

## **Masaaki Shirakawa: Recent economic and financial developments and the conduct of monetary policy**

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at a meeting with business leaders, Nagoya, 2 September 2008.

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### **Introduction**

I am honored to be here today to speak and to exchange views with business leaders from the Chubu region, and would like to take this opportunity to express my deep gratitude for your cooperation with the Bank of Japan's Nagoya Branch. Before we begin, I also would like to express my heartfelt sympathy to the people in the Tokai area who suffered damage from the unprecedentedly heavy rain observed last week.

Today, I will speak about issues facing Japan's economy and the Bank's thinking regarding the conduct of monetary policy.

### **I. The current situation of Japan's economy**

First, I would like to discuss the current situation of Japan's economy. Since the beginning of 2002, the economy has enjoyed a moderate but prolonged period of economic expansion. Since the end of last year, however, the pace of economic growth has gradually slowed. Business fixed investment has been leveling off because the rise in energy and materials prices, which has accelerated since this spring, has depressed corporate profits. Private consumption has also been relatively weak due to the ongoing price rise, while growth in wages has remained sluggish. The pace of increase in exports has slowed, because of the effects of a slowdown in overseas economies. Given this situation, the Bank's assessment at the Monetary Policy Meeting held on August 18 and 19 was that Japan's economic growth had been sluggish.

Prices, on the other hand, have been on the rise. The year-on-year rate of increase in the domestic corporate goods price index (CGPI) exceeded 7 percent in July due mainly to the rises in prices of steel and petroleum products. This was the highest rate of increase in 27 years, since 1981. The year-on-year rate of increase in the consumer price index (CPI) excluding fresh food reached 2.4 percent in July. This was the highest rate in 16 years excluding fiscal 1997, when CPI inflation increased reflecting the rise in the rate of consumption tax.

Japan currently faces a difficult situation given the sluggishness in the economy and the rise in prices. This situation has been caused by two factors: the disruptions in global financial markets and the slowdown in the global economy; and the surge in energy and materials prices.

### **II. Disruptions in global financial markets and the slowdown in the global economy**

First, I will address a topic related to the disruptions in global financial markets and the slowdown in the global economy. Roughly one year has passed since the U.S. subprime mortgage problem emerged, underlying the disruptions in global financial markets, and the nature of this problem seems to have evolved over time.

The first stage was the time of "liquidity constraints," when conduits and aggregators of securitized products and financial institutions faced difficulties in raising funds. Then the second stage emerged: the time of "credit contraction." In this stage, financial institutions

have tightened their credit standards and their lending attitudes, and this has started to exert strong downward pressure on the economy.

Most recently, a third stage has emerged. In this stage, delinquency rates of not only subprime-related products but also commercial real estate loans and consumer loans have been rising reflecting the sluggishness in the U.S. economy. As a result, a situation in which the sluggishness in the economy causes financial institutions' asset quality to deteriorate further – with further adverse impact on the economy – is becoming a focus of concern. To put it another way, at the third stage there are concerns about a negative feedback loop between financial markets, asset prices, and economic activity.

U.S. economic growth is likely to remain sluggish for some time, since it is unforeseeable at present when and how the negative feedback loop will diminish. In Europe, economic growth is slowing further. In Asia, although the Chinese and Indian economies continue to post high growth, some of the NIEs and ASEAN economies are showing deceleration in exports and signs of slowing domestic demand. The growth rate in the world economy taken as a whole will inevitably slow, although it remains at a high level when compared with the average for the past three decades.

### **III. The surge in energy and materials prices and Japan's economy**

Next, I will address a topic related to the surge in energy and materials prices. Since Japan depends heavily on imports of resources, a rise in such prices exerts downward pressure on Japan's economy through an outflow of income and exerts upward pressure on prices.

The rise in crude oil prices during the current phase has been the largest, even compared with the two oil crises. During the first oil crisis, crude oil prices surged from 3 U.S. dollars to 12 dollars per barrel – a fourfold rise – and during the second oil crisis they surged from 15 dollars to 40 dollars – an increase of two and a half times. In the current phase, if we start from 2002, when the level of oil prices was 21 dollars, the present level of 110-120 dollars – somewhat below the recent peak – is more than five times the level recorded in 2002. As a result, the size of the income outflow resulting from the surge in oil prices has also been the largest during the current phase: about 5 percent of real GDP, compared with about 3 percent during the two oil crises.

The effects of rises in crude oil prices, such as the resultant outflows of income and decreases in production capacity, cannot be offset unless export prices are raised to the same extent as import prices. Nevertheless, there seem to be many aspects where the situation can be improved through our own efforts. In fact, economic and price developments differed markedly between the periods immediately after the two oil crises emerged.

During the first oil crisis, Japan's economy suffered from a combination of runaway inflation and economic stagnation – in other words, stagflation. The economy suddenly contracted, and CPI inflation peaked at an annual rate of 25 percent. Contrarily, during the second oil crisis, the economy continued to grow at a rate of 3-5 percent and the CPI posted only a single-digit increase.

Of the various factors behind the difference in Japan's economic and price performance between the two oil crises, two seem to be most important.

The first factor was the difference in the economic and price situation immediately before the crises as well as the policy response. Already prior to the first oil crisis, the economy was overheated and the financial environment was overly accommodative, having increased the inflation expectations of households and firms. Against this background crude oil prices surged, making matters even worse. On the other hand, when the second oil crisis occurred, the economy was not overheated, the financial environment was not overly accommodative, and monetary tightening was initiated in a timely manner. This kept inflation expectations low

and thus succeeded in avoiding the second-round effects – a rise in prices of non-petroleum goods and services triggered by a rise in crude oil prices.

The second factor was that Japan succeeded in transforming its economic structure while accepting the change in the relative-price structure due to the surge in crude oil prices. After the first oil crisis, Japanese firms pursued resource saving, and as a result, crude oil consumption per unit of output – the amount of crude oil used to produce a unit of value added – decreased in 1980 by 22 percent compared with the period of the first oil crisis. Meanwhile, Japanese firms made use of the change in the operating environment, seeking to develop energy-saving products.

This experience clearly suggests policies necessary to cope with the current rise in crude oil prices. First, the second-round effects should be avoided so that inflation is contained within the rise in import costs and passing of the rise in import costs on to output prices. And second, it is crucial to promote a change in economic and industrial structures to make them compatible with the new structure of relative prices.

It should, however, be noted that the current rise in crude oil prices has characteristics different from the past crises. In the past oil crises, supply constraints were the main cause of the rise in crude oil prices. In the current phase, on the other hand, the major cause was a change in the structure of the world economy resulting from the rapid rise of emerging economies. Looking at the current rise in crude oil prices from a somewhat longer-term perspective, we can also observe that it and the subprime mortgage problem share a similar background and thus have not occurred independently.

#### **IV. Issues facing the global economy and Japan's economy in the medium to long term**

Looking back on major trends in the global economy, we find that the rise in crude oil prices nearly coincides with the overheating in the markets for securitized products, including those backed by subprime loans. In the period that saw the onset of these two events, especially in and after 2003, the world economy enjoyed a positive combination of high growth and stable prices. A major factor supporting this combination was that the entry of emerging economies into the market economy expanded global supply capacity, providing an environment for low inflation. In this situation, accommodative monetary policy continued worldwide.

In these favorable circumstances, however, problems that can be seen today in the world economy started to emerge. First, the rapid growth of emerging economies whose energy consumption was inefficient multiplied the demand for resources such as crude oil. In addition, in these economies, improvement in the level of income increased the demand for general merchandise such as food, and this raised inflation rates there. And second, as represented by the emergence of the U.S. subprime mortgage problem, investors and financial institutions eased their credit standards amid the prolonged, favorable economic environment and accommodative financial conditions, and this resulted in expansion of credit and a rise in asset prices.

Although the causes of the subprime mortgage problem and the rise in crude oil prices are complex, they seem to share a similarity in that neither might have occurred without a continuation of high economic growth and accommodative financial conditions worldwide. This fact would seem to hold several implications for the future development of the economies of both Japan and the world.

First, the world economy should be regarded as being in a process of transition to a sustainable growth path. An economic slowdown entails hardships in every economy. However, in view of the background of high energy and materials prices, which I mentioned earlier, a certain pace of adjustment in the world economy seems necessary for them to meet the conditions – such as stable resource prices – for moving to another stage of development.

Second, from the viewpoint of the conduct of monetary policy in general, the risks that may arise from prolonged accommodative financial conditions warrant attention. Looking back at previous bubbles in financial activities and asset prices, including Japan's asset price bubble, we can see that many have occurred following a period of price stability and continued low interest rates. It is difficult, however, to recognize the emergence and bursting of a bubble as they happen. Given this, we should keep in mind the view that excessively accommodative financial conditions often cause large swings in the economy after a certain time lag, although such a view may not appear well grounded.

And third, in view of the background of the current rise in energy and materials prices, the probability that these prices will fall back to the previous low levels is likely to be small, although the pace of increase seen to date may not continue. It therefore seems inappropriate to consider the current surge an "oil crisis," which implies a "temporary supply shock." In this situation, it is all the more important – even more so than during the periods of the two oil crises – for Japan's economy to transform firms' production structure into one that is compatible with the new structure of relative prices for better resource allocation, and to react positively to the change in the operating environment and create areas of high competitiveness.

In this regard, Japanese firms have already started to undertake a range of projects, in response to the surge in energy and materials prices and growing interest in environmental issues. These include the reduction in use of structural steel and facilitation of the reuse of scrap, the use of alternative energy, and the introduction of energy-saving equipment. In these areas, large firms in particular have been increasing capital spending to improve efficiency. With regard to development of new products, automakers, for example, have been working to develop energy-saving products such as hybrid cars and electric cars, and sales of hybrid cars are growing steadily. Some electric manufacturers are increasing production of products related to alternative energy, such as solar batteries.

## **V. The outlook for Japan's economy and the conduct of monetary policy**

In view of the issues I have discussed, I would now like to talk about the outlook for Japan's economy and the Bank's conduct of monetary policy.

The Bank's main scenario is that growth will likely remain sluggish for the time being against the backdrop of high energy and materials prices and weaker growth in exports due to a slowdown in overseas economies. The sluggishness in Japan's economy has arisen against the background of the broad adjustments in the world economy that I mentioned earlier. In this situation, the point that should be examined is whether or not Japan's economy will experience a deep adjustment phase. I believe that the possibility of this occurring is small.

Let me explain the thinking behind this projection. First, as a result of firms' restructuring efforts, which continued in the 1990s up until recently, the "three excesses" – namely, in production capacity, employment, and debt – have been eliminated, and Japan's economy has become more resilient to shocks that weaken economic growth. Second, losses incurred by Japanese financial institutions due to the subprime mortgage problem are limited compared to those of U.S. and European financial institutions and Japanese financial markets continue to be stable, which suggests that the functioning of the financial system remains intact. And third, Japan's financial conditions have been accommodative. Although it is a cause for concern that financing conditions of firms in construction and real estate industries and small firms in general are becoming increasingly severe, financial conditions taken as a whole have been accommodative. The short-term real interest rate calculated by subtracting the CPI inflation rate from the call rate has been negative, as the policy interest rate – the uncollateralized overnight call rate – has been at a low level of 0.5 percent. Firms' financing costs have also remained low. This accommodative environment for corporate finance is expected to continue to support business activity.

Because of this, it is reasonable to expect, as the main scenario, that Japan's economy will return gradually to a moderate growth path as commodity prices level out and overseas economies move out of their deceleration phase.

Let me now discuss developments in prices. Currently, the year-on-year rate of increase in the CPI exceeds the upper limit of the range of "understanding of medium- to long-term price stability" – that is, the level of inflation that each member of the Policy Board understands, when conducting monetary policy, as being consistent with price stability over the medium to long term. The assessment of price stability should, however, be based on whether it can be sustained in the medium to long term. From this point of view, the issue that requires particular attention is whether second-round effects will emerge. This largely depends on whether people's confidence in price stability is maintained, which ultimately is determined by the stance of monetary policy. We consider that the second-round effects are unlikely to emerge in the near term, given the current level of the domestic output gap, the inflation expectations of households, and firms' price-setting behavior. Developments in wages are one of the important indicators pointing to the emergence of second-round effects, and so far wage growth has been relatively weak. In sum, the rate of increase in consumer prices will likely remain elevated over the coming months, since the pass-through of earlier increases in import prices is expected to continue for a while. Thereafter, however, the rate of increase is expected to decline gradually in line with the expected moderation in the rises in international commodity prices and the resultant subsiding of firms' raising of sales prices.

The outlook for economic activity and prices, however, entails considerable uncertainty, and various risk factors are influencing the outlook. Global financial markets, which I mentioned earlier, are likely to remain unstable for the time being, and there are downside risks to the world economy. Regarding the outlook for Japan's economy, there is a risk that domestic demand may weaken as a result of the outflow of income due to the high energy and materials prices. The Bank is therefore attentive to the downside risks to economic growth, although the economy does not face the need to adjust production capacity and employment.

As for prices, the Bank is focusing on the upside risks to inflation. As I mentioned earlier, energy and materials prices have been rising for a long time and this rise should not be regarded as "temporary." Moreover, given that Japan's economy has not faced such a high level of inflation in recent years, the Bank should pay attention to the risk that possible changes in the inflation expectations of households and firms' price-setting behavior may generate second-round effects.

As I have explained, the current situation requires the Bank to carefully monitor both downside risks to economic growth and upside risks to inflation. Furthermore, it should be mindful of the risk that if the downside risks to the economy turn out to decrease, prolonging the period of accommodative financial conditions may lead to swings in economic activity and prices, as the recent experience of the world economy suggests. The Bank continues to carefully assess the future outlook for economic activity and prices, closely considering the likelihood of its projections as well as factors posing upside or downside risks, and will implement its policies in a flexible manner. Moreover, since global financial markets are expected to remain unstable and there are various uncertainties in the outlook for economic activity and prices, it is essential for the Bank to ensure the stability of the Japanese financial markets.

## **Closing remarks**

Thus far, I have spoken about the issues facing Japan's economy and the Bank's thinking regarding the conduct of monetary policy.

It takes about one and a half to two years for the effects of monetary policy to permeate throughout the economy. It is therefore extremely important to make macroeconomic projections for the period covering this lag. You may be able to imagine the difficulty in

making an accurate projection. However, speaking from my own experience as a policymaker, it is not easy even to grasp the current state of the economy. To succeed in doing so, a close analysis of both macroeconomic indicators and microeconomic information is essential. The indicators and information have both advantages and disadvantages. Macroeconomic indicators are important, but do not show the most recent developments due to the lag between the relevant period and the time of release. On the other hand, microeconomic information that is gathered through interviews with firms has an advantage of a minimal lag. The latter also includes information that cannot be expressed numerically, such as business sentiment. However, it also has drawbacks: there often is a significant disparity in the view of business conditions among firms and industries; and there may be also a tendency for respondents to play down positive news regarding their business.

The Bank, keeping in mind both the advantages and limitations of the two types of information, strives to gather as much microeconomic information as possible using no small amount of operating resources. To explore the activities of various economic entities in depth, the Bank's 32 branches and 12 local offices throughout Japan perform an important role. Their analyses of regional economic developments and the behavior of firms and financial institutions in the respective region are concentrated in the Bank's Head Office through, for example, the meeting of general managers of the Bank's branches. The branches make reports based on the results of the Tankan (Short-Term Economic Survey of Enterprises in Japan) for the respective region, analyses of regional economic indicators, and interviews with firms and financial institutions in the region. The information gathered from the branches is summarized in the Bank's Regional Economic Report, which is released quarterly. The branches also disseminate information locally in their respective areas through the monthly release of a report on recent economic and financial developments and quarterly release of the Tankan for the respective region.

The staff of the Bank's branches and offices, including the general managers, may have asked you on occasion to devote some time to completing interviews and Tankan surveys. I wish to express my deep thanks for your kind cooperation, and would like you to know that these interviews and surveys provide an essential foundation for the Bank's conduct of monetary policy. We seek your continued cooperation with us to this end, and please know that your opinions and requests are always welcome.

Thank you very much for your kind attention.