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Centralbahnplatz 2 · CH-4002 Basel · Switzerland · Tel: +41 61 280 8080 · Fax: +41 61 280 9100 · email@bis.org

Ben S Bernanke: Junior Achievement Finance Park

Brief remarks by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, at the Grand Opening of the Junior Achievement Finance Park, Fairfax, Virginia, 19 October 2010.

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Financial education helps young people cultivate a sense of financial responsibility. It is essential for their personal well-being, and for the effective functioning of our economy.

Junior Achievement was founded in 1919 and continues to be one of the world's largest and fastest-growing organizations dedicated to educating youth in financial literacy, work readiness, and entrepreneurship. It is committed to relevant, hands-on learning for students from kindergarten through high school. It serves 10 million students each year in 121 countries – about 50,000 of them here in the Washington, D.C., area. I applaud Junior Achievement's mission, which is to inspire and prepare young people to succeed in a global economy and cultivate their understanding of the principles of market-based economics and entrepreneurship.

We are here today to discover Junior Achievement's Finance Park in Fairfax County. It is the 15th such facility in the United States and will serve 14,000 students annually. The program offers an intensive six-week classroom curriculum, followed by a capstone day at the Finance Park where students participate in a practical personal budgeting simulation. This experiential facility helps students build financial skills that are essential to a successful financial future. Students immerse themselves in reality-based decision making. They practice essential household skills by developing a budget that includes housing, transportation, food, utilities, health care, investments, philanthropy, and banking. The opportunity will enable them to better navigate real-life decisions.

I applaud the ongoing partnership among Junior Achievement, schools, and businesses in the greater Washington area. As states and school districts around the country continue to integrate personal finance instruction into their curricula, organizations like Junior Achievement can provide important services to both students and teachers. Thank you for inviting me to participate in today's event.

William C Dudley: Regional economy and housing update

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Quarterly Regional Economic Press Briefing, New York City, 19 October 2010.

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Good morning and welcome once again to the New York Fed's Quarterly Regional Economic Press Briefing. As always, I am pleased to have this opportunity to talk with the journalists covering our region – and through you, to the people in our District. This morning I will focus on regional economic conditions, with particular attention to the housing sector in the nation and especially the Second Federal Reserve District, which covers New York, northern New Jersey, Fairfield County, Connecticut; Puerto Rico and the U.S. Virgin Islands. My colleagues will follow my remarks and provide more detail. As always, what I have to say reflects my own views and not necessarily those of the Federal Open Market Committee or the Federal Reserve System.

National economic conditions

To provide context, let me start with a few comments about national economic conditions. As I discussed in a recent speech, the long and deep recession that ended in June 2009 has been followed by a very tepid recovery. Since June 2009, economic activity has grown – but only slowly from levels far below the productive capacity of the economy.

In recent months, the momentum of the recovery has slowed. For example, after rising at a 3.25 percent annual rate during the second half of 2009, there has been a progressive slowing – to a 2.75 percent annual rate during the first half of 2010 and, most likely, to an even slower rate when the third-quarter real gross domestic product (GDP) figures are released at the end of this month.

With demand growth barely keeping pace with firms' ability to increase productivity, job creation has been too weak to significantly reduce unemployment, which stands today at 9.6 percent. And, as is typical in such circumstances of considerable slack, the rate of inflation has declined.

Viewed through the lens of the Federal Reserve's dual mandate – the pursuit of the highest level of employment consistent with price stability, the current situation is wholly unsatisfactory. Given the outlook that the upturn appears likely to strengthen only gradually, it will likely be several years before employment and inflation return to levels consistent with the Federal Reserve's dual mandate.

Why are we experiencing this soft patch now? There are several reasons:

- As is typical for the early stages of a recovery, the economy over the past four quarters has benefited from a strong inventory cycle. The swing in inventories from liquidation back to restocking contributed about 1.75 percentage points of the 3 percent growth of real GDP over that period. But this effect is now petering out.
- The growth impulse from the 2009 fiscal stimulus package is beginning to wane.
- The usual hand-off from inventory-led growth to private final demand is not yet fully established.

Instead, we have ongoing sluggishness in two key sectors that have led past recoveries: consumer spending and housing.

The slow recovery of consumer spending and housing in the face of very substantial monetary and fiscal stimulus reflects the painful unwinding of the dynamics at work during the expansion that preceded it. Beginning around 2003, underwriting standards for residential mortgages were significantly relaxed, leading to a sharp rise in household borrowing and in home prices. The rise in home prices helped to support additional demand for credit as households used the collateral represented by their homes to borrow large sums of money via home equity lines of credit and second mortgages. This also fueled a strong boom in home construction. But house price increases could not be sustained without limit. When home prices peaked and started to turn down, the dynamic linking house prices, credit and consumption went into reverse, forcing substantial adjustments on the part of the household sector and in the housing market itself.

I've discussed in recent speeches the role monetary and regulatory policy can play in helping to support economic activity and in improving economic outcomes relative to what would otherwise be experienced in the absence of this support. These steps include critical reforms that make the financial system safer and accommodative monetary policy that make mortgages more affordable and make the investments that create jobs are more attractive. Today I will focus on the economic trends themselves.

Let's consider first the consequences of this dynamic for consumer spending – that is, households' purchases of goods and services. Families' expenditures rose at a slow 2 percent annual rate over the first half of 2010 and (so far) this sluggishness appears to have continued in the third quarter of 2010. Families have not yet boosted their spending above the levels preceding the severe cuts they made during the recession. This frugality stands in stark contrast to the first year of recovery from previous deep recessions. Several factors are inhibiting families from spending. Many people have lost their jobs and are still unemployed, or have had their hours or pay reduced. Confidence in the economy remains quite low. And households' net worth, which fell substantially as real estate and stock prices dipped, remains well below its previous peak compared with disposable income. So, households have been saving more. The personal saving rate, which rose to 5.5 percent by the end of 2009 from a recent low of 1.2 percent in the third quarter of 2005, seems headed even higher in the third quarter. Households are "deleveraging"; they are paying down their debts. Of course, lenders have also reinforced this tendency as they have tightened underwriting standards for consumer credit, relative to their pre-recession standards.

Have households completed their deleveraging, so they will soon spend more? Although we believe that substantial progress has been made, it is hard to tell how much further this process has to run. For example, the share of household after-tax income that families owe for servicing debts and paying for housing (including property taxes, homeowners insurance and rents) has declined sharply over the past two years and is now back to levels last seen in the late 1990s. Households have cut the total amount of debt they owe. They are also refinancing outstanding debt to take advantage of the lowest mortgage interest rates since the mid 1950s. We expect the increased rate of mortgage refinancing now in place to continue over the near term. This represents another means by which households can free up income for other uses.

Now, let's consider the slow housing recovery. Housing market activity – both new construction and sales – remains depressed. On the construction side, total housing starts are running at just 600,000 units per year (seasonally-adjusted) in recent months. This is up from 530,000 units at the trough in the first quarter of 2009 but it is still extremely low by the standards of the last 50 years. In fact, the rate of new construction is so low that there is barely any net growth in the U.S. housing stock these days.

One reason why so little housing is being built is that many existing homes stand vacant. We estimate that there are roughly 3 million vacant housing units more than usual. And more vacancies are added daily as the foreclosure process moves homes from families to mortgage lenders. This stock of vacant homes will shrink when fewer are foreclosed upon and more of these homes are sold or rented out.

On the sales side, even though low mortgage interest rates and falling home prices have together boosted housing affordability to its highest level in 40 years, the current pace of sales is quite sluggish. Impediments to home sales include tight lending standards, a weak job market and continued uncertainty regarding the future path of home prices. The large decline in home prices that occurred between 2006 and 2008 is also important. This decline reduced the amount of equity that owners have in their homes, making it difficult for people to come up with the funds needed to "trade-up" and move into better homes.

In addition, the steep decline in home prices put many families at risk of mortgage delinquency and, ultimately, losing their homes to foreclosure. With lower home prices, many families now owe more on their mortgage than their home is worth. This means that they cannot refinance or sell their homes easily if they experience a financial crisis, such as a job loss or a serious illness. Recent developments on foreclosures have been mixed. While RealtyTrac reports that foreclosure completions in the United States exceeded 100,000 for the first time in September, it is important to remember that foreclosure is a lengthy process in most states. Our data indicate that, in recent quarters, borrowers are becoming less likely to fall behind on their mortgages, so fewer households are now entering the foreclosure process. At the same time, though, major lenders have acknowledged serious problems in the processes they have used to repossess homes and announced moratoria on new foreclosures. Taken together, these developments suggest that the situation in housing remains uncertain for the foreseeable future.

The Federal Reserve actively encourages efforts to find viable alternatives to foreclosure, like loan modifications, or deeds in lieu. We also support due process and access to legal counsel for homeowners facing foreclosure, for instance through legal aid programs. At the same time, it is important that foreclosures that properly comply with state and federal law can ultimately take place, as this is a necessary part of the adjustment that will eventually return us to more normal conditions in the housing market.

At present, the extent of the documentation problem and its wider ramifications are still uncertain. In conjunction with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, the Federal Reserve is therefore seeking to establish the facts through a review of the foreclosure practices, governance and documentation at the major bank mortgage servicers. We want to ensure that the housing finance business is supported by robust back-office operations – for processing of new mortgages as well as foreclosures – so that buyers of homes and investors in mortgage securities have full confidence in the process. We are monitoring developments closely in order to evaluate any potential impact on the housing market, financial institutions and the overall economy.

The key role that housing has played during this recession and recovery makes it a timely topic for our regional economic briefing.

Regional economic conditions (update since the July regional press briefing)

Now, let me turn to regional economic conditions. Overall, the recession seems to have been less severe in much of our region than in many other parts of the country, though unemployment remains unacceptably high.

As attendees at previous Regional Press Briefings may recall, the New York Fed produces Coincident Economic Indicators to help track the performance of the regional economy. Since July, these indicators point to recovery in New York State, and particularly in New York City.

Although New York City and New York State are recovering, elsewhere in the region, the story is different. In New Jersey, although activity is no longer declining, there has yet to be a sustained recovery. New Jersey's economy remains essentially flat. An index produced in Puerto Rico by the Government Development Bank shows that the pickup in economic activity there in late spring and early summer has retreated and activity in the past few months has again turned down.

Now, let's look at jobs, which are the key for people to truly feel the recovery in their lives. I am pleased to note that private-sector jobs have continued to grow moderately across much of the region in the past few months, just as they have in the nation. Growth in private-sector jobs – which is not affected directly by hires and layoffs from the decennial census – signals that, on balance, firms are expanding their workforces to meet their business needs. While state and local government job cuts have also reduced total employment, the fact that the private sector is creating jobs is a good sign and necessary for a sustainable recovery.

The number of private-sector jobs has increased in and around New York City, in northern New Jersey and in some parts of Upstate New York. The latest job market report for New York shows a continuation of the generally rising trend of employment in the state at a pace that roughly matches the nationwide growth rate. In New York City, employment has expanded at rates substantially above the nation. Since we last met, employment in New Jersey has expanded, and while that growth has been quite modest, it is an encouraging sign. In Puerto Rico, employment reports continue to give mixed signals, showing a see-saw pattern that has yet to add up to a strong rebound.

Despite these employment gains, unemployment in the region remains painfully high. In August, New York City's and New Jersey's rates were very close to the national jobless rate of 9.6 percent. The rate for New York State, which has been improving since the first quarter, is noticeably lower at 8.3 percent. Puerto Rico, which has had much higher unemployment than the mainland for the past several decades, saw a modest decline in its jobless rate, but at 15.6 percent is still showing little evidence of a recovery.

Regional housing trends in New York and New Jersey

We focus on housing at today's briefing because it represents the most important asset that many households own, provides a substantial number of high-wage jobs and is often a key driver of regional as well as national business cycles.

I'll start with a key observation: During this recession, the housing sector contributed less volatility to the regional economy than it did in much of the nation. We have, of course, seen painful losses of homes, construction jobs and housing equity in New York and northern New Jersey. This pattern can be seen quite directly in the construction sector, where many jobs were created during the housing boom, but then were lost as the housing market deteriorated. However, our housing markets tend to be less influential in our economy because we are a relatively mature region. That is, we are not adding population as rapidly as some other parts of the country, so housing construction – which tends to be very cyclical – and associated purchases account for a smaller share of aggregate activity here than it does in faster growing regions.

In addition, much of our region was spared the worst effects of the non-prime mortgage boom and bust. There was generally lower penetration of nonprime loans into our housing markets, and in general, our region shows better performance, with fewer delinquencies and foreclosures. This pattern was particularly true across Upstate New York. However, as can be seen on the New York Fed's U.S. Credit Conditions maps, there are significant pockets of housing distress around the greater New York City metro area, especially in communities in the Bronx, Dutchess County and Long Island. Indeed, we recently documented the severity of problems on Long Island in our *Facts and Trends* publication. Moreover, New Jersey had non-prime mortgage activity closer to the national average and now has more delinquencies and foreclosures than is the case for much of the region.

As the uneven pattern of nonprime lending suggests, the region is hardly uniform. The housing section fared better in Upstate New York than it did in much of the region during the recession. In fact, the housing boom and bust largely bypassed Upstate New York, where construction activity is a relatively small part of the overall economy.

Relative to Upstate New York, most areas in downstate New York and northern New Jersey more closely tracked the national cycle. Sales activity and home prices ramped up during the housing boom, but then dropped sharply.

More recently – over the past year – home sales and prices in the region have followed different paths. Home prices have generally stabilized across upstate New York, with some parts, such as Buffalo, Rochester and Syracuse, even experiencing price increases over this period. However, home prices have continued to decline in the greater New York and New Jersey area. By contrast, the number of home sales have generally increased throughout the region over the past year. But the pattern has been erratic because of various policy changes. In particular, the introduction, initial expiration and subsequent extension of the home buyer tax credit introduced volatility as it boosted, slowed and then boosted sales again. With the final expiration of this tax credit, the recent rise in home sales across New York and northern New Jersey may well be short-lived.

Regional housing trends: focus on New York City

I'll end with a few remarks about New York City's housing market – a very large market that stands out as unique in many respects.

Let me remind you of some of these key differences:

- Compared with the rest of the region, and with the rest of the country, New York City has an exceptionally large share of rental housing: 67 percent of homes citywide versus 33 percent for the United States.
- The market is dominated by multi-family structures, especially in Manhattan and the Bronx. When these units are owner-occupied, they are more likely to be co-ops than condominiums, and, thus, to have comparatively low leverage rates.
- New York City has very high housing prices and long construction lags. Since the number of homes cannot adjust quickly, rising demand during a boom typically leads to rapid rises in prices and unregulated rents. Eventually, of course, the amount of housing supplied responds to changes in demand.

So, how did the economic expansion and contraction affect New York City's housing market? For a mature city, the city saw an unusually strong boom in housing sales, construction and prices. This expansion actually began in 1996 and continued even in the aftermath of the 9/11 attack. Since 2007, however, New York City's market has turned down. This decline started later than the nation's and prices have fallen less sharply. Now, prices appear to have stabilized.

This pattern can also be seen in Manhattan's rental market. After a long period of rising rents, the market weakened substantially from 2007 to 2009, and rents have rebounded moderately in 2010.

New York City has not been spared from the high rates of mortgage delinquencies characteristic of this recession. Manhattan's delinquency rates are elevated although they remain markedly below the national average. By contrast, pockets of distress are much more prevalent in the outer boroughs, all of which have delinquency rates, per owner-occupied unit, above the national average.

The relatively mild recession and the recovery in the City are lending support to both home prices and sales. Also positive, compared with the rest of the country, are the City's low mortgage leverage rates and a low share of homes with underwater mortgages.

Nevertheless, several risks to home prices in the City remain. These risks include the ongoing completion of a considerable number of new apartment buildings – ones that were started at the end of the boom. Another risk comes from the slow pace of job growth in high-pay sectors (including the securities industry) in New York City. Finally, during the boom, prices rose substantially faster than rents. Going forward, this disparity could exert downward pressure on home prices as renting has become a more affordable alternative.

Conclusion

In sum, after a recession that was milder than in many parts of the country, the region is showing signs of a modest recovery in New York, but little growth elsewhere. The housing sector played a pivotal role in the recent national downturn. In the region, the fact that housing activity has a smaller weight in the regional economy helped to limit the recession's impact on many communities. Going forward, given housing's significance to the well-being of people in our region and beyond, the New York Fed will continue to focus on the sector as we monitor regional and national economic conditions.

Thank you for your kind attention. I will now ask James Orr to provide more details on current regional economic conditions.

Jean-Claude Trichet: The continuing quest for reliable and timely statistics

Opening address by Mr Jean-Claude Trichet, President of the European Central Bank, at the fifth ECB conference on statistics "Central bank statistics: what did the financial crisis change?", Frankfurt, 19 October 2010.

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Ladies and gentlemen,

I would like to welcome you, on behalf of the Executive Board of the European Central Bank, to our biennial ECB statistics conference. I am delighted that the conference has once more attracted many distinguished participants from central banks around the world, European and international institutions, the financial sector, academia and the media.

As many of you know, the conference was originally scheduled for April this year, but had to be postponed because of the Icelandic ash cloud. Making a virtue out of necessity, the conference now also contributes to marking the first World Statistics Day tomorrow on "twenty-ten-twenty-ten". World Statistics Day has been designated by the General Assembly of the United Nations to remind us all of the importance of official statistics and the core values of service, integrity and professionalism. Also on behalf of Mr. Stark, I would like to invite you to join us in a dedicated ECB event tomorrow afternoon, to celebrate World Statistics Day.

Two years ago, I concluded my address before this conference saying, "European policy-makers need to have at their disposal a wide array of timely, high-quality statistics on which to base their decisions". This conclusion has been fully vindicated by the financial and economic crisis, both globally and in Europe. The necessary strengthening of economic governance, particularly in the euro area, must go hand-in-hand with enhanced statistics.

The ECB makes extensive use of a wide range of economic and financial statistics. The ECB is also a producer of selected European statistics for its own decision-making purposes and for the public at large. The European Parliament and Council have underlined the fact that European statistics are developed, produced and disseminated by both the European System of Central Banks (ESCB) and the European Statistical System (ESS).[1] To minimise the reporting burden and enable the efficient development, production and dissemination of European statistics, it is important to reinforce the close cooperation between the ESCB and the ESS, and notably to foster the exchange of confidential statistical information between the two systems for statistical purposes.

I would like to address four themes today: the statistical component of a quantum leap in euro area economic governance; second, recent ECB initiatives to enhance European statistics; third statistical information for macro-prudential purposes; and fourth European statistics as a possible model for global statistics.

1. Statistical implications of a quantum leap in economic surveillance

It is essential to strengthen further the euro area dimension of surveillance and policy adjustment. In a speech three days ago,[2] I reviewed the recent Commission proposals from

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1 The European Statistical System is the partnership between the statistical authority of the European Union, namely the Commission (Eurostat), and the national statistical institutes and other national authorities in each Member State that are responsible for the development, production and dissemination of European statistics.

2 "Global governance and euro area economic governance", World Policy Conference, 16 October 2010.

a euro area perspective and highlighted where we need more ambition still for the euro area, in order to safeguard the smooth functioning of our monetary union.

Today, I would like to outline in more detail what we need in terms of the statistical implications for the "quantum leap" that is needed in economic surveillance. There are essentially three points.

First, the reliability of the general government statistics underlying the Excessive Deficit Procedure and the Stability and Growth Pact must be guaranteed when they come out. While the government finance statistics of the overwhelming majority of the Member States is reliable, this does not yet apply to all of them. Yet as we are in a highly integrated union, we need reliable statistics not just from the majority of Member States – we need it from each and everyone, no matter how large or how small the country is. We have seen that the potential for loss of credibility affects the entire union.

Therefore, in cases of data deficiencies, the recently amended powers of the Commission (Eurostat) regarding the quality assessment of statistics in the context of the Excessive Deficit Procedure must be applied in full. This is best documented in action plans to be monitored at the European level. Moreover, in terms of both reliability and timeliness, government finance statistics would benefit in several countries from closer integration of the budget process, in particular among different parts of general government. Where the planning, execution and monitoring of public budgets is a well integrated process, reliable government finance statistics are available almost without delay for decision-makers and the public at large. Why would GDP, which is an economy-wide concept, be available in a timelier manner than statistics on general government deficit and debt?

My second point is that there should be mechanisms to ensure that governance and quality provisions laid down in the European statistics Code of Practice of the ESS[3] are fully adhered to. This is best achieved by reinforcing the binding nature of the European statistics Code of Practice and enshrining its minimum standards, in particular on professional independence, in a European legal act. Simultaneously, the alignment of national statistical legislation with the principles of the Code of Practice and the Regulation on European statistics[4] should be accelerated.

Third, we must have full assurance that the statistical indicators supporting enhanced macroeconomic surveillance are robust and timely available. We must have assurance that indicators – such as international indebtedness, unit labour costs and other indicators of competitiveness – are firmly based on accepted statistical methodologies, ideally already legislated, and that the degree of estimation in compiling them is limited. Where compiled by the ESS, the European statistics Code of Practice should apply.

These three points are absolutely essential and it is in the fundamental interest of all euro area members that they are included in the current upgrade of the economic governance reform.

2. Recent ECB initiatives to enhance European statistics

Let me recall that the primary objective of the ECB is to maintain price stability, defined as euro area annual inflation below, but close to, 2% over the medium-term. It is worth noting that over the first 11¾ years of the euro, the average annual euro area inflation has been 1.97%. The ECB is in its 12th year of existence and, as you see, its mandate is fully fulfilled.

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3 See *http://epp.eurostat.ec.europa.eu/portal/page/portal/quality/documents/VERSIONE_INGLESE_WEB%20 new%20links.pdf*

4 Regulation (EC) No 223/2009 of the European Parliament and of the Council of 11 March 2009 on European statistics. OJ L 87, 31.3.2009, p. 164.

Moreover, inflation expectations over the medium to longer term remain firmly anchored in line with the ECB's objective. This has been an outstanding achievement in the first few years of Economic and Monetary Union – and it is an achievement to which European statistics have made an important contribution.

In line with the allocation of responsibilities between the ESCB and the ESS for collecting, compiling and disseminating European statistics, the monetary analysis of our monetary policy strategy is mainly supported by statistics compiled by the ESCB[5]. In 2009 and 2010 the ECB, supported by the national central banks of the Eurosystem, has been implementing two ECB regulations on enhanced Monetary Financial Institutions' balance sheet statistics and on securitisation vehicles.[6] These regulations introduced reporting requirements for loan securitisations, in particular, and new statistics on the assets and liabilities of these vehicles. The aim is to compile more detailed monthly and quarterly data to be published for the first time in June 2011. In addition, new statistics on euro area money market funds and on other investment funds, including hedge funds,[7] were released in December 2009. Following the adoption of the new ECB Regulation addressing banks' interest rate statistics,[8] the monthly banks' interest rate statistics are now produced more quickly and are available already one month after the Governing Council's monetary policy decisions. Further new and enhanced statistics are being compiled based on data already available at the national level, such as data from credit registers and supervisory data. A key example is detailed statistics on insurance companies and pension funds, which are also expected to be published from June 2011 onwards. As you can see, there is considerable and very tangible progress in the area of monetary and financial statistics. All these developments will contribute to enhanced monetary analysis and are also available for in-depth financial stability analysis.

The economic analysis of our monetary policy strategy benefits from much more consistent statistics on the euro area balance of payments. The size of the statistical discrepancy in balance of payments statistics has been decreasing substantially in recent years. The quality of these statistics has also improved, in particular by drawing on the Centralised Securities Database (CSDB),[9] Phase 2 of which went live in spring 2009. The CSDB also supports the compilation of investment fund statistics, the residual maturity of government debt securities and new statistics on securitisation vehicles. The ECB will publish the results of the third wave of the joint ECB and European Commission survey on the access to finance of small and medium-sized enterprises in the euro area later this week, and fieldwork is being carried out for the Eurosystem survey on household finance and consumption.

The flagship of the cooperation between the ESCB and the ESS on European statistics remains the quarterly euro area accounts. These provide a consistent statistical framework for the ECB's monetary and economic analysis, both for transactions and balance sheets. The euro area accounts are also widely used in the ECB Financial Stability Review. The main challenge remains more timely delivery, no later than 90 days after the end of the

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5 An updated overview of all available ECB statistics has recently been published in "ECB statistics: an overview". See http://www.ecb.europa.eu/pub/pdf/other/ecbstatisticsanoverview/2010en.pdf.

6 Regulation (EC) No 25/2009 of the ECB of 19 December 2008 concerning the balance sheet of the monetary financial institutions sector (Recast) (ECB/2008/32) OJ L 15, 20.1.2009, p. 14; and Regulation (EC) No 24/2009 of the ECB of 19 December 2008 concerning statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions (ECB/2008/30) OJ L 15, 20.1.2009, p. 1.

7 Regulation (EC) No 958/2007 of the ECB of 27 July 2007 concerning statistics on the assets and liabilities of investment funds (ECB/2007/8) OJ L 211, 14.8.2007, p. 8.

8 Regulation (EC) No 290/2009 of the ECB of 31 March 2009 amending Regulation (EC) No 63/2002 (ECB/2001/18) concerning statistics on interest rates applied by monetary financial institutions to deposits and loans vis-à-vis households and non-financial corporations (ECB/2009/7) OJ L 94, 8.4.2009, p. 75.

9 See "The 'Centralised Securities Database' in brief", available at http://www.ecb.europa.eu/pub/pdf/other/centralisedsecuritiesdatabase201002en.pdf.

reference quarter. The ECOFIN Council supports this timeliness objective[10] and it is my expectation that the ESCB and the ESS will achieve it by 2014 as currently planned.

In addition to the European statistics provided by the ESCB, the ECB relies, for the purposes of its monetary policy and particularly for its economic analysis, on a wide range of economic statistics provided by the ESS. They include, in particular, the Principal European Economic Indicators that are endorsed by the Economic and Financial Committee (EFC) through its Status Reports on Information Requirements in EMU. These annual reports are prepared jointly by Eurostat and the ECB's Directorate General Statistics.[11]

3. Statistical information for macro-prudential purposes

Let me now turn to statistical information for macro-prudential purposes. The upcoming launch of the ESRB and the entire ESFS including the three European Supervisory Authorities will have important statistical implications. When developing the statistical support needed for the ESRB, we may distinguish between the "input", the "throughput" and the "output" of the statistics function.

Let me start with the core of the task, which is the "throughput" – namely the compilation of statistical information. All statistics on the financial institutions, financial markets and financial market infrastructures of the EU as a whole, including sufficiently granular breakdowns, depend first and foremost on a sizeable team of statisticians who are well-versed in the legal provisions to be observed, trained and experienced in the economic and financial stability requirements, knowledgeable about the statistical concepts and methodology related to data on the financial system, familiar with the IT infrastructure to be applied, and used to cross-border cooperation in a European and international environment.

Such a team has been built and maintained by the ECB and the national central banks of the EU to provide European financial and economic statistics for monetary policy purposes. In addition, the ESCB statistics function offers sophisticated tools, such as statistical databases, internationally agreed standards and data transfer formats, registers of financial institutions, tested procedures for handling confidential data, and an array of proven methodologies and software for collecting and compiling financial statistics.

The "output" comprises a large number of statistical deliverables needed to support the work of the ESRB. Much work still needs to be done and it is appropriate that the final statistical framework for the macro-prudential oversight of the financial system will be decided by the ESRB. I would like to distinguish between four main types of statistical deliverables.

The first is macro-financial information relating to the macroeconomic environment, financial market data and information on financial market infrastructures.

The second is macro-prudential information on regulated and unregulated financial intermediaries. This comprises sufficiently granular aggregated micro-prudential information across countries and financial sectors, as well as individual information on large financial intermediaries.

The third type of statistical deliverable is information on exposures to counterparties, which will draw, in particular, on a securities holdings database containing data on a security-by-security basis, and will be supported by the CSDB. Detailed and reliable data on securities issues and holdings are indispensable to any systemic risk assessment. The CSDB would be best complemented by a public reference data utility providing standardised

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10 ECOFIN Council conclusions on EU statistics of 4 November 2008 and on 10 November 2009.

11 See also the article entitled "Update on developments in general economic statistics for the euro area", in the February 2010 issue of the ECB Monthly Bulletin.

information on instruments and entities that would be operated on the basis of an international agreement.

The fourth type of statistical deliverable is ad hoc information obtained via one-off surveys where it is undisputed among statisticians that only regular and tested data flows that are connected to the internal accounting systems of reporting agents limit the reporting burden with a lasting effect, and produce a timely and reliable output.

Concerning the "input" – namely the collection of data – the reporting burden of financial institutions could be reduced by improving processes to ensure that information is only reported once. One example of this streamlining is the use of supervisory data to compile macro-financial statistics. Here, the ECB and the Committee of European Banking Supervisors (CEBS) have published a bridging manual aligning the ECB's monetary and financial statistics requirements with the supervisory reporting templates developed by CEBS and have created a relational database identifying similarities and differences between the two frameworks.[12]

It is even more important to reach a common understanding on the regular flow of data from the reporting agents in the EU financial system, via national and European databases, to the ESRB. In this context, I also welcome the fact that the ECB and CEIOPS[13] are working on an optimised usage of the future data reporting by the insurance sector under the Solvency II Directive[14]. Clearly, there is a difference between the use of confidential micro-data for statistical purposes and their use for policy purposes. This distinction is respected in the day-to-day business of any developed statistics function. To achieve detailed agreements on the flow of data, I count of a very fruitful cooperation between the three future European Supervisory Authorities and their predecessors, CEBS, CEIOPS and CESR[15] with the ESRB preparatory Secretariat recently established at the ECB and our Directorate General Statistics. The statistics departments of the national central banks of the EU Member States are involved via the ESCB Statistics Committee.

4. European statistics as a model for global statistics

The financial crisis not only had an impact on individual economies and groups of countries; it also had a global dimension. The Group of Twenty Finance Ministers and Central Bank Governors (G20) now has a much more important role than it did before the financial crisis. It established a Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets that called on the International Monetary Fund (IMF) and the Financial Stability Board (FSB) to explore information gaps and propose ways to strengthen data collection. The report of the IMF and the FSB, entitled "The Financial Crisis and Information Gaps"[16], makes 20 high-level recommendations to address the measurement of risks in the financial sector, international financial linkages and the vulnerability of economies to shocks, as well as the communication of official statistics and was endorsed by the G20 in November 2009. I am pleased that this report was produced with significant input from the ECB.

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[12] "MFI balance sheet and interest rate statistics and CEBS' guidelines on FINREP and COREP", February 2010.

[13] Committee on European Insurance and Occupational Pension Supervisors (CEIOPS).

[14] Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) (recast) OJ L 335, 17.12.2009, p. 1.

[15] Committee of European Securities Regulators (CESR).

[16] See http://www.financialstabilityboard.org/publications/r_091107e.pdf.

As new collections of data from reporting agents will be required in most G20 economies to close information gaps, a multi-year programme, combined with an appropriate governance framework and sustained policy support, is needed to implement the recommendations. The G20 have therefore received an action plan in June 2010, detailing the recommendations and timetables for their implementation. This action plan was welcomed recently also by the International Monetary and Financial Committee of the IMF Board of Governors.

Although the need for more comprehensive and more comparable statistics extends beyond the G20 economies, the G20 have volunteered to set an example. Because of the economic importance of the G20 economies, their data are sufficient to compile reliable and timely key world aggregates, such as quarterly GDP, within two months of the end of the reference quarter. Experience in the euro area confirms the traditional statistical paradigm that more aggregated data, such as euro area or world aggregates, are more reliable than their component data.

Comparable statistics are important in a globalised world in which decision-makers and the public at large need to focus not only on their own economy, but also on key partner economies. I welcome the development of the Principal Global Indicators (PGIs) that will be comparable for the G20 economies, including the euro area, and which are similar to the Principal European Economic Indicators for Economic and Monetary Union. The PGI website maintained by the IMF[17] is supported by six other international organisations, including the ECB.

Conclusions

Let me conclude. Evidence-based decision-making in modern economies is unthinkable without statistics. This applies a fortiori to monetary and financial stability policies. The financial crisis has revealed information gaps that we have to close while also preparing ourselves for future challenges. This is best achieved through creating a wide range of economic and financial statistics that are mutually consistent, thereby eliminating contradictory signals due to measurement issues. The main aggregates must be both reliable and timely, and, in a globalised world, they should be comparable across countries and economies.

Reliability and timeliness are key for statistics, but may seem to be conflicting objectives. This is more the case in the short-term, as the production frontier for compiling statistics can be enhanced in the medium term by a higher degree of automation. The effective and efficient collection, compilation and dissemination of European statistics requires a well developed statistical infrastructure, including, most importantly, a team of skilled and experienced statisticians familiar with European and international cooperation. I take tomorrow's World Statistics Day as an occasion to remind all of us of the importance of high-quality statistics. They are central to the foundations of public and private sector decision-making throughout our societies.

Thank you for your attention.

[17] See http://financialdatalink.sharepointsite.net/default.aspx.

Gabriel Loza Tellería: The role of central banks in macroprudential regulation – the case of Bolivia

Opening remarks by Mr Gabriel Loza Tellería, Acting President of the Central Bank of Bolivia, at the Primera Jornada de Estabilidad Financiera, La Paz, 29 September 2010.

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Translated and slightly revised from the Spanish original, available at www.bcb.gob.bo/jfinanciera/sites/default/files/presentaciones/GabrielLozaBolivia.pdf.

Today I will speak about the experience of Bolivia, a small, open, partially dollarized and commodity export-oriented economy. Gathered here are representatives from the central banks of Argentina, Brazil, Chile and Colombia with whom we usually meet within the framework of Mercosur, CEMLA and FLAR to discuss not only monetary policy issues but also issues regarding the financial system. I would like to highlight the presence of the Bank for International Settlements' (BIS) Chief Representative for the Americas, because of the close relationship we have been building in recent years. As you know, the BIS is the leader in macroprudential regulation issues. I am also pleased to welcome the European Central Bank, as well as the Bank of Spain. From Argentina, the Center for Financial Stability will present us its private-sector point of view on the subject.

Macroprudential regulation is not an isolated issue, but is closely related to macroeconomic policy, specifically central banks' monetary policy and so-called macroprudential policy instruments, which are the general topic of this conference. We will be speaking about stress tests and reviewing the experiences of Argentina and Bolivia, the latter as part of our Financial Stability Report.

With regard to Bolivia, I would like to point out that our experience is perhaps not widely known, and that, furthermore, each country's experience is unique. I will briefly highlight some lessons from the international crisis and recent reforms in macroprudential regulation, particularly the role of central bank in macroprudential regulation, then describe the Bolivian experience, and finally draw some conclusions.

1. Lessons from the international crisis

One of the main lessons from the crisis is that, after Lehman, financial markets will not return to their pre-crisis level. The most likely scenario is one of successive crises/shocks of different magnitudes and intensities. Some experts, for instance Roubini, foresee a number of big crises yet to come. Stock, bond and foreign exchange markets are currently characterized by higher levels of volatility than those observed during the Lehman period.

After Lehman, world economies had to deal with the Greek crisis and, more recently, the Irish one. Some financial stress has also been observed in emerging markets due to transmission effects, although not of the magnitude seen in previous crises.

A recent work by Blanchard *et al*. (2010)[18] questions the ability of policy makers to conduct macroeconomic policy, and, among other things, concludes that one of the lessons of the international crisis is that financial intermediation used to be considered – at least by most economists – as not relevant, despite its importance for the credit channel and for the role of central bank as lender of last resort. The financial system as such received little attention, whereas emphasis was given to inflation targeting, low inflation and the role of interest rates.

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[18] Blanchard, O., Dell' Aricia, G. and Paulo, M. "Rethinking of macroeconomic policy". IMF Staff Position Note No. 10/03.

Lessons drawn from the crisis suggest that financial intermediation is important and that proper attention should be given to supervision and systemic regulation. On top of that, central banks should follow household prices and other asset prices – in addition to consumer prices – to prevent or take action during bubbles, like the one we have just seen in the real estate sector in several advanced economies.

The policy interest rate, as a traditional instrument, was not enough to prevent the recession and should be complemented with other instruments such as capital and leverage ratios. Central banks have also asked themselves if they should have regulatory capabilities in macroprudential issues. Recent experience points to using a variety of instruments for several objectives, and within this mix of objectives and available tools macroprudential regulation is a key issue. As I said before, the predominant opinion before the crisis was that macroprudential regulation was not part of macroeconomic policy; instead, regulation had mainly microeconomic objectives. In addition, since the 1990s there had been a trend towards deregulation.

Another lesson from the crisis is that macroregulation is not neutral: insufficient regulation led to the crisis, and it follows that it is necessary to combine monetary policy and regulation. In addition, central banks should not only be responsible for monetary policy, but also for macroprudential issues. In the end, we have learned that financial markets do not necessarily move to equilibrium. Government intervention is necessary to achieve stability. Macroeconomic policy alone was not sufficient to prevent the crisis, especially in advanced economies.

Regulation should be one element alongside macroeconomic policy instruments: before the crisis systemic risk was not trivial, it was latent, and it turned out to have been extremely costly to have neglected this variable. Price stability is not a sufficient condition to guarantee financial stability; the relationship between monetary and macroprudential policy should be taken into account. What is required is: proper risk management, awareness of procyclicality and of how risk is distributed, removing the notion of banks as “too big to fail”, surveillance and individual and systemic risk assessment, and awareness of credit growth.

2. Recent reforms and macroprudential regulation

I will only briefly summarize stylized facts, since throughout the conference we will dig deeper into these issues. The establishment of the Financial Stability Board within the G20 framework was an excellent initiative, as was taking into account macroprudential risks and the establishment of anticyclical capital buffers and a capital conservation buffer, among others.

Some additional work was also undertaken by the Obama administration, in particular updating the legal framework of the Federal Reserve and exit rules for big banks; enhancing consumer and depositor protection; strengthening deposit insurance; regulating derivatives markets; requiring a higher level of capital for banks; and improving control over credit rating agencies (which ahead of the crisis did not work properly and could not send early warnings to the markets).

There was, and still is, a debate about taxing banking activity, for instance in the U.S. and Europe. Germany is assessing how to handle the social cost of future financial crises and possible government intervention. We must decide who will face the burden of future crises. Hence the current debate on taxing banking activity – although it is important to keep in mind a global tax, since a mere national tax may lead to disequilibrium. The level of tax for each country may be dependent on risk and the size of the financial system. We must be very diligent in this, since imposing taxes does not in itself eliminate the possibility of future crises, and coordination among countries may be required.

Regarding the reforms to the capital adequacy framework, known as Basel III, one lesson drawn from the crisis was that financial institutions' capital was not enough to protect them from losses. Currently, banks have to keep a Tier 1 (primary capital) of 4%. From 2013, this proportion will be raised to 4.5% and to 6% in 2019. By the end of the decade, quality reserves of banks should be around 8.5%.

In parallel, the European Union has made progress on transparency and safety of derivatives trading, on regulating swaps and hedge funds and on improving a new framework for banking supervision.

3. Prudential regulation and the role of central banks

In the end, the key issue is: what is the role of central banks in prudential regulation? If the traditional approach has revealed itself to be narrow, then we need a systemic approach that incorporates economic cycles and macroprudential regulation. In times of crisis, central banks tend to react quickly, either because they have a mandate or because they are lenders of last resort: central banks are usually the first to try to extinguish the fire. The reason that underlies the former should be clear: central banks oversee monetary stability, financial stability, macroeconomic policies (in our case, monetary and exchange rate policy) and macroprudential regulation.

Several reasons point to the need for central banks to be involved in prudential regulation (in Bolivia there is currently an institutional separation between the central bank and the Financial Supervision Authority (ASFI)). Central banks have daily flows of information coming not only from the financial system but also from the economy as a whole. Therefore, monetary policy decisions should be made in coordination with those decisions related to the macroprudential area in order to smooth the economic cycles. We should take preventive measures before illness appears. The central bank's reputation plays a key role in systemic regulation, as does its role of lender of last resort.

Nevertheless, there are some pending issues[19]:

- What financial stability mandate should central banks have? Is there a need for a new mandate in terms of macroprudential policy?
- Close coordination with government agencies plays a fundamental role. In Bolivia, we thought hard about the true meaning of central bank independence. Central banks had to act immediately, pushed by governments. How do these relationships impact on institutions and their management? Obviously, policy decisions regarding financial stability have some political aspects: whether Lehman should be bailed out or not, or whether any other corporation should be. There is still some debate about this. We can discuss such issues for a long time after a given event, but taking decisions at the right moment is harder to do.

Macroprudential policy is not a substitute for sound macroeconomic policies; macroprudential policies alone do not fix everything, so there has to be close coordination. Who decides the timing and the design of these policies? What is the relationship between the macro- and microprudential issues?

4. The Bolivian experience

The consensus within the Bolivian financial system is that the international financial crisis did not have a direct impact on our economy.

The Central Bank of Bolivia implicitly recognizes that financial stability is a public policy objective, but not an end in itself. Financial stability has to contribute to the economic development of the country. Our approach, therefore, includes close coordination between the Ministry of Economy and Public Finance (Ministerio de Economía y Finanzas Públicas, MEFP) and ASFI.

One of the factors that contributed to the small impact of the international crisis in Bolivia is our low vulnerability – not only in the financial system, but also low fiscal and external vulnerability. We were ready to face exogenous shocks a result of prudential and sound macroeconomic management in the years before, during and after the crisis. The following table shows some relevant data in this regard.

Ratios (%)	Dec-08	Dec-09	Aug-10
Capital			
Regulatory capital to risk-weighted assets	13,7	13,3	12,5
Nonperforming loans net of provisions to capital	-7,7	-7,0	-8,5
Assets quality			
Nonperforming loans to total loans	4,3	3,5	2,7
Provisions to nonperforming loans	132,3	135,5	147,5
Management			
Administrative expenses to total assets	4,2	3,9	4,9
Administrative expenses to financial income	56,4	59,4	71,3
Earnings			
Return on equity	18,7	19,6	20,2
Return on assets	1,7	1,7	1,7
Liquidity risk			
Liquid assets to total assets	43,3	48,0	41,2
Liquid assets to short-term liabilities	91,2	96,8	82,2
Foreing investments to financial investments	10,3	17,9	18,0
Bolivianización			
Loans in domestic currency to total loans	32,1	38,4	50,5
Deposits in domestic currency to total deposits	46,8	47,7	49,6
Foreign liabilities to total liabilities	**3,8**	**2,8**	**2,2**

[19] Heinrich, G. (2010). “El papel de los bancos centrales en la supervisión macroprudencial”. CEMLA-LXXXIX Meeting of Central Bank Governors of Latin America and Spain. 13–14 May 2010. Buenos Aires. Argentina.

As can be noted, the Bolivian financial system has sound capital, adequate asset quality and profitability ratios, as well as good ratios of deposits and loans in local currency relative to foreign currency – which is something I would like to highlight. The Bolivian case is still the one of a highly dollarized economy. Financial dollarization, i.e., deposits and loans in foreign currency, used to be around 90% of total deposits and loans. As a result of close coordination among the central bank, MEFP and ASFI, the ratios of loans and deposits in domestic currency over total loans and deposits are, for the first time in several decades, a little higher than 50% for loans and close to 50% for deposits. Banks' foreign currency liabilities are less than 3% of total liabilities due to low involvement in international financial markets, as explained before.

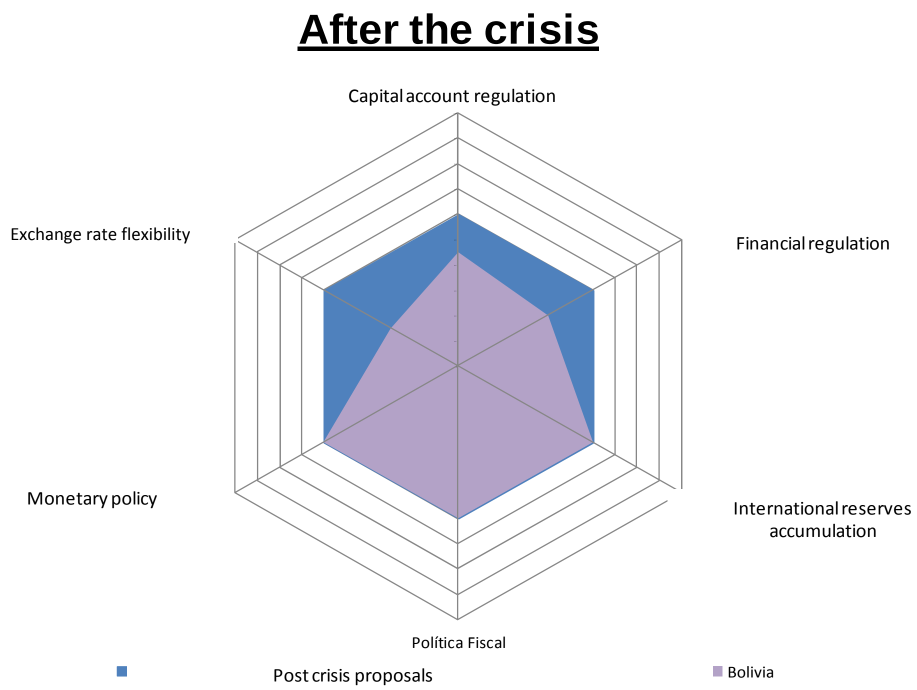
In Bolivia we view financial regulation as important. The prudential regulation measures taken by the Central Bank of Bolivia have improved in recent years and have been closely coordinated internally (monetary and exchange rate policies) and with the MEFP and ASFI. The challenge ahead is to give this coordination a more formal framework. What are the decisions we should make to arrive at coordinated results and decisions?

On the one hand, our experience is based upon a sound macroeconomic policy: current account and fiscal surplus, price and foreign exchange stability. On the other, microprudential analysis is performed with emphasis on individual entities, while we also perform macroprudential analysis, for example, our Financial Stability Report, which includes an analysis of stress tests.

The following chart uses an approach presented by the governor of the central bank of Argentina at the conference "Jornadas financieras y bancarias 2010". It is based upon the following variables: current account, financial regulation, exchange rate flexibility, monetary policy, fiscal policy and net foreign asset accumulation. As can be seen, before the crisis, emphasis was on monetary policy and exchange rate flexibility. The exchange rate was endogenous and little progress was made in capital account and financial regulation; net foreign asset accumulation and fiscal policy were not that important before the crisis. Bolivia, before the crisis, had a broader scope on these issues.

Exchange rate stability and net foreign asset accumulation policy were very important for us. This policy has led us to reach the current level of $9 billion in international reserves (45% of GDP). Some of the central banks represented here will be telling us their experiences in this area. Colombia and Mexico would be cases worth hearing about.

Adequate fiscal policy led to consecutive fiscal surpluses. In order to manage capital flows, the Central Bank of Bolivia imposes fees of 1% for outflows and 0.6% for inflows. These measures have been carefully analyzed, and the Bank continues to monitor them closely. In the wake of the crisis, recommendations have pointed to an equilibrated approach, and we have followed this line.



5. Conclusion

The financial crisis is not over; we are not going back to pre-crisis levels, and the financial environment will continue to be one of uncertainty. The challenge for central banks is to make monetary and macroprudential policies in times of stress. The current lack of macrofinancial regulation is part of the problem, but it is not the only one. There are market failures, but it is not possible to assess their intensity: there was not an automatic adjustment or a smooth transition back to equilibrium; there were also drawbacks derived from dominant macroeconomic policy thinking. Financial stability should be a public policy goal and a means to stimulate economic growth. In this context, that the role of the central bank is important: monetary stability is not enough, and sound macroeconomic and macroprudential policies to promote financial stability are needed. Integrated market regulation and supervision should include all agents and instruments as well as oversee leverage, liquidity and provisions. Macroprudential regulation is still in the process of being defined, and it is a pertinent issue. It is necessary to define and identify its tools and aims. As usual, these definitions should be done case by case, with a pragmatic approach.

I would like to thank you all for your presence at this conference, and I would like to extend a particular welcome to the university students in the audience, because ultimately you will be able to apply the information disseminated today, since you are, in the last analysis, the final users of the information. We have a very large audience today, and may I now invite all our speakers to share their experiences. Thank you very much.

Kiyohiko G Nishimura: Japan's economy and monetary policy – comprehensive monetary easing and strengthening of the foundations for economic growth

Speech by Mr Kiyohiko G Nishimura, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Hiroshima, 20 October 2010.

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Introduction

First of all, I would like to express my sincere gratitude for your cooperation in interviews and surveys conducted by the Hiroshima branch of the Bank of Japan. Information from these interviews and surveys is invaluable and utilized fully in our business operations.

Before we exchange views, I will first explain economic developments at home and abroad. I will then speak about the Bank's thinking on monetary policy by focusing on recently-introduced "Comprehensive Monetary Easing" and the "Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth."

I. Overseas economic developments

The pace of growth in overseas economies has been slowing. Here I will explain the developments in the Unites States and emerging economies, which have a particularly significant impact on Japan's economic activity and prices.

In the United States, while a relatively strong recovery was forecasted around this spring due mainly to the policy effects, anxiety about the future increased as a series of weak economic indicators such as GDP and employment were released in August. Since some favorable data such as durable goods orders were released in September, I have been maintaining the view that the U.S. economy has been recovering moderately. However, compared with this spring, the possibility of prolonged low growth has increased.

Economic growth in the United States has been restrained partly because the household sector has been burdened by debt such as mortgage payments and thus has been constrained from consuming. The process of restoring the sound asset condition by repaying debt is called "balance-sheet adjustment," and is a factor in lowering spending in a continuous manner following the burst of "a bubble." As seen in the case of Japan, such adjustments are bound to take time and thus we have been holding the view that the recovery in the U.S. economy, where the household sector faces significant balance-sheet adjustment pressure, will remain modest. Yet, if there is an increase in the growth of employee income or a rise in house prices, the debt repayment capacity of the household sector will increase and the adjustments will be completed in relatively a short period. Thus, the U.S. employment- and housing-related indicators are particularly drawing attention. A typical employment-related indicator is the unemployment rate. It surged to about 10 percent after the Lehman shock, slightly declined around this early spring, rose again thereafter and has remained at an elevated level. House sales picked up due to the effects of preferential tax breaks for buyers of residential houses, but plunged immediately after the tax breaks expired at the end of April and have remained at a low level thereafter. Meanwhile, house prices have been more or less unchanged following the significant decline. As you can see, employment and housing conditions are weaker than expected, and thus it is becoming likely that "balance-sheet adjustments" might take more time than previously envisaged.

Emerging economies are also slowing, although their adjustments are relatively light. From a longer-term perspective, there is a strong possibility that those economies will maintain stable high growth as there is robust potential domestic demand toward spreading durable goods and building social infrastructure. Some emerging economies have been shifting away from accommodative policies to prevent the economies from overheating, but there are still many economies whose measures to contain overheating are not considered to be sufficient, and thus there remains a risk of overheating that the pace of growth in emerging economies might accelerate amid continued capital inflows. At the same time, since sizable exports have been made from those countries to the United States, the slowdown in the U.S. economy might have no small effect on emerging economies and such downside risks also require vigilance.

II. Developments in economic activity and prices in Japan

Japan's economy has been showing signs of recovery until recently. This summer, sales of air conditioners and beverages were buoyant due to the extremely hot weather, and a last-minute increase in demand ahead of the expiration of the subsidies for purchasing energy efficient cars turned out to be extremely large. Both factors have elevated the economy. However, amid increased uncertainty due mainly to fiscal problems in European peripheral countries and the outlook for the U.S. economy, global investors have become increasingly risk averse, which increased demand for the yen that was considered as a relatively safe currency and resulted in the yen's appreciation. In addition, overseas economies have slowed, and the pace of growth in exports has recently been rather moderating. Taking into account that exports, which have been leading economic activity, have been showing weak signs, it is appropriate to judge that Japan's economy still shows signs of moderate recovery, but that the pace of recovery is slowing down.

While the economic outlook is to be examined in the *Outlook for Economic Activity and Prices* that will be published after the next Monetary Policy Meeting on October 28, compared with the outlook presented in the Bank's July interim assessment, the economic growth rate is likely to be somewhat lower than expected. During this fiscal year, the slow recovery pace is likely to continue mainly due to the slowdown in overseas economies and the expected decline following the last-minute increase in demand ahead of the expiration of subsidies for energy efficient cars. The fact that the recent appreciation of the yen is deteriorating business sentiment is also a big factor in putting downward pressure on economic activity. In the recently-released September *Tankan* (Short-Term Economic Survey of Enterprises in Japan), business conditions D.I. has substantially improved, compared with three months ago, but the D.I. is forecasted to deteriorate considerably in three months ahead, suggesting that firms have come to be cautious due partly to the appreciation of the yen. However, when looking from a somewhat longer perspective, Japan's economy is expected to return to the moderate recovery path as emerging economies with high growth potential will complete the current mild adjustment phase.

While there are various risks associated with such outlook, we need to keep an eye on developments in overseas economies, mainly the U.S. economy. An important risk factor unique to Japan would be developments in car sales in the future, and I think that there is considerable uncertainty associated with the sales. From August through early September, the last-minute increase in demand ahead of the expiration of the subsidies for purchases of energy efficient cars was extremely large, which might suggest that consumers have become sensitive to prices. While it is expected that car sales will plunge for some time following the expiration of the subsidies, what pace the sales will subsequently recover will be critical since that would gauge the strength of Japan's potential demand. Moreover, the automobile industry has a wide range of supporting industries and its developments affect business conditions of many small- and medium-firms, and thus, from such a viewpoint, the developments warrant close attention.

As for prices, the year-on-year decline in the CPI (excluding fresh food) has been slowing. However, the possibility that weaker-than-expected economic activity will affect price developments requires vigilance. Moreover, there is a risk that the yen's appreciation will lower consumer prices not only through worsening economic activity but also through changes in import prices.[20] Given those circumstances, it has become more likely that the return of Japan's economy to the sustainable growth path with price stability will be delayed than previously envisaged.

III. Comprehensive monetary easing

Under the situation in which "it has become more likely that the return of Japan's economy to the sustainable growth path with price stability will be delayed," it is necessary to further enhance monetary easing. On that basis, at the Monetary Policy Meeting on October 4 and 5, the Bank decided to carry out "Comprehensive Monetary Easing," or "Comprehensive Easing" for short, composed of the following three measures.

First, a change in the guideline for money market operations. The most fundamental policy of the Bank is to guide the overnight rate, that is, the interest rate applied in the market where banks borrow or lend money only overnight, to a pre-determined target rate. At the Monetary Policy Meeting on October 4 and 5, the Policy Board changed the target rate for the overnight rate from "at around 0.1 percent" to "at around 0 to 0.1 percent." While the Bank said it has been maintaining the extremely low interest rate level of virtually zero percent, this time it changed the target interest rate to further clarify that it has been pursuing the virtually zero interest rate policy. If the Bank is to make further ample liquidity provision through, for example, a purchase of assets I will mention later, there might be strong downward pressure on the overnight rate. In that situation, if the Bank tries to maintain the overnight rate at around 0.1 percent, some flexibility in market operations might be lost. That is another reason the Bank allowed the overnight rate to shift downward.

Second, the clarification of a condition that the virtually zero interest rate will be maintained. The Bank, regarding the criterion for being consistent with price stability, indicates that on the basis of the year-on-year rate of change in the CPI, each Policy Board member's judgment falls in a positive range of 2 percent or lower, and that the midpoints of most Policy Board members' judgment are around 1 percent. The Bank calls this criterion the "understanding of medium- to long-term price stability" (the "understanding"). At the Monetary Policy Meeting on October 4 and 5, the Policy Board confirmed that the Bank will maintain the virtually zero interest rate policy until it judges that the price stability is in sight from a medium- to long-term perspective.

What I would like to emphasize here is that the Bank employs as its judgment criterion, whether developments in the inflation rate expected in the future, not the rate at the moment, is consistent with the "understanding."[21] Given that it takes some time for the effects of monetary policy to spread, in order to achieve price stability from a long-term perspective, it would be necessary to pay attention not only to the short-term inflation rate at the moment but also to the forecast of how the future inflation rate will develop and to consider its consistency with the "understanding." Moreover, it is essential to learn from the experience that stability in economic activity and prices from a long-term perspective was undermined in the emergence and bursting of the recent global credit bubble, as a result of significant risks

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[20] While rather technical, as for the CPI, effects of a revision of the base year should also be noted. The change in the base year from 2005 to 2010 is scheduled to be made in the summer of 2011. In general, a year-on-year change in the CPI tends to be overestimated as it goes farther from the base year, and such distortion tends to be corrected at the time of a base year revision. Namely, at the time of base year revision in 2011, it is likely that the year-on-year changes in the CPI will be revised downward. While it is difficult to estimate the degree of downward revision at this point, we should keep in mind a possibility that, looking back in the future, the degree of decline in the CPI could have been larger than previously recognized.

[21] This thinking is similar to that called "forecast targeting," which uses whether a forecast will reach the target rate as a judgment criterion.

including the accumulation of financial imbalances being overlooked. In other words, if one becomes complacent about the current price stability and overlooks the accumulation of financial imbalances such as a "bubble," there is a possibility that the economy will face a continued decline in prices after the burst of a "bubble." The Bank stated that it will maintain the virtually zero interest rate policy on condition that examination of risk factors, including the accumulation of financial imbalances, does not reveal any problems.

Third, the Bank will specifically examine a program to purchase financial assets. The program aims at purchasing various financial assets, such as government securities, commercial paper, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs). That deserves some detailed explanation.

Taking a firm for an example, when it raises funds, it is conventional to pay higher interest rates than those of safe assets such as government bonds. That is because fund providers request adding interest rates worth the factors such as a firm's default risk. The interest rates on safe assets are called risk-free interest rates and the additional interest rates are called risk premiums. The added interest rates depend on the probability of a firm's default as well as to what extent fund providers' want to avoid risk, namely, the degree of risk aversion. The stronger anxiety about the future and risk aversion are, the bigger the added interest rates become.

Taking into account that there is little room for short-term interest rates to decline, the measure taken this time aims to encourage the decline in longer-term risk-free interest rates and risk premiums on risk assets, to pursue further enhancement of monetary easing.[22] The Bank has been encouraging a decline in slightly longer-term risk-free interest rates by utilizing what we call the "fixed-rate operation," through which the Bank provides funds with a maturity of three or six months at a low interest rate of 0.1 percent. This time the Bank decided to encourage the decline in further longer-term interest rates by purchasing long-term government bonds and corporate bonds with a remaining maturity of about one to two years. Moreover, to reduce risk premiums, the Bank will examine the purchases of ETFs and J-REITs. While such purchases are the first attempt for the Bank, its risk-taking through the purchases could have an effect of reducing risk premiums of stocks and real estate.[23]

Such purchases of assets are extraordinary measures for a central bank, especially the purchases of financial assets to encourage a decline in risk premiums. Interest rates of risk-free assets have already become rather low and there is little room, albeit some in longer-term interest rates, for further reduction. Nevertheless, firms' funding activity has not become active. Therefore, the Bank decided that it was appropriate to further support firms' forward-looking activity from a financial side by encouraging a reduction in risk premiums.

The asset purchase should be examined deliberately also from a viewpoint of national burden. If prices of purchased assets decline, the consequent losses will be borne by the Bank. Since the Bank makes payments to the national treasury out of earnings obtained through the issuance of the currency, if the Bank incurs losses, it will eventually become a public burden in that the national treasury could not receive payment it was supposed to

[22] When there is strong anxiety about the future of the economy, namely, when there is the so-called Knightian uncertainty, there is a tendency that aversion against assets that are considered to be risky, such as stocks and real estate, becomes excessive and demand for those assets declines, leading to risk premiums of those assets remaining high (Meanwhile, it could happen at the same time that demand concentrates on assets whose risks are considered to be small, thereby lowering risk premiums of those assets). In such a case, there is a possibility that the central bank's purchase of risk assets will lead the central bank to play a role as a "catalyst" to alleviate the tendency of excessive risk aversion. For reference, please see Nishimura, K.G., and H. Ozaki, "Irreversible Investment and Knightian Uncertainty," *Journal of Economic Theory*, 136 (2007), 668–694.

[23] For the purchases of ETFs and J-REITs, the Bank needs to seek approval from the government and it will do so in due course.

receive. The reason the Bank puts emphasis on its financial soundness and is cautious about carrying out a policy that takes such risk is that, it considers it natural for a central bank to be cautious about a policy that could risk the public burden. Nevertheless, taking into account the outlook for economic activity and prices as well as the situation in which there is little room for further reduction in short-term interest rates, the Bank judges it appropriate to take certain risks. To clarify that the measure is an extraordinary and temporary one, the Bank will newly establish a program on its balance sheet and manage separately from other assets held for different purposes. Meanwhile, since the fixed-rate operation, through which the Bank provides financial institutions with funds with a maturity of three or six months at a low interest rate of 0.1 percent, has the same purpose of encouraging a decline in longer-term interest rates through the purchase of assets, the Bank judged it appropriate to manage the operation under this program. The Bank will examine the size of the program centering on about 35 trillion yen, which is the sum of assets to be newly purchased – about 5 trillion yen – and the size of the fixed-rate operation – about 30 trillion yen.

IV. Fund-provisioning to support strengthening the foundations for economic growth

The "Comprehensive Easing" I have described can be considered as a policy, when a decline in future demand is worried but is expected to pick up after some time, to support such return of the demand or to underpin the demand by powerful monetary easing.

The challenges Japan's economy is faced with are not only the temporary decline in demand. It faces the medium- to long-term challenge of overcoming the trend decline in the growth rate that would still remain even after the temporary decline in demand is resolved. In other words, elevating the economy in a sustainable manner is considered to be an important challenge. Taking the developments after the Lehman shock as an example, demand declined rapidly and temporarily due partly to inventory adjustments, but picked up as time passed. On the other hand, global demand for, for example, automobiles, which had been at a high level amid the "credit bubble" in the United States prior to the Lehman shock, will not pick up so easily. In the world following the burst of the credit bubble, to return to the previous high level and to further grow, there is no choice but to increase the strength for growth through the efforts such as further innovation in product development and sales network formulation. On the basis of such recognition, the Bank introduced the "Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth." In what follows, I will explain my views about the background against which the Bank introduced the measure.

Let me first overview the changes in the environment surrounding Japan's economy. Japan has been faced with the low birth rate and the aging population for a long period. Meanwhile, emerging economies, especially in Asia, have been growing rapidly. Therefore, the main demand has shifted from the youth and middle-aged to the aged people, and from advanced to emerging economies, and it has been required to establish a supply system of products and services that could meet such new demand. Looking at the history of hit products as an example of such changes in demand, the main purchasers of the so-called 3Cs – color television sets, air conditioners, and cars – were young couples and were a relatively homogeneous group. By contrast, recently, demand for low calorie foods preferred by elders and services that deliver purchased products to elders with weak mobility have been growing, and the purchasers have become heterogeneous.

The development of information technology has also brought a significant environmental change. For example, even in a traditional industry like agriculture, it has become possible to directly provide information to customers through the internet and deliver products. Firms now have to tap the new demand by utilizing such information technology and establishing a supply system that promptly responds to the niche, diversified demand of high-mix, low-volume production.

Amid such changing environment, while Japanese firms have been trying to reform their supply system to incorporate new types of demand, there seems to be much room remaining for further reform. So far as the new demand goes, the supply system is lagging far behind potential demand. Meanwhile, because the transition of the supply system has not been sufficiently progressing, there remains a substantial supply capacity for the old-type demand. Therefore, the output gap with respect to the old-type demand is in the state of excess supply, and firms have no choice but to reduce the prices of their products and services. The fact that the transition to a supply system corresponding to the new demand has not sufficiently progressed seems to be a major factor behind the phenomenon called deflation Japan is plagued with.

To promote the transition of the supply system, it goes without saying that firms play a significant role. I also hope that financial institutions will enhance their risk management capacity and increase fund provisioning to firms that are promoting supply system transition. The policy authorities also need to play their respective roles in preparing an environment that encourages innovative activity of firms and financial institutions. If the authorities' policy becomes a certain trigger to lead to an increase in fund provisions to firms that are trying to reform their supply system, a virtuous cycle can be generated in which financial institutions accumulate the know-how, enhance their risk management capability, and provide further funds. A related example is that, in the United States, venture capital has been playing an important role in nurturing firms, and what triggered an increase in investments by the venture capital was said to be a law revision to relax the restrictions on investments by corporate pension funds in venture capital funds. The accumulation of know-how in the process of managing the increased inflow of funds seemed to have enabled venture capital funds to increase their yields and generated a virtuous cycle of attracting further investment funds.

In my view, the Bank's "Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth" could be a trigger for the transition of the supply system. The measure is not only different from the conventional monetary policy of controlling the policy rate, but also a completely new and unique measure even among the so-called unconventional policy measures. Therefore, we have received many opinions mainly at the outset of the introduction that "it is not a policy measure a central bank should take." Nevertheless, I believe that if the transition of the supply system is to be promoted by the measure and firms become able to tap the new demand, it will contribute to overcoming deflation and thus will be consistent with the mission of monetary policy of "achieving price stability, thereby contributing to the sound development of the national economy" as stipulated in the Bank of Japan Act. Moreover, financial institutions' accumulation of know-how to provide funds to new areas and the expansion of their business bases will not only contribute to the sound development of the national economy but also increase financial institutions' profitability and increase their capital strength, thereby also contributing to "financial system stability," which is the other objective of the Bank.

In designing the "Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth," the Bank has aimed at supporting as broad as possible the various approaches taken by financial institutions on their own initiatives. Therefore, it has been designed so that many financial institutions can participate in, and, in terms of areas and plans, due attention has been paid to make an extremely flexible framework so as not to inhibit financial institutions' voluntary approach. Moreover, by striking a balance between the views that exploiting innovative areas needs time and that the time limit is necessary in letting financial institutions use the measure as soon as possible, the lending period was set for a maximum of four years.

The 47 participating financial institutions at the first round of loan disbursement carried out on September 6 included various types of financial institutions such as the major banks, regional banks, and *shinkin* banks and covered a wide area geographically. The areas of loan disbursement expanded to all the 18 areas illustrated by the Bank, centering on "environment and energy business" and "medical, nursing care, and other health-related business," and, besides, there was a range of plans in local industries. Moreover, the average duration of lending or investment projects was 8.2 years, suggesting financial institutions' stance to support over time the firms' efforts to exploit innovative areas. Such financial institutions' efforts have been showing depth and width in line with the intention of the measure, which I feel quite encouraging.

Concluding remarks

Today I have focused on the economic situation at home and abroad as well as "Comprehensive Monetary Easing" the introduction of which was decided in October and "Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth" introduced in June. The Bank will continue to carefully examine the outlook for economic activity and prices, and take policy actions in an appropriate manner as a central Bank.

As I have mentioned earlier, to meet the critical challenge of reforming the supply system, which is faced by Japan's economy, the role of the policy authorities and, even more than that, of firms and financial institutions would be crucial. To meet the challenge, it is necessary to respond to the new demand created in accordance with the changes in the economic environment such as a rise in emerging economies as well as to nurture new businesses that tap potential demand.

In that regard, in Hiroshima Prefecture, manufacturing industry including automobile, machinery, and steel has been actively engaged in exporting to Asian countries and has been exerting their strength. Moreover, there are not a few firms, inclusive of non-manufacturers, which were established here and developed to run nation-wide business, and thus this region seems to be equipped with a basis to nurture new businesses. This region already holds a variety of elements necessary for growth such as a geographical merit that it is close to other Asian countries, ample tourism resources with two world heritage sites and the rich natural environment, a distinguished reputation as an international city, and high education level with Japan's fourth highest college advancement rate. That shows that the region has enormous potential.

On the financial front, financial institutions in Hiroshima Prefecture have been pursuing forward-looking approaches such as establishing a system to support firms that are strengthening their businesses toward Asian countries. Moreover, several financial institutions have participated in the Bank's "Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth" and have been using it as an opportunity to expand new lending methods that enable long-term lending.

I sincerely wish you every success in your endeavor to achieve growth and I also hope that the economy of this region will further fulfill its potential.