Masaaki Shirakawa: Japan's economy and monetary policy

Keynote speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the 2008 International Monetary Conference, Barcelona, (via satellite), 3 June 2008.

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Thank you, Mr. Chairman. I will give you my thought on Japan's economy and monetary policy in the present context.

With regard to the global economic conjuncture, I don't have much to add to the views expressed by my colleagues. In light of the persistent tensions in financial markets and slowing growth in the advanced economies, we need to keep a close watch on how the negative feedback loop between financial markets, asset prices and the real economy will play out going forward. Uncertainties surrounding this adverse dynamics are still substantial.

Meanwhile, the global economy is facing greater inflationary pressures with commodity prices hitting all-time highs. Since the surge in commodity prices has continued for the past several years, strong demand from emerging market economies probably plays a substantial role in this phenomenon. In these circumstances, both developed and emerging market economies are facing the difficult balancing act between maintaining sustainable economic growth on the one hand and anchoring longer-term inflationary expectations on the other.

These global economic forces, both downside and upside, affect Japan's economy through a variety of channels, adding to uncertainty for policy-makers. In this situation, Japan's economy is slowing because of the deterioration of the terms-of-trade associated with higher import prices. Corporate earnings are squeezed by soaring energy and raw material prices, and industrial production and capital investment are losing traction somewhat. Business sentiment is increasingly on the cautious side with greater downside risks to the global economic outlook.

As these headwinds are likely to stay for some while, Japan's economy seems to slow for the time being. With regard to the baseline scenario for the next one to two years, however, I am of the view that Japan's economy will grow near potential. To be more specific, Japan's growth rate will pick up again after some hiatus to reach one-and-half percent in 2008 and somewhat higher in 2009, both of which are close to Japan's potential growth rate.

Let me elaborate on this from three perspectives.

First, Japan's exports have been and will continue to be robust. Exports to the United States have weakened in tandem with the U.S. economic slowdown, but this is more than offset by strong growth in other regions – major emerging market economies and resource-rich countries in particular. Thus, Japan's whole exports are growing briskly toward a wider range of areas and/or countries. In a nutshell, strong external demand is counter-balancing the negative terms-of-trade effects which I mentioned earlier.

Second, Japan's economy has improved resilience in recent years. In the late 1990s, for example, Japan's economy accumulated excesses in a variety of forms which made it doubly vulnerable to various shocks. But now, the corporate sector is not under the burden of those excesses, and the aggregate business profits are close to record levels. Owing to improved resiliency of corporate borrowers, Japan's financial sector is on a sounder footing as well.

Third, Japan's easy monetary conditions will continue to support demand. The real short-term interest rate is in the neighborhood of zero. In addition, unlike in the United States and Europe, credit spreads are relatively compressed.

On the inflation side, Japan's core CPI inflation, which excludes fresh food, has edged up in recent months to hover around 1 percent, and the 1.2 percent increase for this March was the highest in almost 15 years except in 1998, when Japan's consumption tax rate was raised. According to our April projections, our CPI inflation rate is expected to be around 1 percent in both 2008 and 2009. But more recently, signs are emerging that upside risks on the inflation front increase gradually amid rising energy and food prices. Therefore, we are closely watching whether corporate pricing behavior will change and how general inflationary expectations will evolve going forward. This vigilance is important because higher input costs are gradually feeding through into the down-stream, and there are some indications that inflation sentiment among consumers might be slowly growing.

Having said all this, I think the risk balance for growth is still slanted to the downside, while pressures on prices are on the upside. At the same time, though, it is true that Japan's monetary conditions have been extremely accommodative for quite some time. In this light, we bear it in mind that if this monetary accommodation is maintained for long while downside risks subside, it might accentuate future cyclical swings in the economy by, for instance, encouraging excessive risk-taking.

With respect to monetary policy stance in this fairly uncertain environment, the Bank of Japan has no prejudgment about the future direction of policy rates. Examining the likely path of growth and inflation for the next one to two years while assessing the changing risk balance from a longer perspective, the Bank of Japan will make an appropriate judgment in a flexible manner in order to ensure sustainable economic growth with price stability.

Lastly, let me finish up with a few remarks about Japan's financial markets.

On the whole, Japan's financial markets function well. For example, because of the market turmoil over the past ten months, Japan's TED spread, defined as the inter-bank offered rate minus the T-bill rate, has widened by 25 bps, while those spreads in the U.S. and European markets expanded by 100 bps and 70 bps respectively.

The prime reason for this relative stability of Japan's markets is that Japan's financial firms have smaller exposures to structured credit markets than their foreign competitors. In addition, I believe the flexible framework of our money market operations has contributed to preserving the stability of short-term funding market. The Bank of Japan has acquired this operational flexibility over time, including through its experience of the financial crisis in the last decade. Let me discuss this from three angles.

First, the Bank of Japan sets the maturity of market operations quite flexibly, from O/N to one year, depending upon prevailing market conditions. Flexibility in liquidity-draining operations such as bill-selling operations also makes it possible to provide large quantities of funds without worrying too much about excess reserves being left in the system.

Second, the Bank of Japan executes market operations with a broad range of counterparties, banks, securities houses, and money market broker-dealers.

Third, our collateral regime is efficient and user-friendly. Under the so-called pooled collateral scheme which covers not only regular market operations but also the standing lending facility and day-light overdraft, counterparties are able to pledge a variety of collateral in advance, ranging from government securities to private-label debts including asset-backed securities.

When faced with increased stress in the money market over the past ten months, the Bank of Japan responded by providing ample liquidity or supplying longer-term funds earlier than usual. These operations, conducted within the normal operational modalities, enabled us to control short-term interest rates without serious difficulties.

In short, I am reminded that financial market stability is essential for effective monetary policy.