

## **“New Challenges for Central Bank Market Operations”**

**Opening Speech by Haruyuki Toyama, Director-General,  
Financial Markets Department of the Bank of Japan,  
at the 5<sup>th</sup> Euromoney Annual Japan Forex Forum in Tokyo  
(June 4, 2010)**

1. Good morning, ladies and gentlemen. It is my real pleasure to be able to speak at this distinguished gathering.
2. Over the past year, conditions in global financial markets have improved, with real economic activity regaining traction. Against this backdrop, central banks in advanced economies have already unwound some of their unconventional policies introduced following the Lehman’s collapse to address severe dislocations in financial markets. The winding down of the unconventional policies reflects the restoration of market functions that specific unconventional measures were intended to achieve. Likewise, several central banks in emerging market economies have also embarked on the phased removal of strong monetary stimulus.
3. However, uncertainties remain with the global economy, which is further compounded by growing concerns over the sovereign debt problems in Europe. Under these conditions, major central banks are still preserving a low interest rate environment to ensure durable economic growth with price stability.
4. In Japan’s case, deflationary forces are still at work, although to a lesser extent than several months ago. Market participants do not expect the Bank of Japan (BOJ) to raise policy rates anytime soon. In these circumstances, the BOJ has been going down the route of further monetary easing via newly-adopted fixed-rate liquidity operations.
5. With these developments in mind, I would like to begin by talking about the BOJ’s unconventional policy measures put in place last December to strengthen the effects of monetary easing, namely, fixed-rate funds-providing operations under which 3-month term funds are supplied at the O/N policy rate, currently 0.1%. Because of these sweeteners, the bid-to-cover ratios for the operations have been as high as 6 to 7 times, with the funds allocated to the bidders on a pro rata basis.

6. We initially intended to provide ¥10 trillion through this facility, but at the Monetary Policy Meeting in March this year, the target was raised to ¥20 trillion. We are currently conducting the operations twice a week, providing ¥800 billion each time. This means that liquidity provision through these fixed-rate tenders will amount to roughly ¥20 trillion this month.
7. So far this special facility seems quite a success. Since the commencement of its weekly tenders, the 3-month term rates in the Tokyo money market, such as the T-Bill rate, TIBOR and LIBOR, have all declined. Particularly symbolic among these changes is that the negative spread between dollar LIBOR and yen LIBOR has turned positive for both the 3-month and 6-month tenors.
8. The bank lending rates have also come down. As both LIBOR and TIBOR are the benchmark rates for bank lending, their declines are translating into the lower bank lending rates, providing a support for corporate and household activity.
9. But we cannot ignore the side effects of our expanded liquidity operations. First of all, the money market has become even less active because the ample liquidity provision by the BOJ has undermined the autonomous functioning of the short-term funding market. In particular, the downward pressure on term rates has helped flatten the yield curve, thereby depressing positive carry whereby banks earn profits by selling short-term debt and buying long-dated bonds. Under these circumstances, the BOJ is facing a delicate balancing act between reinforcing the easing effects of monetary policy on the one hand and maintaining market functioning on the other.
10. At this point, let me spend a few words on why market functioning is vital. Without efficient financial markets, the potency of monetary policy would be severely constrained because effects of monetary policy are transmitted through financial markets. In addition, our experience under the quantitative easing policy (QEP) from 2001 through 2006 is a good reminder that market functioning is hard to repair once they are damaged. In fact, coupled with the zero policy rate, the BOJ's massive liquidity provision under the QEP made the money market look like a desert town; no life, no sound, and very limited transactions in early morning.

11. After the QEP was terminated in March 2006, Japan's money market participants realized how difficult it was to re-instate skilled dealers and rebuild their trading room infrastructures after the long interregnum. Likewise, financial institutions had to re-establish credit lines, but this was a time-consuming process because it entailed rigorous re-assessments of counterparties' credit standing in accordance with their internal procedures.
12. At present, the BOJ pays interest (0.1%) on excess reserves. As this constitutes the lower bound for the O/N rate, market players have so far retained marginal incentives to deal in the money market. We should safeguard these marginal incentives to the extent possible because we need a pilot-light that would rekindle our life once the financial markets return to normality.
13. In connection with unconventional policies, I should also mention other initiatives we have announced lately.
14. At the Monetary Policy Meeting on April 30, the BOJ decided to consider the introduction of a new lending scheme, under which the BOJ will be back-financing those financial institutions that lend and invest in the areas conducive to enhancing growth potential. The terms and conditions of the loans to these financial institutions will be so designed as to provide them with incentives. For example, financial institutions can borrow funds with the 1-year maturity at the 0.1% policy rate and the loans can be rolled over. We are now talking with financial institutions to flesh out the details of this new lending scheme, which will hopefully be ready for the implementation sometime during this summer.
15. This new facility is surely unconventional. But the background that prompted us to take this step is the fact that Japan's economy faces dual challenges of the cyclical downturn after the Lehman's collapse and the structural downtrend caused by the falling population and stagnant productivity. Under these adverse conditions, we thought it was time to explore further measures that were still at our disposal.
16. The new lending facility is neither a credit easing nor quantitative easing policy, but we believe it should be consistent with the monetary policy goal, which is to "contribute to the sound development of the national

economy through price stability”, as the BOJ Law states. In devising the specifics of the facility, we will take care not to distort the resource allocations at firm-specific or industry-specific levels, as well as not to compromise the asset quality of the BOJ.

17. In early May, the BOJ also reactivated the dollar swap line with the US Federal Reserve as part of the concerted efforts by major central banks to defuse the mounting tensions in global financial markets. On May 18, the BOJ auctioned 3-month dollar funds and \$200 million was allotted. This is not a big amount, but our market contacts say they welcome the resumption of the swap line as an effective back-stop. Foreign exchange swap markets, especially those involving the US dollar funds, have generally become thinner and deserve careful monitoring given the underlying fragility.

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18. To change the subject slightly, let me speak about central bank’s balance sheet expansion for a while. In view of the persistent deflationary pressures in Japan, some are raising a question like this; why not the BOJ re-initiate the QEP which it implemented from March 2001 through March 2006? Why is the reluctance on the part of the BOJ to expand its balance sheet as vigorously as the US Federal Reserve?

19. It is true that the balance sheets of the major central banks have grown significantly after the Lehman’s collapse. In fact, the balance sheets of the Federal Reserve and the Bank of England have more than doubled and that of the ECB increased more than 40%. In contrast, the expansion of the BOJ’s balance sheet has been relatively modest. This is why some people insist that the BOJ deliver further monetary easing by enlarging its balance sheet.

20. Based on our hands-on experience under the QEP, however, I would like to emphasize that things are quite different today and that a simple replication of what we did in the past is neither possible nor desirable. Let me elaborate a bit more on this.

21. When the BOJ introduced the QEP, the policy O/N rate had already hit

the zero lower bound. Under the QEP, the target for monetary operations was shifted from the O/N rate to reserve balances held by financial institutions at the BOJ. The quantitative target for reserve balances was raised in steps to reach the range of ¥30-to-35 trillion. Compared with the minimum reserve requirement of ¥6 trillion, this means that the BOJ injected ¥25-odd trillion of excess reserves into the banking system. How was the liquidity infusion of this scale made possible? Why did financial institutions opt to place so much cash at the BOJ?

22. This is probably because the nightmare of the acute funding difficulties during the banking crisis was still fresh for the Japanese banks. For this psychological reason and still-heightened sensitivity to counterparty risks, Japanese banks in the early 2000s had strong precautionary demand for liquidity, and the BOJ was able to supply ample liquidity to meet banks' liquidity hoarding needs by replacing the intermediation function of the inter-bank money market. Put differently, it is this lingering sense of insecurity among Japanese banks that made the QEP operationally feasible and successful. Indeed, as the financial crisis subsided into 2005 and banks no longer had strong precautionary demand for cash, the BOJ began to encounter difficulties in meeting the quantitative target of its reserve balances, as evidenced by the repeated under-biddings in the liquidity-providing operations.
23. Today, there is no banking crisis in Japan, and the city banks have little intention to hold excess reserves, trying to keep their excess reserves to the minimum necessary. Instead, excess reserves are held by foreign banks, smaller regional banks, securities houses and money market brokers, but they are much smaller than those under the QEP regime.
24. In short, I believe that the size of central bank's balance sheet per se does not reflect the actual extent of monetary relaxation. Rather, it represents the degree of official intervention aimed at addressing the market malfunctioning in times of financial stress. The more dysfunctional financial markets are, the larger central bank's balance sheet tends to grow to correct those market failures.

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25. Finally, I would like to touch briefly on the flexibility of central bank's balance sheet.

26. I earlier talked about the size of central bank's balance sheet, but equally important from the operational perspective is its flexibility. While not having expanded that much, the BOJ's asset profile has taken on a longer tenor as a result of the various measures adopted in the post-Lehman period. In general, the longer maturity configuration of central bank's assets means less flexibility of its balance sheet. And lower flexibility of central bank's balance sheet could complicate the trade-off between providing sufficient liquidity and maintaining autonomous market functioning.

27. In addition, it also poses a challenge when it comes to an exit from exceptionally accommodative monetary conditions. When the BOJ began to exit from the QEP in March 2006, the slim-down of its balance sheet proceeded rather well because more than half the assets it held was of a short-term nature, that is, assets corresponding to excess reserves created through short-term liquidity operations. In other words, the BOJ was able to let its assets roll off within a relatively short time frame, which in turn resulted in corresponding declines in reserve balances.

28. But the scope for a smooth reduction in central bank's balance sheet, or other policy changes for that matter, might be narrowed if the balance sheet is comprised of less flexible assets. Viewed in this light, central banks need to pay due attention to securing their balance sheet flexibility within their individual contexts.

29. Let me stop here and thank you for your attention.