internal deliberations and political considerations.

g. Application of the deposit insurance system

In August 1991, the MOF announced the "Measures to Restore Confidence in the Financial System." Regarding the development of a framework to maintain financial system stability, the MOF stated in the announcement that "it will strive to appropriately manage the deposit insurance system in addition to requesting financial institutions to further enhance the mutual aid system." Accordingly, the deposit insurance system was applied for the first time

³⁸ "Summary of the Press Conference by the Chairman of the Policy Board on December 30, 1991," BOJ Archives "Summary of the Governor's Press Conferences," No. 39268.

³⁹ "Reduction of the Official Discount Rate," a private note by the Director of the Policy Planning Department, December 30, 1991, BOJ Archives "Private Notes by Directors from 1991 to 1993," No. 39500.

in resolving the failure of the Toho Sogo Bank in October 1991, and it was decided that the Deposit Insurance Corporation of Japan (DICJ) would provide financial assistance to the Iyo Bank. At that time, resolution schemes were generally implemented in the form of providing financial assistance to a receiving bank designated as an organization that would take over business operations of a failed financial institution. This was an extension of the conventional scheme under which financial institutions with poor performance were bailed out outside the framework of the deposit insurance system.

The Toyo Shinkin Bank, whose issuance of fraudulent certificates of deposits in August 1991 came to light, agreed in April 1992 to a merger, becoming the second case of the application of the deposit insurance system. The failure resolution took the form of transferring its business operations to 18 *shinkin* banks in Osaka Prefecture, followed by a merger with the Sanwa Bank. At a press conference in August 1991, when the incident came to light, Governor Mieno explained, "The Bank judged that, if a bank run were to immediately occur due to a case of misconduct by an individual, it would be appropriate to implement a suitable resolution by keeping in close contact with the MOF and other parties." When asked by a reporter "whether the Bank intends to provide a bailout in the event of a rise in concern over financial system stability as a result of an individual's misconduct," Governor Mieno responded, "The provision will be decided on a case-by-case basis."⁴⁰ On October 6, 1992, at a press conference held after the dissolution of the Toyo Shinkin Bank, a reporter asked, "What does the Bank think of the view that the method of the resolution adopted in the Toyo Shinkin Bank's case on October 1 -- namely, the dissolution and absorption -- may become a precedent for future bailout of failed financial institutions?" In response, Governor Mieno stated, "The failure resolution of small and medium-sized financial institutions may not always take this form. It will merely be one of the options."⁴¹

B. Continuation of Monetary Easing and Worsening of the NPL Problem (Spring 1992)

⁴⁰ "Summary of the Governor's Press Conference on August 21, 1991," BOJ Archives "Summary of the Governor's Press Conferences," No. 39268.

⁴¹ "Summary of the Governor's Press Conference on October 6, 1992," BOJ Archives "Summary of the Governor's Press Conferences," No. 43328.

through Autumn 1993)

1. Progress in the Japan-U.S. Structural Impediments Initiative

From the late 1980s, the forum for international policy coordination shifted from the G5 and G7 to bilateral negotiations.⁴² Specifically, the emphasis shifted from multilateral negotiations realized under the Plaza Accord and the Louvre Accord to bilateral negotiations on structural impediments, such as trade barriers in specific sectors and poor market access for foreign suppliers. At forums such as the Japan-U.S. Working Group on Financial Markets and the Japan-U.S. Framework for a New Economic Partnership, the United States' negotiation stance became tougher, and Super 301 was revived. The follow-up meeting of the Japan-U.S. Working Group on the Yen-Dollar Exchange Rate, which first took place in 1986, was renamed the Japan-U.S. Working Group on Financial Markets in 1989, and the group held a total of four meetings in Washington D.C. and Tokyo from November 1989 through October 1991. Matters of concern for the United States at those meetings were not macroeconomic issues, but concrete issues associated with specific fields, including the deregulation of deposit interest rates, the progress in deregulation pertaining to the short-term markets, recent developments concerning Article 65 of the Securities and Exchange Act, and the access to foreign financial instruments and services, all of which should be recognized as structural policy matters.

In parallel with the Japan-U.S. Working Group on Financial Markets, the Structural Impediments Initiative (SII) and its follow-up meetings were held. On May 25, 1989, the U.S. government designated Japan, together with India and Brazil, as a country subject to Super 301. It also announced a proposal to hold Japan-U.S. negotiations on structural impediments separately from the negotiations concerning Super 301. Following this announcement, the SII commenced. Regarding the SII, the United States proposed to set a goal for correcting external imbalances and to create five baskets covering automobile parts, government procurement, deregulation of financial, insurance, and other services, observance of existing agreements, and Japan-U.S. cooperation. As for the objectives of the Japan-U.S. Framework for a New Economic Partnership, it was proposed that Japan's current account surplus be reduced to 1.0-2.0 percent relative to GDP within three years, benchmarks be set for market access, and that summit meetings be held biannually to discuss macroeconomic policies to review the progress made in the

⁴² Office of Historical Studies, Information Service Department, Policy Research Institute, MOF (2017), pp. 84-93.

past six months.

Negotiations were held over several years, and on July 10, 1993, Prime Minister Kiichi Miyazawa and President Clinton announced the "Joint Statement on the Japan-U.S. Framework for a New Economic Partnership," in which an agreement on a framework for Japan-U.S. negotiations was reached. The joint statement proclaimed that summit meetings would be held biannually. It also clarified the following basic objectives: "Japan will achieve a meaningful decrease in its current account surplus over the medium term"; "it will promote growth led by strong and sustainable domestic demand with determination"; "it will actively pursue the medium-term objective of increasing market access"; and "in this context, Japan will implement measures on the fiscal and monetary fronts as necessary to realize these objectives." Regarding government procurement, it was confirmed that "the Japanese government should aim at expanding its procurement to some extent."

2. Economic conditions in Japan

Turning to economic conditions in Japan, signs of economic adjustments became clear in a greater degree in fiscal 1992 (Chart 1). As for fiscal policy, in addition to the front-loaded implementation of the budget for fiscal 1992 regarding public construction, the government formulated a comprehensive economic stimulus package worth a total of 10.7 trillion yen in August 1992. On the financial side, short- and long-term market interest rates declined sharply and loan interest rates also decreased against the backdrop of the deepening of economic adjustments and the reductions in the official discount rate (Chart 4). By the end of the year, the official discount rate was reduced twice, on April 1 (by 0.75 percentage point from 4.5 percent to 3.75 percent) and on July 27 (by 0.5 percentage point from 3.75 percent to 3.25 percent). Despite these reductions, money stock remained on a downtrend due to the recurrence of developments that were seen during the previous phase of monetary easing, such as asset price declines and a reduction in firms' transactions in which they raised funds while making investment, in addition to a decline in firms' demand for funds associated with a decrease in business fixed investment (Chart 5).

Furthermore, in fiscal 1992, it became a major policy challenge to take the initiative in securing the stability of the financial system, reflecting the failure of a financial institution and other events caused by financial misconduct in the previous year. As a result, the Act on Preparation, etc. of Related Acts for Reform of Finance System and Security Exchange System was enacted. Moreover, there were strong signs of autonomous economic adjustments due to a reversal of a long period of economic expansion, with a sharp decline in asset prices, significant deterioration in corporate profits, and progress in corporate

restructuring. In sum, economic adjustments became prolonged and severe in fiscal 1992, partly because of the direct and indirect effects of the asset price decline in addition to strong downward pressure from capital stock adjustments.⁴³

The economic recession continued through fiscal 1993 (Chart 1). In response, the government formulated in April 1993 -- immediately after the turn of fiscal 1993 -- a comprehensive economic stimulus package (worth a total of 13.2 trillion yen), which included the establishment of infrastructures and the front-loaded implementation of the initial budget for fiscal 1993 regarding public construction. The amount of the front-loaded budget implemented by the fiscal authorities largely exceeded that of the emergency economic stimulus package in 1987, which amounted to 6.0 trillion yen.⁴⁴ However, despite the underpinnings of this public investment, economic activity as a whole remained sluggish due to a significant slowdown in the growth of private consumption, in addition to a decline in business fixed investment, and wholesale prices had been below the previous year's level, while the consumer price index (CPI) had been more or less unchanged (Chart 2). The Bank recognized the reason for the prolonged recession as the following three adjustments that had progressed simultaneously: (1) cyclical capital stock adjustments; (2) balance-sheet adjustments associated with the bursting of the bubble economy;⁴⁵ and (3) increased pressure to adjust the industrial structure, reflecting changes in the global competition environment triggered by the yen's appreciation. As for the second adjustments, the Bank assessed that firms' balance-sheet adjustments accompanied by the asset price decline in the 1990s had constrained the overall spending activity. Regarding the third adjustments, the Bank judged that the adjustments of the industrial structure were inevitable and that it was necessary to reform government regulations, as the mass production technology for medium-high-technology products was being transferred to other regions such as East Asian countries, and production of existing products had actively been shifted overseas, particularly in the automobile and electrical machinery sectors.⁴⁶

The growth in financial institutions' loans had been declining quarter after quarter, mainly for the following three reasons: (1) demand for funds related to investment in

⁴³ Research and Statistics Department, BOJ (1993a), pp. 9-11, and Research and Statistics Department, BOJ (1994), p. 11.

⁴⁴ Komine (2011), pp. 415-423.

⁴⁵ The first clear reference to the balance-sheet adjustments appears in Research and Statistics Department, BOJ (1993b), p. 16.

⁴⁶ Research and Statistics Department, BOJ (1994), pp. 12, and 47-72.

tangible assets became sluggish amid the protracted economic stagnation; (2) firms' financial restructuring proceeded; and (3) firms' risk-taking capacity declined due to the asset price decline (Chart 5). Consequently, the Bank continued its monetary easing stance on the whole in fiscal 1993, and lowered the official discount rate on February 4 (by 0.75 percentage point from 3.25 percent to 2.5 percent) and on September 21 (by 0.75 percentage point from 2.5 percent to 1.75 percent) to the lowest-ever level.

In terms of the external balance of payments, Japan's real trade surplus followed a downtrend from spring 1992 due mainly to the effects of the appreciation of the yen. Nevertheless, the dollar-based surpluses for both trade and current accounts marked the record high due to the J-curve effects arising from the yen's appreciation and to an increase in the receipt of investment returns. As a result, Japan faced increased pressure from the United States to narrow the trade imbalance, and it became an important issue for Japan to deal with the external surplus. The cause of Japan's external surplus could be divided into a cyclical factor and a factor pertaining to the fundamental saving-investment balance. The former, which was attributable to the gap between the growth rates of Japan and other countries, was likely to be resolved. However, the latter would not be resolved in the short term, and the Bank judged it necessary to resolve this by enhancing infrastructures and housing stock in Japan.⁴⁷

3. Toward an unprecedentedly low level of interest rates

a. Fourth reduction of the official discount rate (April 1992)

On April 1, 1992, the Bank lowered the official discount rate from 4.5 percent to 3.75 percent. After the rate reduction, Governor Mieno stated, "Japan's economy has remained solid in some respects recently, as seen in the continued uptrend in employment. However, signs of economic adjustments have become clearer on the whole, as firms have been constraining production more strenuously due to full-fledged inventory adjustments amid the continued slowdown in final demand." He also noted the following points: "Business sentiment has recently started to become more cautious, mainly due to declines in sales and profits"; "as for financial conditions, growth rates in financial institutions' loans and money supply both have stayed relatively low, reflecting extremely sluggish demand for funds amid economic adjustments"; and "today's decision to lower the rate from 4.5 percent to 3.75 percent was based on the recognition that a greater rate reduction at this point after comprehensively taking

⁴⁷ Research and Statistics Department, BOJ (1994), pp. 11-14.

account of economic conditions would further ensure that the effects of monetary easing would permeate through economic activity and further secure the path for Japan's economy to shift to sustainable growth based on price stability."⁴⁸

Meanwhile, the reduction of the official discount rate became a political issue, and various politicians expressed their opinions successively, including Mr. Shin Kanemaru.⁴⁹ Regarding such remarks, in a private note by the Director of the Policy Planning Department, the Director emphasized the need to maintain the Bank's independence as a central bank by stating as follows: "The series of inappropriate remarks by politicians have made it significantly difficult for the Bank to judge the best timing of lowering the official discount rate solely from an economic perspective, while ensuring the Bank's credibility. I assume that those remarks are not a temporary matter as they were made against the backdrop of, for example, concerns that the bursting of the economic bubble may 'go too far,' the political stalemate, and a sense of crisis regarding the election. Fortunately, the government began to regard such obstruction as regrettable, and while trying to restrain inappropriate remarks (although this effort has not necessarily been successful), it has adopted the stance of upholding the Bank's argument that 'the Bank must not allow politicians to presume that the rate can be cut if they make a commotion.'"⁵⁰

b. Fifth reduction of the official discount rate (July 1992)

On July 27, 1992, the Bank decided on the fifth reduction of the official discount rate (from 3.75 percent to 3.25 percent). At a press conference, Governor Mieno stated as follows: "On the financial front, both short- and long-term interest rates have recently been declining further, and lending rates have also been decreasing steadily. Even so, there are some signs showing that the current situation is somewhat different from the past monetary easing

⁴⁸ "Summary of the Press Conference by the Chairman of the Policy Board on April 1, 1992," BOJ Archives "Summary of the Governor's Press Conferences," No. 43328.

⁴⁹ At a general meeting of the Noboru Takeshita faction of the Liberal Democratic Party on February 17, 1992, Mr. Kanemaru, Vice President of the party, stated as follows: "I have been arguing that the official discount rate should be lowered by 0.5 percentage point. The adjustment of the rate is said to be the prerogative of the Bank's Governor, but the Prime Minister can handle anything. He can lower the rate by dismissing the Governor at his will." This comment attracted intense media attention, and the media as well as opposition parties unanimously criticized it as infringement of the Bank's independence.

⁵⁰ "Reduction of the Official Discount Rate," a private note by the Director of the Policy Planning Department, April 1, 1992, BOJ Archives "Private Notes by Directors from 1991 to 1993," No. 39500.

phases. For example, growth rates of financial institutions' lending and money supply have remained relatively low in a situation where demand for funds remained weak mainly because of sluggish asset transactions, in addition to the ongoing economic adjustments. . . . After comprehensively taking account of these circumstances, the Bank decided on today's measure based on the judgment that it was appropriate to further promote the monetary easing effects to permeate through economic activity and better secure the economy's transition to a sustainable growth path with price stability by further reducing the rate."⁵¹

A private note by the Director of the Policy Planning Department⁵² elaborated on that point as follows: "The timing of today's decision was rather complicated (in addition to the election, the summit and the Governor's business trip to the Bank for International Settlements [BIS] had affected the timing somewhat), but the 'structure' of the judgment is simple and straightforward." The note also mentioned the following three points. First, there was an argument that an interest rate reduction should be implemented as a way of bailing out financial institutions, which had been rapidly attracting attention since Chairman Masaru Hayami of the Japan Association of Corporate Executives referred to it. This, however, was completely different from the Bank's thinking. Second, in relation to international economic policy coordination, "it is true that uneasy movements have strengthened somewhat in the global foreign exchange and stock markets since the interest rate hike in Germany on July 17," but that was not an important factor in the Bank's decision today to lower the interest rate. And third, the Bank judged that a rate reduction was necessary at this time in order to further secure the process of transition of Japan's economy to a sustainable growth path with price stability based on its outlook for economic activity.⁵³

c. Sixth reduction of the official discount rate (February 1993)

On February 4, 1993, the Bank lowered the official discount rate from 3.25 percent to 2.5 percent. At a press conference,⁵⁴ Governor Mieno explained the following points: "As business fixed investment, which is a major component of final demand, continues to lose

⁵¹ "Summary of the Press Conference by the Chairman of the Policy Board on July 27, 1992," BOJ Archives "Summary of the Governor's Press Conferences," No. 43328.

⁵² "Reduction of the Official Discount Rate," a private note by the Director of the Policy Planning Department, July 27, 1992, BOJ Archives "Private Notes by Directors from 1991 to 1993," No. 39500.

⁵³ As for the money supply controversy that took place in Japan during 1992-1993, see Appendix 1.

⁵⁴ "Summary of the Press Conference by the Chairman of the Policy Board on February 4, 1993," BOJ Archives "Summary of the Governor's Press Conferences," No. 44682.

momentum and private consumption has also been slowing further, final demand has tended to remain sluggish"; "given this situation, the Bank decided on today's measure based on the judgment that it was appropriate to promote the effects of monetary easing to permeate through economic activity with a further interest rate reduction"; and "while it is true that the official discount rate has matched its record low, the Bank decided on this measure after fully taking account of developments in the asset markets and financial institutions' behavior, as I mentioned earlier. In light of the recent developments in land prices and financial institutions' lending attitudes, I believe that the so-called bubble phenomena, such as land price rises, are very unlikely to heat up immediately again."

On this rate reduction, a private note by the Director of the Policy Planning Department⁵⁵ provided supplementary explanation that "when announcing this policy decision, the Bank focused on how strong the economic recovery would be toward the beginning of the new fiscal year." Various economic indicators released around the turn of 1993 indicated conspicuous weakness in final demand. In addition, although not all reports released around that time were pessimistic, on the whole, they strongly suggested that private final demand remained weak. Therefore, the timing of this rate reduction in early February was a natural consequence of the analysis of these circumstances. As for the Bank's assessment of the coordination between monetary policy and fiscal policy, the note explained that the Bank judged that a rate reduction at that time would not bring about an unbalanced policy mix, given that the government's stance on state finance in fiscal 1992 and 1993 was quite different from the stance adopted in the past when fiscal consolidation was imperative.

d. Guiding market interest rates lower

Moreover, in August 1993, the Bank started to guide market interest rates lower. On September 13, Governor Mieno provided the following explanation about the specifics of this measure: "Regarding economic conditions, there is no concrete evidence at present to assure future recovery in private demand. In that sense, the Bank's assessment is that downside risks to the scenario that the economy will recover in the second half of 1993 are starting to increase. In fact, the Bank has already been dealing with these risks. For example, in money market operations, it has been guiding short-term interest rates lower within a range consistent with the current official discount rate of 2.5 percent as the premise." A

⁵⁵ "Reduction of the Official Discount Rate," a private note by the Director of the Policy Planning Department, February 4, 1993, BOJ Archives "Private Notes by Directors from 1991 to 1993," No. 39500.

reporter asked the following question: "I believe that the Bank has distinguished between 'guide,' a term used when the Bank intends to make a policy change, and 'tolerate,' a term used when it lets interest rates move in line with changes in market sentiment. May I take it that the fact that the Bank used the term 'guide' at this time means that in August, it was already trying to change market sentiment on the assumption of a later policy change?" To this question, Governor Mieno responded as follows: "Ultimately, that is correct. It is not appropriate to choose words based on one's personal preference, but I do not really like the phrase 'guide lower'; "as I have already mentioned earlier, when deposit rates were regulated, it was difficult, or impossible, to change deposit rates without changing the official discount rate. However, with the progress in deregulation of interest rates, a framework has been established under which deposit rates change in ways that reflect movements in market interest rates, even if the official discount rate remains unchanged. In that sense, it is true that the function of promoting a change in deposit rates, which is one of the functions of the official discount rate, has weakened, while the significance of controlling market interest rates has grown all the more"; and "many countries, including the United States and Germany, are fully using the functions of controlling the official discount rate and market interest rates, although the method differs by country. I believe that Japan has finally arrived at that stage."⁵⁶

e. Seventh reduction of the official discount rate (September 1993)

On September 21, 1993, the Bank lowered the official discount rate from 2.5 percent to 1.75 percent. This rate reduction is said to have been taken in response to heightened downside risks to the economy, in other words, a decreased likelihood of the scenario that the economy would recover in the second half of 1993.⁵⁷

It was around end-July that the Bank judged it necessary to lower interest rates further. The first measure implemented for that purpose was guiding market interest rates lower from August, as explained in the previous section. In September, particularly toward late September, "reports speculating about a rate reduction started to run wild in newspapers and other media, and expectations for lower interest rates increased in the market." However, Governor Mieno consistently and strongly instructed the Bank's officers and staff that the

⁵⁶ "Summary of the Governor's Press Conference on September 13, 1993," BOJ Archives "Summary of the Governor's Press Conferences," No. 44682.

⁵⁷ "Reduction of the Official Discount Rate," a private note by the Director of the Policy Planning Department, September 21, 1993, BOJ Archives "Private Notes by Directors from 1991 to 1993," No. 39500.

utmost priority should be to thoroughly examine the outlook for the economy from the second half of 1993 onward and that the Bank should take action in accordance with its assessment of the situation in an unwavering manner. The Bank's final assessment of the situation was that a relatively drastic monetary easing measure was necessary, and the Bank set the margin of the rate reduction at 0.75 percentage point. As a result of the rate reduction, the official discount rate recorded the lowest-ever level.

When the rate reduction was decided, Governor Mieno stated, "The reduction of the official discount rate is the maximum monetary policy measure that can be implemented in light of the present situation. The Bank is confident that the effects of this rate reduction, coupled with the cumulative effects of earlier monetary easing and the effects of the government's emergency economic stimulus package that has recently been announced, will contribute to the economy's transition to a path of sustainable growth with price stability." At the same time, he expressed concern about the negative side effects by stating as follows: "However, now that the Bank has lowered interest rates this far, the Bank cannot totally rule out the risk that unprecedentedly low interest rates may generate some 'side effects' apart from the intended effect of supporting normalization of economic activity, if I may exaggerate a little."⁵⁸

In this respect, a private note by the Director of the Policy Planning Department⁵⁹ emphasized that this rate reduction was an "emergency measure" by stating as follows: "As the Governor and other officers unanimously emphasized, reducing the rate to the range of 1-2 percent is an emergency measure, and this means that, if recovery in economic activity becomes clear or negative side effects arise, the rate must be raised swiftly."⁶⁰

⁵⁸ "Summary of the Press Conference by the Chairman of the Policy Board on September 21, 1993," BOJ Archives "Summary of the Governor's Press Conferences," No. 44682.

⁵⁹ "Reduction of the Official Discount Rate," a private note by the Director of the Policy Planning Department, September 21, 1993, BOJ Archives "Private Notes by Directors from 1991 to 1993," No. 39500.

⁶⁰ Regarding the reductions of the official discount rate from the second half of 1993 onward, Okina and Shiratsuka (2002) pointed out the possibility that the Bank had been reluctant about additional monetary easing. "The pace of the Bank's reduction of interest rates from late 1993 to autumn 1995 was, according to the Taylor-type policy rule, slow when the Bank was about to face a record-low official discount rate of 2.5 percent seen during the period of expansion of the bubble, suggesting the possibility that the Bank was rather reluctant to pursue additional easing" (Okina and Shiratsuka [2002], pp. 99-100). This paper also offered the assessment that a bolder, earlier interest rate reduction would have been desirable. Specifically, it stated, "Based on an observation that the financial system was already substantially damaged in the period after 1993 and the effectiveness

f. Worsening of the NPL problem

In April 1992, the MOF disclosed the amount of NPLs for the first time. However, as the MOF's definition of NPLs was narrow, the disclosure generated various speculations.⁶¹ On August 18, 1992, the MOF announced the "Present Policy for Management of Financial Administration -- Ensuring Financial System Stability and Improving Efficiency," which was based on the thinking that the disposal of NPLs should be implemented by banks on their own responsibility in principle.⁶² Governor Mieno stated at a press conference on August 19 that the "Present Policy for Management of Financial Administration" was consistent with the Bank's thinking that "it should request each financial institution to (1) make efforts to thoroughly manage risks and improve its capital base and (2) secure sound management; at the same time, the Bank, for its part, needs to review various systems and practices related to the management of financial institutions and financial transactions with a view to thoroughly pursuing the principle of financial institutions' self-responsibility, and establish a framework in which financial institutions can conduct sound management." He also said, "The Bank will strongly support the government's earnest efforts" and expressed the view that it was quite possible to ensure the stability of the financial system as a whole.⁶³ Later, confusion arose over the

of monetary easing was limited, what might have been worth trying was a more drastic interest rate reduction before 1993, even though it was adequate in light of the Taylor rule."

⁶¹ When it disclosed the amount of NPLs in April 1992, the MOF defined NPLs as delinquent loans for which interest payment was overdue for six months or more. When it disclosed the amount of NPLs in October 1992, the MOF disclosed for the first time the amount of uncollectible loans that were not covered by collateral or guarantee. In response to the criticism that the MOF's definition of NPLs was too narrow, the MOF announced in June 1995 a new definition that expanded the scope of NPLs in two respects. First, the scope of financial institutions covered by the NPL disclosure was expanded from 21 major banks to all deposit-taking financial institutions. And second, loans with reduced or exempted interest rates were added to the scope of NPLs, in addition to loans to bankrupt borrowers and delinquent loans. Komine (2011), pp. 470-472.

⁶² Mr. Nobuyuki Teramura, who was then Director-General of the MOF's Banking Bureau, stated in an interview conducted in January 2010 that it was written in the "Present Policy for Management of Financial Administration" that "the MOF intends to make its maximum efforts to ensure that public confidence in the financial system that has been placed for many years will not be undermined at all" based on the recognition that injection of public funds would be necessary for protecting depositors if it turned out that a bank would become insolvent with excessive debt. However, the MOF's basic stance was that using public funds before disclosing that a bank was apparently insolvent and bankrupt would only cause confusion and increase the burden of the public (Matsushima and Takenaka [2011], pp. 225-226, and BOJ [1992], pp. 71-73).

⁶³ "Summary of the Governor's Press Conference on August 19, 1992," BOJ Archives "Summary of

government's policy; for example, media reported that, at the Liberal Democratic Party's Karuizawa seminar at end-August, Prime Minister Miyazawa commented, "The government is ready to use public funds, if necessary." However, as the Chairman of the Federation of Bankers Associations of Japan (FBAJ) stated at a press conference on September 8 that banks should make every possible effort on their own responsibility, the argument for the injection of public funds subsided.

Nevertheless, the NPL problem persisted thereafter. In January 1993, the Bank conducted on-site examinations of the Hyogo Bank, the results of which revealed significant discrepancies with those of the MOF's inspection conducted in August 1992. Specifically, whereas the amount of NPLs and the required write-off amount at the Hyogo Bank identified as a result of the MOF's inspection were 674.7 billion yen and 25.3 billion yen, respectively, the corresponding amounts identified through the Bank's on-site examinations were 2,062 billion yen and 255.7 billion yen. While there was a time lag of six months, the large discrepancies between the amounts identified by the MOF and the Bank were attributable to the Bank's calculation, which automatically included a certain proportion of the NPLs in the required disposal amount for parent banks based on the thinking that the cost of disposal of NPLs held by affiliated nonbanks would be borne by parent banks. Recalling that time, Mr. Nobuyuki Teramura, who was then Director-General of the MOF's Banking Bureau, commented, "The Bank's on-site examinations were more foresighted."⁶⁴

In February 1993, the second reconstruction plan for Japan Housing Finance Co. was formulated under the leadership of the MOF. Regarding the bailout plan for housing loan companies (*jusen*), Governor Mieno stated at a press conference, "This was an issue to be addressed by *jusen* themselves and financial institutions supporting them" and "Decisions should be made based on the principle of self-responsibility."⁶⁵ The memorandum of understanding concerning the reconstruction plan for *jusen* (exchanged between Director-General Teramura of the MOF's Banking Bureau and Director-General Takenori Manabe of

the Governor's Press Conferences," No. 43328.

⁶⁴ Matsushima and Takenaka (2011), p. 247. In December 1992, the Bank established a commitment line of 20 billion yen for each of the Hyogo Bank's three major shareholders -- the Sumitomo Bank, the Long-Term Credit Bank of Japan (LTCB), and the Industrial Bank of Japan. Loans provided through the commitment line were extended by the three banks to the Hyogo Bank in their entirety.

⁶⁵ "Summary of the Governor's Press Conference on February 17, 1993," BOJ Archives "Summary of the Governor's Press Conferences," No. 44682.

the Ministry of Agriculture, Forestry and Fisheries' Economic Bureau) stated as follows: "Given that an interest rate reduction or exemption on loans for *jusen* by financial institutions related to agriculture and forestry is very burdensome for these institutions in light of their financial soundness, it will be coordinated so that the Bank of Japan will provide the necessary funds to the Norinchukin Bank (this fund provision should be made in the form of ordinary Bank of Japan loans and should not be predetermined)."⁶⁶ However, regarding this point, Bank of Japan Governor Yasuo Matsushita later stated, "The Bank was not involved in drafting of the memorandum at all"; "it seems that at that time, the MOF sounded out the Bank about the feasibility of providing loans when formulating a reconstruction plan for *jusen*. I have heard that in response, the Bank did nothing more than to make a statement that 'the provision of Bank of Japan loans is a measure implemented as necessary while examining developments in overall financial markets and the funding situation of each financial institution on a daily basis, and the Bank should not provide loans for purposes other than that.'"⁶⁷ During the period of 1992 through 1993, the MOF and the Bank emphasized the need for (1) swiftly proceeding with the disposal of NPLs, (2) the principle of financial institutions' self-responsibility, and (3) financial institutions' financial soundness as well as profitability sufficient to implement the disposal of NPLs; they expressed a negative view on the idea of immediately injecting public funds.

In retrospect, it may be said that this view was based on insufficient recognition of the balance-sheet adjustment mechanism operated during the process of the bursting of the

⁶⁶ In June 1995, a project team was established within the ruling parties to deliberate on early resolution of the NPL problem. At the seventh meeting of the project team held on August 24, 1995, on the topic of the background to and current status of the *jusen* problem, the MOF and the Ministry of Agriculture, Forestry and Fisheries submitted a memorandum of understanding exchanged on February 3, 1993, and the content of the memorandum was revealed (Nishimura [1999], p. 144, FBAJ [1995c], pp. 53-58, and the morning edition of *The Nikkei* on August 25, 1995). At a meeting of the Budget Committee of the House of Representatives on December 13, 1995, Mr. Yoshimasa Nishimura (Director-General of the MOF's Banking Bureau), who was a government member of the committee, stated, "The content of this memorandum had already been made public on August 24" (Secretariat of the House of Representatives [1995]). Meanwhile, at a meeting of the Budget Committee of the House of Representatives on February 15, 1996, Messrs. Teramura and Manabe, who attended the meeting as unsworn witnesses, made statements with respect to the memorandum (Secretariat of the House of Representatives [1996]).

⁶⁷ "Summary of the Governor's Press Conference on February 14, 1996," BOJ Archives "Summary of the Governor's Press Conferences (1996)," No. 65161.

bubble economy.⁶⁸ Nevertheless, given the scale of NPLs that arose during the process of the bursting of the bubble economy, it was impossible for monetary policy alone to resolve this problem. In fact, economic stimulus measures in the 1990s were gradually implemented in terms of both macroeconomic policy, including fiscal and monetary policies, and prudential policy.

IV. Changes in Financial Conditions and Monetary Policy Response (Early 1994 through Summer 1995)

A. Concerns about Economic Growth Stalling due to the Yen's Appreciation and Pressure from Global Competition

1. Economic conditions in major overseas economies

In 1994, the economies of many countries and regions gained momentum for growth.⁶⁹ The pace of growth in the U.S. economy accelerated, and in Europe, the U.K. economy entered a recovery phase, followed by the German and French economies. The Asian economies also continued to follow their robust expansionary paths (Chart 7).

In the United States, where the steady economic expansion continued, the monetary policy stance shifted to tightening in February 1994; subsequently, the discount rate was raised four times by February 1995 for total rate hikes of 2.25 percentage points. The U.S. economy slowed in the first half of 1995, mainly reflecting the cumulative effects of the rate hikes. However, as the federal funds rate (FF rate) was reduced in July (from 6 percent to 5.75 percent), marking a shift of the monetary policy stance to easing, the U.S. economy started expanding again. Meanwhile, consumer prices stayed relatively stable. In the foreign exchange market, the U.S. dollar depreciated against the currencies of other major countries, mainly due to the dim prospects for further reductions of the U.S. fiscal deficit and the growing view that it was not easy to resolve the Japan-U.S. trade imbalance. After the turn of 1995 in particular, the dollar depreciated further, partly because of the Mexican Currency Crisis.

The U.K. economy expanded, led by exports and private consumption (Chart 7). Therefore, the Bank of England raised the policy interest rate three times between September 1994 and February 1995. The pace of economic expansion slowed because growth in domestic demand, mainly private consumption, decelerated due to the tightening

⁶⁸ Okina, Shirakawa, and Shiratsuka (2000), pp. 315-319.

⁶⁹ Research and Statistics Department, BOJ (1995c), p. 15.

measures (Chart 7). The German and French economies recovered in 1994 amid robust exports; however, in 1995, the pace of expansion of these economies moderated, reflecting slowdowns in exports caused by the appreciation of the deutsche mark and the French franc (Germany lowered the discount rate in August). Meanwhile, prices generally stayed stable in these countries.

In Asia, the growth rates of the NIEs and ASEAN countries remained at high levels in 1994, mainly due to increases in exports to industrialized countries and in intra-Asia exports, an expansion of inward direct investment, and active infrastructure investment (Chart 7).⁷⁰ In the ASEAN countries, while the momentum for growth in exports to the United States subsided, economic expansions continued on the back of inflows of direct investment and active trade within East Asia. In China, although a somewhat overheated economic expansion continued, the growth rate of industrial production declined slightly because construction and business fixed investment were restrained by the strengthening of the austerity policy. Under these circumstances, the inflation rate was relatively high and the trade deficit expanded due to an increase in imports of capital and intermediate goods.⁷¹

2. Economic conditions in Japan

In 1994, Japan's economy finally moved out of the recession that continued for two and a half years from spring 1991, and started to show signs of recovery (Chart 1). This was attributable to low levels of interest rates and the government's economic stimulus package adopted in February 1994, amounting to a total of 15.3 trillion yen (including 6 trillion yen of tax reductions in, for example, income tax and inhabitant tax). The package aimed to (1) expand domestic demand to stimulate the economy, (2) implement priority measures in sectors that faced challenges, and (3) develop an environment that induced economic vitalization. However, the economy lacked momentum for recovery as was particularly evident in the slow recovery of business fixed investment, which plays a key role in a self-sustaining economic expansion.⁷²

As a background to such slow recovery in business fixed investment, the Bank pointed out the following three factors in 1994. First, economic activity remained at a low level.

⁷⁰ The economic expansion is known as the East Asian Miracle. This was a phrase used in a report released by the World Bank in September 1993. As characteristics of the economic miracle of East Asia, the report pointed out rapid growth and highly equal income distributions (World Bank [1993]).

⁷¹ Research and Statistics Department, BOJ (1995c), pp. 15-17.

⁷² Research and Statistics Department, BOJ (1995a), pp. 15-16.

Although indicators such as corporate profits and the capacity utilization rate were recovering, their levels remained low due to the effects of the preceding large-scale economic adjustments, and this showed that the perception among firms of having excess capital stock persisted. Second, financial positions of firms and financial institutions had been deteriorating, reflecting the earlier declines in asset prices. The Bank assumed that the balance-sheet adjustment pressure might have intensified the risk aversion among firms and financial institutions. And third, Japan's economy was brought under pressure to adjust the industrial structure mainly against the backdrop of the yen's appreciation and development of the NIEs. The Bank believed that, with the global economic structure changing, manufacturers had reduced their domestic investment, mainly reflecting a shift of production sites overseas, while nonmanufacturing firms had also constrained their investment due to imports of low-priced goods brought about by the intensification of global competition in the field of, for example, distribution and due to firms' cost-cutting efforts.⁷³

Although Japan's economy followed a recovery trend thereafter through early 1995, albeit at a moderate pace, the pace of recovery became stagnant from early spring 1995. On a quarter-on-quarter basis, industrial production, which had been increasing from early 1994, started to decline from the turn of 1995 (Chart 1). This was caused by the following three factors amid a lack of momentum for sufficient recovery in business fixed investment and private consumption: (1) economic activity such as production temporarily weakened after the Great Hanshin-Awaji Earthquake, which occurred in early 1995; (2) exports declined mainly due to the rapid appreciation of the yen and a temporary slowdown of the U.S. economy; and (3) growth in public investment weakened, while households postponed housing investment as their expectations for a fall in interest rates heightened.⁷⁴

The Great Hanshin-Awaji Earthquake -- a disaster caused by the Hyogoken-Nanbu Earthquake that occurred on January 17, 1995 -- resulted in severe financial damage estimated at a total loss of approximately 9.6 trillion yen.⁷⁵ Immediately following the earthquake, many economic indicators, including those of industrial production, private

⁷³ Policy Board, BOJ (1995), pp. 3-4, and Research and Statistics Department, BOJ (1995b), pp. 19-26.

⁷⁴ Research and Statistics Department, BOJ (1996), p. 5.

⁷⁵ Estimate by the National Land Agency in February 1995 (the morning edition of *The Nikkei* on February 17, 1995).

⁷⁶ Research and Statistics Department, BOJ (1995c), p. 19.

consumption, as well as exports and imports, recorded temporary declines (Chart 1).⁷⁶ The Bank's Kobe Branch, the building of which fortunately did not suffer any significant damage, commenced its business operations from 9 a.m. as usual.⁷⁷ With the support of other branches mainly through the dispatch of staff, the Kobe Branch was able to execute the most crucial operation in times of disaster -- namely, the smooth supply of cash, including withdrawals of deposits and exchange of damaged banknotes. Meanwhile, from January 21 through February 26, the Kobe Branch conducted its business operations not only on business days but also on weekends and holidays.⁷⁸ Moreover, in order to avoid confusion in terms of the financial and settlement systems in the disaster-stricken areas, the General Manager of the Bank's Kobe Branch and the Director of the Kobe Finance Office of the MOF's Kinki Local Finance Bureau jointly issued various requests for financial measures to assist the disaster-stricken areas, as did the General Manager of the Bank's Osaka Branch and the Director-General of the MOF's Kinki Local Finance Bureau. The requests were addressed to financial institutions to implement measures to flexibly meet the financial needs of their customers, including withdrawals of deposits, processing of overdue bills, exchange of damaged banknotes, and provision of disaster-related loans. In addition, the Bank recognized that support from the financial side through private financial institutions' smooth supply of funds for rebuilding was important in steadily proceeding with rebuilding in the disaster areas. Based on this recognition, with a view to supporting efforts of private financial institutions in providing loans intended for rebuilding in the affected areas, the Bank decided in July to disburse disaster assistance loans with a lending period of around one year to financial institutions. Eligible counterparties were those that had business offices in the disaster-stricken areas and that wished to apply for the loans (loan disbursement amounted to 271.5 billion yen).⁷⁹

From March 1995, uncertainty over the outlook for the economy heightened rapidly, mainly because of the sharp appreciation of the yen and falls in stock prices (Charts 3 and 6).⁸⁰ Regarding foreign exchange rates, the yen temporarily exceeded 80 yen

⁷⁷ From January 20 through February 3, 1995, the Bank provided temporary windows on behalf of 14 financial institutions whose offices had collapsed.

⁷⁸ Descriptions on the Bank's Kobe Branch at the time of the Great Hanshin-Awaji Earthquake are based on the morning edition of *The Nikkei* on January 20, 1995, the evening edition of *Asahi Shimbun* on February 25, 1995, and Kobe Branch, BOJ (1995).

⁷⁹ Policy Board, BOJ (1996), p. 41.

⁸⁰ Research and Statistics Department, BOJ (1995c), pp. 19 and 25, and Research and Statistics Department, BOJ (1996), pp. 9 and 13-14.

against the U.S. dollar in mid-April in the Tokyo foreign exchange market, recording the highest-ever level in the postwar period of 79.75 yen on April 19, reflecting the yen's appreciating trend that had accelerated from the second half of February 1995. Thereafter, the yen mostly stayed around 85 yen amid concern over the slowdown of the U.S. economy and an overshooting of the yen (Chart 3). Bullish market sentiment on the yen started to change from around summer, mainly because of coordinated actions concerning foreign exchange rates taken by monetary authorities of major countries, resulting in the yen's depreciation to the 97-98 yen level toward early September.

Stock prices declined in the first half of 1995, mainly reflecting the failure of British investment bank Baring Securities at end-February, in addition to concern over matters such as the rapid appreciation of the yen. In late March, they fell below 16,000 yen. From late May, they followed a downtrend mainly against the backdrop of uncertainty over the outlook for the economy, and fell below 15,000 yen in mid-June. They rebounded to around 18,000 yen in mid-August, and temporarily regained the 20,000-21,000 yen level in end-December (Chart 6). Meanwhile, land prices continued to decline (Chart 6).

Prices had bottomed out in the second half of 1994, but started declining by early spring 1995 because of the yen's appreciation and a further slack in domestic supply and demand conditions (Chart 2).

Under these circumstances, in order to further stimulate the economy, the Bank decided on March 31, 1995, to encourage a decline in short-term market interest rates, while giving consideration to the possible impact of an excessive price decline on the economy. It then reduced the official discount rate on April 14 by 0.75 percentage point to 1.0 percent. Thereafter, the Bank successively implemented monetary easing measures. In July, it decided to guide money market rates lower, and reduced the official discount rate in September from 1.0 percent to 0.5 percent (see Section B.2. of this chapter for the details of the Bank's monetary policy).

Meanwhile, the government also adopted (1) the Emergency Economic Measures to Cope with the Yen Appreciation in April and June, which primarily consisted of deregulatory initiatives, and (2) the largest-ever economic stimulus package in September, worth a total fiscal stimulus of 14.2 trillion yen. As for the foreign exchange market, the G7 statement released in April 1995 included an agreement that "orderly reversal of movements in such market was desirable," and a concerted intervention with the monetary

authorities of major countries was conducted.⁸¹ In the second half of 1995, the economy regained its momentum toward recovery.⁸² This was mainly attributable to the fact that adjustment pressure on the private sector waned to a certain extent, accompanied by the progress in capital stock adjustments and by the strengthened profit base of firms due to restructuring, in addition to the aforementioned policy actions on both the monetary and fiscal fronts. In particular, business fixed investment became active among large manufacturers, such as those of personal computer-related goods and in the communications sector -- including mobile phone and personal handy-phone system (PHS) service providers -- in which deregulation proceeded.

B. Changes in Financial Conditions and Policy Response

1. Changes in financial conditions

a. Progress in financial deregulation

Discussions on the need for the deregulation of deposit interest rates had been hosted mainly by the Financial Problems Research Group (a private advisory panel to the Director-General of the MOF's Banking Bureau) since the mid-1970s.⁸³ In September 1993, the group embarked on a study on the final stage in the deregulation of interest rates, and subsequently submitted a report entitled "Implementation of Deregulation of Interest Rates on Term Deposits and Future Deregulation of Interest Rates on Liquid Deposits" (December 22, 1993), in which stability of the payment and settlement systems as well as the presence of postal savings were raised as relevant points to be considered in deregulating interest rates on liquid deposits. Accordingly, in April 1994, an agreement was reached between the MOF and the Ministry of Posts and Telecommunications on rules concerning the setting of interest rates on ordinary postal savings and ordinary private deposits. The agreement paved the way for the deregulation of interest rates on private liquid deposits other than current deposits, for which a ban on the provision of interest remained in place, on October 17, 1994.⁸⁴ This marked the completion of the deregulation process, which had gradually taken

⁸¹ Research and Statistics Department, BOJ (1996), p. 5. The term "concerted intervention" was used in the *Bank of Japan Monthly Bulletin* and *Nenji Houkoku Sho* (Annual Report of the Policy Board of the Bank of Japan), but when reporters asked questions using such term at press conferences and on other occasions, the Governor took the stance of avoiding use of the term.

⁸² Research and Statistics Department, BOJ (1996), pp. 5 and 67.

⁸³ Nishimura (2003), p. 218.

⁸⁴ Nishimura (2003), pp. 230-232.

place since the introduction of large-lot term deposits in October 1985.⁸⁵

b. NPL problem and the Bank's response

NPLs held by financial institutions that had financed firms' excessive investments during the bubble period had grown over the years, reflecting the protracted economic stagnation and the continued decline in land prices (Charts 5 and 6).

In a list of anticipated questions and answers compiled in February 1994 for a G7 meeting, the Bank adopted a cautious stance toward the NPL problem, having prepared the following response: "In numerical terms, impaired assets as a whole continue on an increasing trend, with new recession-induced NPLs arising from the prolonged economic stagnation in addition to existing developments regarded as after-effects of the bursting of the bubble economy, such as sluggish sales of collateral real estate. It therefore remains to be said that the amount of impaired assets has peaked out." In the same vein, for a subsequent G7 meeting, the Bank again chose its words carefully as suggested by its list of anticipated questions and answers prepared in September 1994. In one of its responses, the Bank stated, "According to figures disclosed by city banks, long-term credit banks, and trust banks, the total amount of impaired assets (the sum of loans to failed borrowers and loans delinquent for six months or longer) stands at 13.6 trillion yen as of the end of this March, almost flat compared with the level as of the end of last September (13.8 trillion yen), and appears to show signs of peaking out," and therefore "the situation surrounding the problem of impaired assets is turning favorable on the whole." At the same time, the Bank noted, "Given the scope of the problem and other factors, it can be presumed that solving it in general will require some more time."⁸⁶ When inquired of the Bank's approach to and the future outlook for the NPL problem at the press conference on December 19, 1994, Governor Yasuo Matsushita stated, "As far as I understand, the generation of NPLs has passed its peak -- the outstanding amount is peaking out." He continued, however, as follows: "It appears that the disposal of collateral real estate will not necessarily proceed at once, given that the recovery of the real estate market has been very slow and that Japanese real estate assets are entangled in complicated webs of rights in many cases. Therefore, it all comes down to taking measures considered most suitable at each point in

⁸⁵ Policy Board, BOJ (1995), p. 17.

⁸⁶ "Anticipated Questions and Answers Related to G7, Policy Planning Department, International Department, and Financial and Payment System Office, February 1994," and "Materials Related to G7, September 1994," BOJ Archives "G Process (2) (1/3)," No. 47671.

time, while bearing in mind that the overall process is an extensive one." Governor Matsushita's remarks reflected his awareness of the continued significance of the NPL problem.⁸⁷

Meanwhile, another issue emerged. The Tokyo Kyowa and Anzen credit cooperatives had been judged insolvent, with excess debt of approximately 110 billion yen, meaning that they had gone virtually bankrupt. Together with the Tokyo Metropolitan Government, which directly supervised them, the Shinkumi Federation Bank, the Association of Tokyo Shinyou Kumiai, and the LTCB as well as other private financial institutions, the Bank reached an agreement concerning the failure resolution of the credit cooperatives.⁸⁸ Accordingly, a resolution plan, under which the two credit cooperatives would be dissolved and their business operations would be transferred to a newly established receiving bank, was announced on December 9, 1994.⁸⁹ The process went as follows: (1) the Bank of Japan, together with private financial institutions, would establish an ordinary bank (to be called the Tokyo Kyodo Bank), to which the entire business operations of the Tokyo Kyowa and Anzen credit cooperatives would be transferred for the resolution of the two credit cooperatives; (2) the Tokyo Metropolitan Government and private financial institutions would provide necessary assistance for the transfer of those business operations; (3) the Tokyo Kyodo Bank would dispose of NPLs in addition to inheriting all deposits from the Tokyo Kyowa and Anzen credit cooperatives; and (4) the Tokyo Kyodo Bank would request financial assistance from the DICJ.⁹⁰

From the viewpoint of maintaining the stability of the financial system as a whole, the Bank of Japan decided in January 1995 to establish the Tokyo Kyodo Bank by making a joint investment with private financial institutions, with the aim of resolving the management problems facing the two credit cooperatives. In doing so, it made a total investment of 20 billion yen (equivalent to the amount by private financial institutions) pursuant to Article 25 of the Bank of Japan Act.⁹¹ The Tokyo Kyodo Bank, which would later replace the investment with that of the DICJ and become an organization specializing in the disposal of NPLs (to be called the Resolution and Collection Corporation), started as

⁸⁷ "Summary of the Governor's and Deputy Governor's Press Conference on December 19, 1994," BOJ Archives "Summary of the Governor's Press Conferences," No. 46878.

⁸⁸ Nishimura (2003), p. 310, and Policy Board, BOJ (1995), pp. 14 and 22-23.

⁸⁹ FBAJ (1995a), pp. 42-44.

⁹⁰ Policy Board, BOJ (1995), pp. 14 and 22-23.

⁹¹ Policy Board, BOJ (1996), pp. 13 and 36.

an ordinary bank that collected deposits and provided new loans. As such, it succeeded the business operations of the two credit cooperatives with financial assistance from the DICJ, and transferred NPLs to the Tokyo Credit Cooperative Debt Collection Agency (established within the Tokyo Credit Cooperative) in March 1995.⁹²

On reasons behind the implementation of such emergency measure, at the press conference on December 9, 1994, Governor Matsushita noted, "Considering that the credit cooperatives were insolvent and left without a single bank that was enthusiastic about a merger . . . on account of their excessive amount of NPLs, leaving the current situation unattended could well trigger significant turmoil." Regarding investment in the Tokyo Kyodo Bank, the Bank's view was that "smooth functioning of the receiving bank following its establishment would require back-up of a capital base sufficient enough for it to maintain credibility as a legitimate institution."⁹³ Subsequently, the following inquiries were made at the press conference on January 25, 1995. "Does the Bank consider the investment in question -- based on Article 25 of the Bank of Japan Act -- as public funds? While a consensus seems yet to be reached, is it possible that the Bank will carry out investment and other emergency measures again at such stage based on Article 25?" In response, Governor Matsushita stated the following points: "As this was not the kind of problem that the Bank could resolve by asking a favor of a specific bank, the Bank formulated a resolution plan through the support of a broad range of financial institutions"; "in doing so, the Bank judged that widespread support from financial institutions would be within greater reach if the central bank effectively communicated its deep concern about the given circumstances and its determination to fully resolve the problem"; and "as long as the resolution plan was based on the premise that the Bank of Japan would be among the investors, the Bank would need to collect the funds after the receiving bank's business got on track, and this, among other reasons, made investment a reasonable method."⁹⁴ With regard to why blanket deposit insurance was not applied to the two credit cooperatives, at the press conference on April 6 at the Kobe Branch, Governor Matsushita noted, "Many

⁹² Banking Study Workshop, BOJ (2001), pp. 42-43, Policy Board, BOJ (1996), p. 11, and FBAJ (1995b), p. 53.

⁹³ "Summary of the Governor's Press Conference (in Attendance of Executive Director Kunio Kojima) on Resolution of the Management Problems of Tokyo Kyowa and Anzen Credit Cooperatives, December 9, 1994," BOJ Archives "Summary of the Governor's Press Conferences," No. 46878.

⁹⁴ "Summary of the Governor's Press Conference on January 25, 1995," BOJ Archives "Summary of the Governor's Press Conferences," No. 53956.

financial institutions are in a difficult situation because they hold some amount of NPLs, which they are struggling to dispose of, and there is still room for improvement in their information disclosure and depositors' understanding of the blanket deposit insurance scheme." He continued, raising as a source of concern the fact that "applying blanket deposit insurance under these circumstances could upset not only depositors of the two credit cooperatives but also depositors across the country, triggering a chain reaction of concern over the stability of the financial system," and that, therefore, "the Bank was given no other choice but to resolve this case without applying blanket deposit insurance."⁹⁵

By the end of July 1995, less than six months after the Tokyo Kyodo Bank had begun its operations, the failure of the Cosmo Credit Cooperative, based in Tokyo, had manifested itself. As this credit cooperative was larger in size than the aforementioned two, it was expected that liquidity support from the Bank of Japan (the so-called *Nichigin Tokuyū*) would become necessary in order to ensure smooth repayment of deposits. Therefore, until a resolution package was implemented, the Bank of Japan -- through the provision of loans based on Article 25 of the Bank of Japan Act -- supplied the minimum amount of funds required for the repayment of deposits via the Shinkumi Federation Bank.⁹⁶ Apart from this, the Bank of Japan decided to provide the Tokyo Kyodo Bank -- to which all business operations of the Cosmo Credit Cooperative were to be transferred -- with additional loans as part of the resolution package, as a means of funding and profit support.⁹⁷ Regarding the repeated invocation of Article 25 of the Bank of Japan Act, Governor Matsushita stated at the press conference on August 9, "Naturally, it was necessary to consider strict requirements for its invocation, as Article 25 prescribes the authority to implement, only in very special cases, measures that cannot be recognized in other provisions of the Act."⁹⁸

By the end of August 1995, the failure of the Kizu Credit Cooperative and the Hyogo Bank had materialized. Their large amount of cash held at hand -- slightly over 1

⁹⁵ "Summary of the Governor's Press Conference on April 6, 1995," BOJ Archives "Summary of the Governor's Press Conferences," No. 53956.

⁹⁶ Specifically, "when deposits were repaid by the Cosmo Credit Cooperative, the portion of deposits that was not covered by cash on hand at the cooperative or funds borrowed from the Shinkumi Federation Bank was covered by loans from the Bank of Japan ("Summary of the Governor's Press Conference on August 9, 1995," BOJ Archives "Summary of the Governor's Press Conferences," No. 53956).

⁹⁷ Banking Study Workshop, BOJ (2001), pp. 43-44, Policy Board, BOJ (1996), p. 36, and Policy Board, BOJ (1997), p. 43.

⁹⁸ "Summary of the Governor's Press Conference on August 9, 1995," BOJ Archives "Summary of the Governor's Press Conferences," No. 53956.

trillion yen and around 2.5 trillion yen, respectively -- gave rise to concerns about possible repercussions on other financial institutions. The Kizu Credit Cooperative was ordered to suspend its operations, and it was decided that its business operations would be transferred to the Resolution and Collection Bank, reorganized from the Tokyo Kyodo Bank as an exclusive organization specializing in the failure resolution of credit cooperatives. Meanwhile, it was decided that, while the Hyogo Bank would be liquidated, its business operations would be transferred to the Midori Bank -- a receiving bank created mainly from investments by local business and financial circles -- as it was necessary to preserve the financial function of the failed bank considering possible effects on the local economy in the aftermath of the Great Hanshin-Awaji Earthquake. At the press conference on August 30, Governor Matsushita stated as follows regarding the invocation of Article 25: "When the failure resolution of a financial institution is implemented, there is, naturally, a dimension of providing liquidity as temporary funding support, while at the same time the Bank needs to address the issue of how losses should be dealt with. . . . Considering the nature of a central bank, where liquidity provision should be given top priority under normal circumstances, conducting this for the purpose of failure resolution should well be an indication of a kind of temporary emergency measure."⁹⁹ In January 1996, the Bank of Japan decided to provide the Midori Bank with subordinated loans amounting to 110 billion yen, pursuant to Article 25.

Under these circumstances, the Bank of Japan advised financial institutions holding a current account with the Bank to work to further ensure sound management through (1) the appropriate disposal of NPLs, (2) restructuring through streamlining and ensuring capital adequacy, and (3) developing their risk management frameworks, among other measures.¹⁰⁰

c. Disclosure of the amount of NPLs

Moves to disclose the amount of NPLs had been spreading gradually, for example, with city banks, trust banks, and long-term credit banks starting their verbal disclosure of the amount of loans exempted from interest payment (loans to borrowers to which interest rates below the official discount rate at the time of financial assistance were applied) and lenders including some regional banks, regional banks II, and *shinkin* banks considering to expand

⁹⁹ "Summary of the Governor's Press Conference on August 30, 1995," BOJ Archives "Summary of the Governor's Press Conferences," No. 53956.

¹⁰⁰ Policy Board, BOJ (1996), p. 35.

the scope of information they would disclose.¹⁰¹ The NPL problem facing financial institutions thus saw an increase in the amount of write-offs and provisions on the whole as well as an expansion of NPL disclosure. Nevertheless, it remained a significant issue for Japan's financial system, as could be seen, for example, in the fact that the total amount of NPLs remained considerable and some financial institutions were lagging behind in their disposal of NPLs, given the large volume relative to their financial strength.¹⁰²

2. Shift in monetary policy tools

a. Encouraging a decline in short-term market interest rates (March 1995)

Through 1994, the Bank maintained its policy stance of continuing its monetary easing based on the recognition that the economy was recovering moderately. After the turn of 1995, uncertainty over the economic outlook strengthened due to such factors as the Great Hanshin-Awaji Earthquake and the rapid appreciation of the yen as well as a sharp decline in stock prices amid these developments, giving rise to expectations of a decline in interest rates.¹⁰³

In this situation, on March 31, 1995, the Bank's Policy Board approved the decision to encourage a decline in market interest rates as the guideline for market operations for the immediate future.¹⁰⁴ Specifically, the Bank judged that it was appropriate to encourage a

¹⁰¹ The FBAJ defined the scope of NPL disclosure for each type of bank based on the uniform disclosure standards established by the federation. Starting in fiscal 1992 (ending in March 1993), the 21 city banks, trust banks, and long-term credit banks were required to disclose the amounts of loans to failed borrowers and delinquent loans (loans for which interest payment was overdue for six months or longer). Regional banks and regional banks II were required to disclose the amount of loans to failed borrowers but not the amount of delinquent loans. Starting in fiscal 1995 (ending in March 1996), the city banks, trust banks, and long-term credit banks were required to disclose the amounts of loans exempted from interest payment and loans to borrowers receiving management support as well, while regional banks were required to disclose the amount of delinquent loans. In fact, regional banks and regional banks II voluntarily started to disclose the amount of loans exempted from interest payment. Starting in fiscal 1996 (ending in March 1997), all five types of banks disclosed the amounts of loans to failed borrowers, delinquent loans, loans exempted from interest payment, and loans to borrowers receiving management support. From fiscal 1997 (ending in March 1998) onward, all types of banks were required to disclose the amount of risk management loans (loans to failed borrowers, delinquent loans, loans delinquent for three months or longer, and loans with relaxed borrowing conditions) (Policy Board, BOJ [1998a], p. 21, BOJ [1999c], p. 130, and Komine [2011], pp. 470-473).

¹⁰² Research and Statistics Department, BOJ (1996), p. 21.

¹⁰³ Research and Statistics Department, BOJ (1995c), p. 21.

¹⁰⁴ Policy Board, BOJ (1996), pp. 42-43. As for why the term "approval" rather than "decision" was used concerning the Policy Board's judgment on this measure, Director Yutaka Yamaguchi of the

decline in short-term market interest rates within a range consistent with the level of the official discount rate, so that the effects of monetary easing could be exercised to the maximum possible extent (implementation of the so-called measure to guide interest rates toward a lower target range).¹⁰⁵ It was then that the Bank began to place more emphasis on short-term interest rate control than official discount rate control and to release the target range.¹⁰⁶ As a result of the measure to guide short-term market interest rates toward a lower target range, the uncollateralized overnight call rate declined by around 0.5 percentage point from the previous level of 2.2-2.3 percent to around 1.75 percent, the same level as the official discount rate (Chart 4). In a rare press conference on March 31, Director Yamaguchi of the Policy Planning Department sought to clarify the Bank's intent behind the policy change. However, as market participants interpreted this as a reflection of the Bank's reluctance to lower the official discount rate, the yen continued to appreciate and stock prices kept declining. Such market developments led news reports to state on April 1 that "the Bank will soon be left with no other choice but to lower the official discount rate."¹⁰⁷

Policy Planning Department provided the following explanation at the press conference on March 31: "Authority over the daily conduct of market operations is entrusted to the Executive Directors in accordance with the Policy Board's basic principles. When a significant adjustment is made, the measure is explained to the Policy Board, as was the case today, after which it was approved" (the evening edition of *The Nikkei* on March 31, 1995). The Bank of Japan Act of 1997, which came into effect on April 1, 1998, stipulates that matters concerning monetary control shall be decided by the Policy Board (Article 15, paragraph 1 [iv]). However, given that the Bank of Japan Act of 1942 did not contain such provisions yet, the term "approval" rather than "decision" was applied to the Policy Board's judgment on March 31, 1995.

¹⁰⁵ With regard to the measures announced on March 31 and July 7, 1995, while the expression "guide market interest rates toward a lower target range" appears in some cases in questions and answers, for example, at the Governor's press conferences, the standard expression used in the Bank's releases was "encourage a decline in short-term market interest rates."

¹⁰⁶ Miyanoya (2000), p. 8.

¹⁰⁷ The morning editions of *The Nikkei* and *The Yomiuri Shimbun* on April 1, 1995. Some news articles noted a shift in the Bank's policy tools, which was the foremost intent behind this measure. For example, one article (the evening edition of *The Nikkei* on March 31, 1995) observed that "it may be said that the Bank has started to adopt policy tools similar to those adopted by the U.S. Federal Open Market Committee (FOMC) and the Central Bank Council of the Deutsche Bundesbank, which effectively communicate to the public their monetary policy and the intent thereof." Such perspective was hardly taken note of at that stage, however. On this point, Deputy Governor Toshihiko Fukui commented on November 13, "When the interest rate was reduced in March, the Bank's message was not necessarily understood clearly because the measure was

b. Eighth reduction of the official discount rate (April 1995)

On April 14, 1995, the Bank lowered the official discount rate by 0.75 percentage point to 1.0 percent in order to guard against the risk that developments such as a further appreciation of the yen and sluggish stock prices would harm the sustainability of the economic recovery trend through a decline in corporate profits and deterioration in business sentiment.¹⁰⁸

The reduction of the official discount rate to 1.0 percent was followed by an exchange of questions and answers at the press conference by the Chairman of the Policy Board held on the same day.¹⁰⁹ First, a reporter asked for comments on the concern that any leeway in conducting monetary policy would be lost, which meant no more room for a further rate reduction. In response, Governor Matsushita pointed out that, in the history of central banks across the globe, there had been precedents in terms of lowering the discount rate to 1 percent, and stated as follows: "The Bank does not have an overly rigid policy approach, such as setting limits on the official discount rate. If policy measures are feasible within the realm of acting flexibly and prudently in light of economic and financial developments, they will be effective and useful enough when taken together. Therefore, although the level of 1 percent is unprecedented in Japan, the Bank believes that this measure is within the scope of what can be considered an appropriate combination of policy measures." A question was also raised regarding the fact that the Bank resorted to a change in policy just two weeks after implementing the measure to guide market interest rates toward a lower target range on March 31, namely, whether this would act as an impediment to lowering market interest rates in the future. In response, Governor Matsushita replied, "It was necessary to conduct monetary policy in view of the future economic outlook through the combined effects of the two measures, namely, guidance of market interest rates toward a lower target range and reduction of the official discount rate." Regarding the timing of the interest rate reduction, a reporter inquired whether the measure had been implemented in coordination with the government's decision on the Emergency Economic Measures to Cope with the Yen Appreciation the same morning and whether it had been taken as international economic policy coordination in anticipation of the forthcoming Japan-U.S. Finance

unfamiliar to market participants and because the reduction of the discount rate in Germany the previous day stirred intense speculation of a similar measure in Japan" (Fukui [1995], p. 7).

¹⁰⁸ Research and Statistics Department, BOJ (1995c), pp. 21-22.

¹⁰⁹ "Summary of the Press Conference by the Chairman of the Policy Board on April 14, 1995," BOJ Archives "Summary of the Governor's Press Conferences," No. 53956.

Ministers' Meeting and G7 meeting. Governor Matsushita replied in the negative, stating, "The measure was not based on such factors as the relationship with various other forums of policy decision-making and the schedules of international meetings."

c. Encouraging a decline in short-term market interest rates (July 1995)

Subsequently, economic recovery stalled and downward pressure on prices persisted on the whole toward summer (Chart 2). In light of this, on July 7, 1995, the Bank implemented a measure to encourage a further decline in short-term market interest rates. In doing so, it announced that it expected these rates to remain on average slightly below the official discount rate and supplied ample funds to the market. Under these circumstances, the uncollateralized overnight call rate generally stayed at around 0.8-0.9 percent from late July onward.¹¹⁰ Neither the type of market interest rate targeted for guidance (target interest rate) nor the target level of the rate was specified in the statements released on March 31 and July 7.¹¹¹ Specifically, the March statement read that "it was appropriate to encourage a decline in short-term market interest rates within a range consistent with the official discount rate so that the effects of monetary easing can be exercised to the maximum possible extent." In a similar vein, the July statement went only so far to say that "the Bank expected market interest rates to remain on average slightly below the current official discount rate."

d. Ninth reduction of the official discount rate (September 1995)

As a result of an interest rate decline that reflected the monetary easing measures implemented thus far and the correction of the yen's appreciation against the U.S. dollar, excessive deterioration in business sentiment subsided, and stock prices recovered. However, as downward pressure on general prices persisted, there were concerns about the possibility that economic activity would remain stagnant for an extended period of time. In light of this situation, on September 8, 1995, the Bank lowered the official discount rate by an additional 0.5 percentage point to 0.5 percent. At the same time, it announced that market operations were directed toward maintaining the uncollateralized overnight call rate on average slightly below the official discount rate. Following the implementation of this measure, the uncollateralized overnight call rate fell to the range of 0.4-0.5 percent, lower than the official discount rate.¹¹²

Regarding the appropriateness of lowering the rate below 1 percent, Governor

¹¹⁰ Research and Statistics Department, BOJ (1996), p. 11.

¹¹¹ Policy Board, BOJ (1996), pp. 42-43 and 47.

¹¹² Research and Statistics Department, BOJ (1996), p. 11.

Matsushita made the following remarks at a press conference: at the September Policy Board meeting, when the official discount rate was lowered from 1.0 percent to 0.5 percent, "no argument was made from the standpoint that a reduction to below 1 percent should not be conducted or was not appropriate because 1 percent was a threshold that was very difficult to cross"; and "this might have reflected the situation where market interest rates had already fallen below the official discount rate, which was set at 1 percent." When Governor Matsushita was asked about the factors behind the decision to lower the official discount rate instead of only guiding money market rates lower for monetary easing, he replied as follows: "The Bank has revised downward its outlook for economic activity, recognizing emerging concerns that economic activity will remain stagnant for an extended period of time. Given this assessment, the intent of the latest policy measure is to sufficiently support, from the financial side, the economy to return to a recovery path in order to prevent the spread of deflationary phenomena. The Bank has concluded that, in order to clarify its strong determination on this point to both the market and the general public, it is desirable to lower the official discount rate, a move that sends a strong signal. The Bank has implemented a composite measure of lowering the official discount rate and promoting a further decline in actual market interest rates at the same time."¹¹³

e. Change in monetary policy tools

With the completion of deregulation of deposit interest rates in 1994 and the ensuing change in the financial market environment, the guidance of market interest rates became more important than the control of the official discount rate, the function of which was to directly bring changes to deposit interest rates and lending rates.¹¹⁴ Consequently, as was mentioned earlier, the Bank introduced, on March 31, 1995, a new system under which the guidance of market interest rates was defined as a monetary policy tool, which was as significant as the official discount rate. In this system, the Bank releases a public statement regarding the guideline for market operations after it is approved by the Policy Board,

¹¹³ "Summary of the Press Conference by the Chairman of the Policy Board on September 8, 1995," BOJ Archives "Summary of the Governor's Press Conferences," No. 53956.

¹¹⁴ With respect to the official discount rate, however, the Bank retained the idea that "the official discount rate still has the function of more explicitly indicating the general framework of a central bank's policy stance (the so-called announcement effect); therefore, the official discount rate does not lose its significance even after interest rates are fully deregulated." The Bank believed that it was necessary to make effective use of both official discount rate changes and the guidance of money market rates. Research and Statistics Department, BOJ (1995c), p. 22.

announcing clearly the target level of the uncollateralized overnight call rate; for example, it "expects that the call rate will remain on average slightly below the official discount rate."¹¹⁵ When the Bank encouraged a decline in the market rates on July 7, the policy intent permeated smoothly through the market without causing any confusion.¹¹⁶

Meanwhile, the Bank continued to make efforts to improve and expand daily money market operations. Specifically, it increased the frequency of same-day operations concerning treasury bills (TBs). In addition, it improved transparency over money market operation tools, for example, by changing the auction method of same-day settlement bill purchasing operation tools from the fixed-rate method to the competitive auction method, starting in July. Regarding the expansion of the capacity to supply funds through the use of various market operations, from July, the Bank increased the frequency of outright purchases of Japanese government bonds (JGBs) (often referred to as *Rinban* operations) and the purchases/sales of Japanese government securities (JGSs) with repurchase agreements.¹¹⁷ In September, the Bank decided to purchase certificates of deposit (CDs) through *tanshi* companies that conducted auctions using loans provided by the Bank. The Bank explained, "This operation was implemented for the purpose of securing the flexibility of money market operations and further facilitating overall market transactions in view of expected tightening of the supply and demand conditions for funds."¹¹⁸ In November, it resumed the purchases of CP with repurchase agreements for the first time in four years.¹¹⁹

¹¹⁵ Matsushita (1997), p. 7.

¹¹⁶ On this point, Governor Matsushita stated that the effects of the measure to encourage a decline in market interest rates "have permeated smoothly through the market" and that "the Bank's use of the guidance of money market rates has gradually gained understanding and has taken root in Japan as well" (Matsushita [1997], p. 7).

¹¹⁷ Research and Statistics Department, BOJ (1996), pp. 11-12.

¹¹⁸ "Extension of Bank of Japan Loans to Be Used by *Tanshi* Companies to Purchase CDs, September 26, 1995" BOJ Archives "Operations," No. 53988.

¹¹⁹ It was the first implementation of CP operations since November 1991. As for the background to the resumption of CP operations, a roundtable paper (reference materials prepared by the Policy Planning Department and the Credit and Market Management Department for a meeting of the Bank's officers) noted as follows: "As the outstanding amount of loan extension will increase further toward the year-end -- when shortages of funds tend to occur -- the capacity to supply funds through the existing money market operation tools is expected to decline significantly. Under these circumstances, it is necessary to strengthen the funds-supplying operation tools in order to continue to smoothly conduct money market operations and secure the formation of stable market conditions" ("Resumption of CP Operations, Policy Planning Department and Credit and Market Management Department, November 9, 1995," BOJ Archives "Operations," No. 53988).

Unlike in the case of the previous CP operation scheme, "from the viewpoint of improving the transparency and fairness of the operation and securing a certain volume for the operation, the Bank decided to (1) use, in principle, the competitive auction method for the determination of interest rates, (2) purchase mainly term instruments, and (3) add financial institutions and securities companies as eligible counterparties." In a list of anticipated questions and answers in preparation for the announcement concerning the expansion of eligible counterparties, the Bank explained, "It decided to add financial institutions and securities companies, which were major participants in the CP market along with *tanshi* companies, to the eligible counterparties in order to secure stable bids, among other purposes."¹²⁰

V. Materialization of a Financial System Crisis in Japan (Autumn 1995 through Summer 1998)

A. Beginning of Global Financial Crises (Autumn 1995 through the End of 1996)

1. Economic conditions in major overseas economies¹²¹

In the United States, the economy continued to expand (Chart 7). Due to continued increases in private consumption and production, labor market conditions remained tight, and the rate of rise in wages accelerated somewhat; meanwhile, prices were stable.

The European economies as a whole remained sluggish (Chart 7). In major continental European countries, long-term interest rates converged on a downtrend overall, due mainly to the respective governments' efforts to reduce fiscal deficits before introducing a single currency, the euro. Short-term interest rates in Germany were flat, whereas those in France and Italy declined somewhat, reflecting marginal policy rate cuts. Meanwhile, in the United Kingdom, both long- and short-term interest rates rose somewhat. This reflected a policy rate hike implemented in October 1996, owing to increased upward pressure on prices on the back of continued economic expansion led by domestic demand. With respect to the European Union (EU), the European Council, at its December 1996 meeting, reaffirmed that the third stage of the EMU would commence in January 1999. At the meeting, the council also concluded the Stability and Growth Pact so as to maintain fiscal discipline after the euro adoption, and reached basic agreement on such matters as the introduction of the new exchange rate mechanism (ERM II) -- an arrangement to provide the framework

¹²⁰ "139th Document concerning the Resumption of CP Operations, Credit and Market Management Department, November 10, 1995," BOJ Archives "Operations," No. 53988.

¹²¹ International Department, BOJ (1997), pp. 41-47.

for exchange rate relationships between the euro area and other EU countries. In this sense, progress was made in the deliberations on the EMU's institutional arrangements, and this seemed to have contributed to the rise in the EMU's credibility in the financial and capital markets.

With regard to East Asia, in the Asian NIEs, such as South Korea and Singapore, and the ASEAN countries, such as Thailand, the pace of economic expansion decelerated, mainly due to continued slowdown in exports. Chinese economic growth also slowed, but remained at a high level. In Hong Kong, the economy headed toward recovery: exports and private consumption picked up, supported mainly by increased trade with China, which was to resume the exercise of sovereignty over Hong Kong in July 1997. In Taiwan, the pace of economic expansion slowed somewhat (Chart 7).

2. Economic conditions in Japan

Japan's economy had been facing the challenge of establishing an economic structure suitable for the new era while overcoming the aftereffects of the bursting of the bubble economy. In 1996, there were some positive developments toward overcoming this challenge.¹²²

The economy started to move out of stagnation at the end of 1995, reflecting powerful economic stimulus measures on the monetary and fiscal sides, and then followed a recovery path in 1996. Due in part to the reversal of the yen's appreciation from 1995, the momentum for recovery in private demand became increasingly firm, business fixed investment increased steadily, and private consumption continued to increase moderately on the whole. As for prices, the downward pressure seen during 1995 subsided in 1996, and prices stopped declining in the second half of 1996 (Chart 2).¹²³

With regard to financial developments, until around July 1996, long-term interest rates and stock prices followed an uptrend overall. Thereafter, however, long-term interest rates declined (Chart 4), and stock prices fell through the end of 1996 (Chart 6). This was mainly because views about the outlook for Japan's economy became more cautious in the markets. Meanwhile, the yen was on a depreciation trend throughout 1996 (Chart 3).

¹²² Policy Board, BOJ (1997), pp. 1-8.

¹²³ Research and Statistics Department, BOJ (1997e), pp. 2-4, and Research and Statistics Department, BOJ (1997a), pp. 13-19.

3. The *jusen* problem and six financial system related laws

NPLs of financial institutions had increased as firms had financed their excessive investment during the bubble years from bank loans reflecting the prolonged economic stagnation as well as the continued decline in land prices since the 1990s (Chart 5).¹²⁴ A typical example of excessive investment was seen at bank-affiliated nonbanks including *jusen* that had aggressively financed real-estate investment during the bubble years.¹²⁵ It was of great concern that borrower nonbanks, including *jusen*, might fail because that would exert an adverse impact on the soundness of lender financial institutions.¹²⁶

To address the situation, deliberations progressed on measures to secure the soundness of financial institutions and to further facilitate the disposal of failed financial institutions. In December 1995, the Financial System Research Council and the Financial System Stabilization Committee made public a basic framework for conducting such measures in light of the deliberations. Furthermore, there were discussions on the method of disposing of *jusen*, and a wide range of efforts had been made toward the swift disposal of NPLs as seen, for example, in the Cabinet decision on December 19 regarding a package of measures for the disposal, including injection of public funds.

Specifically, the Cabinet decision included the following points. First, the Jusen Disposal Organization would be established and it would dispose of expected losses pertaining to NPLs that were uncollectible at seven *jusen*, which amounted to about 6.27 trillion yen in total, and of about 140 billion yen of expected deficit. Second, the government would request the parent banks to give up on their claims for *jusen*, of which the total amount was 3.5 trillion yen, and other banks to give up a part of their claims, amounting to about 1.7 trillion yen; it would also request financial institutions for small businesses to donate about 530 billion yen to the Jusen Disposal Organization. Third, after

¹²⁴ At that time, the Bank's assessment on land price developments was as follows: "Land prices as a whole remained on a weakening trend, but prices of superior residential land had gradually stopped declining and those of some commercial land with favorable conditions saw improvement in their supply-demand conditions" (Policy Board, BOJ [1997], p. 8).

¹²⁵ There is no standard definition of nonbanks, but a working group on research on nonbanks -- established as a private advisory panel headed by the Director-General of the MOF's Banking Bureau -- defined nonbanks as "companies that provide loans without taking deposits," for example, housing finance companies and consumer credit companies. In other words, those categorized as financial institutions, namely, cooperative financial institutions, securities companies, and insurance companies are not defined as nonbanks (IMES, BOJ [1995], p. 387).

¹²⁶ Council for Nonbanks (1997).

setting up the Jusen Account at the DICJ, the government would disburse 680 billion yen to the account from its initial budget for fiscal 1996. And fourth, the Jusen Disposal Organization would strongly proceed with debt collection under the DICJ's guidance, while taking legal steps with support from experts such as lawyers and those specialized in real-estate transactions.¹²⁷

At the press conference on January 24, 1996,¹²⁸ Governor Matsushita responded to a question from a reporter about whether the Bank was responsible for causing the bubble economy by its misconduct of monetary policy, in view of the fact that the government had announced its decision to inject fiscal funds to address the *jusen* problem, as follows: "The bubble economy was caused by various factors such as heavy concentration of population and industry in the Tokyo metropolitan area as well as laws and taxes pertaining to land transactions, and it cannot be denied that the prolonged monetary easing had also played a role. However, given that the national policy at that time was to stabilize the foreign exchange market and correct external imbalances, the Bank had to make difficult decisions on its monetary policy conduct in view of such policy. We therefore cannot argue on the cause of the bubble economy based on the results alone in retrospect. I also believe that it was quite difficult to prevent the bubble economy from emerging solely by monetary policy." Moreover, he responded to a question about the role of the Bank's on-site examinations and off-site monitoring as follows: "Needless to say, the Bank's purposes are to aim at achieving price stability and to contribute to financial system stability, and the soundness of Japan's currency can only be ensured when these purposes are achieved. In this regard, the Bank's on-site examinations and off-site monitoring are indispensable in achieving these purposes as well as inseparable from various policy measures conducted by the Bank."

Under these circumstances, the serious state of the NPL problem facing Japanese financial institutions became widely recognized among the public. Moreover, distrust grew over Japanese financial institutions' information disclosure concerning their business conditions, triggered by a revelation that trading losses had been covered up at the Daiwa Bank's New York branch.¹²⁹ Such movements heightened concern over the stability of

¹²⁷ Policy Board, BOJ (1996), pp. 14-15.

¹²⁸ "Summary of the Governor's Press Conference on January 24, 1996," BOJ Archives "Summary of the Governor's Press Conferences (1996)," No. 65161.

¹²⁹ The Daiwa Bank incident -- which took place at the U.S. branch and subsidiary of the Daiwa Bank -- came to light in autumn 1995. Following this incident, the U.S. federal and state banking

Japan's financial system, particularly among overseas market participants, and the so-called Japan premium expanded.¹³⁰

To address the situation, the government introduced a package of measures for securing the financial system stability. It amended the Deposit Insurance Act and enacted six laws relating to the financial system, mainly aiming at ensuring the management soundness of financial institutions. The package of measures also incorporated the establishment of the Resolution and Collection Bank -- a restructured institution of the Tokyo Kyodo Bank, which was originally established to take over the assets and liabilities of the Tokyo Kyowa and Anzen credit cooperatives -- and the Housing Loan Administration Corporation (HLAC).

The six laws relating to the financial system were passed by the Diet in June 1996. These laws were intended as (1) a framework to ensure financial institutions' management soundness and to further facilitate smooth disposal of failed financial institutions, and (2) a step toward implementing measures to address the *jusen* problem. The HLAC was established in July 1996, so as to take over and handle the assets and liabilities of seven failed *jusen*. The HLAC's capital of 200 billion yen was all financed by the DICJ -- of which 100 billion yen was provided by the Bank of Japan as funds to be returned upon the HLAC's dissolution. Moreover, an incorporated association, the New Financial Stabilization Fund, was established in September, with the aim of stabilizing Japan's financial system and

regulators ordered the Daiwa Bank to withdraw from the U.S. market. In September 1995, the Daiwa Bank announced that it would write off in the first half of fiscal 1995 the entire losses stemming from the misconduct by its New York branch's employee of about 1.1 billion dollars. It also reported in October that its New York-based subsidiary had incurred losses of about 97 million dollars from trading activities during the period of 1984 to 1987. In November, the U.S. federal and state banking regulators issued consent orders terminating all U.S. operations of the Daiwa Bank's branches, offices, and subsidiary. In the meantime, the Bank of Japan conducted a special on-site examination of the Daiwa Bank. Reflecting these movements, the credibility of Japanese banks deteriorated in overseas financial markets, and their foreign currency funding rates became higher than those for major European and U.S. banks (Policy Board, BOJ [1996], p. 12).

¹³⁰ "Japan premium" refers to the additional interest rate imposed on Japanese banks when they raise foreign-currency funds. This was caused by an overall decline in the creditworthiness of Japanese financial institutions in overseas financial markets. At the Governor's press conference on September 8, 1995, the Japan premium drew attention as a problem arising from the failures of financial institutions in Japan. This premium expanded following the Daiwa Bank incident, but Governor Matsushita commented, "At the moment, this has not caused a significant problem in Japanese financial institutions' funding conditions" ("Summary of the Governor's Press Conference on October 26, 1995," BOJ Archives "Summary of the Governor's Press Conferences," No. 53956).

securing the system's credibility at home and abroad. This establishment was in response to a joint statement by the government and the ruling coalition parties released in June concerning the disposal of failed *jusen*. The Bank of Japan became the founder of the New Financial Stabilization Fund, and decided to provide 100 billion yen to the Fund as the special member.¹³¹

4. Monetary policy conduct from autumn 1995 through 1996

The Bank conducted a series of successive monetary easing measures in 1995, part of this being the adoption of a measure to control short-term market rates until they reached levels below the official discount rate.¹³² Given this measure, through which it now conducted monetary control through market operations other than extending Bank of Japan loans,¹³³ the Bank abolished the credit line system intended for nine city banks on January 16, 1996.

In this situation, attention came to be focused on the role of the official discount rate in the Bank's monetary policy conduct. At the Governor's press conference on January 24, 1996, a reporter inquired whether the current measures taken by the Bank would result in a reduced role of the official discount rate as well as an increased significance of the measure for controlling market rates, and ultimately, a change in the Policy Board's role of deciding the official discount rate. Governor Matsushita stated in response, "The Bank abolished the credit line system recently on the assumption that, for future money market operations, the Bank would avoid, in principle, using Bank of Japan loans in monetary adjustment." In comparison with the measure for controlling market rates, he added, "While market rates are to be controlled in a flexible and timely manner, Bank of Japan loan rates are set at a relatively stable level; however, they both have signal effects to encourage the market rates to be at levels that central banks consider appropriate."¹³⁴ Similarly, at the Governor's press

¹³¹ Policy Board, BOJ (1997), pp. 14-17, 68-69, and 76-78.

¹³² "Announcement of the Guideline for Money Market Operations" released on July 7, 1995. The monthly average of the uncollateralized overnight call rate for July was below the official discount rate.

¹³³ "Guidelines for Bank of Japan Loans in Future Money Market Operations and Abolishment of the Credit Line System," written by the Director of Policy Planning Department and the Director of Credit and Market Management Department, January 12, 1996, BOJ Archives "Loan Extension," No. 65178. This document includes the description that "Bank of Japan loans are measures to extend credit in the most timely manner; however, when market rates exceeded the official discount rate in the past, there was some criticism that they were 'subsidies to financial institutions.'"

¹³⁴ "Summary of the Governor's Press Conference on January 24, 1996," BOJ Archives "Summary of the Governor's Press Conferences (1996)," No. 65161.

conference on May 15, 1996, in response to a question about the change in the relative significance of controlling market rates and altering the official discount rate in monetary policy, Governor Matsushita stated, "The Bank considers that changing the guideline for controlling market rates has taken hold as an independent policy tool." Meanwhile, the Governor expressed his view in which he continued to value the role of the official discount rate, stating, "Nevertheless, the Bank judges that the fundamental role of the official discount rate has not changed. In other words, altering the official discount rate in light of significant changes in the Bank's assessment of economic conditions still plays the role of announcing the change in the Bank's basic policy stance to various economic entities with clarity and intelligibility."¹³⁵

B. Outbreak of the Asian Financial Crisis and a Financial System Crisis in Japan (1997)

1. Outbreak of the Asian Financial Crisis

Overseas economies experienced sustained economic expansion during 1997. The United States entered the seventh year of its economic expansionary phase. The European economies, particularly Germany, France, and the United Kingdom, also registered relatively high growth compared to the previous year. As for East Asia, while the Chinese economy continued its high growth -- one that led to sustained economic expansion in Taiwan and Hong Kong -- countries such as Thailand, Indonesia, and South Korea experienced economic slowdowns (Chart 7).¹³⁶

Meanwhile, on July 2, the Thai government abandoned the Thai baht's peg to the U.S. dollar and implemented a managed float exchange rate regime. In this situation, the Thai baht -- which had repeatedly been under devaluation pressure since the turn of the year -- immediately depreciated sharply on that day, down by about 15 percent against the U.S. dollar. Following the plunge of the baht, the contagion spread from one Southeast Asian country to another; starting in mid-July, the Philippine peso, the Malaysian ringgit, and the Indonesian rupiah began to depreciate, and they registered a 25-35 percent depreciation against the U.S. dollar by early October. From mid-October, the currency crises in these countries spilled over to Taiwan, Hong Kong, and South Korea. Specifically, in mid-October, the New Taiwan dollar plunged as the Central Bank of the Republic of China

¹³⁵ "Summary of the Governor's Press Conference on May 15, 1996," BOJ Archives "Summary of the Governor's Press Conferences (1996)," No. 65161.

¹³⁶ Policy Board, BOJ (1998a), p. 13.

(Taiwan) switched its stance to one allowing currency depreciation. This triggered large-scale speculation against the Hong Kong dollar. As a punitive action against this movement, the Hong Kong Monetary Authority raised interest rates, which resulted in the largest-ever fall in the Hong Kong Stock Exchange's benchmark Hang Seng Index. The contagion then spread to the stock markets in Tokyo, New York, and South Korea. The Korean won, for example, depreciated significantly in parallel with the plunge in stock prices. These developments show that the currency crises that broke out in Asian countries directly resulted in a larger financial crisis (the Asian Financial Crisis).¹³⁷

Under these circumstances, the governments of Thailand, Indonesia, and South Korea requested emergency assistance from the IMF on July 29, October 8, and November 21, respectively. In response, the IMF provided emergency financial assistance under strict conditionality to carry out structural reforms. The IMF's decision to provide support bore no fruit, however, and the Indonesian rupiah plunged again in January 1998. In light of this, Malaysia introduced capital and currency exchange control while shifting toward monetary and fiscal easing, upon witnessing a drop in the country's domestic demand following the implementation of severe austerity measures to avoid further depreciation of its currency.¹³⁸ This action was based on Prime Minister Mahathir bin Mohamad's view that whether a currency crisis materialized was not an issue of economic structure, nor was it the result of a deterioration in economic activity; rather, it was caused by financial panic in such forms as capital outflows, banks' liquidity crises, and bank runs. Thus, each country responded differently to its own currency crisis. However, the real GDP of Indonesia, Thailand, Malaysia, and South Korea for 1998 all recorded negative growth year on year, at minus 13.7 percent, minus 8.0 percent, minus 6.8 percent, and minus 5.5 percent, respectively.¹³⁹

In this situation, the Bank of Japan took the following measures to contribute to international assistance in stabilizing the East Asian economies. First, in July 1997, it attended the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) Governors' Meeting,¹⁴⁰ where Governors discussed countermeasures against the East Asian currency

¹³⁷ Office of Historical Studies, Information Service Department, Policy Research Institute, MOF (2017), pp. 250-256.

¹³⁸ Hayami (1998b), p. 2.

¹³⁹ Office of Historical Studies, Information Service Department, Policy Research Institute, MOF (2017), pp. 257-258.

¹⁴⁰ EMEAP was established in 1991 on the initiative of the Bank of Japan to foster closer cooperation among member central banks. While executive-level meetings were initially held on a

turmoil. Second, in August 1997, the Bank of Japan, together with the Asian, European, and U.S. monetary authorities as well as the BIS, clarified its position that it would support the stabilization program prepared by the Thai authorities and that together they should stand ready, in case of need, to provide a short-term bridging facility. This was announced in the "Statement in support of the Thai adjustment programme" released by the BIS. Third, in November 1997, in response to requests from Bank Indonesia, the Bank of Japan sent a team consisting of its staff members on a technical assistance mission to improve Indonesia's payment and settlement systems. And fourth, in December 1997, in response to requests from the Bank of Korea, the Bank of Japan provided a short-term bridging facility amounting to 165.0 billion yen until loans were provided by the IMF.¹⁴¹

2. Economic conditions in Japan

Japan's economy had been on an improving trend from the second half of 1995, as described in Section A.2. of this chapter. From April 1997, however, it staged a turnaround and entered a deceleration phase that grew increasingly evident over time.¹⁴² Specifically, the economic slowdown was triggered by a consumption tax hike -- from 3 percent to 5 percent -- and the discontinuation of the special tax cut,¹⁴³ both of which were implemented in April 1997.¹⁴⁴

regular basis, a decision was reached at the first EMEAP Governors' Meeting held in Tokyo on July 19, 1996, to hold Governors' Meetings once a year. The members of the first meeting in 1991 comprised the Reserve Bank of Australia, Bank Indonesia, the Bank of Korea, Bank Negara Malaysia, the Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, the Monetary Authority of Singapore, the Bank of Thailand, and the Bank of Japan. Currently, it comprises the central banks and monetary authorities of 11 economies with the addition of the People's Bank of China in 1992 and the Hong Kong Monetary Authority in 1993 (International Department, BOJ [2005], "Document on the Fifth EMEAP Meeting and Reference on the List of Past EMEAP Participants, International Department, January 13, 1993," BOJ Archives "EMEAP," No. 44848, and EMEAP [<http://www.emeap.org/>]).

¹⁴¹ Policy Board, BOJ (1998a), pp. 47-48.

¹⁴² Research and Statistics Department and Policy Planning Office, BOJ (1998), p. 24.

¹⁴³ In autumn 1994, with the tax reform to rectify the imbalance between direct and indirect income taxes, the consumption tax hike as well as income tax and inhabitant tax cut of 5.5 trillion yen -- of which 3.5 trillion yen was an institutional tax cut by changing the tax rate table and 2 trillion yen was a special tax cut -- were decided. Since 1995, although the institutional tax cut prior to the consumption tax hike and the special tax cut had been implemented, in the outline of the tax reform decided by the Cabinet on January 10, 1997, a decision was reached to discontinue the special tax cut during fiscal 1997 (Office of Historical Studies, Information Service Department, Policy Research Institute, MOF [2014], pp. 556-557, and BOJ [1997a], p. 179).

¹⁴⁴ Initially, the effects of the consumption tax hike were considered to be only temporary; however, private consumption continued to be sluggish even as of autumn 1997. In light of the lasting effects,

Thereafter, Japan's stagnant economic growth became particularly evident from autumn 1997 due to the following factors: (1) household spending waned as consumer sentiment became cautious due mainly to the failures of some financial institutions¹⁴⁵ and (2) exports peaked out against the background of currency and economic adjustments in Asian economies.¹⁴⁶

Meanwhile, prices had been stable on the whole, excluding the effects of the consumption tax hike; however, from autumn 1997, they softened somewhat (Chart 2),¹⁴⁷ and asset prices, namely, land prices and stock prices, continued to decline throughout the year (Chart 6). Regarding land prices, while commercial land prices near city centers -- where large-scale development was possible -- showed signs of bottoming out, prices of irregular-shaped and small-scale commercial land continued to decline, and residential land prices also remained somewhat weak. As for stock prices, after a temporary decline around the turn of 1997, they rose moderately from the beginning of April but started to decline again from summer.

In this situation, the year 1997 witnessed the failure of many financial institutions -- namely, 11 depository institutions, 5 securities firms, and 1 life insurance company. In particular, since the beginning of November, financial institutions including some city banks and major securities firms failed successively, such as Sanyo Securities, the Hokkaido Takushoku Bank,¹⁴⁸ Yamaichi Securities Co., and the Tokuyo City Bank.¹⁴⁹ On November 3, Sanyo Securities announced that it had decided to suspend part of its business

the Bank changed its assessment from "Japan's economy continues on a moderate recovery trend" to "Japan's economic growth has been decelerating" (BOJ [1998i], p. 1, and Research and Statistics Department, BOJ [1997b, 1997c, and 1997d]).

¹⁴⁵ In addition, implementation of the health-care insurance system reform, namely, raising coinsurance of the insured, intensification of debate over the pension system reform, and other such factors are considered to have led to the weakening of consumer sentiment (Research and Statistics Department and Policy Planning Office, BOJ [1998], p. 45).

¹⁴⁶ BOJ (1998i), p. 1.

¹⁴⁷ Research and Statistics Department and Policy Planning Office, BOJ (1998), pp. 27-28 and 60-65, Research and Statistics Department, BOJ (1997b), p. 10, Research and Statistics Department, BOJ (1997c), p. 10, Research and Statistics Department, BOJ (1997d), pp. 13 and 23, and Policy Board, BOJ (1998a), pp. 7 and 9.

¹⁴⁸ The Hokkaido Takushoku Bank was established as a special bank in 1900 under the Hokkaido Takushoku Bank Law, but was eventually converted to an ordinary bank in 1950 in accordance with the enforcement of the Act on Repeal of the "Nihon Kangyo Ginko Act" and Other Acts (Hokkaido Takushoku Bank [1971], pp. 37-39, 44, 303-305, and 310).

¹⁴⁹ Policy Board, BOJ (1998a), pp. 14-15.

operations and that the application for the commencement of reorganization proceedings based on the Corporate Reorganization Act that it had filed with the Tokyo District Court had been accepted.¹⁵⁰ Sanyo Securities had been raising funds in the call market, but with the commencement of reorganization proceedings, a default occurred in the call market for the first time.¹⁵¹ This was followed by the Hokkaido Takushoku Bank, which, on November 17, made a request to the DICJ to have its NPLs purchased and announced the transfer of its business operations in the Hokkaido region to the North Pacific Bank (Hokuyo Bank), on the grounds that it was no longer possible to fulfill its overall funding requirements, making it difficult to continue its business operations. Thereafter, on November 24, Yamaichi Securities announced its decision to suspend its business operations as a step toward closing down its business and dissolving the firm. Furthermore, on November 26, the Tokuyo City Bank made a request to the DICJ for financial assistance including the purchase of its NPLs, and announced a business transfer to the Sendai Bank on the premise that a part of its assets and deposits would be transferred to financial institutions within and outside Miyagi Prefecture, including the 77 Bank.¹⁵²

Concern among market participants regarding Japan's financial system heightened, reflecting the successive failures of financial institutions, and resulted in major turmoil in financial markets.¹⁵³ In particular, on November 25 and 26, stock prices fell significantly, mainly for bank stocks, giving rise to confusion among market participants as various rumors proliferated. Monetary authorities and other related entities denied these rumors through press conferences and other means,¹⁵⁴ and as a means to reinforce these efforts, the Minister of Finance and the Governor of the Bank of Japan, in a joint statement released in the evening of November 26, 1997, asked the public to avoid being misguided by groundless rumors and to act sensibly.¹⁵⁵

¹⁵⁰ BOJ (1998a), pp. 43-44, and FBAJ (1997d), pp. 49-53.

¹⁵¹ FBAJ (1997d), p. 50.

¹⁵² The Tokuyo City Bank held a press conference at 7:45 a.m., and the Minister of Finance and the Governor of the Bank of Japan each held a press conference at 8:00 a.m. (the evening editions of *Asahi Shimbun* and *Mainichi Shimbun* on November 26, 1997, and "Summary of the Governor's Press Conference on November 26, 1997," BOJ Archives "Summary of the Governor's Press Conferences [1997]," No. 66741).

¹⁵³ Policy Board, BOJ (1998a), p. 15.

¹⁵⁴ Specifically, the Kiyo Bank, the LTCB, the Ashikaga Bank, the Keiyo Bank, and the Hiroshima Bank each denied the various rumors in the market through the release of statements and other means.

¹⁵⁵ FBAJ (1998a), pp. 120-121.

3. Monetary policy measures as part of crisis management operations

a. Use of the New Financial Stabilization Fund for restructuring the Nippon Credit Bank (April 1997)

On April 1, 1997, the Nippon Credit Bank (NCB) announced the following: a package of restructuring plans including sales of real estate it had owned, reduction in its personnel, and the disposal of its NPLs; the legal resolution of its three nonbank affiliates; the revision of its financial results for fiscal 1996 to record a significant deficit; and the suspension of its fiscal year-end dividend payments.

The NCB had worked to improve its financial conditions following the bursting of the bubble economy by addressing the deterioration in its asset portfolio, namely, through the disposal of its NPLs. Despite these efforts, however, yields on bank debentures issued by the NCB generated a significantly higher premium relative to those on other bank debentures, giving rise to rumors confirmed on February 5, 1997, that the NCB might be facing financial difficulties. Markets soon regained composure but only briefly. Taking into account the downgrading of its debentures by a U.S. credit rating agency on March 21, market participants had been directing their attention to the NCB's restructuring plans in view of the upcoming book-closing period at end-March. Subsequently, given newspaper coverage of the NCB's restructuring plans on March 27, which included its withdrawal from overseas operations, the NCB made its official announcement at the turn of the fiscal year on April 1, 1997.¹⁵⁶

In compiling the package, the government strongly requested that the Bank of Japan contribute to the Primary Account of the New Financial Stabilization Fund,¹⁵⁷ in which funds provided by the Bank would be managed. Given this request for the reinforcement of the NCB's capital base by about 300 billion yen, the Bank judged it appropriate to use the

¹⁵⁶ FBAJ (1997b), pp. 131-132.

¹⁵⁷ An incorporated association established on September 25, 1996, with the objective of enhancing the stability of Japan's financial system and ensuring confidence in it at home and abroad. In its establishment, the following decisions were made: in said association, a fund for receiving contributions from official members (private financial institutions such as banks, life insurance companies, securities companies, as well as agricultural and forestry financial institutions) and the special member (the Bank of Japan) will be set up; it will be managed in two separate accounts, the Primary Account for contributions by the special member and the Secondary Account for contributions by official members; and the Primary Account will be utilized to consolidate the capital base of financial institutions. With a view to ensuring the stability of the financial system as a whole, the Bank became a founder of the association, and, as the special member, provided 100 billion yen to the Fund. See Policy Board, BOJ (1997), pp. 76-78.

Fund with an upper limit of 80 billion yen through underwriting preferred stocks to supplement the shortage of capital subscribed by private financial institutions. The Bank agreed to the use of funds it would contribute to the Primary Account upon consultation by the Fund, in line with the procedure specified in the articles and rules of the Fund. This was based on the judgment that (1) the underwriting of preferred stocks using the Fund as part of the NCB's restructuring package met the objective of the Fund, namely, "to enhance the stability of Japan's financial system and to ensure confidence in it at home and abroad," and (2) the use of the Fund was considered reasonable in light of the Bank's four principles for fund provision, namely, that there must be a strong likelihood that systemic risk will materialize, there must be no alternative to the provision of central bank money, appropriate measures will be taken to prevent moral hazard, and that the financial soundness of the Bank must not be impaired.¹⁵⁸

b. The Bank of Japan's fund provision for the resolution of the Hokkaido Takushoku Bank, Yamaichi Securities, and the Tokuyo City Bank (November 1997)

On April 1, 1997, the Hokkaido Takushoku Bank announced that, alongside its decision to withdraw from its overseas operations, it had reached an agreement with the Hokkaido Bank that they would merge on equal terms.¹⁵⁹ However, on September 12, the Hokkaido Takushoku Bank announced postponement of its planned merger due to discrepancies in understanding on such issues as the recognition of NPLs and plans for writing them off. On the same day, it also made public a restructuring program consisting of the disposal of NPLs, raising of new capital, and improvement in management efficiency, and made efforts toward its implementation.¹⁶⁰ However, the Hokkaido Takushoku Bank's financial position deteriorated due to its failure to gain market confidence, as was seen in the sharp decline in its stock prices in addition to a decrease in the amount of deposits, and due to difficulties in securing funds in the money market mainly given the effects of Sanyo Securities defaulting in the call market.¹⁶¹

¹⁵⁸ Policy Board, BOJ (1998a), p. 120. At this point, provisions of risk capital had been conducted as these were regarded as satisfying the four principles for the Bank's fund provision. However, reflecting the refinement of other components of the special safety net to avoid a financial crisis, it was specified in "Application of Four Principles of Special Loans to Maintain Financial System Stability," which was decided by the Bank's Policy Board on May 14, 1999, that the Bank should not provide risk capital (Policy Board, BOJ [1999b]). For details, see Appendix 2.

¹⁵⁹ FBAJ (1997b), pp. 129-131.

¹⁶⁰ FBAJ (1997c), pp. 83-91.

¹⁶¹ Policy Board, BOJ (1998a), pp. 101-105, and FBAJ (1997d), pp. 39-43.

Under these circumstances, the Bank of Japan was informed by the Hokkaido Takushoku Bank of the following points in the evening of November 16: (1) it had become difficult to continue its business operations on its own; (2) in order to maintain its role as a financial intermediary in Hokkaido, it would seek to transfer its business to a receiving bank, and in doing so, request the DICJ to purchase its NPLs, among other measures; and (3) in order to clarify management responsibility, all of its directors would resign prior to the transfer of its business operations. Given this situation, the Bank of Japan held an unscheduled Policy Board meeting in the morning of November 17, and, from the perspective of ensuring the stability of the financial system as a whole, it decided to provide the Hokkaido Takushoku Bank with a minimum amount of liquidity necessary to continue such business operations as deposit repayments, pursuant to Article 25 of the Bank of Japan Act of 1942, until a resolution package was implemented.^{162, 163}

Thereafter, early in the morning of November 24, 1997, Yamaichi Securities decided to suspend its business operations as a step toward closing down its business and dissolving the firm.¹⁶⁴ Developments leading up to this decision were as follows. After having faced a continued decline in profits since the bursting of the bubble economy, the situation grew increasingly severe from spring 1997. Specifically, the decline in market confidence in the firm became significant at home and abroad due to, for example, moves among credit rating agencies to downgrade the firm's rating and to the materialization of scandals, such as profit provision involving corporate racketeers. Moreover, massive off-the-book liabilities held by the firm surfaced.¹⁶⁵ In response, the Bank of Japan held an unscheduled Policy Board meeting in the morning of November 24, and, in order to fulfill its mission of maintaining stability of the financial system, decided to take an extraordinary measure, pursuant to Article 25 of the Bank of Japan Act of 1942.¹⁶⁶ Under this measure, the Bank of Japan

¹⁶² At a press conference held on November 17 from 8:20 a.m., Governor Matsushita responded to a question from a reporter that "the Bank held the unscheduled Policy Board meeting this morning, and decided on the measure" ("Summary of the Governor's Press Conference regarding the Hokkaido Takushoku Bank on November 17, 1997," BOJ Archives "Summary of the Governor's Press Conferences [1997]," No. 66741).

¹⁶³ Policy Board, BOJ (1998a), pp. 49-50 and 100-101.

¹⁶⁴ Regarding this decision, President Shohei Nozawa of Yamaichi Securities explained at a press conference held on November 24 that it had been "decided officially at the board meeting at 6:00 this morning" (the morning edition of *Mainichi Shimbun* on November 25, 1997, p. 8).

¹⁶⁵ Policy Board, BOJ (1998a), pp. 105-106, and FBAJ (1998a), pp. 129-134.

¹⁶⁶ The press conference on the Policy Board's decision on the measure was held on November 24

would provide liquidity to Yamaichi Securities through extending loans to the Fuji Bank -- the firm's major correspondent financial institution -- of an amount necessary for proceeding with the following: return of customer assets, orderly settlement of outstanding transactions, and withdrawal from overseas operations.¹⁶⁷

Moreover, on November 26, 1997, the Tokuyo City Bank transferred its business operations to the Sendai Bank after (1) making a request to the DICJ for financial assistance, including the purchase of its NPLs, and (2) transferring part of its assets and deposits to financial institutions within and outside Miyagi Prefecture, including the 77 Bank. In order to clarify management responsibility, it was decided that the Tokuyo City Bank's Chairman and President would resign.¹⁶⁸ After developing a restructuring plan in March 1996, the Tokuyo City Bank had sought to carry it out. However, concern about financial stability arising from the successive failures of Sanyo Securities, the Hokkaido Takushoku Bank, and Yamaichi Securities, among other developments, led customers to continue withdrawing their deposits amid stock price declines, resulting in the failure of the Tokuyo City Bank to raise the necessary funds.¹⁶⁹ In this situation, the Bank of Japan held an unscheduled Policy Board meeting in the morning of November 26,¹⁷⁰ and decided to provide the Tokuyo City Bank with a minimum amount of liquidity -- through extension of loans pursuant to Article 25 of the Bank of Japan Act of 1942 -- necessary for continuing such business operations as deposit repayments, until a resolution package was implemented.¹⁷¹

c. Market developments and the Bank of Japan's money market operations (November

from 10:30 a.m. ("Summary of the Governor's Press Conference on November 24, 1997," BOJ Archives "Summary of the Governor's Press Conferences [1997]," No. 66741). A newspaper reported on November 25 that the Policy Board meeting was held from 8:15 a.m. to around 9:00 a.m. (the morning edition of *Tokyo Shimbun* on November 25, 1997, p. 5).

¹⁶⁷ Policy Board, BOJ (1998a), pp. 49-51 and 106-110.

¹⁶⁸ The Tokuyo City Bank's unscheduled board meeting was held from around 5:00 a.m., and a press conference was held by President Tokio Niida from 7:45 a.m. (the evening editions of *Sankei Shimbun*, *Asahi Shimbun*, and *Mainichi Shimbun* on November 26, 1997).

¹⁶⁹ Policy Board, BOJ (1998a), pp. 110-114, and FBAJ (1998a), pp. 127-129.

¹⁷⁰ The press conference on the Policy Board's decision was held on November 26 from 8:00 a.m. ("Summary of the Governor's Press Conference on November 26, 1997," BOJ Archives "Summary of the Governor's Press Conferences [1997]," No. 66741).

¹⁷¹ Policy Board, BOJ (1998a), pp. 49-50 and 111-114.

through end-December 1997)

Following the series of failures of financial institutions, concern about financial system stability in Japan heightened. The Japan premium -- which had been low and stable through October 1997 -- expanded rapidly from late November. Liquidity declined in the domestic financial market as well.¹⁷² Specifically, in the call market, regional banks and trust banks almost instantly adopted a cautious lending stance following the voluntary closure of Yamaichi Securities in late November. As a result, market liquidity declined temporarily, and the weighted average of the uncollateralized overnight call rate, which had been slightly below the 0.5 percent level, reached 0.64 percent on November 27. In the Eurodollar market, the Japan premium began to expand gradually in the wake of the failure of Sanyo Securities in early November, and widened further, reflecting the successive failures of the Hokkaido Takushoku Bank and Yamaichi Securities, with the 3-month premium reaching around 1.0 percent by early December. Similarly, in the money market, interest rates on term instruments with approximate maturities ranging from 1 month to 1 year -- for example, interest rates on CDs and euro-yen rates -- rose significantly from late November, primarily reflecting the expansion of the Japan premium. Among these, 3-month euro-yen rates reached the range of 1.1-1.2 percent in early December, rising sharply from their previous level of slightly below 0.6 percent.

In view of such market developments, the Bank of Japan -- while maintaining its monetary easing stance -- made its utmost efforts to reduce market anxiety through money market operations.¹⁷³ Specifically, in response to the upward divergence of the uncollateralized overnight call rate from its target level, the Bank provided ample liquidity to the money market through its money market operations with the aim of ensuring the stable formation of market interest rates and smoothing interbank transactions.¹⁷⁴

¹⁷² FBAJ (1998a), pp. 121-123, and Policy Board, BOJ (1998a), pp. 15 and 40-41.

¹⁷³ The Bank's stance on the conduct of money market operations during this time was also disclosed in the statement by the Governor released on November 24, 1997, upon the failure of Yamaichi Securities, and in the joint statement by the Minister of Finance and the Bank's Governor on ensuring financial system stability, released on November 26 (Policy Board, BOJ [1998a], pp. 52-54 and 108-110).

¹⁷⁴ Throughout 1997, the Bank continued to conduct money market operations based on the following guideline adopted in September 1995: "The Bank will maintain the money market interest rate (the uncollateralized overnight call rate) slightly below the official discount rate (cut to 0.5 percent per annum in September 1995) on average" (Policy Board, BOJ [1998a], p. 37).

As part of its efforts, the Bank also supplied longer-term funds with a duration over the year-end and fiscal-year end, so as to restrain upward pressure on interest rates on term instruments maturing beyond the year-end or the fiscal year-end, thereby promoting stability in market interest rates as a whole. Specific tools of the operation included borrowings of Japanese government bonds (JGBs) against cash collateral (the so-called repo operations), purchases of TBs and CP, and outright purchases of bills.¹⁷⁵ The Bank's provision of ample longer-term funds resulted in excess liquidity relative to immediate liquidity needs arising from payment and settlement in the market, and caused the uncollateralized overnight call rate to remain susceptible to downward pressure. In order to prevent the rate from approaching 0 percent, the Bank, in tandem with its longer-term funds-supplying operations, conducted funds-absorbing operations, in which it absorbed relatively short-term funds -- mostly with approximate maturities of 1 day to 3 weeks -- through sales of bills.¹⁷⁶ As a result of these money market operations, the uncollateralized overnight call rate, which had temporarily exhibited a substantial rise, gradually regained stability from the beginning of December, and thereafter stayed somewhat below the official discount rate on average, albeit with some fluctuations.¹⁷⁷

When extending loans on bills based on Article 20 of the Bank of Japan Act of 1942, the Bank used to calculate the amount of interest by including both the date of extension and the date of repayment in the loan period. However, given the increasing need to flexibly extend short-term loans on bills in line with money market developments, the Bank decided on November 28 to adopt another method of interest calculation as a special measure effective through end-December 1997. By introducing this method, under which the loan period covered day two of loan extension through the date of repayment, the Bank aimed at preventing the effective interest rate of loans on bills from largely exceeding the market interest rates.¹⁷⁸ Subsequently, on December 25, the Bank decided to modify calculation

¹⁷⁵ At the Policy Board meeting held on October 28, 1997, it was decided that "bonds such as JGBs with cash collateral shall be valid for borrowing or lending, but for the time being, only repo operations shall be conducted." Following the approval by the Minister of Finance on October 30, the Bank released a statement introducing the repo operations on October 31 (Policy Board, BOJ [1998a], pp. 81-84).

¹⁷⁶ BOJ (1998i), pp. 49-52, 64, and 66.

¹⁷⁷ Policy Board, BOJ (1998a), pp. 41-42.

¹⁷⁸ FBAJ (1998a), p. 123, and "125th Document Consulted on with the Governor concerning the Special Measure for the Calculation of Interest on Loans on Bills, Credit and Market Management Department, Policy Planning Department, Operations Department, and Financial and Payment

methods for amounts of both discounts and interest arising from discounts and loans on bills, fully conforming to the aforementioned method. This was based on the line of thinking that (1) the decision would allow for consistency between the said method and conventional rules governing transactions in the call market and the bill market, and (2) equivalence in the official discount rate and the effective interest rate would enhance the transparency of the Bank's policy conduct.¹⁷⁹

d. Revision of the Bank of Japan Act

Prompted by the emergence, expansion, and bursting of the bubble economy as well as the occurrence of the NPL problem and other repercussions, vigorous discussions were held on Japan's financial administration and monetary policy among a wide range of entities. This led to increasingly heated arguments calling for reform of the institutional framework of the central bank, responsible for conducting monetary policy, by revising the Bank of Japan Act of 1942, which had been legislated during World War II; specifically, through further clarification of the Bank's independence and accountability regarding its policy decisions, in other words, greater transparency of its policy management.¹⁸⁰ Under these circumstances, the government proceeded with revisions to the Bank of Japan Act of 1942, and on March 11, 1997, the bill for the new Bank of Japan Act was submitted to the Diet after the Cabinet's approval was obtained. The bill passed the House of Representatives and

System Department, November 28, 1997," BOJ Archives "Loan Extension," No. 66574.

¹⁷⁹ "148th Document Consulted on with the Governor concerning Changes in the Calculation Method for Amounts of Discounts and Interest Arising from Discounts and Loans on Bills, Credit and Market Management Department, Policy Planning Department, Financial and Payment System Department, Operations Department, and Information System Services Department, December 25, 1997," BOJ Archives "Loan Extension," No. 66574.

¹⁸⁰ A report titled "Reforms of Financial Administration and Monetary Policy," published on June 13, 1996, by a project team of the ruling coalition parties, raised the revision of the Bank of Japan Act of 1942 as one of the important pillars of the reforms. The report stated, "It is necessary to revise the Bank of Japan Act in the form of further clarifying the Bank's independence and accountability regarding its policy decisions as a central bank, so as to avoid any repetition of failures of macroeconomic policy in addressing excessive liquidity and the bubble economy" (FBAJ [1996b], pp. 17-19). The following day, Governor Matsushita, at a speech at the Japan National Press Club, stated that a common understanding on the basic thinking on central banking was a prerequisite for deliberating on specifics of the revision of the Bank of Japan Act. He then explained the following three major points that constituted the basis of any debate on central banking by also making reference to discussions that had taken place outside Japan: (1) roles of a central bank; (2) the relationship between a central bank and the government; and (3) the status of a central bank in a democratic society (Matsushita [1996]).

the House of Councillors by a majority vote on May 22 and June 11, respectively, and was then promulgated as the Bank of Japan Act of 1997 on June 18.¹⁸¹

At a press conference held on June 11, 1997, upon passage of the Bank of Japan Act of 1997 in the Diet as well as its enactment, Governor Matsushita commented that the revision was "the most remarkable event in the 115 years of the Bank's history." Meanwhile, the following question was raised at the press conference: "Given that there are views that the Bank has mistaken the timing of implementing its monetary policy measures twice -- in the first half of the 1970's and in the latter half of the 1980's -- both of which resulted in inducing economic downturns, can we say that the revision of the Bank of Japan Act of 1942 completely dispelled concerns that the Bank would make a mistake again?" Governor Matsushita responded, "The Bank has indeed undergone some valuable experiences that should be reviewed and reflected when conducting monetary policy, such as the emergence, expansion, and bursting of the bubble economy as well as inflation prior to the bubble period." He then pointed to the following as lessons learned from such experiences: "(1) It is not necessarily appropriate to consider that the objective of monetary policy is to directly address the issues of, for example, exchange rates and balance of payments; and (2) in conducting monetary policy, it is a matter of course that the Bank pay attention to developments in such factors as prices, but at the same time the Bank needs to swiftly take preemptive responses by making efforts to foresee how developments in, for example, asset prices will affect the future course of the economy or economic activity." He further stated, "The Bank will ensure appropriate policy management by paying due attention to these points in making policy decisions and implementing measures going forward."¹⁸²

C. Pursuing Financial System Stability amid the Prolonged Financial Crisis (Early 1998 through Summer 1998)

1. Economic conditions in major overseas economies¹⁸³

In the United States, exports followed a decreasing trend since the turn of 1998 due mainly to a decline in demand stemming from the currency and economic adjustments in Asia. Nevertheless, the economy continued to expand firmly on the whole, supported by solid

¹⁸¹ Policy Board, BOJ (1997), p. 49, and Policy Board, BOJ (1998a), pp. 58-59. For an outline of the revision of the Bank of Japan Act of 1942, see Appendix 3.

¹⁸² "Summary of the Governor's Press Conference on June 11, 1997," BOJ Archives "Summary of the Governor's Press Conferences (1997)," No. 66741.

¹⁸³ The description in this section is based on Chapter I.A.3. of BOJ (1998i), unless otherwise noted.

expansion in domestic demand, particularly in household spending and business fixed investment (Chart 7).

Regarding the European economies, the GDP growth rate for 1998 exceeded the previous year's level in the case of France, while remaining more or less unchanged in the United Kingdom and Germany (Chart 7).

As for East Asia, domestic demand remained sluggish in many of the NIEs and the ASEAN countries due to the implementation of economic austerity measures, inevitably bringing about economic deceleration in the overall region. The Chinese economy, which continued to exhibit high growth through 1997, also saw a gradual deceleration mainly due to the slower growth in private consumption, in addition to downward pressure on exports from such factors as the decline in domestic demand in other Asian countries (Chart 7).

Meanwhile, in Russia, financial markets had been unstable since the turmoil in Asian currencies and financial markets in summer 1997. From May 1998, capital flight from the country increased, and prices of bonds and stocks plunged. In response, the government announced on August 17 a change in the target zone for exchange rates, the *de facto* devaluation of the ruble, and emergency measures -- including the suspension of some repayments of external public debt for 90 days.¹⁸⁴ Thereafter, however, partly affected by political unrest, economic and financial conditions remained unstable. Such turmoil in the currency and financial markets further spread to countries in Central and South America, as seen in Brazil's substantial rate hike aimed at defending its currency's depreciation.

2. Economic conditions in Japan

a. Falling into negative growth

As mentioned in Section B.2. of this chapter, from April 1997, Japan's economy entered a deceleration phase triggered mainly by the consumption tax hike. From autumn 1997, stagnant economic growth became evident: household spending waned as consumer sentiment became cautious due mainly to failures of some financial institutions; exports peaked out, reflecting currency and economic adjustments in Asian economies.

From the start of 1998,¹⁸⁵ business fixed investment fell sharply, reflecting not only the economic factors mentioned above, but also financial factors such as private banks' lending attitudes that became cautious due to the NPL problem. As final demand plunged, production activity declined significantly with downward pressure from inventory

¹⁸⁴ Economic Planning Agency (EPA) (1999), Chapter I.C.3.

¹⁸⁵ The description in this section is based on Chapter I.A.1. of both BOJ (1998i) and BOJ (1999n), unless otherwise noted.

adjustments. A vicious cycle among production, income, and spending gradually became strong: the decline in production activity led to decreases in corporate profits and employment income, which in turn restrained firms' and households' spending, such as business fixed investment and private consumption (Chart 1).

In response to the deterioration in the economy, the government set out a series of expansionary fiscal policies,¹⁸⁶ and implemented the following fiscal stimulus measures in 1998: (1) special income tax cut (applied from February); (2) an economic stimulus package with a total project size of 16 trillion yen (announced in April); (3) amendment of the Fiscal Structural Reform Act (in May) to make the issuance amount of deficit financing bonds flexible in order to carry out the economic stimulus package, and to postpone the target year for reducing fiscal deficit from fiscal 2003 to fiscal 2005; and (4) suspension of enforcement of the Fiscal Structural Reform Act (in December) until a date specified separately by an act.

b. Enactment of two acts to stabilize financial functioning (February 1998)

As a result of successive failures of large financial institutions in autumn 1997, banks' lending attitudes became severe and the so-called credit crunch occurred, thereby making it difficult for the corporate sector to raise funds. This reinforced the view that a delay in financial institutions' disposal of NPLs would exert strong adverse effects on the economy as a whole. In consequence, the importance of resolving the NPL problem promptly through the injection of public funds and recovering the financial intermediation function was reconfirmed.¹⁸⁷

Against this background, in December 1997, the ruling party of the government drafted and decided on a scheme to stabilize the financial system, through which 30 trillion yen of public funds was set to be injected to dispose of the failed financial institutions and enhance capital bases of surviving institutions.¹⁸⁸ Two acts based on this scheme were passed on

¹⁸⁶ Office of Historical Studies, Information Service Department, Policy Research Institute, MOF (2014), pp. 165 and 177, and Office of Historical Studies, Information Service Department, Policy Research Institute, MOF (2013), pp. 640-643 and 659-660.

¹⁸⁷ Ikeo (2009), pp. 95-97.

¹⁸⁸ The headquarters in charge of deliberating on emergency measures for stabilizing the financial system, which was set up at the Liberal Democratic Party, drafted and decided on the scheme on December 16, 1997, and made public on December 24, 1997, specific actions to support financial institutions in enhancing their capital bases as part of the emergency measures (FBAJ [1998a], pp. 105-113). In addition, the Cabinet decided on the draft supplementary budget of the general account for fiscal 1997, which included the government guarantee funds, and the draft budget of the general

February 16, 1998, namely, the Act on the Partial Revision of the Deposit Insurance Act and the Act on Emergency Measures for the Stabilization of Financial Functions. These acts stipulated the government's provision of JGBs worth 10 trillion yen in total to the DICJ -- specifically, 7 trillion yen to the Special Operations Fund and 3 trillion yen to the Financial Crisis Management Fund.¹⁸⁹ The government also formulated the supplementary budget of the general account for fiscal 1997 on February 4, 1998, and the general account budget for fiscal 1998 on April 8, 1998. It decided to provide the DICJ's accounts with the government guarantees worth 20 trillion yen in total -- specifically, 10 trillion yen each of guarantees against loans extended under the Special Operations Account and the Financial Crisis Management Account.¹⁹⁰

In this manner, public funds of 17 trillion yen were secured to protect depositors in case financial institutions failed, and those of 13 trillion yen were secured to enhance surviving financial institutions' capital bases. In March 1998, 1,815.6 billion yen of public funds were decided to be injected for the first time, into 21 financial institutions.¹⁹¹ These funds were borrowed from the Bank of Japan and private financial institutions; put into the Financial Crisis Management Account established at the DICJ pursuant to the Act on Emergency Measures for the Stabilization of Financial Functions; then lent to the Resolution and Collection Bank as it invested in or provided loans to individual financial institutions. On March 24, 1998, the Policy Board of the Bank of Japan decided on the principal terms and conditions on loans for the Financial Crisis Management Account at the DICJ, which stipulated that the amount should be kept to the minimum necessary for implementing business operations and repaying the existing loans.¹⁹²

account for fiscal 1998 on December 20, 1997, and December 25, respectively (FBAJ [1998b], pp. 39-40 and 53).

¹⁸⁹ The Special Operations Fund is established under the Special Operations Account for the purpose of conducting specially permitted business operations -- namely, financial aid exceeding costs of blanket deposit insurance and asset purchases from failed financial institutions. The Financial Crisis Management Fund is created, pursuant to the Act on Emergency Measures for the Stabilization of Financial Functions, in the Financial Crisis Management Account for the purpose of conducting financial risk management (DICJ [2007], pp. 60 and 238-240, and BOJ [1998b], pp. 119 and 126).

¹⁹⁰ DICJ (2007), pp. 32 and 58-59, BOJ (1998b), pp. 113 and 118-128, BOJ (1998c), p. 177, and FBAJ (1998b), pp. 39-40 and 53.

¹⁹¹ FBAJ (1998c), pp. 57-62.

¹⁹² Policy Board, BOJ (1998b).

c. Launch of the Financial Supervisory Agency (June 1998)

On June 22, 1998, the Financial Supervisory Agency (FSA) was launched as an external agency of the Prime Minister's Office with the enforcement of the Act Establishing the Financial Supervisory Agency and the Act on Arrangement of Relevant Acts Incidental to Enforcement of the Act Establishing the Financial Supervisory Agency, both of which passed the Diet on June 16, 1997.¹⁹³ The FSA took charge of inspection and supervision of private financial institutions -- such as those in the banking, insurance, securities, and other financial sectors -- including the authority to address matters related to failure resolution.

As a result, the inspection and supervisory authority over private financial institutions was completely transferred from the Minister of Finance to the Prime Minister, ranging from giving/revoking licenses, ordering business improvement and business suspension, and approving mergers. The authority was then legally transferred from the Prime Minister to the FSA Commissioner, except for licensing.

In addition, the acts stipulated that, in cases where the Prime Minister (or the FSA Commissioner, to whom the authority was legally transferred) acknowledged the risk that revocation of banks' licenses or provision of business suspension orders would exert grave adverse effects on the stability of the financial system, the Prime Minister (or the FSA Commissioner) should discuss the necessary measures in advance with the Minister of Finance.

d. Emergence of financial problems at the Long-Term Credit Bank of Japan

In June 1998, financial problems emerged at the LTCB.¹⁹⁴ The LTCB recorded a net deficit of 280 billion yen when settling accounts in March 1998, due mainly to the disposal of an enormous amount of NPLs. Meanwhile, its stock price fell due to the following factors: a release of an article on June 5 with a title including "bankruptcy of the LTCB" in a monthly magazine; circulation from June 9 of a rumor that a partnership with the Swiss Bank Corporation would dissolve; spreading of another rumor from June 17 that the LTCB faced financing difficulties; and a downgrade on June 18 by a rating agency.¹⁹⁵ Specifically, its stock price closed at 199 yen on June 4, but then temporarily marked below 100 yen on Friday, June 19, with the lowest price at 95 yen and the closing price at 112 yen, and remained below 100 yen from the opening on the following business day of Monday, June

¹⁹³ The description in this section is based on FSA (1999), pp. 1-3, and FBAJ (1997a), pp. 81-84.

¹⁹⁴ BOJ (1999c), p. 131.

¹⁹⁵ FBAJ (1998d), pp. 108-109.

22, and closing at 62 yen on that day.¹⁹⁶

Reflecting these developments, on June 26, the LTCB announced a merger plan with the Sumitomo Trust and Banking Co. (STB).¹⁹⁷ On the same day, the FSA Commissioner and the Governor of the Bank of Japan each released a statement, making it clear that the FSA, the MOF, and the Bank of Japan would cooperate closely to provide necessary support for the smooth implementation of the merger plan.¹⁹⁸

Nevertheless, even after the announcement of the merger plan with the STB, information about the LTCB facing excess debt or financing difficulties, as well as a rumor that the merger plan might be cancelled, continued to circulate in the markets, and its stock price closed at below 50 yen on July 22, and at 38 yen on August 11.¹⁹⁹ In order to address the situation, on August 21, the LTCB announced that it would take drastic restructuring measures in preparation for the merger with the STB and would work to improve its financial structures by applying for a capital injection pursuant to the Act on Emergency Measures for the Stabilization of Financial Functions. In response, the Prime Minister announced on the same day that the government would take every possible measure to support the merger plan, and the FSA Commissioner, the Minister of Finance, and the Governor of the Bank of Japan each released a statement that they would respond appropriately when the LTCB filed its application for capital injection.²⁰⁰

3. Pursuing a new approach to the monetary policy regime

a. New monetary policy framework based on the Bank of Japan Act of 1997

From January 1998, the Bank began to hold Monetary Policy Meetings (MPMs) in line with the new Bank of Japan Act of 1997 prior to the enforcement of the Act on April 1, 1998. With a view to enhancing the transparency of policy management, the Bank of Japan Act of 1997 stipulates that the MPMs, Policy Board meetings on monetary control matters,²⁰¹ shall be held regularly (Article 17, paragraph 2) and that the minutes and other related

¹⁹⁶ The stock price of the LTCB was taken from the securities column on *The Nikkei* (a reduced-size, reprinted edition, June 1998).

¹⁹⁷ On June 26, President Atsushi Takahashi of the STB and President Katsunobu Onogi of the LTCB held individual press conferences and explained that they had started a negotiation from June 22 (FBAJ [1998e], p. 86).

¹⁹⁸ FBAJ (1998e), pp. 86-88, and BOJ (1999c), pp. 159-160.

¹⁹⁹ FBAJ (1998f), p. 71.

²⁰⁰ FBAJ (1998f), pp. 71-76, and BOJ (1999c), pp. 161-162.

²⁰¹ "Monetary control matters" refers to matters concerning currency and monetary control listed in the items of Article 15, paragraph 1 of the Bank of Japan Act of 1997.

documents of the meetings shall be made public (Article 20). The Bank decided to implement all possible measures as soon as preparations were completed, even before the Bank of Japan Act of 1997 took effect.²⁰² Specifically, the Bank decided on the following at the Policy Board meeting held on December 26, 1997: (1) the meeting on monetary policy conduct would be named the Monetary Policy Meeting; (2) the MPM would be held about twice a month in principle and the schedule would be announced at the end of each quarter, that is, at the end of March, June, September, and December, for the six months following the month of the announcement; (3) matters to be decided at the MPM were (i) the guideline for money market operations, (ii) the level of the official discount rate, (iii) changes in the reserve requirement ratio, and other related matters; (4) decisions made at the MPM would be made public immediately after the meeting; and (5) the minutes of the MPM would be approved by the Policy Board at the second MPM following the MPM concerned and would be released on the third business day after the approval.²⁰³

The first MPM was held on January 16, 1998. At the regular press conference on January 20, 1998, Governor Matsushita was asked about the impression on the first meeting and answered, "It was the first experience for me to have discussions comprehensively and intensively with Policy Board members for determining the Bank's stance on monetary policy, and it was very meaningful to discuss at MPMs the future course of policy conduct, including the possibility of policy changes, given that the minutes of the MPMs will be released." He also noted, "Through the release of the minutes of the MPMs, we, the Policy Board members, intend to enhance the transparency of a policy decision-making process that is appropriate for the independence of a central bank."²⁰⁴

²⁰² At the press conference on June 11, 1997, when the Bank of Japan Act of 1997 was enacted, Governor Matsushita noted, "We are determined to promote, in line with the aim of the revision of the Act, wide-ranging reforms to further improve the transparency of policy management and the efficiency of the Bank's operational management" ("Summary of the Governor's Press Conference on June 11, 1997," BOJ Archives "Summary of the Governor's Press Conferences [1997]," No. 66741). At a speech on the theme of a new framework for monetary policy under the new Bank of Japan Act given on June 27, Governor Matsushita elaborated on the content of the Act and mentioned as follows: "The Bank intends to implement all possible measures as part of the Bank's self-reform even before the new Act takes effect, to accommodate the aims of the new Act"; and "The Bank is currently studying a concrete mechanism for holding regular Policy Board meetings on monetary control matters and for disclosing the minutes of those meetings, which will be implemented as soon as preparations are completed" (Matsushita [1997]).

²⁰³ BOJ (1997b).

²⁰⁴ "Summary of the Governor's Press Conference on January 20, 1998," BOJ Archives "Summary

With regard to the rules for the formulation of policy proposals and the determination of policy action, Chairman Matsushita proposed the following at the first MPM: (1) the guideline for money market operations would be determined at every MPM, including determination of unchanged guidelines, and (2) the official discount rate and the reserve requirement ratio would be determined only when policy changes were involved. This proposal was approved by the Policy Board members, and the monetary policy decisions started to be made in line with these rules.²⁰⁵

b. Conduct of monetary policy from early 1998 through summer 1998

From early 1998 through summer 1998, a downtrend in Japan's economy gradually became evident, as described in Section C.2. of this chapter. So as to firmly underpin economic activity from the financial side, the Bank maintained the monetary easing stance that it had decided to take in September 1995. Specifically, at the 13 MPMs held from January 16 to August 11, 1998, the Bank decided to maintain the guideline for money market operations, which set that "the Bank will encourage the uncollateralized overnight call rate to remain on average slightly below the official discount rate." Throughout this period, the Bank did not make any decisions of changing the official discount rate and maintained the rate at 0.5 percent on an annualized basis since September 8, 1995. As for the definition of the duration to which the guideline applies "on average," Chairman Matsushita explained, in submitting the proposal at the MPM held on January 16, 1998, "It seems appropriate to continue considering the reserve maintenance period of one month as the average duration, in principle." He also said that "if the average duration is the intermeeting period of two weeks, the duration would be too short to conduct money market operations in a deliberate manner." The Policy Board members agreed on this view.²⁰⁶

With regard to monetary policy decisions, four Policy Board members -- namely, the Governor and three appointed members -- had the right to vote under the provisions of the Bank of Japan Act of 1942, and the decisions were made by a unanimous vote at the MPMs held from January 16 to March 26, 1998.²⁰⁷ From April, the vote was taken by nine Policy Board members under the Bank of Japan Act of 1997, namely, the Governor, two Deputy

of the Governor's Press Conferences (1998)," No. 69034.

²⁰⁵ BOJ (1998i), pp. 43 and 128.

²⁰⁶ BOJ (2008), p. 53.

²⁰⁷ Specifically, the vote was taken by the following four members: the Governor, Mr. Shigeru Koino, Mr. Yasuo Gotoh, and Mr. Susumu Taketomi. Governor Hayami succeeded Governor Matsushita on March 20, 1998.

Governors, and six Members of the Policy Board, and monetary policy decisions continued to be made by a unanimous vote through the MPM held on May 19.²⁰⁸ Thereafter, at the MPMs held from June 12 to August 11, the Chairman's proposal was decided by a majority vote, as some members dissented from the proposal: Board Member Nakahara, for example, proposed to lower the target level of the uncollateralized overnight call rate to boost monetary aggregates since economic conditions had been deteriorating further.²⁰⁹ At the MPM held on June 12, Board Member Gotoh made a proposal to change the expression of the target level of the uncollateralized overnight call rate from "slightly below the official discount rate" to "a low level within the 0.40-0.50 percent range" because (1) the current expression was ambiguous and (2) it was not appropriate to decide the target level of the uncollateralized overnight call rate based on the official discount rate since guiding of the overnight call rate had already played the central role in monetary policy management. However, this proposal was defeated by a majority vote, as many members were of the opinion that, if the guideline for money market operations was to be unchanged, then the Bank had better keep the expression used in the guideline unchanged to preclude any misinterpretation, and changes in the expression should be considered when implementing a policy shift in the future.²¹⁰

Meanwhile, the reserve requirement ratios were kept unchanged. At the MPM held on June 12, however, Board Member Miki made a proposal to lower the ratios to reduce the average amount outstanding of required reserves by approximately 1 trillion yen, with a view to reinforcing the accommodative monetary policy. This proposal was defeated by a majority vote, because many members were of the opinion that a lowering of the reserve requirement ratios would alleviate the burdens of financial institutions only marginally, with interest rates already being at low levels and that a reduction in the required reserves might in turn destabilize the formation of short-term interest rates.

During the period from January through August 1998, the Bank provided ample funds, taking account of market developments, through daily money market operations in line with the guideline that "the Bank will encourage the uncollateralized overnight call rate to remain on average slightly below the official discount rate." As a result, the uncollateralized

²⁰⁸ Specifically, the vote was taken by the following nine members: Governor Hayami, Deputy Governor Sakuya Fujiwara, Deputy Governor Yutaka Yamaguchi, Mr. Yasuo Gotoh, Mr. Susumu Taketomi, Mr. Toshio Miki, Mr. Nobuyuki Nakahara, Ms. Eiko Shinotsuka, and Mr. Kazuo Ueda.

²⁰⁹ BOJ (1998i), pp. 43-48, 228-231, 242-244, 261-263, 276-278, and 294-296.

²¹⁰ BOJ (1998i), pp. 49 and 228-229.

overnight call rate had been at the level of 0.42-0.44 percent on average.²¹¹

In addition, at the MPM held on June 12, with a view to improving the transparency of money market operations, the Bank decided and released the criteria and rules for the selection of the bidders in the Bank's repo operations (the lenders of government securities in the Bank's government bond-borrowing operations against cash collateral).²¹²

VI. Monetary Policy under the Bank of Japan Act of 1997 (Autumn 1998 through Summer 2000)

A. Easing of the Global Financial Crises

1. Economic conditions in major overseas economies²¹³

The U.S. economy continued to expand on the back of strong domestic demand through summer 2000 (Chart 7). In Europe, economic activity continued to decelerate through summer 1999 as external demand decreased significantly due to the effects of Russia's financial crisis in summer 1998. The economy then started to expand moderately as exports recovered with solid domestic demand. Meanwhile, on January 1, 1999, the single currency, the euro, was introduced in 11 countries (Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, Finland, Portugal, Ireland, and Luxembourg) out of the 15 EU member countries, and the euro began to be used in interbank fund transfers.²¹⁴

East Asian economies had fallen into recession due to the significant effects of the currency and financial crisis that began in summer 1997, and adjustments in economic activity continued until early 1999 (Chart 7).

2. Economic conditions in Japan

a. Enactment of the Act on Emergency Measures for the Revitalization of the Financial Functions and the Act on Emergency Measures for Early Strengthening of Financial Functions (October 1998)

From summer 1998, discussions regarding institutional arrangements for revitalizing the

²¹¹ BOJ (1998i), pp. 47-49 and 228-229.

²¹² BOJ (1998i), pp. 42-44 and 72-83.

²¹³ The description in this section is based on Chapter I.A.3. of BOJ (1998i, 1999n, 1999u, 2000e, and 2000j), unless otherwise noted.

²¹⁴ Greece hoped to join the euro area from January 1999, but its entry was put off because it failed to meet the convergence criteria as of 1998. Greece applied for a membership in March 2000, and at the meeting held in June of that year, the European Council approved that Greece would join the euro area on January 1, 2001 (EPA [2000], Chapter I.C.1.a.[1]).

financial system became active. The Government-Ruling Party Conference to Promote the Comprehensive Plan for Financial Revitalization released the "Comprehensive Plan for Financial Revitalization (First Report)" on June 23, 1998, and subsequently the "Comprehensive Plan for Financial Revitalization (Second Report)" on July 2, 1998, as measures to comprehensively address issues concerning the disposal of NPLs by financial institutions and other parties.²¹⁵ In this situation, at a regular press conference on June 16, 1998, Governor Hayami commented, "The Bank expects that the market confidence in Japan's financial system will be restored and prospects for financial revitalization will become clear as more information related to the NPLs is disclosed on the whole and the disposal of such loans is consequently facilitated."²¹⁶ He also stated in his speech on July 29, 1998, that keys to the prompt solution of the NPL problem were (1) full disclosure of NPLs, (2) removal of NPLs and collateral real estate from balance sheets, and (3) effective use of public funds.²¹⁷ Through such occasions, the Bank expressed that it was urgently necessary for each financial institution to clearly disclose the details of its NPLs and the path toward the drastic disposal of these loans, while strengthening its capital base to a level that was sufficient to restore market confidence at home and abroad.²¹⁸

On October 12, 1998, the Act on Emergency Measures for the Revitalization of the Financial Functions (Financial Revitalization Act) was enacted. It lays down the following: rules, such as the basic principles for the disposal of failed financial institutions; as emergency measures, systems regarding the management of financial institutions by the financial reorganization administrators, transfer of failed financial institutions' business operations, and the temporary nationalization of banks; and a system that allows the DICJ to purchase assets from financial institutions and other parties to promote the disposal of

²¹⁵ BOJ (1999c), p. 131, BOJ (1998d), pp. 164-170, and BOJ (1998e), pp. 95-100.

²¹⁶ A handout regarding his comments was distributed at 6:27 p.m. after the press conference, which lasted about 80 minutes starting from 5:00 p.m. The handout is filed in BOJ Archives "Summary of the Governor's Press Conferences (1998)," No. 69034, together with the "Summary of the Governor's Press Conference on June 16, 1998." Regarding these comments, FBAJ (1998d, p. 101) wrote, "A statement by the Governor was released," while BOJ (1998d, pp. 149-150) noted, "The Governor made the following comments regarding financial institutions' voluntary disclosure of the results of self-assessment of assets." BOJ (1999c, pp. 158-159) also recorded them as "comments by the Governor" not as "a statement by the Governor."

²¹⁷ Hayami (1998a), pp. 3-5.

²¹⁸ BOJ (1999c), p. 131.

NPLs.²¹⁹ The Financial Revitalization Account was established at the DICJ as an account for operations conducted under the Financial Revitalization Act. Through this account, the DICJ could borrow funds from the Bank of Japan, financial institutions, or other parties if it was necessary to conduct operations for financial revitalization. In accordance with the Financial Revitalization Act, the Act on Emergency Measures for the Stabilization of Financial Functions was repealed, and the Financial Revitalization Account took over the assets and liabilities of the abolished Financial Crisis Management Account. In response to these developments, the Bank, at the Policy Board meeting held on October 22, determined the principal terms and conditions regarding loans to the DICJ's Financial Revitalization Account.²²⁰ On October 16, the Act on Emergency Measures for Early Strengthening of Financial Functions (Early Strengthening Act) was enacted, and an emergency response scheme for strengthening financial institutions' capital bases was established with the aim of contributing to the reconstruction of Japan's financial system and revitalization of the economy. The Financial Revitalization Act and the Early Strengthening Act were both enforced on October 23.²²¹

After the enactment of laws and regulations related to the Financial Revitalization Act and the Early Strengthening Act as well as discussions at the Diet, 13 trillion yen of public funds -- secured based on the Act on Emergency Measures for the Stabilization of Financial Functions -- was abolished.²²² However, 18 trillion yen and 25 trillion yen of government guarantees were provided against borrowings under the Financial Revitalization Account and the Early Strengthening of Financial Functions Account, an account for operations conducted to achieve an early strengthening of financial functions, respectively. The government also allocated 7 trillion yen in grant bonds under the Special Operations Account -- an account for such operations as the provision of financial assistance -- and 10 trillion yen in government guarantees against borrowings under such account. As a result, a total of 60 trillion yen of public funds was secured for the stabilization of Japan's financial system.²²³

b. Temporary nationalization of the Long-Term Credit Bank of Japan (October 1998)

²¹⁹ DICJ (2007), p. 193, BOJ (1999c), p. 135, and BOJ (1998j), p. 92.

²²⁰ Policy Board, BOJ (1998c). The principal terms and conditions were revised on July 9, 1999 (Policy Board, BOJ [1999c]).

²²¹ BOJ (1999c), p. 136, BOJ (1998j), p. 92, and DICJ (2007), p. 70.

²²² FBAJ (1998g), p. 53.

²²³ BOJ (1999c), p. 136, and FBAJ (1998g), pp. 53-54.

and the Nippon Credit Bank (December 1998)

Based on the new framework established under the said circumstances, the LTCB and the NCB were decided to be temporarily nationalized on October 23, 1998, and December 13, 1998, respectively, in accordance with the Financial Revitalization Act.²²⁴

As described in Section C.2.d. in Chapter V, on June 26, 1998, the LTCB announced a plan to merge with the STB in order to address the decline in its stock price due mainly to reputational damage caused by rumors. On August 21, it further announced measures for the disposal of its NPLs and for restructuring based on the merger plan, but failed to regain market confidence, and continued to face a fall in its stock price and a withdrawal of deposits. Meanwhile, on September 25, the ruling and the opposition parties agreed to put the LTCB under temporary nationalization, and on October 8, President Takahashi of the STB stated at a press conference that the STB would terminate merger negotiations with the LTCB.²²⁵ On October 19, the FSA notified the LTCB that the inspection it conducted on the LTCB -- as part of a series of inspections on 19 major banks that began in July -- revealed that the capital of the LTCB, estimated based on the results of the inspection, was significantly lower than its unrealized capital losses mainly on securities as of end-September 1998. On October 23, 1998, in accordance with the Financial Revitalization Act enacted on that day, the LTCB submitted a report to the Prime Minister indicating that "there is a possible danger that, in light of the LTCB's business and financial conditions at present, the LTCB will be forced to suspend repayment of its obligations including deposits." Based on the report and the LTCB's financial conditions, the Prime Minister decided to temporarily nationalize the LTCB on the same day. In response to the decision, the Bank of Japan released the Governor's statement that it strongly expected that restructuring measures with respect to the LTCB would be promptly implemented while the LTCB was nationalized, and that the Bank was determined to continue to make the utmost efforts, in cooperation with the government, to ensure the stability of Japan's financial system.²²⁶

²²⁴ FSA (1999), pp. 70-73, 301-303 (Source 7-4-4), and 324-325 (Source 7-4-13).

²²⁵ FBAJ (1998h), p. 23. As the reasons for calling off the merger, President Takahashi stated at the press conference that "the basic framework for merger negotiations is starting to change, in that this is no longer a private sector case," and that "the LTCB's assets and customer bases have been deteriorating over time" (the morning edition of *The Nikkei* on October 9, 1998, p.1, and the morning edition of *Mainichi Shimbun* on October 9, p. 9).

²²⁶ BOJ (1999c), pp. 162-163, and BOJ (1998j), pp. 93-94.

On November 16, the FSA notified the NCB that the inspection it conducted on the NCB -- as part of the series of inspections on 19 major banks -- showed that the NCB was insolvent as of end-March 1998, with the amounts of write-offs and loan-loss provisions exceeding its capital. The FSA ordered the NCB to consider and report back what measures it could take to recapitalize itself and restore its financial soundness; however, the NCB had yet to outline a realistic path to achieve recapitalization even after a month had almost passed since the notification of the inspection results. Under these circumstances, on December 13, 1998, the Prime Minister decided to temporarily nationalize the NCB in accordance with the Financial Revitalization Act. In response to the decision, the Bank of Japan expressed that (1) it was truly regrettable that the NCB ended up being temporarily nationalized; (2) it strongly hoped that the temporary nationalization would be terminated as soon as possible; and (3) it would continue to make every effort, in cooperation with the government, to ensure the stability of Japan's financial system.²²⁷

c. Establishment of the Financial Reconstruction Commission (December 1998) and the Financial Services Agency (July 2000)

Among laws and regulations related to the Financial Revitalization Act legislated on October 12, 1998, the Act for Establishment of the Financial Reconstruction Commission and the Act on Arrangement of Relevant Acts Incidental to Enforcement of the Act for Establishment of the Financial Reconstruction Commission were enforced on December 15, 1998. On the same day, the Financial Reconstruction Commission was established as an external agency of the Prime Minister's Office, and it was decided that the Financial Reconstruction Commission would (1) carry out investigations and planning and drafting of matters concerning the financial failure resolution system and financial crisis management, (2) inspect and supervise the financial industry, (3) supervise institutions such as the DICJ, and (4) have jurisdiction over operations such as the resolution of financial institutions. Moreover, on this day, the Act Establishing the Financial Supervisory Agency was repealed and the FSA was set up under the Financial Reconstruction Commission.²²⁸

Thereafter, as part of the reorganization of government offices stipulated in the Basic Act on Central Government Reform, which was legislated on June 12, 1998, the FSA and the Financial System Planning Bureau of the MOF were integrated to form the Financial Services Agency on July 1, 2000. This integration preceded the rest of the reorganization

²²⁷ BOJ (1999c), pp. 163-164, and BOJ (1999d), p. 107.

²²⁸ FSA (1999), pp. 3-5, and BOJ (1999c), p. 135.

of offices which was to be conducted as the central government reform. When such reform took place on January 6, 2001, the Financial Reconstruction Commission was abolished and it was decided that the Financial Services Agency become an external agency of the Cabinet Office.²²⁹

d. Injection of public funds based on the Early Strengthening Act (March 1999)

The Early Strengthening Act, which was enacted and enforced in October 1998, stipulated the following: (1) the DICJ could, with approval from the Financial Reconstruction Commission, entrust the injection of funds into financial institutions to the Resolution and Collection Bank, conducted through underwriting of stocks and other capital-raising instruments (hereafter, injection of funds conducted in such way is referred to as "injection of public funds");²³⁰ (2) as for funds necessary to conduct such operations as underwriting of stocks, the DICJ could extend loans to the Resolution and Collection Bank; (3) as for funds needed by the DICJ in extending loans to the Resolution and Collection Bank, the DICJ could borrow from the Bank of Japan or other financial institutions, or it could issue bonds, and the government could guarantee the debt of the DICJ pertaining to such loans and bonds; and (4) when the DICJ decided to borrow funds, the Bank of Japan could extend loans to the DICJ, regardless of Article 43, paragraph 1 of the Bank of Japan Act of 1997.²³¹

Under such legal framework, the Financial Reconstruction Commission carried out preliminary examinations from January 1999 on 15 major banks that planned to apply for injection of public funds, and a total of 7,459.2 billion yen of public funds were injected in March 1999 (the Financial Reconstruction Commission approved the applications for the injection of public funds on March 12; the restructuring plan of each bank was released on March 15, and payments of capital increase mainly from preferred stocks were made on March 30).²³²

Upon the aforementioned injection of public funds, the Bank of Japan, at the Policy Board meeting held on March 3, 1999, decided on the basic stance regarding its loans to the DICJ's Early Strengthening of Financial Functions Account, stating, "The Bank's lending to the DICJ is originally meant to provide temporary bridge funds, and it is a

²²⁹ Financial Services Agency (2001), p. 1.

²³⁰ Of the injection of public funds into financial institutions, those conducted in the way described in this section were indicated as "injection of public funds" in statements released by the Bank in 1999 (including BOJ [1999a]).

²³¹ BOJ (1999c), p. 153.

²³² BOJ (1999c), pp. 131 and 153, FBAJ (1999), p. 63, and BOJ (1999l), p. 90.

supplementary provision of funds that is conducted after greatest possible efforts are made by the DICJ in borrowing funds from the private sector."²³³

B. Introduction and Termination of the Zero Interest Rate Policy

1. Introduction of the zero interest rate policy and enhancement of the functioning of money market operations

a. Lowering the target level of the uncollateralized overnight call rate to 0.25 percent (September 1998)

From mid-1998 to early autumn, deterioration in Japan's economic conditions became further notable, and prices were on a downtrend (Charts 1 and 2). Against the background of the global plunge in stock prices and the heightened cautiousness toward credit risks, at end-August, stock prices in Japan temporarily marked the lowest-ever level since the bursting of the bubble economy (Chart 6). In addition, there were expansions in (1) the yield spreads between Euro-yen deposits and TBs, (2) the Japan premium, and (3) the yield differentials between private-sector bonds and JGBs. In this way, financial markets became increasingly volatile, and uncertainties regarding the outlook for the economy increased further.²³⁴

Based on these circumstances, at the MPM held on September 9, the Bank decided to further ease the stance of money market operations, changing the guideline for the operations as follows: "The Bank will encourage the uncollateralized overnight call rate to move on average around 0.25 percent. Regardless of this target level of the call rate, the Bank will provide more ample funds, if judged necessary, to maintain the stability of financial markets."²³⁵ As described in Section B.2. in Chapter IV, the Bank had already introduced a monetary policy measure in March 1995 by which it announced the guideline for money market operations in its statement in response to the increased significance of the guiding of money market rates, due to the completion of deregulation of deposit interest rates and the subsequent changes in the environment surrounding financial markets. However, it was in September 1998 that the Bank started referring to a specific target level ("on average around 0.25 percent"), rather than describing the uncollateralized overnight call rate in relation to the official discount rate.

²³³ BOJ (1999c), pp.153-154.

²³⁴ BOJ (1998i), pp. 54-58, and BOJ (1998h), p. 14.

²³⁵ BOJ (1998f).

With regard to the reason for further easing the stance of money market operations, the Bank explained in its statement on September 9 that it was "to prevent the economy from falling into a deflationary spiral and to ensure the slowdown of economic deterioration." At the press conference held on the same day, Governor Hayami explained the background for implementing monetary easing as follows: "The dominant factor is that economic activity has been extremely deteriorating. In addition, market participants are beginning to grow somewhat concerned about financial instability. Thus, the Bank judged that this was the appropriate timing to decide to conduct monetary easing to ensure financial stability."²³⁶

In accordance with the monetary easing decision made on September 9, the Bank provided funds that largely exceeded required reserves into financial markets on September 10. As a result, the uncollateralized overnight call rate declined smoothly to 0.23 percent, close to the new target level of "on average around 0.25 percent" on September 10, from 0.45 percent as of the previous day. In the morning of September 14, the last day of the reserve maintenance period when upward pressure on the uncollateralized overnight call rate intensified, the Bank made an advance announcement that it would leave excess reserves in the markets at closing so as to restrain the rise in market interest rates. As a result of the Bank's carefully considered money market operations, the uncollateralized overnight call rate moved in line with the new target level from September 10 through end-September.²³⁷

b. Introduction of new measures for money market operations to facilitate firms' financing activities

Around autumn 1998, the lending attitudes of private financial institutions generally tightened as they faced a severe hardship in fund-raising and the worsening performance of borrowing firms. In addition, capital market participants became more sensitive to credit risks, and it seemed likely that borrowers would encounter more difficulties in raising funds, especially toward the end of calendar year 1998 and the fiscal year, end-March 1999. In light of these situations, the Bank decided at the MPM held on November 13, 1998, to take the following three measures "to contribute to facilitating firms' financing activities, both in the lending market and the capital market, while maintaining the soundness of the Bank's balance sheet."²³⁸

²³⁶ BOJ (1998g).

²³⁷ BOJ (1998i), p. 61.

²³⁸ BOJ (1999c), pp. 84-95.

The first measure was to expand the size of CP repo operations in the day-to-day money market operations, by extending the remaining maturity of eligible CP from up to three months to up to one year (decided on November 13, effective from November 16). The second measure was to establish a temporary lending facility to support firms' financing activities. Specifically, with the intention of encouraging financial institutions to extend loans to firms, the Bank decided to establish a temporary lending facility for refinancing 50 percent of the increase in loans provided by each financial institution in the October-December quarter of 1998, and set the lending period until April 1999 with an interest rate of 0.5 percent, in principle. The Principal Terms and Conditions on a Temporary Lending Facility to Support Firms' Financing Activities, which prescribed the fundamental matters on this lending facility, were decided at the MPM held on November 27, 1998, and the Bank offered the facility from the same day. The third measure was to establish a new market operation scheme utilizing corporate debt obligations as eligible collateral. Specifically, in order to facilitate smooth money market operations and further utilize private firms' debt obligations in its money market operations, the Bank decided to introduce an operation scheme in which it purchased bills issued by financial institutions through a bidding process against pooled collateral solely composed of corporate bonds and loans on deeds. At the MPM held on February 12, 1999, the Bank decided the Principal Terms and Conditions for Bill Purchasing Operations Utilizing Corporate Debt Obligations as Eligible Collateral, which prescribed the fundamental matters regarding the said operations, and started to conduct them on the same day.

c. Introduction of the zero interest rate policy (February 1999)

From around the end of 1998, the pace of deterioration in Japan's economy gradually moderated, due to the increase in public investment (Chart 1). Nevertheless, as corporate profits continued to be on a downward trend and the unemployment rate remained high, corporate and household sentiment remained cautious and prices were also on a downward trend (Chart 2). With respect to financial developments,²³⁹ long-term interest rates rose from late November 1998 (Chart 4). In particular, the pace of the rise in these rates accelerated in late December when the government's JGB issuance plan for fiscal 1999 and the suspension of JGB purchases by the MOF's Trust Fund Bureau were announced (the so-

²³⁹ BOJ (1999a), pp. 14 and 33, BOJ (1999b), pp. 6 and 22, BOJ (1999i), p. 28, and BOJ (1999n), pp. 34-36, 40, 42, and 71.

called Trust Fund Bureau shock).²⁴⁰ Also, in the foreign exchange market, the yen appreciated almost consistently from October 1998 through January 1999 (Chart 3), and stock prices remained weak on the whole (Chart 6). Concerns gradually grew over the adverse impact of such market developments on the future prospect of the economy.

In this situation, the Bank decided at the MPM held on February 12, 1999, to ease further the stance of money market operations as follows: "The Bank will provide more ample funds and encourage the uncollateralized overnight call rate to move as low as possible. To avoid excessive volatility in the short-term financial markets, the Bank will, by paying due consideration to maintaining market functioning, initially aim to guide the call rate to move around 0.15 percent, and subsequently induce a further decline in view of the market developments."²⁴¹

The public statement, "Change of the Guideline for Money Market Operations," approved and released on February 12, stated that the pace of deterioration in Japan's economy was moderating, but clear prospects for a rebound of the economy had yet to emerge. It also noted, "The Bank has judged it appropriate to provide, through monetary policy operations, the utmost support for economic activities in order to avoid possible intensification of deflationary pressure and to ensure that the economic downturn will come to a halt."²⁴² Board Member Ueda reflected on the decision in his speech entitled "The Bank of Japan's Forward Looking Approach" that "this was a forward looking decision" based on the assessment that "the economy has stopped declining, but downside risks remain going forward."²⁴³

In line with the change in the guideline for money market operations, the Bank decided to lower the interest rate applied to the temporary lending facility to support firms' financing activities from 0.5 percent to 0.25 percent.²⁴⁴ Yet, the official discount rate was kept unchanged. In this regard, at a press conference held on February 12, Governor Hayami responded to the question "whether the lowering of the official discount rate was among

²⁴⁰ On December 22, 1998, when the MOF decided to suspend JGB purchases by the Trust Fund Bureau from January 1999, JGB prices fell sharply, as seen, for example, in the JGB futures prices reaching the price limit for the first time since August 10, 1988. In a newspaper article released on the following day, such market developments were reported as the "Trust Fund Bureau shock" (the morning edition of *The Nikkei* on December 23, 1998, p. 19).

²⁴¹ BOJ (1999n), pp. 71-72.

²⁴² BOJ (1999e).

²⁴³ BOJ (1999o), p. 32.

²⁴⁴ BOJ (1999c), pp. 90-91.

policy options in the course of discussion" as follows: "As you may know, I think that the official discount rate has virtually become insignificant since 1996."²⁴⁵

Moreover, at that time, the appropriateness of the Bank's underwriting of JGBs or increasing of its outright purchases of JGBs as a countermeasure against a surge in long-term interest rates was discussed among market participants and economists as well as on occasions such as the Diet. At the MPM held on February 12, however, the following points were noted: (1) long-term interest rates were a kind of asset price -- which reflected various expectations, including the outlook for the economy and price developments -- and were therefore outside the control of a central bank, and (2) there was a risk that active purchases of long-term government bonds by a central bank, by whatever means -- including outright purchases of long-term government bonds or "operation twist" in which a central bank purchased long-term government bonds while selling short-term government bonds -- would lead to a lack of fiscal discipline and generate vicious inflation in the future. On this basis, Policy Board members shared the view that the Bank should retain the basic stance that the outright purchases of JGBs should be conducted in accordance with the long-term trend of increase in banknotes issued.²⁴⁶ Furthermore, in consideration of the attention directed toward the Bank's stance of outright purchases of JGBs, in the public statement, "Change of the Guideline for Money Market Operations," the following phrase was included: "With respect to outright purchases of JGBs, the Bank will continue to maintain the current frequency and amount."²⁴⁷

Regarding the monetary easing measures decided on February 12, 1999, the word "zero interest rate policy" was not used either in the public statement released or at the press conference held on the same day.²⁴⁸ At the Governor's regular press conference held on February 16, Governor Hayami was asked, "Does 'encouraging the overnight call rate to move as low as possible' mean the Bank is aiming at a zero interest rate?" He answered, "If there is no problem with a zero interest rate, I think that it is a possible option."²⁴⁹ On

²⁴⁵ BOJ (1999g).

²⁴⁶ BOJ (1999n), pp. 78-81.

²⁴⁷ BOJ (1999f) and BOJ (1999n), pp. 346-350.

²⁴⁸ At the press conference held on the same day, Governor Hayami was asked, "Is there a possibility of the Bank using a zero interest rate or a negative rate?" He answered, "When the interest rate is guided to around 0.15 percent and if it can still be lowered, the Bank may lower it further. I cannot say whether it can go down to zero at this point, as a zero interest rate is beyond our imagination" (BOJ [1999g]).

²⁴⁹ BOJ (1999h).

February 17, the media referred to his statement as "the Bank is virtually guiding a short-term interest rate down to a 'zero interest rate.'"²⁵⁰ From March, the word "zero interest rate policy" started to be seen in media reports.²⁵¹ With regard to the Bank's releases, the word "zero interest rate policy" began to be used in the following: (1) a comment from "one member" in the minutes of the MPM held on March 25, 1999 (released on April 27); (2) Governor Hayami's speech and a statement concerning the *Semiannual Report on Currency and Monetary Control* before the Diet released in June;²⁵² and (3) the statement, "On the Current Monetary Policy," released after the MPM held on September 21, 1999.²⁵³

d. Commitment to maintain the zero interest rate policy

In accordance with the new guideline for money market operations determined at the MPM held on February 12, 1999, the Bank provided more ample funds, initially aiming to guide the uncollateralized overnight call rate to move around 0.15 percent. Specifically, while the Bank provided funds that significantly exceeded the daily average amount of required reserves during the day, it took such measures as ceasing its bill-selling operation for absorbing funds conducted at the end of the day (usually at 5:00 p.m.) to prevent an excessive decline in the uncollateralized overnight call rate. As a result, the uncollateralized overnight call rate plummeted from 0.28 percent on February 12 to 0.12 percent on February 15, declining further to 0.10 percent on February 16. Thereafter, until the following MPM held on February 25, the uncollateralized overnight call rate remained at around 0.10 percent. At the MPM held on February 25, however, the Policy Board deemed it appropriate to confirm whether the market could accommodate any further lowering of the uncollateralized overnight call rate, giving due consideration to avoiding disruptions to the market, and the Bank further strengthened its stance on the provision of funds. Consequently, the uncollateralized overnight call rate declined further from the beginning of March and remained generally in the range of 0.03 to 0.05 percent, which was in line

²⁵⁰ "Bank of Japan Governor states unprecedented money market operations of guiding a short-term interest rate down to virtually a 'zero interest rate,'" the morning edition of *The Yomiuri Shimbun* on February 17, 1999, p. 1.

²⁵¹ For example, see "Further decline in interest rates, the ripple effect of the zero interest rate," the morning edition of *The Nikkei* on March 6, 1999, p. 1.

²⁵² Hayami (1999a), pp. 1-10, and Hayami (1999b), pp. 11-12.

²⁵³ BOJ (1999s).

with the guideline that the Bank would encourage the rate to move "as low as possible" considering, for example, the brokers' margin included in the rate.²⁵⁴

Under such circumstances, the Policy Board deliberated on the possibility of setting some kind of quantitative indicators or interest rates on term instruments as a target for money market operations, in order to ensure intelligibility of the Bank's policy conduct. At the MPMs held in February and March, however, the Policy Board members generally shared the view that both quantitative indicators and interest rates on term instruments had numerous issues, including the setting of a target level and technical matters regarding their controllability.²⁵⁵

Given these developments, at the end of the MPM held on March 25, 1999, Board Member Ueda made the following comments: "I think that the Bank can announce the degree of its commitment to the current policy of maintaining the overnight rate at almost zero a little more strongly to the market," and "a zero interest rate is exceptional and the Bank should not continue with the zero interest rate policy without any conditions; however, it is worth considering whether it is possible to surprise the market in some way by delivering a message that the Bank will continue with this policy until the economy achieves a full-fledged recovery."²⁵⁶ Moreover, at the MPM held on April 9, Policy Board members sought for means to ensure intelligibility of the Bank's policy conduct while at the same time maximizing the effects of the zero interest rate policy.²⁵⁷ Specifically, Deputy Governor Yamaguchi said, "It may be better to express a little more clearly as to how long the Bank will continue with the policy that will keep the overnight call rate close to zero percent" and "Monetary policy over the past several years was aimed at realizing sustainable economic growth and at achieving price stability -- that is, a non-inflationary and non-deflationary situation. I suggest that the Bank reiterate its determination to persistently endure difficulties until that situation is realized, at such occasions as

²⁵⁴ BOJ (1999n), pp. 82-92.

²⁵⁵ BOJ (1999u), p. 59.

²⁵⁶ BOJ (2009a), p. 78. Board Member Ueda later commented that it was at this MPM that the idea of policy duration effect was first proposed (Ueda [2005], p. 66). In addition, regarding the relationship between the idea of policy duration effect and discussions among academics at that time, Ueda (2005) introduced Woodford (1999) as well as Eggertsson and Woodford (2003) as discussions among academics back then, stating that the idea of policy duration effect adopted by the Bank was "essentially the same as what was discussed among academics around that time" (Ueda [2005] pp. 75-86). See Appendix 1 for details on how policy duration effect was later placed in discussions among academics as one of the monetary policy tools under the zero lower bound.

²⁵⁷ BOJ (1999u), pp. 59-60, and BOJ (2009b), pp. 62-81.

Governor's press conferences." Board Member Ueda stated, "I agree with the idea to demonstrate to the market and the others in some way that the Bank has a strong commitment to continue with the policy of keeping the overnight call rate close to zero percent." Governor Hayami noted, "The Bank has no other way but to say that it is conducting the current monetary easing with a view to achieving a situation in which deflationary concern is dispelled." Board Member Gotoh stated, "In order to relieve concern about the economic outlook, it may be appropriate to announce on some occasions that the Bank, as the monetary policy authority, will maintain the current decisive easing stance until the signs of autonomous recovery emerge or the risk of deflationary spiral diminishes, and it will promptly provide necessary, sufficient reserves." There was no explicit opposition to the view that it was appropriate to announce to the public that the Bank would continue with the zero interest rate policy until deflationary concern was dispelled.

Based on these discussions at the MPMs,²⁵⁸ Governor Hayami, at the press conference on April 13, 1999, explained, "Until we reach a situation in which deflationary concern is dispelled, we will continue with the current policy of providing necessary liquidity to guide the uncollateralized overnight call rate down to virtually zero percent, while paying due consideration to maintaining the proper functioning of the market. This was the view on which many Policy Board members agreed at the MPM held last Friday."²⁵⁹ At the following

²⁵⁸ Regarding the discussion at the MPM held on April 9, 1999, the minutes that were approved by the Policy Board at the MPM held on May 18 and released on May 21 summarized as follows: "One member concluded these discussions by stressing that monetary policy over the past several years had been aimed at achieving price stability -- that is, non-inflationary and non-deflationary situation -- and at realizing sustainable economic growth under price stability. To underline this stance, the member suggested that the Bank explicitly convey to the market its intention to maintain the current zero interest rate policy until deflationary concern was dispelled, not in the policy directive, but at such occasions as Governor's press conferences. Many members supported this suggestion" (BOJ [1999j]). The transcript for this meeting was released on July 31, 2009 (BOJ [2009b]). Umeda (2011, pp. 64-68) introduced the discussion at that time in detail by citing the transcript.

²⁵⁹ BOJ (1999k). Regarding this commitment stated at the Governor's press conference, Deputy Governor Yamaguchi commented at the international conference (titled "Role of Monetary Policy under Low Inflation: Deflationary Shocks and Policy Responses") hosted by the IMES in July 2000, as follows: "This statement was received by the financial markets as a signal that the Bank would continue with the zero rate policy for a considerable period of time. Reflecting such market expectations, interest rates on term instruments declined rapidly, and the yield curve became extremely flat. At this point, we confirmed that the zero interest rate with future commitment had a powerful automatic easing effect when economic activity tended to soften" (Yamaguchi [2000a], p. 203). Moreover, Okina, Shiratsuka, and Fujiki (2000), released in October 2000, presented the

press conference on May 20, Governor Hayami responded to the question about "how the Bank will determine whether deflationary concern is dispelled," stating, "It is not something we can determine by simply looking at one indicator or something we can provide with certain *a priori* conditions." He then explained, "The thinking behind the zero interest rate policy is as follows: (1) the Bank has been taking every possible measure in terms of monetary policy; (2) the Bank will maintain the current policy until deflationary concern is dispelled; (3) the Bank has no intention of employing measures that will lead to the loss of fiscal discipline and, as a result, burden future generations; and (4) the Bank acknowledges the importance of progress in structural reforms."²⁶⁰

In addition, at the press conference on August 17, Governor Hayami was questioned about the assessment of the zero interest rate policy that was introduced six months ago. He explained, "The zero interest rate policy has eased concern over the availability of overnight funds and generally brought about positive effects on the whole, as seen in, for example, stable long-term interest rates and firm stock prices," and "The policy has been contributing significantly to preventing further economic deterioration." He also stated that there were concerns about side effects of the zero interest rate policy, including an issue of income distribution where a decrease in the interest income of households resulted in the transfer of funds to firms, delay in structural adjustment, emergence of moral hazard, and market malfunctioning through a decline in the amount outstanding in the call money market, but it was not appropriate to discuss them independently from each other and the current situation was not so critical.²⁶¹

following analysis: important components of the zero interest rate policy were (1) guiding the call rate to virtually zero percent through the provision of ample funds and (2) a commitment to the zero interest rate policy "until deflationary concern is dispelled," in other words, two aspects were important, namely, the "quantity" and the "policy duration." In addition, Shiratsuka and Fujiki (2001) called a mechanism in which a commitment to future policy conduct affected market expectations the "policy duration effect." This policy duration effect was based on the same idea as the forward guidance adopted in the United States after the collapse of Lehman Brothers (Nakaso [2017]). At the 17th World Congress hosted by the International Economic Association in June 2014, regarding the Bank's commitment announced in April 1999 to continue with the zero interest rate policy until deflationary concern was dispelled, Governor Haruhiko Kuroda explained that "the Bank introduced qualitative forward guidance" (Kuroda [2014]).

²⁶⁰ BOJ (1999m).

²⁶¹ BOJ (1999r).

e. Enhancement of money market operations

At the MPM held on September 21, 1999, Chairman Hayami instructed the Bank's staff to deliberate on the enhancement of money market operation tools to assure further permeation of the effects of the zero interest rate policy.²⁶² Market speculation emerged that some kind of monetary easing measures might be taken to address the appreciation of the yen observed since summer 1999 (Chart 3).²⁶³ In this situation, the Chairman's instruction was based on the fact that Policy Board members generally shared the following recognition at this MPM: it was desirable to further enhance money market operations in terms of quality, considering the risk that the yen's appreciation and a rise in long-term interest rates would continue in a way that did not reflect the actual state of the economy.²⁶⁴

The following MPM on October 13 was held amid that situation. At that time, in the financial markets, interest rates on 3-month contracts that would mature beyond the year-end 1999 started to rise in view of the Year 2000 problem. It had become more appropriate to clarify the Bank's stance on the provision of funds that took account of developments such as those regarding the year-end fund demand. Under such policy environment, the following three points were decided at the MPM held on October 13 so as to assure further permeation of the effects of monetary easing. First, while deciding to continue with the zero interest rate policy, the Bank revised the expression of the guideline for money market operations, which implied the zero interest rate policy, as follows: "The Bank will flexibly provide ample funds and encourage the uncollateralized overnight call rate to move as low as possible." Second, in order to firmly continue with the zero interest rate policy even in a market environment where the Year 2000 problem started to attract attention, the Bank decided to respond flexibly, such as by providing ample funds over the year-end, paying due consideration to fund demand related to the Year 2000 problem in conducting money market operations.²⁶⁵ And third, the Bank decided, in maintaining its zero interest rate policy, to flexibly use a wider range of the operations so as to assure further permeation of

²⁶² BOJ (2000e), p. 58.

²⁶³ The yen moved around 120 yen against the U.S. dollar until mid-July 1999. After following an uptrend from the second half of July, it appreciated temporarily to the 103-104 yen level in mid-September (BOJ [1999u], pp. 38-40).

²⁶⁴ BOJ (2000e), pp. 57-58.

²⁶⁵ From the end of 1999 to the beginning of 2000, the financial markets were generally stable, reflecting ample fund provision by the Bank in accordance with this guideline. There were no significant disruptions resulting from the millennium date change in financial transactions (BOJ [2000b], p. 10).

the effects of monetary easing, paying due consideration to developments in financial markets, including the foreign exchange market.²⁶⁶ Specifically, with respect to operations using financing bills (FBs) and TBs, in addition to the existing sales and purchases with repurchase/resale agreements (conditional trading), the Bank decided to introduce outright sales and purchases (unconditional trading) at the same MPM.²⁶⁷ This decision was released together with other measures that could be carried out without a vote by the Policy Board, for example, adding 2-year government securities for repo operations, making full use of operations utilizing private corporate debt obligations such as bill purchasing/selling operations and CP operations.²⁶⁸

2. Termination of the zero interest rate policy

a. Basis for judging whether "deflationary concern is dispelled"

Japan's economy appeared to have stopped deteriorating around spring 1999, due mainly to the fact that (1) the government's stimulus measures implemented in 1998 gradually exerted positive effects and (2) the anxiety about the stability of the financial system eased against the background of the injection of public funds into financial institutions.²⁶⁹ Thereafter, the economy stopped deteriorating and started to improve, and then entered a moderate recovery phase after the turn of fiscal 2000. This was mainly because production activity turned upward, reflecting the rise in exports from summer 1999, and business fixed investment bottomed out and started to increase moderately after the turn of 2000. As for prices, the CPI for all items less fresh food leveled off in summer 1999, and domestic wholesale prices exceeded the previous year's level after the turn of 2000. However, from autumn 1999, the CPI had been below the previous year's level (Chart 2).

In this situation, the Policy Board discussed the basis for judging whether "deflationary concern is dispelled," which was announced in April 1999 as the condition for continuing with the zero interest rate policy. At first, the Policy Board concluded that it would be difficult to judge simply from a specific indicator or numerical value whether "deflationary

²⁶⁶ BOJ (2000e), pp. 58-59.

²⁶⁷ Until March 1999, the Bank conducted purchases under repurchase agreements only for TBs and sales under repurchase agreements only for FBs. In light of public tender for FB issuance to be introduced in April 1999, TBs and FBs were expected to form one short-term JGS market. It was then decided to consolidate these operations as short-term JGS operations at the MPM held on March 25. BOJ (1999n), p.131, and BOJ (2000a), p. 105.

²⁶⁸ BOJ (2000e), pp. 58-59.

²⁶⁹ BOJ (1999n), pp. 1-2, BOJ (1999u), p. 1, BOJ (2000e), p. i, and BOJ (2000j), p. i and 120-122.

concern is dispelled," and it was appropriate to judge comprehensively based on the economic outlook as well as various factors and risks related to price developments.²⁷⁰ Although the Bank's communication to the public was based on this recognition,²⁷¹ its communication was criticized as being "ambiguous."²⁷² Since then, discussion about the basis for judging whether "deflationary concern is dispelled" deepened at MPMs held from the second half of 1999 through 2000, at which the majority of Policy Board members shared the following recognition: (1) in order to judge whether a risk of falling into deflation became sufficiently small, factors underlying prices, such as the slack in supply and demand balance and downward pressure on wages, should be examined thoroughly; (2) "deflation" should be basically defined as a price decline stemming from weak demand; and (3) therefore, the meaning of "deflationary concern is dispelled" was very similar to "a self-sustained recovery in private demand is in prospect."²⁷³

Based on the above discussion, Governor Hayami stated in his speech on March 21, 2000, "What is of central concern in our conduct of monetary policy is to avoid a deflationary spiral, which is a vicious cycle of price declines and recession." He also said, "If we become confident that economic recovery is sustained and that the negative output gap continues to narrow, then we can say that deflationary concern has been almost dispelled."²⁷⁴ In addition, Deputy Governor Fujiwara stated in his speech on June 22, 2000, "The zero interest rate policy is an unprecedented policy to address a critical situation where the economy was on the verge of falling into a deflationary spiral at the beginning of 1999." He also said, "What is of central concern in our conduct of monetary policy is to avoid downward pressure on prices that triggers a deflationary spiral, which is a vicious cycle of recession and price declines, and, based on this thinking, the Bank defines abatement of

²⁷⁰ BOJ (1999u), p. iv.

²⁷¹ For example, a regular press conference by Governor Hayami on May 20, 1999 (BOJ [1999m]), a press conference by Board Member Ueda on July 1, 1999 (BOJ [1999p]), and a press conference by Deputy Governor Fujiwara on July 7, 1999 (BOJ [1999q]).

²⁷² For example, at a press conference by the Chairman of the Policy Board on September 21, 1999, a reporter made a comment that "the Governor often says that 'the Bank will continue with the current policy until deflationary concern is dispelled,' but I think that 'until deflationary concern is dispelled' may be highly ambiguous" (BOJ [1999t]). In addition, in a speech on April 20, 2000, Board Member Miki stated, "Firms and households have criticized the phrase 'deflationary concern is dispelled' as being ambiguous in terms of accountability" (BOJ [2000d], p. 2).

²⁷³ BOJ (2000e), pp. iv-v, and BOJ (2000j), p. 60.

²⁷⁴ Hayami (2000a), pp. 9-10.

deflationary concern as a state in which downward pressure on prices stemming from weak demand becomes sufficiently small."²⁷⁵

b. Decision to maintain the zero interest rate policy at the MPM on July 17, 2000

At the MPM held on July 17, 2000, Policy Board members expressed the recognition that the momentum for recovery in the corporate sector had further strengthened, and that an improvement in the employment and income situation was starting to appear. On this basis, they revised their economic assessment upward to the following: "Japan's economy is recovering gradually, with corporate profits and business fixed investment continuing to increase." As for the outlook, many members supported the view that "the economy is likely to recover gradually, led mainly by business fixed investment, unless there are major adverse external shocks." With regard to prices, members judged that the downward pressure on prices stemming from weak demand was declining significantly compared to the first half of 1999, when the zero interest rate policy was introduced. Given this situation, many members generally agreed that the economy was coming to a stage where "deflationary concern is dispelled."²⁷⁶

Many members, however, took the standpoint that careful consideration should be given in deciding to terminate the zero interest rate policy at this MPM for the following two reasons.

The first reason was the filing of reconstruction proceedings under the Civil Rehabilitation Act by major department store operator Sogo Co. on July 12, just before this MPM.²⁷⁷ At the MPM, many members took the position that the Bank should take some more time to assess the effect of the failure of Sogo on market sentiment,²⁷⁸ and it was appropriate to wait for clearer signs that financial markets had overcome the shock and had become stable.²⁷⁹

Another reason concerned the assessment of economic activity. At the same MPM, many members commented that it was desirable to ensure the judgment on the firmness of economic conditions, given that the termination of the zero interest rate policy would be

²⁷⁵ BOJ (2000g), pp. 3-4.

²⁷⁶ BOJ (2000j), p. 68.

²⁷⁷ Japanese Bankers Association (formerly FBAJ) (2000), pp. 61-67.

²⁷⁸ In this regard, Deputy Governor Yamaguchi explained in his speech on August 4, 2000, "When large firms like Sogo fail, the market sometimes becomes extremely nervous" and "At the moment, we need to closely monitor whether there is the risk that the market may suddenly turn nervous" (Yamaguchi [2000b]).

²⁷⁹ BOJ (2000j), pp. 58-59.

the first rise in the policy rate in about 10 years. For example, with regard to the employment and income situation in which the improvement was starting to appear, some members expressed the view that it was not too late to terminate the zero interest rate policy after examining the overall level of wages, including summer bonus payments.

Based on the above discussion, it was considered appropriate to decide to continue with the zero interest rate policy. At the same MPM, it was also judged appropriate to release a statement on the Bank's thinking behind the decision to continue with the zero interest rate policy, considering that this meeting was attracting much attention from market participants. Based on this, the statement, "On the Current Monetary Policy," was decided and released immediately after the MPM.²⁸⁰

c. Termination of the zero interest rate policy (August 2000)

At the MPM held on August 11, 2000,²⁸¹ the majority of Policy Board members agreed that the employment and income situation, which was considered at the previous meeting to require further examination before a final decision to lift the zero interest rate policy was reached, had stopped deteriorating and was starting to improve. Many members shared the view that the economy had reached the stage where "deflationary concern is dispelled" on the basis of the following assessment: "Japan's economy is showing clearer signs of recovery, and this gradual upturn, led mainly by business fixed investment, is likely to continue" and "the downward pressure on prices stemming from weak demand has markedly receded." Also, many members expressed the view that Sogo's failure, which was another reason for deciding to maintain the zero interest rate policy at the previous MPM, had not triggered any significant spread of concern over the financial system, nor induced any notable deterioration in market sentiment. Based on the above discussion, the Chairman formulated the guideline for money market operations in the intermeeting period ahead as follows: "The Bank will encourage the uncollateralized overnight call rate to move on average around 0.25 percent."

In response to the Chairman's proposal to terminate the zero interest rate policy, the MOF and EPA representatives stated, "It is premature to terminate the zero interest rate policy, given the economic situation and recent developments in financial markets." Subsequently, the MOF and EPA representatives filed a request, pursuant to Article 19, Paragraph 2 of the Bank of Japan Act, that the Policy Board postpone until the next MPM

²⁸⁰ BOJ (2000j), p. 69, and BOJ (2000f).

²⁸¹ BOJ (2000h), and BOJ (2011).

a vote on the Chairman's proposal regarding the termination of the zero interest rate policy. After the discussions, however, the request was voted down by a majority vote.²⁸²

A vote was then taken on the guideline for money market operations, and the termination of the zero interest rate policy was decided by a majority vote.²⁸³ After the votes, the government representatives stated, "It is deeply regretful that our request to postpone the vote on the Chairman's proposal has been voted down." They continued that "the government would like the Bank to continue implementing monetary policy in an appropriate and flexible manner -- for example, by providing ample funds in the markets, giving due consideration to the economic situation and developments in financial markets under the new guideline."

A statement on the change of the guideline for money market operations for the intermeeting period ahead was then discussed. Board Member Miki expressed the view that, in drawing up the statement, the Bank should take into account the fact that its monetary policy should be consistent with the government's basic economic policy. After some discussion on this point, it was decided to include a phrase that the Bank would conduct monetary policy appropriately and flexibly in the final sentence of the statement, which was as follows: "The Bank will conduct monetary policy in an appropriate and flexible manner to support the economic recovery consistent with price stability."²⁸⁴

VII. Conclusion

This monographic paper summarizes views held by the Bank in the 1990s regarding economic and financial conditions as well as the conduct of monetary policy, based on materials compiled during the period mainly in its Archives.

The following points were confirmed in writing this paper. First, throughout the 1990s,

²⁸² Board Member Nakahara voted for the government's request, and the others dissented.

²⁸³ Board Members Nakahara and Ueda dissented from the Chairman's proposal. Board Member Ueda's reason for the dissent was that it would be desirable to examine developments in the stock market and trends in inflation for a little while longer, although his view of the economic situation did not differ significantly from that of other members. Okina (2011, p. 196) stated that the reason why Board Member Ueda, who voted against the termination of the zero interest rate policy, dissented from the government's request was because "he may have considered it a significant risk to provide a precedent of voting for the request to postpone a vote on the Chairman's proposal."

²⁸⁴ The last sentence in the draft statement prepared by the Bank's staff was as follows: "The Bank will maintain the current accommodative stance to support the economic recovery consistent with price stability from the financial side."

the Bank's thinking behind the conduct of monetary policy had shifted toward emphasizing the transparency of its policy management. The basic background to this seemed to be the growing importance of dialogue with market participants, reflecting a change in the target for money market operations from official discount rate changes to the guiding of money market rates. In addition, the fact that the new Bank of Japan Act came into effect in April 1998 under the two principles of independence and transparency accelerated the trend of attaching importance to transparency. Second, on the back of the emphasis on transparency, the Bank enhanced its communication by increasing its releases in the second half of the 1990s, particularly after the enforcement of the Bank of Japan Act of 1997.²⁸⁵ Thus, the materials, especially those referred to in the latter half of this paper, consist mainly of the Bank's releases. And third, in the 1990s, the Bank faced a critical situation in which it needed to conduct monetary policy while paying due attention to the functioning of the financial system. Therefore, unlike Itoh, Koike, and Shizume (2015), which can be considered as a prequel, this paper includes numerous references to the issues regarding the financial system, mainly the disposal of NPLs.²⁸⁶

Various assessments can be made regarding the Bank's conduct of monetary policy in the 1990s, but it seems important to accurately look back upon the views held during the period as a precondition for those assessments. Instead of conducting assessments, this paper focuses on examining facts and views held during the 1990s and presenting a summary that contains basic information from the period, which saw the bursting of the bubble economy and the emergence of deflation. It is always meaningful to learn from history by summarizing facts and views held at the time of events, as it is often the case that they fade away over time.

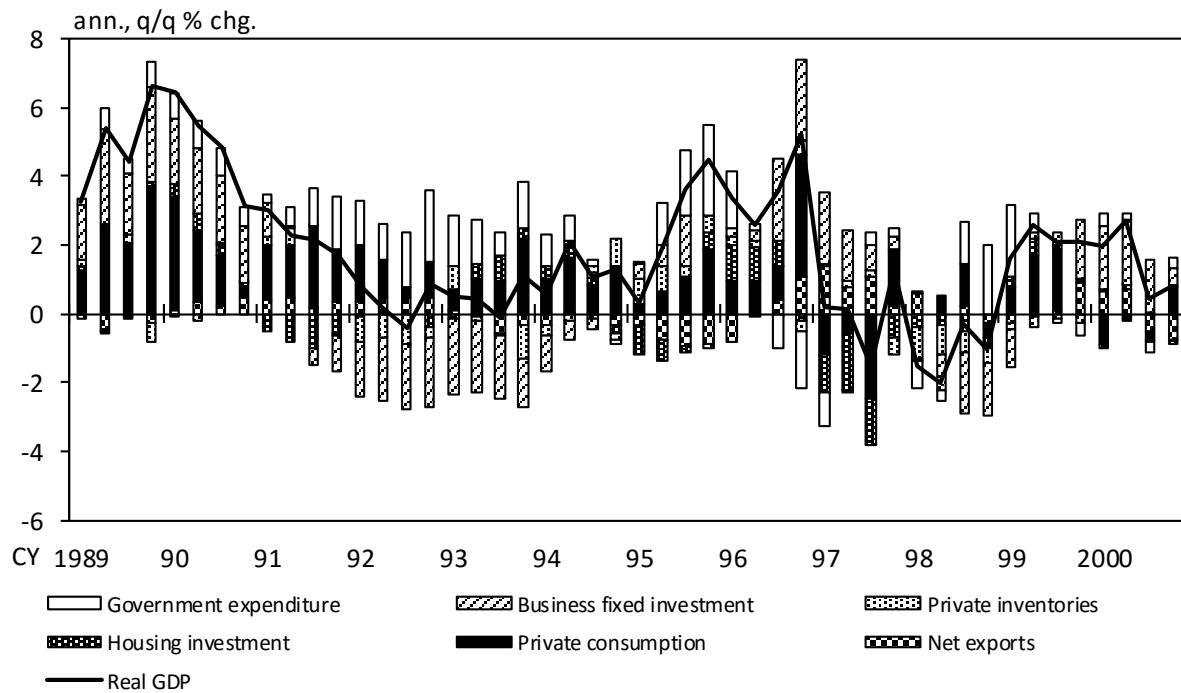
²⁸⁵ On the other hand, the availability of the BOJ Archives was limited as it had been only 27 years since the beginning of the 1990s and 18 years since the end of the 1990s, when this paper was originally drafted in Japanese.

²⁸⁶ This paper refers to developments in the financial system on the basis of the awareness of the ways in which the occurrence of the NPL problem and the subsequent failures of financial institutions affected the Bank's monetary policy. Therefore, this paper does not refer to financial developments such as the so-called "Japanese Financial Big Bang" (the Prime Minister asked the Minister of Finance and others to consider the reform of Japan's financial system in November 1996, and the Financial System Reform Act was enacted in June 1998), mainly due to restrictions on the number of pages.

Charts

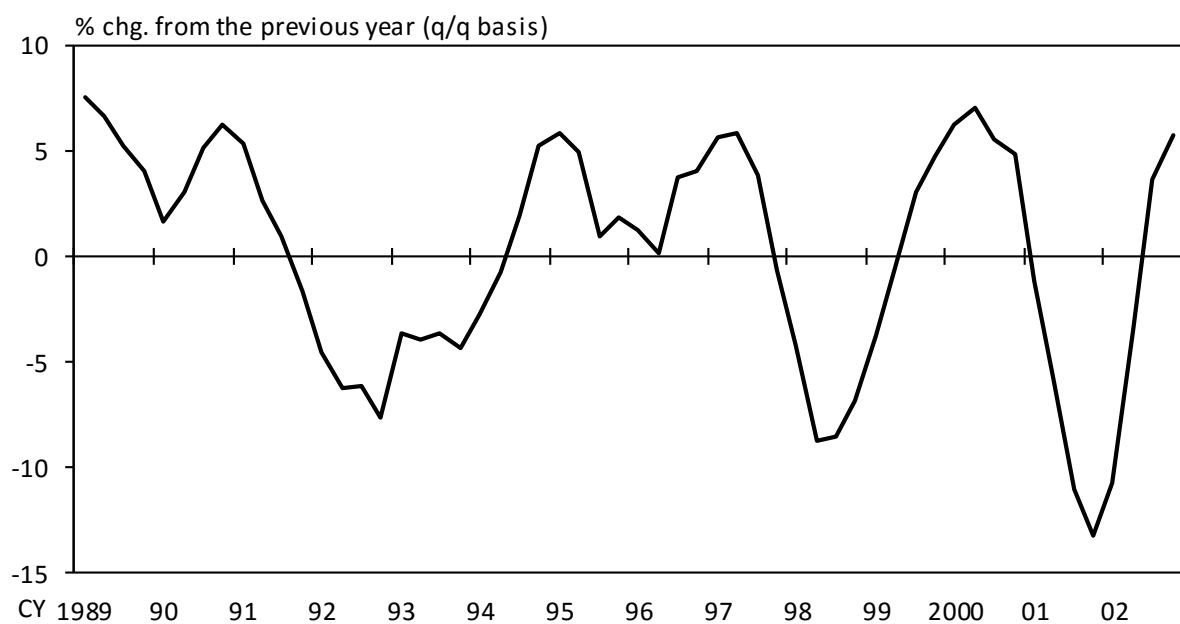
Chart 1 Economic Conditions in Japan

(1) Real GDP



Sources: Cabinet Office, "Real GDP"; Bank of Japan, "Economic and Financial Data on CD-ROM 2001."

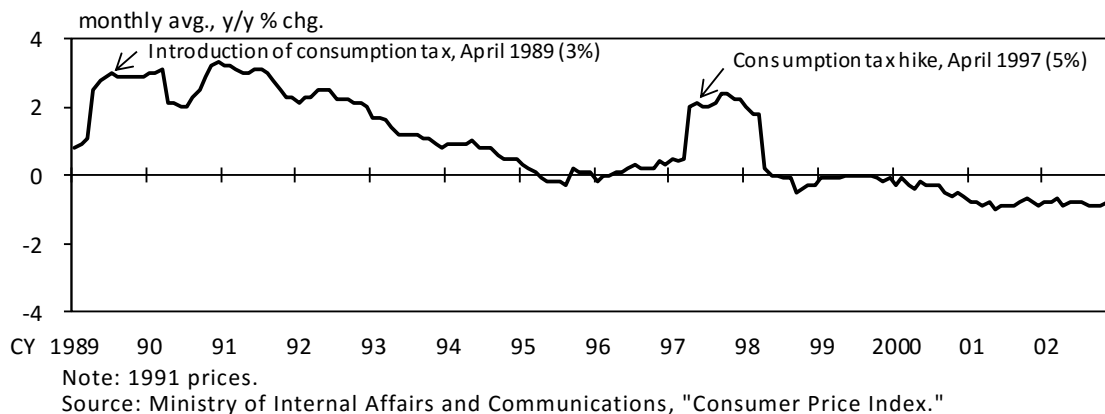
(2) Industrial production



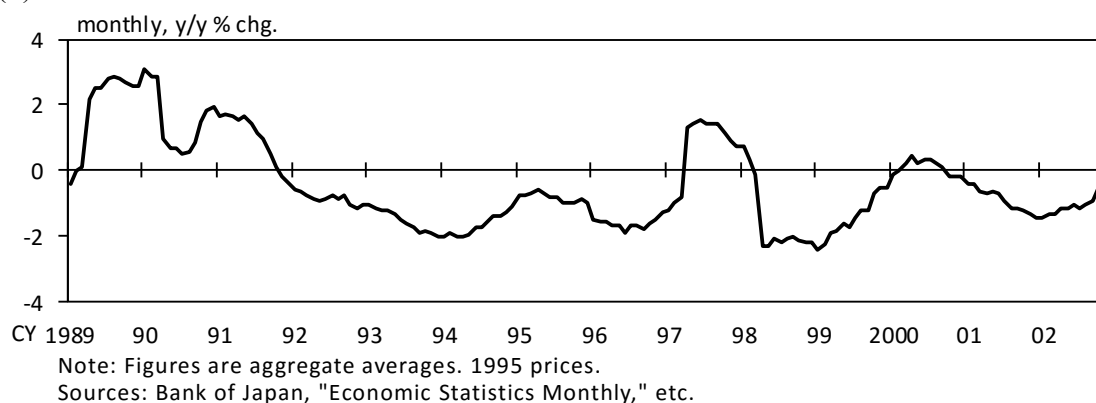
Sources: Ministry of Economy, Trade and Industry, "Production"; Bank of Japan, "Economic and Financial Data on CD-ROM 2001."

Chart 2 Inflation Indicators in Japan

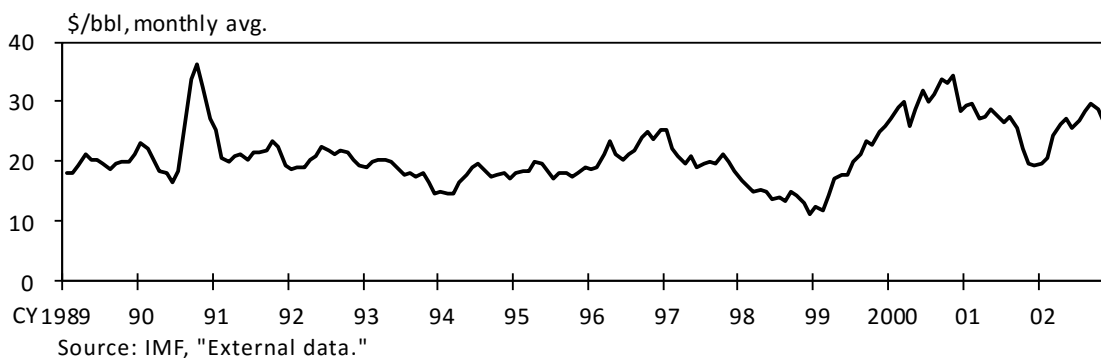
(1) Consumer Price Index (all items less fresh food)



(2) Domestic Wholesale Price Index



(3) Crude oil prices (WTI)



(4) Employment conditions DI (all industries)

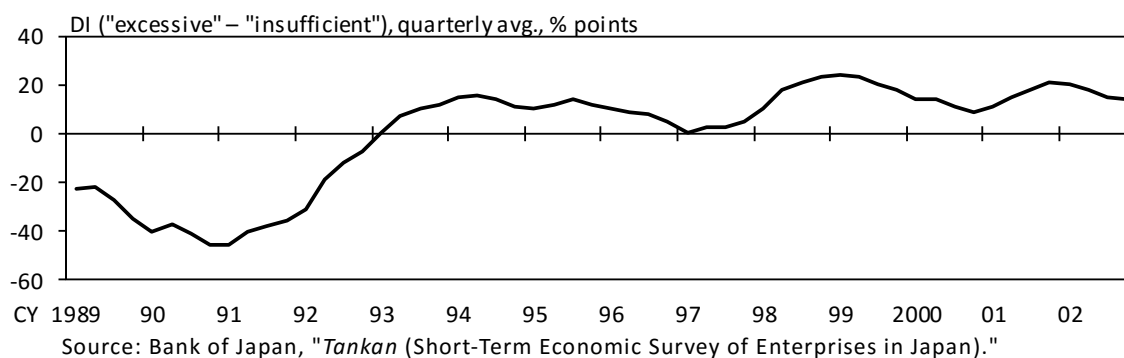
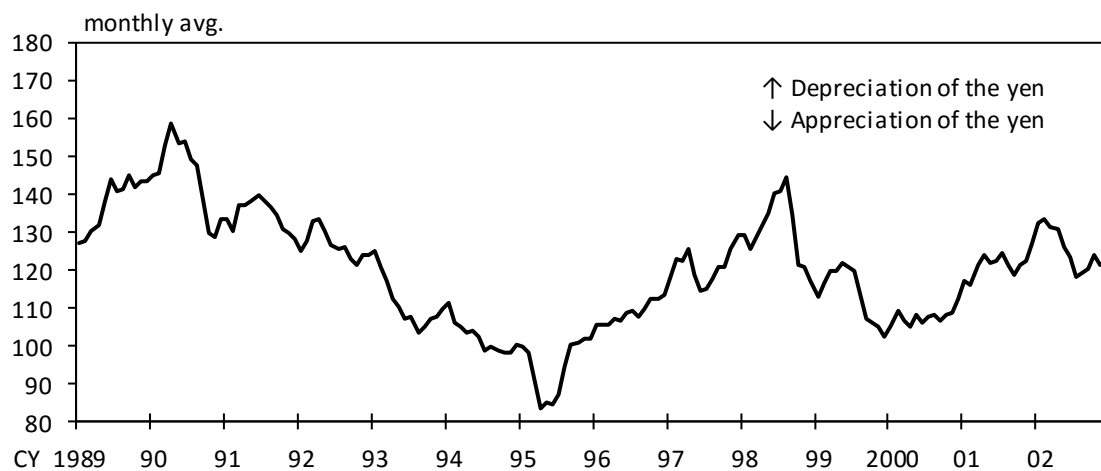


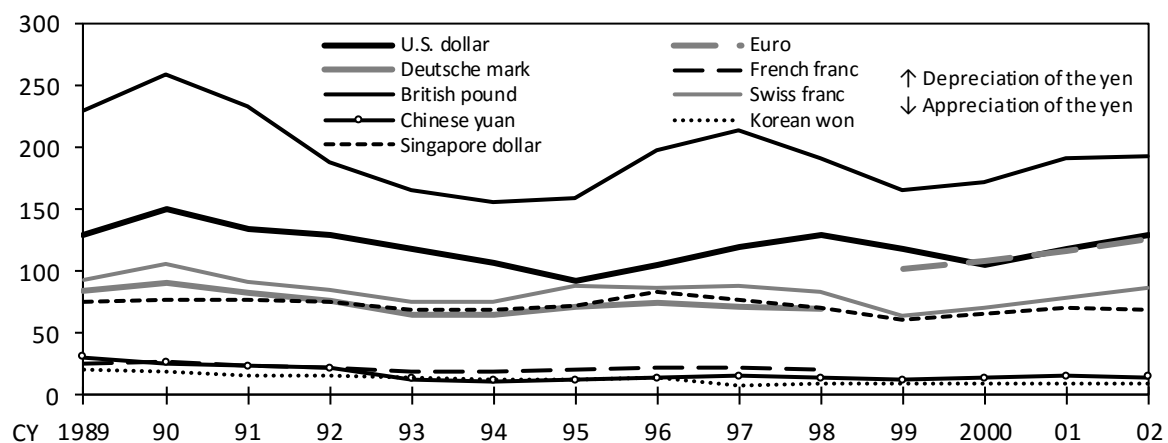
Chart 3 Exchange Rate and Balance of Payments

(1) Exchange rate (yen/dollar)



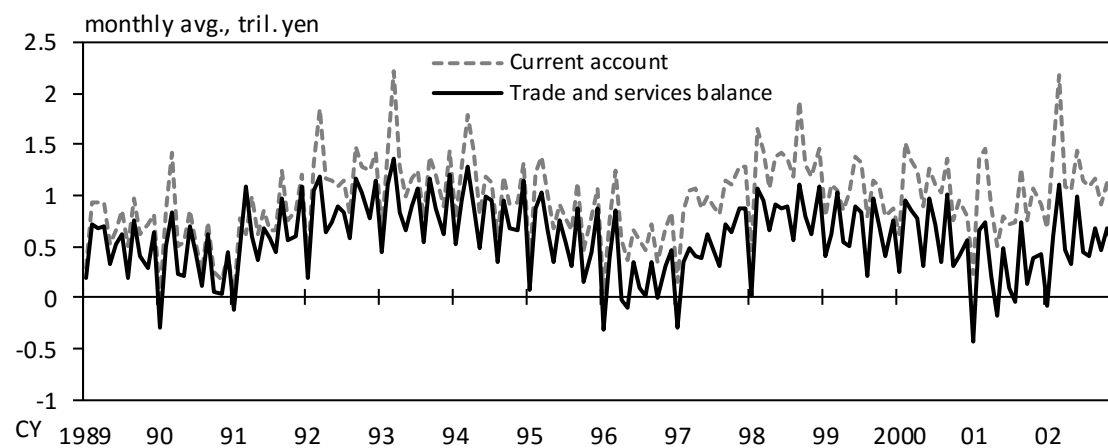
Note: Figures are as of 17:00 in the Tokyo market.
Sources: Bank of Japan, "Economic Statistics Monthly," etc.

(2) Exchange rates (yen/major currencies)



Note: Figures are as of year-end.
Sources: Bank of Japan, "Economic Statistics Monthly," etc.

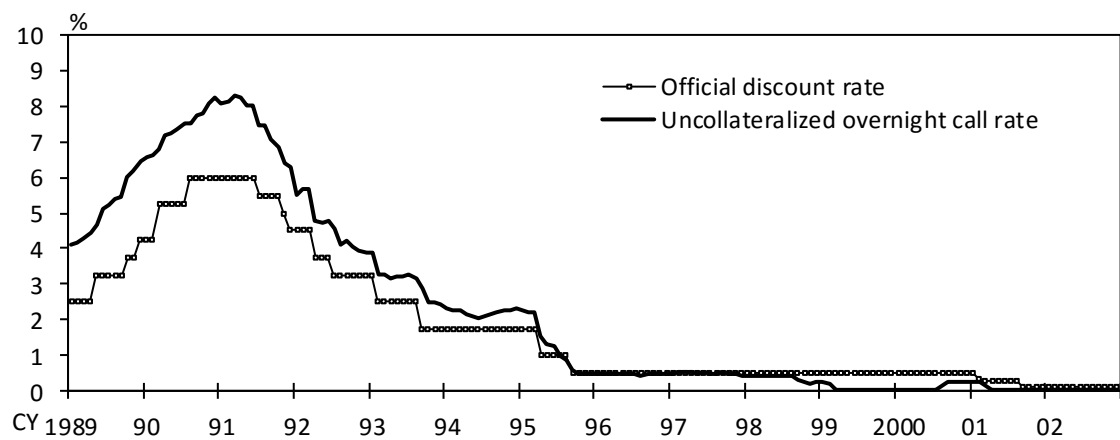
(3) Balance of payments



Source: Bank of Japan, "Balance of Payments Statistics Monthly."

Chart 4 Interest Rate Benchmarks in Japan

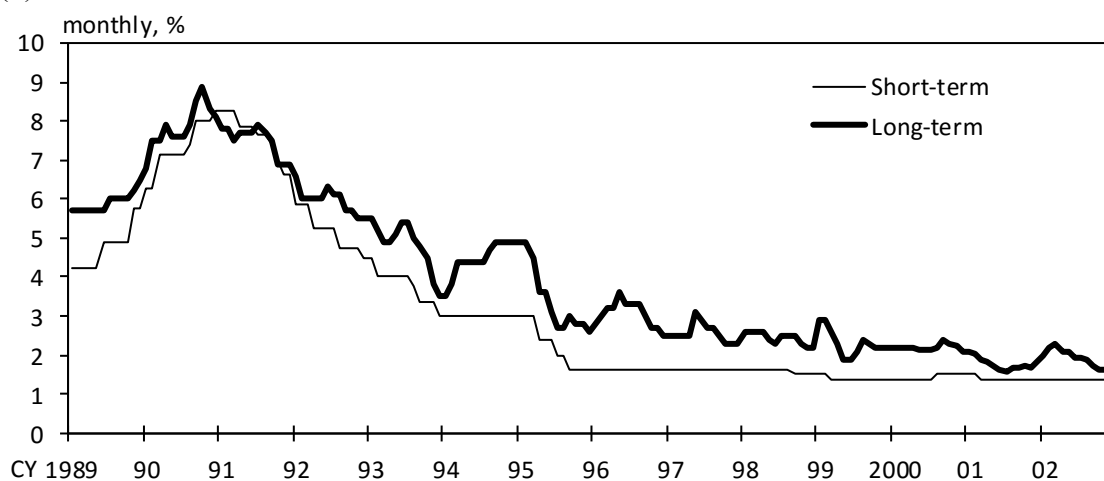
(1) Official discount rate and uncollateralized overnight call rate



Note: Figures are end-month for the official discount rate and monthly averages for the uncollateralized overnight call rate.

Sources: Bank of Japan, "Economic Statistics Monthly," etc.

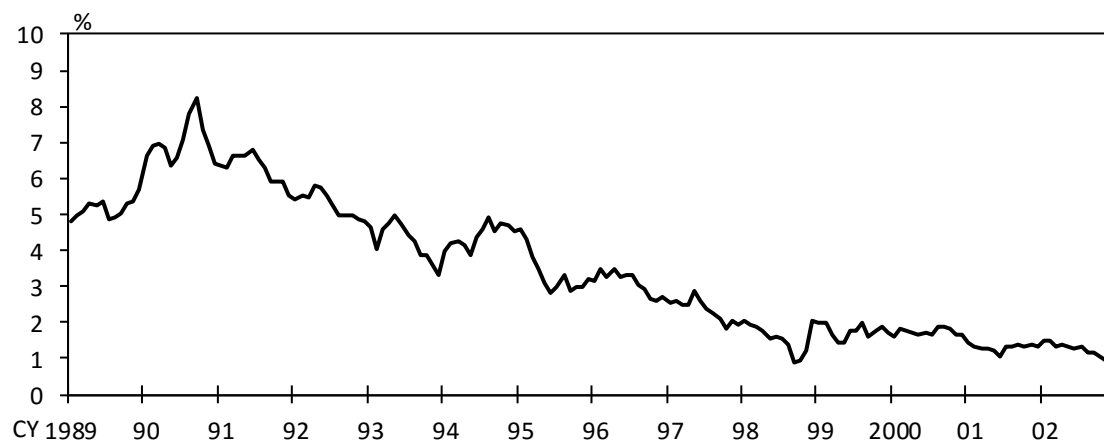
(2) Prime rates



Note: Figures for long-term prime rates are those of the Mizuho Bank.

Sources: Bank of Japan, "Economic Statistics Monthly," etc.

(3) 10-year JGB yields

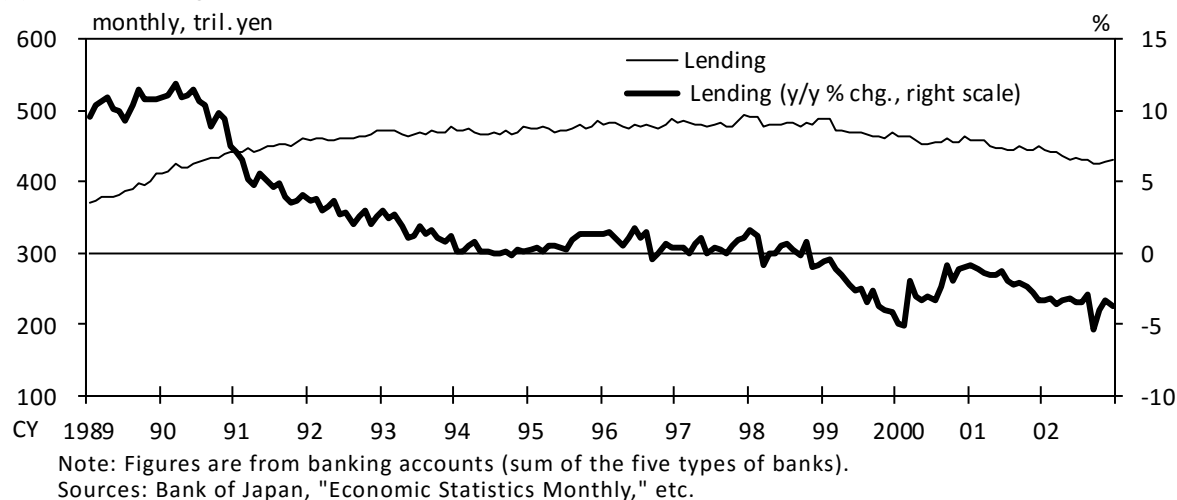


Note: Figures are end-month over-the-counter sales.

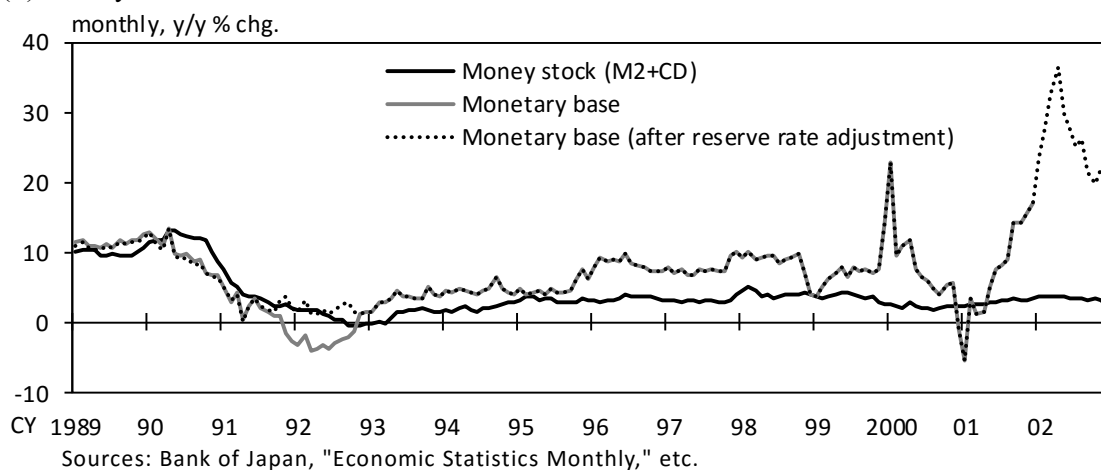
Sources: Bank of Japan, "Economic Statistics Monthly," etc.

Chart 5 Bank Lending and Money

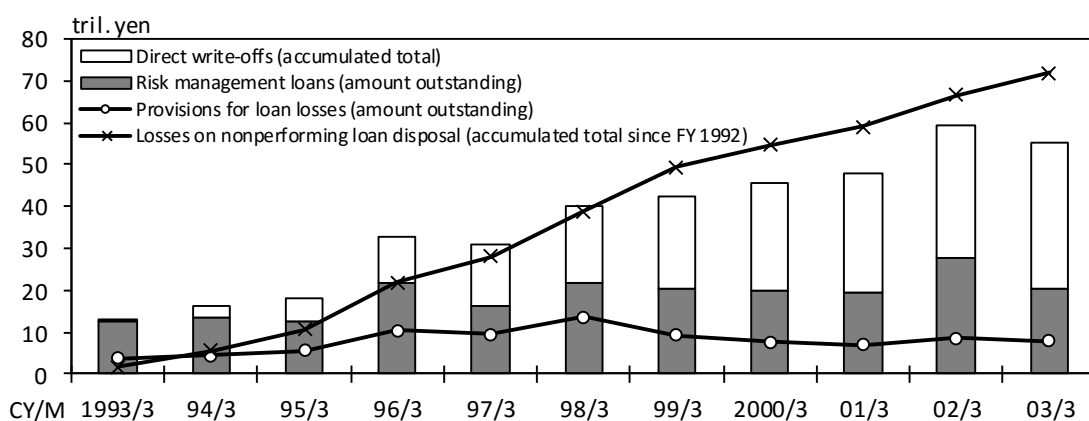
(1) Bank lending



(2) Money



(3) Nonperforming loans



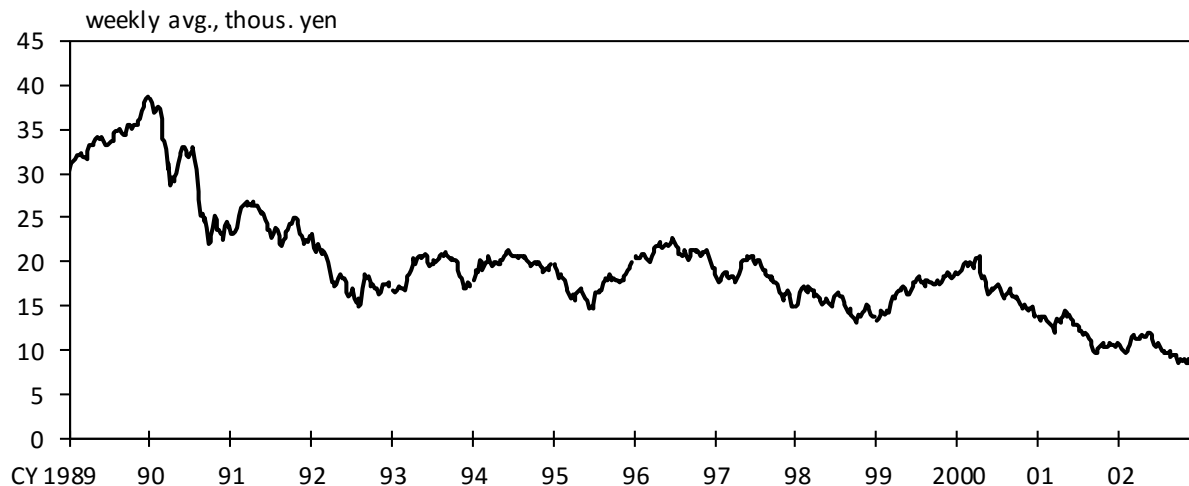
Notes: 1. Total of city banks, long-term credit banks, and trust banks.

2. Figures for risk-management loans are as follows: those through fiscal 1994 (ending in March 1995) indicate the sum of loans to failed borrowers and delinquent loans; those for fiscal 1995 and 1996 indicate the sum of loans to failed borrowers, delinquent loans, and loans exempted from interest payment; and those for fiscal 1997 (ending in March 1998) onward indicate the sum of loans to failed borrowers, delinquent loans, loans delinquent for three months or longer, and loans with relaxed borrowing conditions. See footnote 101.

Source: Financial Services Agency (2004).

Chart 6 Asset Prices in Japan

(1) Nikkei 225 Stock Average

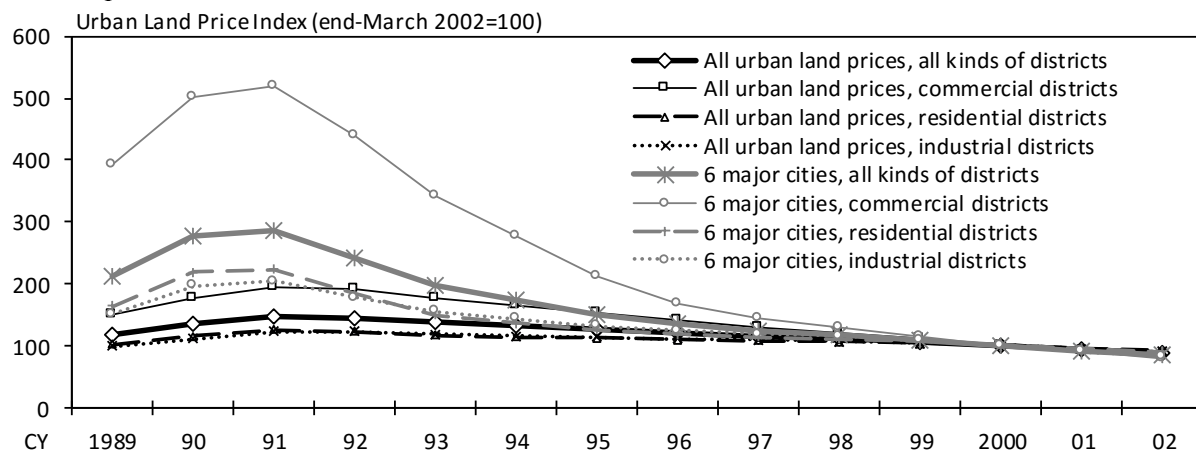


Note: Figures are as of the end of the day.

Source: *Nihon Keizai Shimbun*.

(2) Land prices

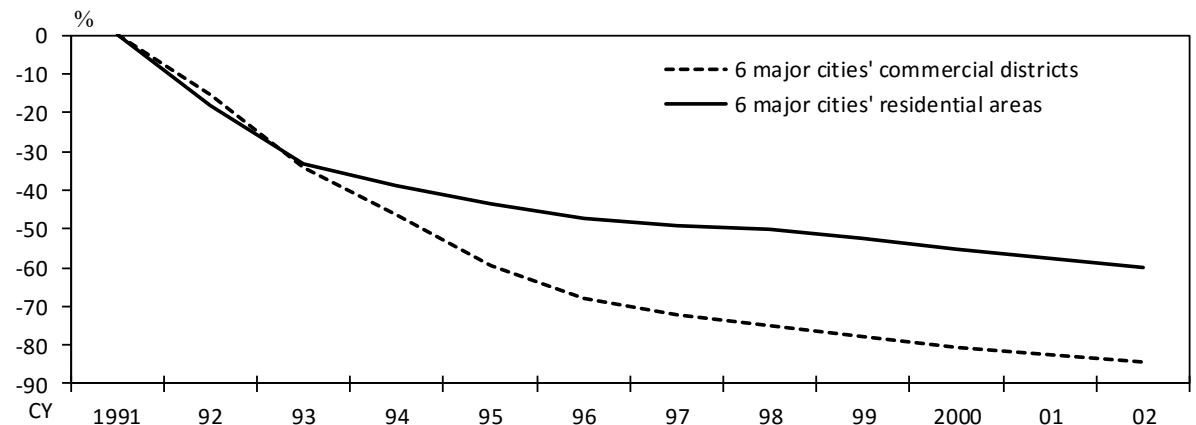
Land prices



Note: Figures are averages of each fiscal year-end. The 6 major cities are the wards of Tokyo, Yokohama, Nagoya, Kyoto, Osaka, and Kobe.

Source: Japan Real Estate Institute, "Urban Land Price Index."

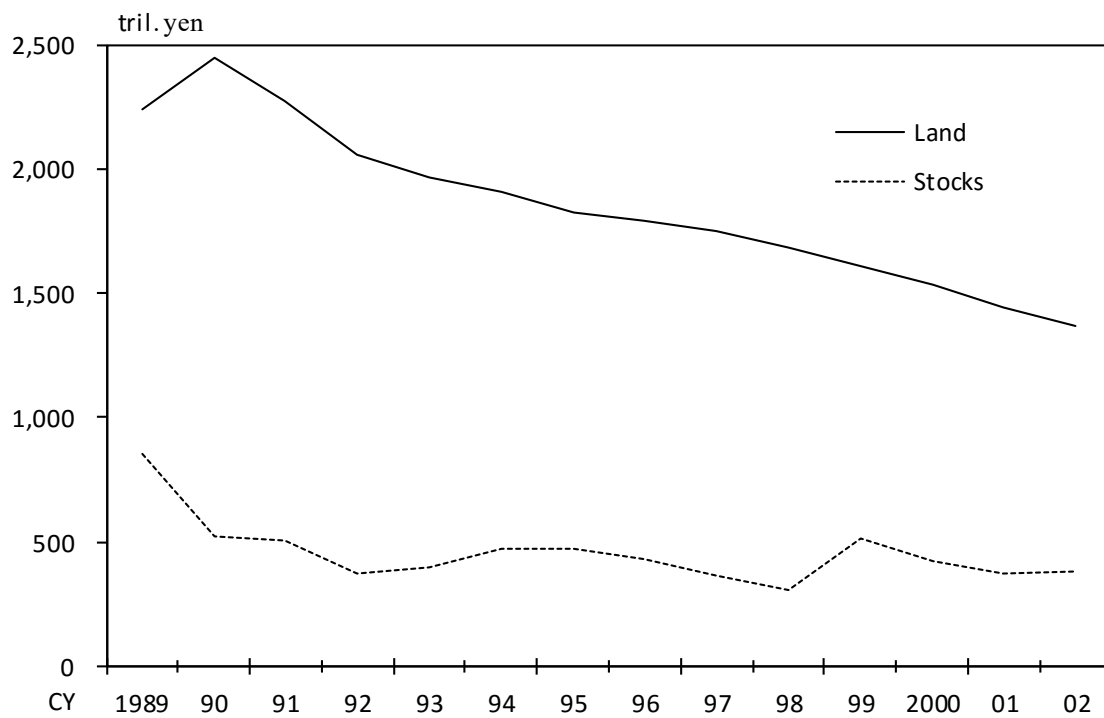
Urban Land Price Index (rate of decline from 1991)



Note: Calculated based on the data available in "Urban Land Price Index" released by the Japan Real Estate Institute.

(3) Asset prices of and capital gains from land and stocks

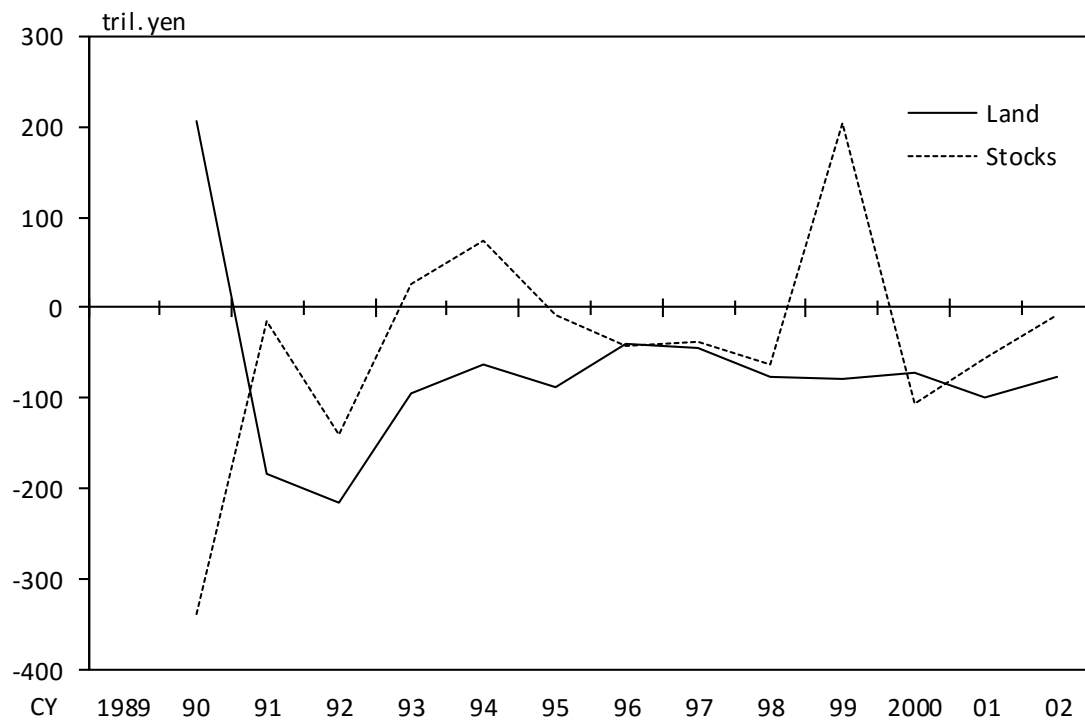
Asset prices



Note: Figures are as of year-end.

Source: Cabinet Office, "National Accounts."

Capital gains



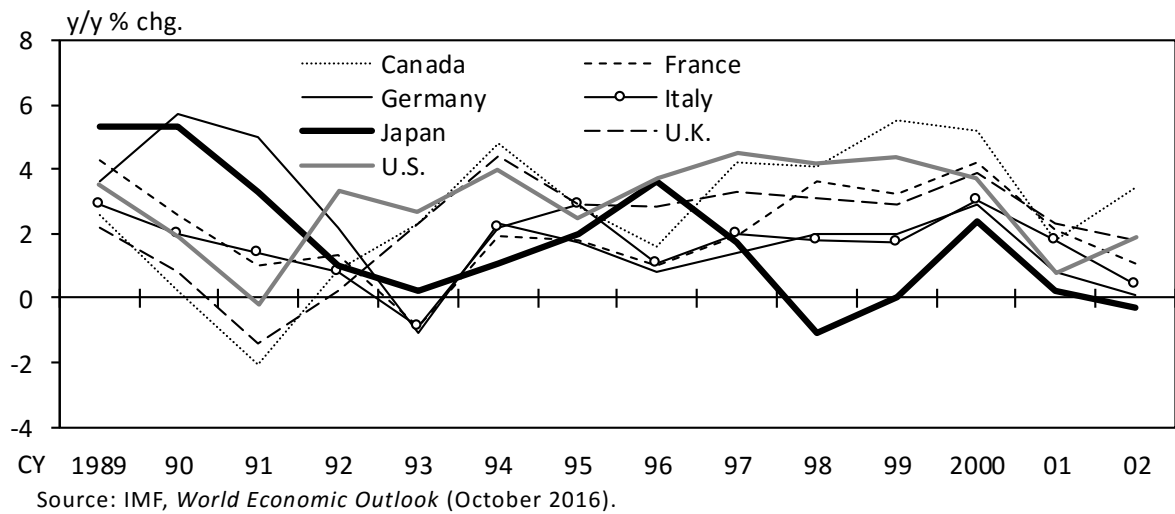
Note: Figures are as of year-end.

Source: Cabinet Office, "National Accounts."

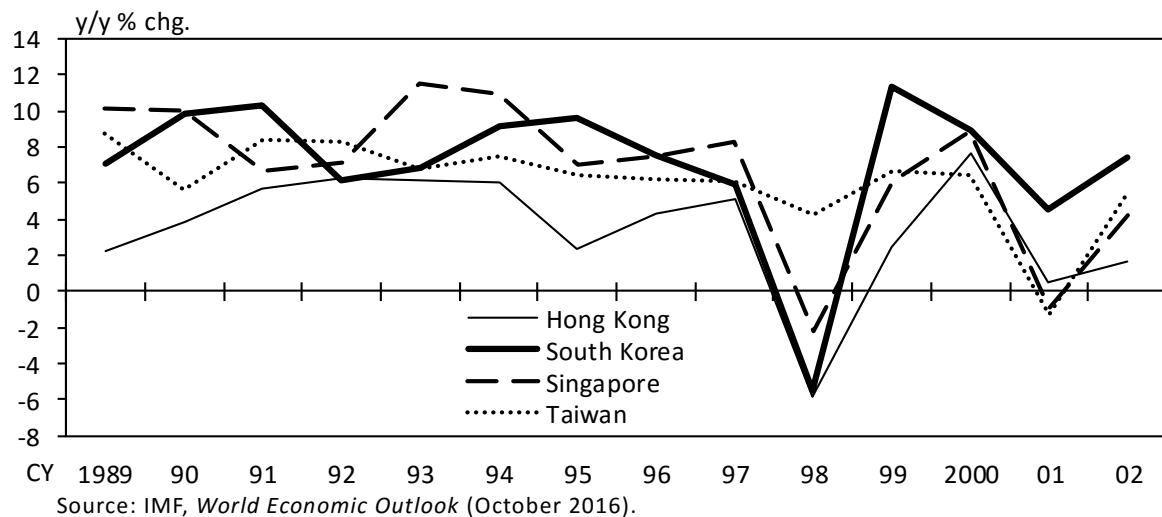
Chart 7 Overseas Economic Conditions

(1) Real GDP

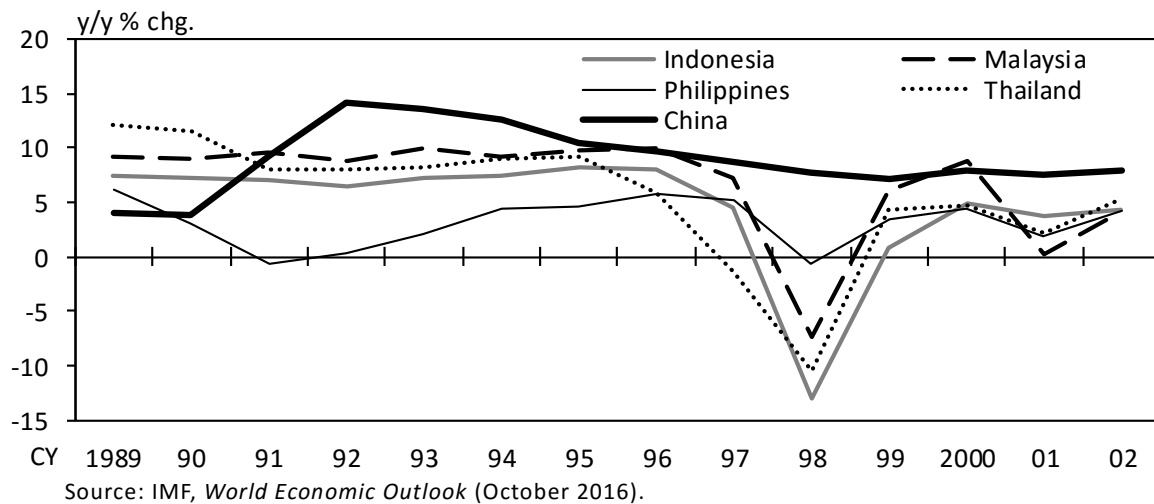
G7



Asian NIEs

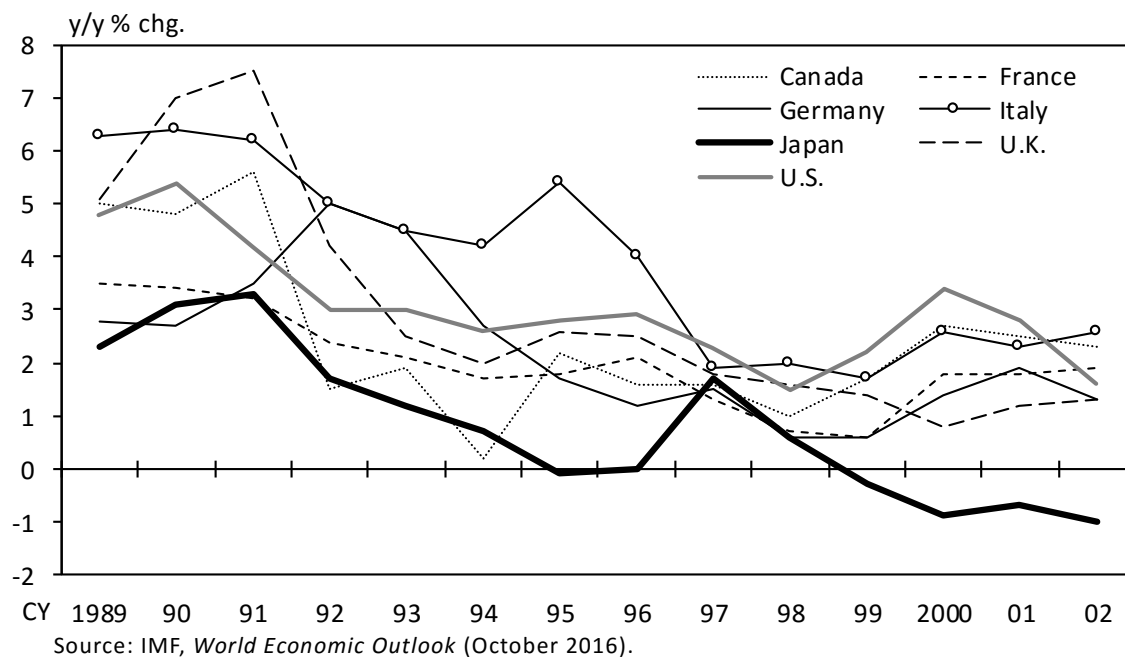


ASEAN4 and China

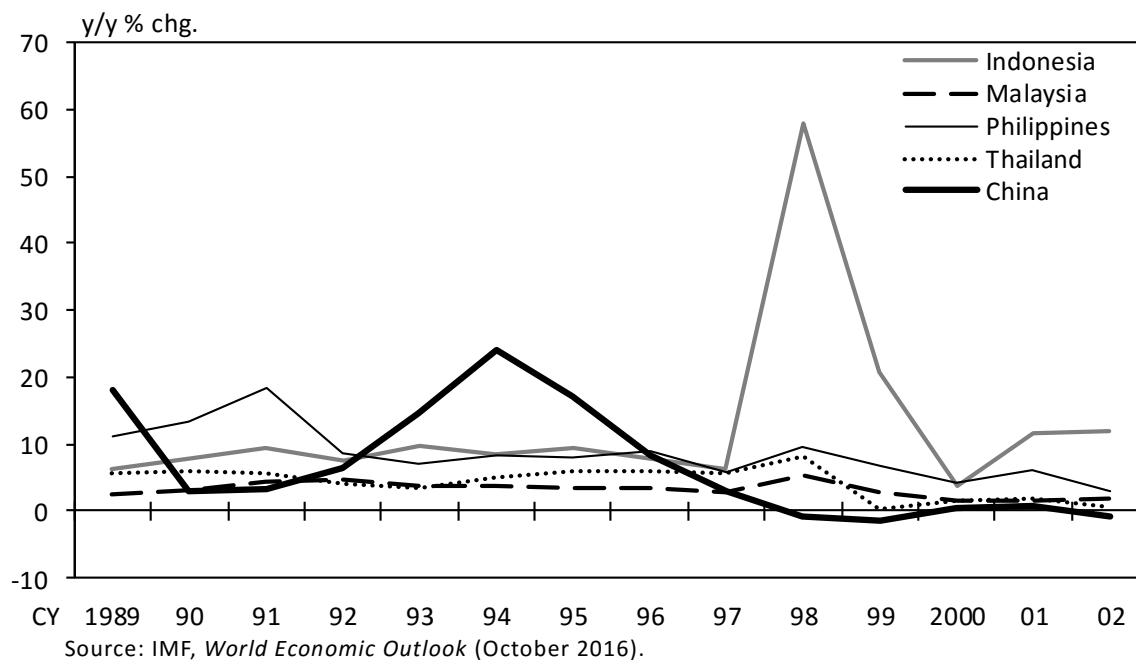


(2) Inflation rates

G7

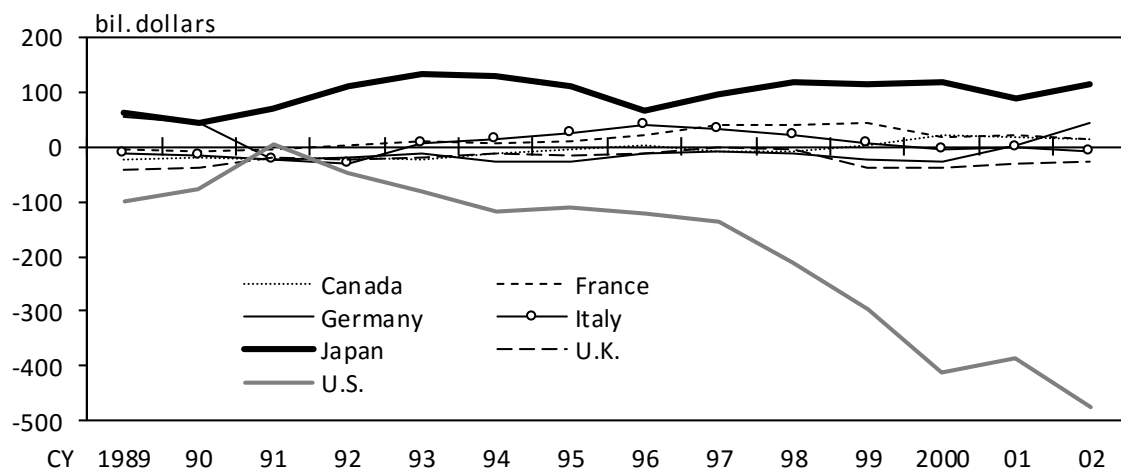


ASEAN4 and China



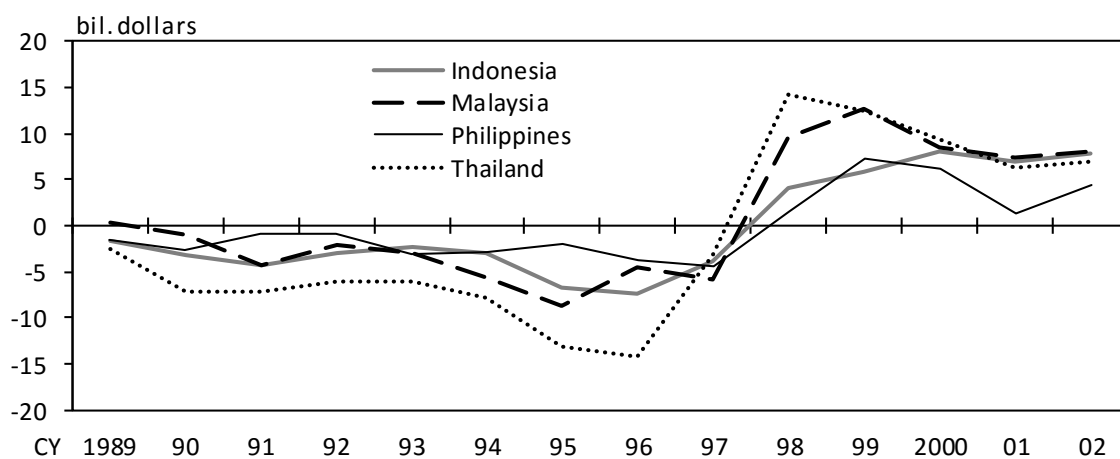
(3) Current Account Balance

G7



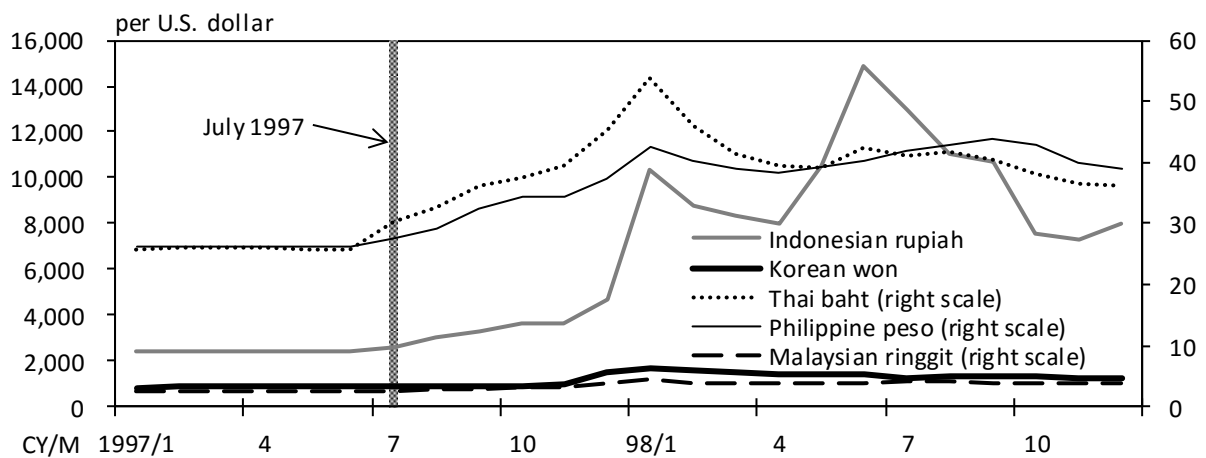
Source: IMF, *World Economic Outlook* (October 2016).

ASEAN4



Source: IMF, *World Economic Outlook* (October 2016).

(4) Exchange rates around the time of the Asian Currency Crisis



Sources: IMF; Bank Negara Malaysia; Bank Indonesia.

Chart 8 Major Events in the 1990s

Year	Month	Events	BOJ Governor	Minister of Finance	Prime Minister
1989	May	The Bank started to raise the official discount rate.	Dec. 17, 1984- Satoshi Sumita	Dec. 24, 1988- Tatsuo Murayama	Nov. 6, 1987- Noboru Takeshita
	Dec.	The Nikkei 225 Stock Average recorded the highest level (38,915 yen).	Dec. 17, 1989- Yasushi Mieno	June 3, 1989- Tatsuo Murayama (reappointed) Aug. 10, 1989- Ryutaro Hashimoto	June 3, 1989- Sousuke Uno Aug. 10, 1989- Toshiki Kaifu
1990	Mar.	The MOF directed quantitative restrictions on real estate-related loans extended by financial institutions.		Feb. 28, 1990- Ryutaro Hashimoto (reappointed)	Feb. 28, 1990- Toshiki Kaifu (the second term)
	Aug.	Iraq invaded Kuwait (multinational force started to attack Iraq in January 1991).			
	Nov.	The Federal Reserve Board shifted the seasonal lending rate from the discount rate to a floating market rate (from January 9, 1992).			

1991	Jan.	"Outline of Promotion of Comprehensive Policies Related to Land" was decided by the Cabinet (for the purpose of lowering land prices, ensuring rational use of land, and others).
	June	Abolition of window guidance was decided (abolished from the July-September quarter).
	July	The Bank started to lower the official discount rate.
	Dec.	The Wholesale Price Index declined in November for the first time in 2 years and 10 months. The government decided to remove the quantitative restrictions on real estate-related lending by financial institutions through year-end.
1992	Mar.	Official land prices fell for the first time in 17 years.
1993	Jan.	Cooperative Credit Purchasing Corporation was established by capital subscription from 162 private financial institutions.
	June	Interest rates on term deposits were deregulated completely.
1994	June	The yen appreciated against the U.S. dollar (1 U.S. dollar was worth 100 yen or less).

Oct. 14, 1991- Toshiki Kaifu	
Nov. 5, 1991- Tsutomu Hata	Nov. 5, 1991- Kiichi Miyazawa
Dec. 12, 1992- Yoshiro Hayashi	
Aug. 9, 1993- Hirohisa Fujii	Aug. 9, 1993- Morihiro Hosokawa
Apr. 28, 1994- Hirohisa Fujii (reappointed)	Apr. 28, 1994- Tsutomu Hata

	Oct.	Financial deregulation was completed with deregulation of interest rates on liquid deposits.		June 30, 1994-	June 30, 1994-
	Dec.	A resolution plan for the Tokyo Kyowa and Anzen credit cooperatives was announced.	Dec. 17, 1994-	Masayoshi Takemura	Tomiichi Murayama
1995	Jan.	Tokyo Kyodo Bank was established (started business operations in March).	Yasuo Matsushita		
		The Great Hanshin-Awaji Earthquake broke out.			
	Mar.	The Policy Board approved of encouraging a decline in market interest rates as the guideline for market operations for the immediate future (released the target range).			
	Apr.	The yen appreciated against the U.S. dollar (1 U.S. dollar was worth 80 yen or less).			
	July	The Policy Board decided to encourage a decline in short-term market interest rates.			
	Sep.	Daiwa Bank released a statement on an enormous loss of its New York branch.			
	Dec.	"On the Package of Specific Measures for the <i>Jusen</i> Problem" was approved by the Cabinet.			

1996	Jan.	The Bank abolished the credit line system intended for nine city banks.
	June	Six laws relating to the financial system were passed by the Diet.
	July	The Bank provided funds to the DICJ for financing the HLAC.
	Sep.	Tokyo Kyodo Bank was renamed and reorganized as the Resolution and Collection Bank.
	Dec.	HLAC took over the assets of seven failed <i>jusen</i> (housing loan companies).
1997	Apr.	The consumption tax was raised from 3 percent to 5 percent.
	July	The Thai baht was shifted to the managed float exchange rate regime (beginning of the Asian Financial Crisis).
	Nov.	Sanyo Securities filed an application for the commencement of reorganization proceedings based on the Corporate Reorganization Act (first default in the call market).
		Hokkaido Takushoku Bank announced the transfer of its business operations to the North Pacific Bank (Hokuyo Bank).

Jan. 11, 1996- Wataru Kubo	Jan. 11, 1996- Ryutaro Hashimoto
Nov. 7, 1996- Hiroshi Mitsuzuka	Nov. 7, 1996- Ryutaro Hashimoto (the second term)

		Yamaichi Securities announced the suspension of its business operations.			
1998	Feb.	Two acts to stabilize financial functioning were enacted (30 trillion yen of public funds was secured, and the Financial Crisis Management Examination Board (FCMEB) was established at the DICJ).	Mar. 20, 1998- Masaru Hayami	Jan. 28-30, 1998 Ryutaro Hashimoto Jan. 30-July 30, 1998 Hikaru Matsunaga	
	Mar.	The FCMEB decided to inject about 1.8 trillion yen of public funds into 21 major financial institutions.			
	Apr.	Bank of Japan Act of 1997 was enforced.			
	June	The Financial Supervisory Agency was launched.			
	Oct.	Laws and regulations related to the Financial Revitalization Act and the Early Strengthening Act were enacted (the amount of public funds was increased to 60 trillion yen).		July 30, 1998- Kiichi Miyazawa	July 30, 1998- Keizo Obuchi
		The government decided to temporarily nationalize the Long-Term Credit Bank of Japan.			
	Dec.	The government decided to temporarily nationalize the Nippon Credit Bank.			

		The Financial Reconstruction Commission was established.		
1999	Feb.	The zero interest rate policy was introduced.		
	Mar.	The Financial Reconstruction Commission decided to inject about 7.5 trillion yen of public funds into 15 major financial institutions.		
2000	July	The Financial Services Agency was established.	Apr. 5, 2000- Kiichi Miyazawa (reappointed)	Apr. 5, 2000- Yoshiro Mori
	Aug.	The zero interest rate policy was terminated.	July 4, 2000- Kiichi Miyazawa (reappointed)	July 4, 2000- Yoshiro Mori (the second term)

Notes: 1. Masaharu Hino assumed the post of Financial Supervisory Agency Commissioner on June 22, 1998.

2. Masaharu Hino assumed the post of Financial Services Agency Commissioner on July 1, 2000.

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APPENDIX 1: MONETARY POLICY RULES

I. Role of Monetary Policy Rules

Monetary policy rules are approaches of systematically conducting monetary policy in response to macroeconomic developments, with a view to ensuring the stability of prices and economic activity. When adopting such approaches, it is desirable to use observable, easy-to-understand indicators in as simple and clear a manner as possible. There have been various studies and discussions on which indicators should be selected and how they should be used.

From the second half of the 1970s through the first half of the 1980s, an approach called "money supply targeting," also known as "monetary targeting," became popular, and it was adopted by central banks in many advanced countries, including the Deutsche Bundesbank. The Bank of Japan did not adopt this policy approach, but it started to release projected figures for the money supply (MS) from the July-September quarter of 1978. Many central banks abandoned this approach by the early 1990s, as it ceased to function effectively when the stable relationship of the MS with the inflation rate and economic activity collapsed, due mainly to financial and technological innovation.

In the 1990s, inflation targeting and the Taylor rule were introduced.²⁸⁷ Inflation targeting is intended to enable central banks to stabilize inflation expectations and more flexibly respond to short-term exogenous shocks by strongly committing themselves to a slightly positive inflation target.²⁸⁸ The Taylor rule determines the policy interest rate based

²⁸⁷ The Taylor rule was first proposed in Taylor (1993), pp. 195-214. There were other approaches, such as nominal GDP targeting, which determines the policy interest rate based on a deviation of the nominal GDP growth rate from the target rate, and the McCallum rule, which uses the monetary base as a policy instrument. In November 1995, the IMES held an international conference titled "Toward More Effective Monetary Policy," at which discussions were held on the theoretical basis of the shift to a framework emphasizing policy consistency and transparency, such as inflation targeting, and other issues, including the independence and accountability of central banks. At the conference, Professor John B. Taylor, Honorary Adviser to the IMES, and Tommaso Padoa-Schioppa, Deputy Director General of the Bank of Italy, each made a keynote address. In-depth discussions were held on monetary policy rules as well as the independence and accountability of central banks. For further details of this conference, see IMES, BOJ (1996).

²⁸⁸ See Bernanke and Mishkin (1997) and Bernanke *et al.* (1999). These papers pointed out that it was important to understand inflation targeting as "constrained discretion," rather than a rigid policy rule. As for the theoretical basis of inflation targeting, see Walsh (1995), Svensson (1997), and Shiratsuka and Fujuki (1997).

on the equilibrium interest rate determined by the potential growth rate and the target inflation rate, by observing the deviation of the actual inflation rate from the target rate, and also the GDP gap. Several variations of these two approaches have been developed, but they have been categorized into two: inflation targeting as a forward-looking rule and the Taylor rule as a backward-looking rule whereby the monetary policy is generally conducted based on a forecast value for the former and an actual value for the latter.²⁸⁹

Inflation targeting was adopted by central banks in many advanced countries. The central banks that adopted this approach not only disclosed and committed themselves to their inflation targets but also implemented various initiatives to enhance policy transparency, such as releasing inflation reports, disclosing the minutes of monetary policy meetings, and holding Policy Board Chairman's press conferences. As a result, inflation targeting proved effective in enabling the central banks to curb the ongoing inflation or to maintain the existing low inflation rates for an extended period of time.²⁹⁰ At that time, it was understood that, although none of the U.S. Federal Reserve Board (FRB), the European Central Bank (ECB), or the Bank of Japan adopted inflation targeting in its original form, they were using similar policy approaches.²⁹¹

II. Money Supply Controversy

As the conduct of monetary policy changed as described above, an academic debate over monetary policy known as the "money supply controversy" arose in Japan from 1992 to

²⁸⁹ "Issues concerning Monetary Policy Rules, December 11, 2000," BOJ Archives "Study Sessions, etc., with the Policy Board (2000)," No. 78702.

²⁹⁰ The Bank judged that it required careful consideration toward immediate introduction of inflation targeting in Japan because "it was not necessarily clear whether the significantly low level of the inflation rate in the 1990s compared with that in the 1980s was achieved solely by inflation targeting," although the Bank acknowledged the significance of inflation targeting, given the growing perception that the role and responsibility of central banks should be further clarified as high inflation rates were observed in other countries. Policy Planning Office, BOJ (2000).

²⁹¹ See Bernanke *et al.* (1999). Regarding the Bank's stance of "continuing with the zero interest rate policy until deflationary concern is dispelled" adopted at that time, Board Member Ueda made a reference at a speech titled "Discussion regarding Japan's Economy and Monetary Policy Framework" on February 25, 2000. In this speech, he explained that the Bank's stance was "not inflation targeting itself but something similar" (BOJ [2000c], p. 5). Concerning the approach of the Bank's Policy Board to inflation targeting at that time, see BOJ (2000i).

1993. In particular, Kikuo Iwata, who was a professor of economics at Sophia University, and Kunio Okina, who was the Chief Manager of the Strategic Research Division of the Bank's Research and Statistics Department, continued to engage in the controversy for about a year. The key points of the controversy were as follows: (1) Whether a central bank could control the monetary base (MB; called the base money at that time) by adjusting current account balances at the Bank (reserve balances) through money market operations; (2) whether the relationship between the MB and the MS (currently known as the money stock) was stable and whether the causal relationship between the two was clear; and (3) whether the relationship between the MS and economic activity was stable and robust.

Iwata advocated the money multiplier approach, arguing that it was possible to ultimately affect economic activity by linking the control of the MB with that of the MS. Contrary to this, Okina argued that, under the framework of money market operations at that time, the Bank supplied the MB so as to accommodate the market's demand for funds and was unable to supply funds in excess of such demand. He also stated that there was no such thing as the money multiplier -- a causal relationship between the MB and the MS -- and that the empirical data showed that the relationship between the MS and economic activity was also weakening.

With respect to this controversy,²⁹² Kazuo Ueda, who was an associate professor at The University of Tokyo at that time, published a paper on how to correctly assess developments in the MS, and reviewed the arguments.²⁹³ The key points of Ueda's review were as follows: (1) Okina's interpretation of developments in the MS and the MB at that time was correct, but the Bank should take notice of Iwata's argument that central banks should pay more careful attention to and assume more responsibility for the MS; and (2) a central bank's control of the MB should be classified into three categories according to the time horizon of the control -- that is, daily control exercised within the reserve maintenance period, short-term control exercised over periods longer than the 1-month reserve maintenance period, and medium- to long-term control exercised over a cycle in which the impact of monetary policy caused changes in economic activity and prices, leading to changes in the MS, thereby affecting the required reserve level. Based on such categories of the time horizon,

²⁹² Their opinions are summarized in Iwata (1993) and Okina (1993).

²⁹³ Ueda (1992). Although the original title of this paper was "Assessment of the 'Iwata vs. Okina Controversy' -- How to 'Correctly' Assess Developments in Money Supply," the phrase "Assessment of the 'Iwata vs. Okina Controversy'" was deleted when the paper was carried again in Iwata (2000) pp. 291-299 as a reference material.

although it was possible to exert some influence over the MB with respect to daily control and medium- to long-term control, it was quite difficult to do so with respect to short-term control.²⁹⁴ As a result, Ueda concluded that it was not impossible but difficult and not very desirable to control the MB.²⁹⁵

III. Toward Unconventional Monetary Policy

The money supply controversy was reignited in a new form in February 1999, when the zero interest rate policy was introduced, and in August 2000, when the policy was terminated.²⁹⁶ There were heated discussions involving not only Iwata and Okina, but also Ryutaro Komiya, Koichi Hamada, Mitsuhiro Fukao, and Nobuyuki Nakahara, among others. It started with discussion in relation to foreign exchange interventions conducted to contain the sharp appreciation of the yen in summer 1999 after the introduction of the zero interest rate, whether the MB supplied into the market should be left to remain in the market (unsterilized intervention) or should be absorbed (sterilized intervention). Then, in terms of an increase in the MS, discussions took place on whether outright purchases of JGBs should be conducted as an additional monetary easing measure to supplement the zero interest rate policy. Furthermore, views were exchanged on how to interpret "deflation" and "deflationary concern is dispelled," when deciding the termination of the zero interest rate policy.²⁹⁷

These points were raised given the recognition of the so-called zero lower bound, which refers to significant limits imposed on the possibilities of monetary policy when interest rates are near zero. As a result, the following new approaches or thinking emerged with respect to monetary policy to be conducted at interest rates near zero: (1) the policy duration effect, which controls expectations for future monetary policy or short-term interest rates;

²⁹⁴ The reason why it was "quite difficult" was as follows: "The amount of the base money that can be reduced through a practical rate of increase in interest rates is highly limited" because "banknotes in circulation and current account balances at the Bank (reserve balances) scarcely react to changes in interest rates in a short period of about a few months," although "it is necessary, for example, that interest rates rise and the demand for base money sufficiently declines in order to reduce the base money," which is "the sum of banknotes in circulation and current account balances at the Bank (reserve balances)." Ueda (1992), p. 293.

²⁹⁵ Ueda (1992). Also, see Ueda (1993).

²⁹⁶ Iwata (2000), and Japan Center for Economic Research and Komiya eds. (2002).

²⁹⁷ Okina (1999).

(2) efforts to reduce the risk premia of assets eligible for a central bank's money market operations by purchasing a large amount of specific assets, such as medium- to long-term government bonds and corporate bonds; and (3) the provision of funds in excess of demand by expanding the size of a central bank's balance sheet.²⁹⁸ These approaches became the basis for various initiatives, which would later come to be collectively known as "unconventional monetary policy."

²⁹⁸ See Bernanke and Reinhart (2004), and Bernanke, Reinhart, and Sack (2004), pp. 96-100.

APPENDIX 2. BANK OF JAPAN'S SPECIAL LOANS (*NICHIGIN TOKUYU*)

Special loans of the Bank of Japan (*Nichigin Tokuyu*) are temporary loans (liquidity provision) extended by the Bank acting as the lender of last resort (LLR) when financial institutions face a temporary shortage of funds and there is no other lender available, in order to secure and maintain the stability of Japan's financial system. The first time the Bank provided this type of the special loans after World War II was to Yamaichi Securities during the securities recession in 1965.²⁹⁹

Pursuant to Article 33 of the Bank of Japan Act of 1997, the Bank normally provides financial institutions with loans against collateral in the form of negotiable instruments, government securities, and other securities in cases where it is acting as the LLR. However, when there is a request from the government -- that is, the Prime Minister (practically, the Commissioner of the Financial Services Agency delegated by the Prime Minister) and the Minister of Finance -- the Bank, in accordance with Article 38 of the Act of 1997,³⁰⁰ may conduct "business necessary to maintain stability of the financial system,"³⁰¹ such as to provide loans under special conditions," including uncollateralized loans, if deemed necessary by the Policy Board to maintain financial stability. The provision of loans to financial institutions under such special conditions is called *Nichigin Tokuyu*.

Since the 1990s, the Bank had often supplied funds through *Nichigin Tokuyu* in response to the emergence of severe financial system problems. According to the Bank's *Nenji Houkoku Sho* published until 1998 (Annual Report of the Policy Board of the Bank of Japan, available only in Japanese) and *Gyoumu Gaikyo Sho* (Outline of Business Operations, excerpts of which are available in English in the *Annual Review*), the amount outstanding of *Nichigin Tokuyu* (loans pursuant to Article 25 of the Bank of Japan Act of 1942 through end-1997, and since 1998, loans pursuant to Article 38 of the Act of 1997) was 1.3 trillion yen at end-1995, 1.2 trillion yen at end-1996, 3.7 trillion yen at end-1997, 0.6 trillion yen at end-1998, 1.5 trillion yen at end-1999, 0.5 trillion yen at end-2000, and 0.8 trillion yen at end-2001.³⁰²

²⁹⁹ Committee for Compiling the One Hundred Year History of the Bank of Japan, BOJ (1986), pp. 151-165.

³⁰⁰ Provisions of the Act of 1997. Under the Bank of Japan Act of 1942, regular business was prescribed in Article 20, and *Nichigin Tokuyu* were prescribed in Article 25.

³⁰¹ Such business includes loan provision and capital injection.

³⁰² For the amount outstanding of *Nichigin Tokuyu*, see Policy Board, BOJ (1997), p. 45, Policy Board, BOJ (1998a), p. 52, BOJ (1999c), p. 140, BOJ (2000a), p. 135, BOJ (2001), p. 131, and BOJ (2002), p. 91.

Financial institutions' casual dependence on *Nichigin Tokuyu* may invite moral hazard, and may also lead to, for example, a deterioration in the Bank's balance sheet. Therefore, the Bank determines whether or not to provide *Nichigin Tokuyu* to failed financial institutions for their resolution based on the following four principles: (1) there must be a strong likelihood that systemic risk may materialize, (2) there must be no alternative to the provision of central bank funds, (3) all responsible parties are required to take clear responsibility to avoid moral hazard, and (4) the financial soundness of the Bank itself should not be impaired. These had been described from 1995 onward in the Bank's *Nenji Houkoku Sho* and the *Gyomu Gaikyo Sho*.³⁰³ In May 1999, the Policy Board examined the four principles under the Act of 1997, and outlined the Bank's thinking on the specific management of these principles. It decided to release them in the *Gyomu Gaikyo Sho* for fiscal 1998 as "Four Principles in Conducting Business Necessary to Maintain Financial Stability."³⁰⁴

In the content of the "Four Principles in Conducting Business Necessary to Maintain Financial Stability" decided in May 1999, the Bank noted as the basic thinking "since the provision of special loans is one of the countermeasures to avoid a financial crisis (hereafter "safety net"), it should be reviewed in light of the changes in the overall framework of the safety net including deposit insurance." Furthermore, in the explanation of the second principle -- namely, there must be no alternative to the provision of central bank funds -- there were descriptions that "in the framework of dealing with failed financial institutions, special loans are provided as bridging finance until failed financial institutions obtain financial assistance under the deposit insurance system on transferring their business to other financial institutions," and that "the LLR function of a central bank basically refers to the temporary provision of liquidity, and is different in nature from funds intended to cover existing losses." Moreover, in the explanation of the fourth principle -- namely, the

³⁰³ Policy Board, BOJ (1996), pp. 37-45, Policy Board, BOJ (1997), p. 44, and Policy Board, BOJ (1998a), p. 50. The *Nenji Houkoku Sho* for 1995 stated that the Bank would provide special loans to failed financial institutions for their resolution, only when the conditions in the principles (1) to (3) were met, and that "since the Bank's assets present evidence for the issuance of banknotes, the Bank -- from the viewpoint of maintaining confidence in the currency -- will give consideration to its financial soundness in implementing such credit provision." However, in the *Nenji Houkoku Sho* for 1996 and 1997, the expression was changed to one that the Bank will provide special loans to failed financial institutions for their resolution, only when the conditions in the four principles were met.

³⁰⁴ Policy Board, BOJ (1999b).

financial soundness of the Bank itself should not be impaired -- it was stated that "in coping with financial system uncertainty in the past, the Bank provided not only temporary liquidity but also risk capital such as capital subscription as a special and exceptional measure." The explanation also stated that "the latter was necessary to avoid systemic risk given the then underdeveloped safety net system," and that the Bank's thinking on the specific management of the fourth principle was that "in principle, liquidity should be provided, not risk capital."

Based on the above principles, the Bank determined whether to provide *Nichigin Tokuyu* by fully assessing the situation at that time, taking into consideration the individual circumstances facing financial institutions. In addition, the interest rate and other conditions for the extension of *Nichigin Tokuyu* had been individually decided by the Policy Board in view of the particular nature of the loans being provided under special conditions for the stability of the financial system. Under such lending principle, *Nichigin Tokuyu* were almost completely collected afterward (the uncollectible loans were those provided to Yamaichi Securities in 1997 [111.1 billion yen]).³⁰⁵

As another fund-provisioning measure during the time of a financial crisis, the Bank also provides loans to the DICJ. Such loan provisions were conducted in the cases where the DICJ gave financial assistance for the resolution of failed financial institutions. The Bank also provided loans to the DICJ in relation to the start of the temporary nationalization of financial institutions, pursuant to the Financial Revitalization Act, and to the capital injection based on the Early Strengthening Act.³⁰⁶ The outstanding amount of loans provided to the DICJ reached 8.477 trillion yen at end-December 1998.³⁰⁷

³⁰⁵ The amount of uncollectible loans was written off by withdrawing the Bank's provisions for possible loan losses (Financial Systems and Bank Examination Department, BOJ [2005], pp. 3-4).

³⁰⁶ BOJ (1999c), p. 7.

³⁰⁷ BOJ (1999c), p. 142. In April 2001, the DICJ fully repaid all loans made by the Bank by refinancing them with loans from private financial institutions (Financial Systems and Bank Examination Department, BOJ [2005], p. 12). Nakaso (2001) gave a detailed summary of a series of financial crises that occurred in the 1990s, the measures adopted by Japan's monetary authorities and the Bank during that period, and the thinking on the role of a central bank in maintaining financial system stability based on the experience gained from such crises.

APPENDIX 3: OUTLINE OF THE REVISION OF THE BANK OF JAPAN ACT (PROMULGATION OF THE BANK OF JAPAN ACT OF 1997)

I. Background of the Revision

The Bank of Japan Act of 1942 was legislated during World War II, and bore a strong characteristic of state control. After World War II, in the latter half of the 1940s, several attempts were made to change the role and organization of the Bank. However, none of them were successful, apart from the act revision made in 1949, which included establishment of the Policy Board. Meanwhile, from August 1957 to September 1960, the Financial System Research Council (FSRC), an advisory committee to the Minister of Finance, deliberated on reform of the Bank. Nevertheless, there was a severe conflict of opinions in the deliberation process, particularly regarding the relationship between the central bank and the government, and both sides of the conflict ended up being indicated in the report by the FSRC; accordingly, a bill incorporating the deliberation results failed to be drafted.³⁰⁸ From 1964 to 1965, revision of the Bank of Japan Act of 1942 was discussed, but no bill was submitted to the Diet.³⁰⁹

Prompted by the emergence, expansion, and bursting of the bubble economy as well as the occurrence of the NPL problem and other repercussions, vigorous discussions were held on Japan's financial administration and monetary policy among a wide range of entities in the mid-1990s. This led to increasingly heated arguments calling for reform of the institutional framework of the central bank, responsible for conducting monetary policy, by revising the Bank of Japan Act of 1942, which had been legislated during World War II; specifically, through further clarification of the Bank's independence and accountability regarding its policy decisions. For example, in a report titled "Reforms of Financial Administration and Monetary Policy," published on June 13, 1996, by a project team of the

³⁰⁸ Committee for Compiling the One Hundred Year History of the Bank of Japan (1985), pp. 623-641. The report submitted by the FSRC to the Minister of Finance in September 1960 proposed two approaches to deal with a case where the competent minister found that the Bank's policy was likely to hinder implementation of the government's policy, consulted about it with the Bank's Governor, but failed to reach an agreement: Approach A, which granted the competent minister the power to give directions on the Bank's policy, and Approach B, which only granted the minister the right to request postponement of a vote on monetary control matters (Committee for Compiling the One Hundred Year History of the Bank of Japan [1985], pp. 664-668).

³⁰⁹ Committee for Compiling the One Hundred Year History of the Bank of Japan (1986), pp. 273-289.

ruling coalition parties, raised the revision of the Bank of Japan Act as one of the important pillars of the reforms.³¹⁰ The report stated, "It is necessary to revise the Bank of Japan Act in the form of further clarifying the Bank's independence and accountability regarding its policy decisions as a central bank, so as to avoid any repetition of failures of macroeconomic policy in addressing excessive liquidity and the bubble economy." Under such circumstances, the Central Bank Study Group (CBSG) was established in July 1996 as an advisory panel to the Prime Minister. After about three months of deliberations, the CBSG compiled a report entitled "Reform of the Central Bank System -- In Pursuit of Open Independence" (CBSG Report), and submitted it to the Prime Minister on November 12.³¹¹

Based on the CBSG report, the FSRC discussed issues to be tackled in revising the Bank of Japan Act, and submitted the "Report concerning the Revision of the Bank of Japan Act" to the Minister of Finance on February 6, 1997.³¹² This report made specific proposals mainly on the Bank's purpose, organization, and business operations based on the following idea: "The Bank of Japan Act of 1942 has many outdated provisions, and it needs to be fundamentally reviewed in light of the progress in globalization and marketization in the fields of economy and finance"; and "in order for the Bank to gain confidence of the public and market participants, it is essential to reform the overall policy decision-making framework from the viewpoint of ensuring the Bank's independence as a central bank and the transparency of its monetary policy conduct."

In response to the report by the FSRC (FSRC Report), the government proceeded with revisions to the Bank of Japan Act of 1942, and on March 11, 1997, the bill for the new

³¹⁰ FBAJ (1996b), pp. 17-19 and 36-37. This report was compiled by the Ministry of Finance Reform Project Team in Enhancing Financial Administration. The team was established based on the purpose of the Three-Party Policy Agreement toward the New Administration, which was agreed and published on January 8, 1996, by the three ruling coalition parties at the time -- the Liberal Democratic Party, the Japan Socialist Party (the party name was changed to the Social Democratic Party on January 19, 1996), and the New Party Sakigake -- toward the inauguration of the Ryutaro Hashimoto Cabinet on January 11 of that year. For the Three-Party Policy Agreement, see FBAJ (1996a), p. 57.

³¹¹ Policy Board, BOJ (1997), p. 49. The CBSG Report and the minutes of the CBSG meetings are contained in CBSG (1996a and 1996b). The Chairman of the CBSG was Mr. Yasuhiko Torii, the President of Keio University.

³¹² Policy Board, BOJ (1998a), p. 58. This report and the "Statement of Reasons for the Report concerning the Revision of the Bank of Japan Act" are contained in FSRC (1997).

Bank of Japan Act was submitted to the Diet after the Cabinet's approval was obtained.³¹³ The bill passed the House of Representatives and the House of Councillors by a majority vote on May 22 and June 11, respectively, and was then promulgated as the Bank of Japan Act of 1997 on June 18.³¹⁴

II. Outline of the Revision

The Bank of Japan Act of 1942, legislated during World War II, was revised based on two principles -- independence and transparency -- in line with major changes in the financial and economic environment, namely, globalization and marketization. The outline of the revision is as follows.

A. Purposes and Principles of the Bank of Japan

The Bank of Japan Act of 1942 set the Bank's purpose as "the regulation of the currency, control and facilitation of credit and finance, and the maintenance and fostering of the credit system, pursuant to the national policy, in order that the general economic activities of the nation might adequately be enhanced" (Article 1). As it was legislated during the war, it became obsolete.

The Bank of Japan Act of 1997 provides that the Bank's first purpose is "to issue banknotes and to carry out currency and monetary control" (Article 1, paragraph 1), and set forth that the Bank is to implement currency and monetary control (monetary policy) based on the principle of "achieving price stability, thereby contributing to the sound development of the national economy" (Article 2).³¹⁵ In addition, it provides that the Bank's second

³¹³ In submitting the bill to the Diet, the purpose of revising the Bank of Japan Act was elaborated as follows: "The Bank's fundamental reform will be implemented, including strengthening of the authority of the Bank's Policy Board and prompt release of the minutes of the Policy Board meetings, in light of the need to (1) respond to economic and social changes at home and abroad, (2) increase the degree of independence in conducting currency and monetary control as well as transparency of its decision-making process as the central bank of Japan, and (3) secure the Bank's appropriate and efficient conduct of business operations" (BOJ [1998i], p. 39).

³¹⁴ Policy Board, BOJ (1998a), pp. 58-59.

³¹⁵ There was a question of whether the purpose of monetary policy was the stability of currency value or prices. It was determined to be price stability based on the conclusion derived in the FSRC Report that "it is appropriate to regard the purpose of monetary policy to be price stability instead of currency value." The reason for this was stated as follows: "Currency value has two aspects, namely, prices, which is an internal value,

purpose is "to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of stability of the financial system" (Article 1, paragraph 2). In other words, the Bank will aim to achieve financial system stability by ensuring smooth and stable operation of the payment and settlement systems.

B. Independence of the Bank of Japan (Respect of Autonomy)

Under the Bank of Japan Act of 1942, the government had strong authority against the Bank on extensive matters, and the Bank's independence was not clearly ensured.³¹⁶ For example, it provided the Minister of Finance with the power to order the Bank to undertake necessary business operations (Article 43) and the government with the power to dismiss the Bank's officers (Article 47).³¹⁷

On this point, the Statement of Reasons for the FSRC Report, which was submitted by the FSRC to the Minister of Finance and published along with the FSRC Report, stated as follows: "The most important objective of monetary policy conducted by a central bank is to achieve price stability. In order to achieve this objective, it is desirable that a central bank can conduct monetary policy with a high degree of independence from the government, as the experiences of the central banks of various countries indicate that the conduct of monetary policy tends to come under pressure to adopt inflationary policies."

In light of such thinking, the Bank of Japan Act of 1997 provides that "the Bank of Japan's autonomy regarding currency and monetary control shall be respected" (Article 3, paragraph 1). Given that the monetary policy is implemented through the Bank's business operations, the Act stipulates that "due consideration shall be given to the autonomy of the Bank of Japan's business operations" (Article 5, paragraph 2). As a framework for ensuring its independence in effect, the Act provides that the Bank's officers shall not be dismissed on the grounds of having a different opinion from the government (Article 25). Some

and exchange rates, which is an external value. A conflict of interest could occur if the stability in these two aspects was pursued by a single economic means of monetary policy."

³¹⁶ CBSG (1996a), Chapter I.A.

³¹⁷ Article 47 of the Bank of Japan Act of 1942 stipulated that the Cabinet could dismiss the Governor and Deputy Governors, and the competent minister could dismiss Executive Directors, Executive Auditors, and Counsellors, not only when they violated laws and regulations, but also when they violated the competent minister's order, harmed public interest, or were found particularly necessary to do so for the purpose of attaining the Bank's objectives.

provisions were deleted, including those on the government's extensive power to order the Bank to undertake necessary business operations and those on the system to dispatch supervisors from the MOF to the Bank. Meanwhile, the clause on loss compensation by the government stipulated in the Supplementary Provisions of the Bank of Japan Act of 1942 (a clause whereby the government must supplement an amount equivalent to the Bank's loss incurred by the Bank's inability to fully compensate for the loss incurred in each fiscal year, even if the Bank used its reserve fund) was not incorporated into the Bank of Japan Act of 1997.³¹⁸

C. Securing Transparency

The CBSG Report stated, "In order for the Bank to conduct its monetary policy, its strong independence and neutrality need to be granted, . . . at the same time, the Bank is accountable to the public and the Diet through transparent policy conduct." The Statement of Reasons for the FSRC Report indicated, "In order to gain public support for strengthening the independence of the Bank's monetary policy, the Bank's monetary policy conduct needs to involve accountability to the public and the Diet by clarifying the policy decision-making body and increasing the transparency of the decision-making process," and, "It should be clarified that the basic thinking in revising the Bank of Japan Act is to secure transparency of the Bank's monetary policy decisions. Specifically, it is important to secure transparency mainly through releasing the minutes and transcripts of Policy Board meetings for monetary control matters."

In light of such thinking, the Bank of Japan Act of 1997 provides that "the Bank of Japan shall endeavor to clarify to the citizen the content of its decisions, as well as its decision-making process, regarding currency and monetary control" (Article 3, paragraph

³¹⁸ Regarding the treatment of the loss compensation clause stipulated in paragraph 9 of the Supplementary Provisions of the Bank of Japan Act of 1942, there were no particular descriptions in the CBSG Report and the minutes of the CBSG meetings, the FSRC Report and its Statement of Reasons, or the summary of discussions at the Subcommittee of the Revision of the Bank of Japan Act in the FSRC (CBSG [1996a and 1996b], FSRC [1997], and Research Division, Banking Bureau, MOF [1996]). A speech given by Mr. Ueda, a Member of the Policy Board, at the Autumn Annual Meeting of the Japan Society of Monetary Economics in fiscal 2003 suggested that the provisions on loss compensation by the government described in the Bank of Japan Act of 1942 were deleted in the Act of 1997 from the viewpoint of ensuring independence of the Bank -- that is, respect of autonomy (Ueda [2003], p. 58).

2), and obliged the Bank to prepare and release the minutes and transcripts of Policy Board meetings for monetary control matters (Article 20).

D. Strengthening the Policy Board

The Policy Board was established following the 1949 revision of the Bank of Japan Act, but it had been pointed out that its status was unclear, including whether it was the Bank's internal or external body.³¹⁹ In addition, apart from the Policy Board, the Bank had organized the meetings of the executives, consisting of the Governor, Deputy Governors, and Executive Directors based on the provisions of the Bank's articles of incorporation. These meetings deliberated on important matters concerning the Bank's business execution and held discussions prior to submitting the executives' draft proposals to the Policy Board. Accordingly, there was a criticism that the Bank virtually had two decision-making bodies.

With regard to the status of the Policy Board, the Statement of Reasons for the FSRC Report set forth that "it is appropriate to set the Policy Board as the Bank's internal body." As for the relationship between the Policy Board and the executives, it indicated, "In order to fully demonstrate and activate the functions of the Policy Board, the meetings of the executives should be abolished and the authority should be concentrated to the Policy Board, adopting a one-board system." With regard to matters that should be decided by the Policy Board, the Statement of Reasons set forth that "in order for the Policy Board to make decisions on the Bank's policy as the Bank's highest decision-making body," "such matters as guidelines for market operations and the basic assessment of financial conditions should be included in the agenda of the Policy Board."

Based on this thinking, the provisions of the Bank of Japan Act of 1997 concerning the Policy Board were stipulated. Whereas the Bank of Japan Act of 1942 did not provide that the appointive members were to be the Bank's officers, the Act of 1997 explicitly indicates that the Members of the Policy Board are to be the Bank's officers (Article 21). As it took effect, the Bank's articles of incorporation were fully revised, and the provisions on the meetings of the executives were abolished.³²⁰

³¹⁹ Article 13-2 of the Bank of Japan Act of 1942 provided that "there shall be established a Policy Board in the Bank of Japan," but it also had provisions which expressed the Policy Board as if it were an external body, such as "the expenses of the Policy Board, including allowances for appointive members, shall be borne by the Bank of Japan" (Article 13-4, paragraph 5).

³²⁰ This revision of the articles of incorporation was decided at the Bank's Policy Board meeting on March 24, 1998 (BOJ [1999c], pp. 387-409).

E. Relationship with the Government

As for the relationship with the government, the Statement of Reasons for the FSRC Report indicated as follows: "The monetary policy conducted by a central bank contributes to the sound development of the national economy in combination with the economic policy implemented by the government. With a view to ensuring that the Bank's monetary policy contributes to the sound development of the national economy, it is necessary to endeavor to maintain compatibility between the Bank's monetary policy and the government's economic policy." On this basis, the Bank of Japan Act of 1997 provides that "the Bank of Japan shall, taking into account the fact that currency and monetary control is a component of overall economic policy, always maintain close contact with the government and exchange views sufficiently, so that its currency and monetary control and the basic stance of the government's economic policy shall be mutually compatible" (Article 4).

In addition, as an institutional framework for ensuring sufficient exchange of views with the government, Article 19 of the Bank of Japan Act of 1997 provides that government representatives may attend and express opinions at Policy Board meetings for monetary control matters, when necessary (paragraph 1), and that government representatives attending a Policy Board meeting may submit proposals concerning monetary control matters or request that the Policy Board postpone a vote on proposals submitted at the meeting until the next Policy Board meeting (paragraph 2). A system has been adopted whereby, when the right to request postponement of a vote has been exercised, the vote is not automatically postponed and the Policy Board is able to decide whether to accommodate the request (paragraph 3).