Masaaki Shirakawa: Balance-sheet adjustments and the global economy

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the Paris EUROPLACE Financial Forum, Tokyo, 16 November 2009.

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Introduction

Thank you for having me today at the International Financial Forum organized by Paris EUROPLACE.

Counting the Banque de France, financial institutions, clearing systems, law firms, and accounting offices among its members, Paris EUROPLACE is an organization with a wide range of members with an interest in French financial markets. Communication among market participants is important for the development of markets, but it is particularly crucial during a period of financial crisis. I have learned that Paris EUROPLACE plays an important role in providing the opportunities for such communication, and I salute the members of Paris EUROPLACE for their contributions.

At this forum today, reflecting the current financial crisis, various workshops will be held to address issues concerning financial markets and the financial system, and the workshops will no doubt give rise to active discussions. The topic I would like to talk about today is balance-sheet adjustments. As the governor of the central bank of a country that has experienced the hardship brought by balance-sheet adjustments before any other advanced economy, I believe that balance-sheet adjustments are a key factor in shaping the prospects for the global economy following the economic crisis.

I. Global economic developments and balance-sheet adjustments

I will start by discussing recent developments in the global economy.

Following the failure of Lehman Brothers in the autumn of 2008, global financial market conditions deteriorated significantly and economies around the world contracted simultaneously and sharply. Recently, however, global financial markets have increasingly been showing signs of improvement, and the global economy has started to pick up. On the whole, Japan's economy has followed a similar trend as other advanced economies, although both the economic contraction and the subsequent recovery were greater in Japan. The reason is that industries that were the most severely affected by the global economic downturn, such as automobiles, electrical machinery, and general machinery, carry a particularly large weight in Japan.

The current pick-up in the global economy is supported by the following three factors. First, dissipation of the panic, namely the liquidity crisis. Second, progress in inventory adjustments. And third, the implementation of massive economic stimulus measures around the world. However, the fundamental problem that caused the current economic crisis, that is, the need for balance-sheet adjustments due to the bursting of the credit bubble in the United States and Europe, remains unresolved. This means that households and firms will have to restrain consumption and investment in order to reduce the debts accumulated when asset prices were rising. While such debt reduction, in other words, deleveraging, is a rational response from the perspective of individual households and firms, if they restrain spending simultaneously in large numbers, this could cause a decline in aggregate demand and a fall in income and profits, which provide the necessary resources for deleveraging. Financial institutions, too, will inevitably have to reduce assets and risks, which had grown excessively relative to their capital bases. While balance-sheet adjustments are indispensable for the economy to return to a sustainable growth path, they will continue to exert chronic downward pressure on the economy during the adjustment process, as Japan's experience shows. Meanwhile, emerging and commodity-exporting economies essentially face few balance-sheet problems of their own and have been recovering at a faster rate than anticipated in early spring.

Given these considerations, a key issue in determining the outlook for the global economy is how to assess the pressures from these balance-sheet adjustments in U.S. and European economies. Comparing Japan's experience of balance-sheet adjustments in the 1990s and the current situation in the United States may provide some important pointers in this context.

II. Balance-sheet adjustments and policy responses

The size of balance-sheet adjustments

Let me begin by comparing the size of balance-sheet adjustments necessary in Japan and the United States. Taking as an example real estate prices in real terms – using the consumer price index as deflator – the pace of decline in both residential and commercial real estate prices from their peak levels has been more or less the same in the United States and Japan, although thus far it seems to have been slightly faster in the United States. Next, how do the two square up in a more direct comparison of the degree of excessive leverage? One way to gauge excessive leverage is to look at the upward divergence of the debt-to-GDP ratio for the non-financial private sector from the trend of the past 20 year. Based on this somewhat mechanical approach, we find that the level of excessive leverage is also about the same for Japan and the United States.

Sectors that require balance-sheet adjustments

Another difference between Japan and the United States is the sectors requiring balance-sheet adjustments. In the case of Japan, it was the corporate sector that mainly faced excessive debt within the non-financial private sector. The excess of investment over savings reached more than 10 percent of GDP in 1990. Amid the rise in asset prices, firms had made aggressive real-estate investments and, at the same time, increased business fixed investment by borrowing from banks using real estate that had gone up in value as collateral. After the bubble burst, economic activity deteriorated together with the fall in asset prices, and the corporate sector was confronted with excesses in debt, production capacity, and employment.

In contrast, in the current situation in the United States, it is the household sector that needs to make balance-sheet adjustments. As seen in the subprime mortgage problem, against the background of rising home prices, households' borrowing against homes as collateral increased substantially, which in turn led to excessive consumption.

Policy responses amid balance-sheet adjustments

Next, I would like to look at differences in the policy responses in Japan and the United States.

The first aspect in this regard is the timing and scale of policy responses. Starting with monetary policy, both the Bank of Japan and the Federal Reserve undertook the first policy rate reduction about one year after real estate prices in major cities had reached their peak. Therefore, the time it took for the Bank of Japan and the Federal Reserve to start lowering interest rates was about the same. On the other hand, the pace of policy interest rate reductions was faster in the United States than in Japan, reflecting the difference in the sequence in which impaired asset problems arose, as described later. In Japan, the policy rate reached 0.5 percent after four years from the start of rate reductions, while in the United States, it was after only 15 months. With regard to the scale of injections of public capital into the financial sector, which are a key to the restoration of the functioning of financial intermediation, the size of public capital injections relative to GDP was approximately 2.5 percent in Japan, while it was 1.5 percent in the United States. The relative size of injections was slightly larger in Japan, but injections were undertaken considerably earlier in the United States. In the United States, because the bursting of the bubble started with a fall in market prices of securitized products, financial institutions' capital shortages were revealed at an early stage by market forces. In contrast, in the case of Japan, it took time before financial institutions' capital shortages were recognized and public capital was injected. The reason is that financial institutions' impaired assets consisted mainly of loans and it was more difficult to gauge the decline in their value. It should, however, be noted that currently in the United States, commercial real estate prices continue to fall and the quality of consumer loans continues to deteriorate, and therefore the sequence in which the problems related to impaired assets arise is different in the United States from that in Japan. Meanwhile, in terms of financial market stability, which is key to avoiding a sharp economic contraction, the degree of instability seems to have been relatively smaller in Japan reflecting partly the Bank of Japan's active stance as the lender of last resort.

The balance-sheet adjustment process and the effectiveness of monetary policy

The second aspect with regard to the policy response concerns the effectiveness of monetary policy. As Japan's experience shows, the effectiveness of accommodative monetary policy through policy rate reductions declines substantially in an economy that is undergoing balance-sheet adjustments. This, of course, does not mean that monetary easing is ineffective. Monetary easing encourages spending and risk-taking activity by entities that are not suffering from excessive debt and supports aggregate spending and income. Monetary easing also enhances debt reduction through a decline in interest payments and accelerates balance-sheet repairs by supporting asset prices.

One of the distinct differences between Japan and the United States in terms of the conduct of monetary policy amid balance-sheet adjustments concerns the income transfer effects between economic entities. Needless to say, in the economy as a whole, for economic entities with excess debt there will correspondingly be entities with excess savings. In Japan, as a result of the reduction in the policy rate, there was a large income transfer from the household sector, which held large amounts of assets, to the heavily indebted corporate sector. However, in terms of income distribution, I believe that in the final analysis, the policy rate reductions supported household sector income: although they lowered households' interest income, thereby restraining consumption to some extent, the policy rate reductions facilitated the adjustment process in the corporate sector and supported economic activity overall, thereby propping up household sector income from employment and hence the economy.

Meanwhile, since the United States, unlike Japan, is a net debtor country, the reduction in policy interest rates will reduce interest payments to creditors overseas, resulting in an income transfer from overseas sectors to the United States. In other words, in terms of balance-sheet adjustments, the United States has the advantage that policy interest rate reductions bring about income transfers that are favorable to the country. However, there are also risks involved in continued low interest rates. If the continuation of low interest rates leads to a substantial rise in long-term interest rates by raising inflation expectations or by generating expectations for a weak dollar, this may give rise to another problem, namely that the fiscal burden increases and in turn the need for adjustments in the government's balance-sheet arises.

Effects resulting from different sectors making balance-sheet adjustments

The difference between the United States and Japan in terms of what sectors have to or had to make balance-sheet adjustments can result in considerable differences not only in income transfer effects, but also in the adjustment process. In the case of Japan, since it was mainly the corporate sector that had to make balance-sheet adjustments, progress in the adjustment process for the economy overall was achieved through an increase in exports owing to high global economic growth. However, at present, it is difficult for the United States to expect similar help from a substantial rise in its exports, because other advanced economies are also, to a greater or lesser extent, undergoing balance-sheet adjustments. An additional problem is that employees' income has declined more substantially than in previous recessions in the United States. While this may help the recovery in corporate profits, it at the same time entails the risk of a delay in balance-sheet adjustments by households.

Having said that, I must hastily add that there are elements in the structure of the U.S. economy that will encourage rapid progress in balance-sheet adjustments. The size of necessary balance-sheet adjustments depends on the size of the excess in supply capacity in the overall economy relative to the long-term equilibrium growth rate – that is, the potential growth rate. If expectations for economic growth are high, pressures for balance-sheet adjustments will be small. In this context, the United States has the significant advantage of having a flexible economic structure. If labor and capital shift swiftly from low-productivity sectors to high-productivity sectors, this should sustain high productivity growth in the economy overall. In contrast, reflecting population aging and a falling birth rate, the growth rate of Japan's working-age population first declined and then turned negative during the 1990s. Moreover, labor and capital mobility was relatively low, which was partly responsible for the gradual decline in productivity growth in the economy overall. As a result, Japan's potential growth rate after the bubble burst declined, which protracted the duration of balance sheet adjustments.

III. Balance-sheet adjustments and the global economy

Lastly, I will broaden my perspective and touch upon the relationship between balance-sheet adjustments and the global economy. What is important in this context is the relationship between developments in emerging and advanced economies. Currently, large-scale economic stimulus measures are being implemented around the world. Although emerging economies did not face pressure for balance-sheet adjustments, given the decrease in global demand they nevertheless implemented large-scale economic stimulus measures. In addition, monetary easing in advanced economies has stimulated capital inflows to emerging economies, boosting economic activity there. On top of that, the effects of monetary easing have been magnified by foreign exchange interventions by emerging economies to contain the appreciation of their currencies. In these circumstances, economic activity in emerging economies has been recovering at a faster rate than anticipated in early spring, contributing to the recovery of the global economy overall. However, we also need to be aware of the risk that if the difference in the pace of recovery in emerging and advanced economies does not diminish, and if capital inflows from advanced economies continue for a protracted period, emerging economies might overheat and experience financial turmoil, triggering a recession. Although this may be stating the obvious, given the growing interconnectedness between economies around the world, what is important for the global economy is that advanced and emerging economies grow in a sustained and well-balanced manner. Therefore, it is necessary to pay attention to the relationship between developments in advanced and emerging economies and especially to capital flows from advanced to emerging economies.

Closing remarks

In my speech today, using Japan's experience in the 1990s for comparison, I highlighted a number of issues concerning balance-sheet adjustments that will play an important role in shaping the outlook for the global economy. As a policymaker, I believe it is important to be aware of the issues I discussed today and, keeping duly in mind that the past is not necessarily a good guide to the future, to continue to carefully assess economic developments without any prejudgment. Thank you.