

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, 30 November 2009.

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Introduction

I am honored today to have an opportunity to speak and to exchange views with business leaders from the Chubu region. I take this opportunity to express my deep gratitude for your cooperation with the Bank of Japan's Nagoya Branch.

The last time I addressed you was in the beginning of September 2008. Immediately after that in mid-September, Lehman Brothers failed and a financial crisis broke out in the United States and Europe. Triggered by that event, the global economy deteriorated rapidly and simultaneously and economic activity in Japan deteriorated substantially, but mainly as a result of various policy measures by the governments and central banks around the world and progress in inventory adjustments, the economies both at home and abroad have started to pick up.

However, the outlook remains uncertain, and many challenges remain for the global economy to shift to a sustainable growth path. Today, before exchanging views with you, I will first explain the economic developments and outlook at home and abroad as well as the thinking on the Bank of Japan's conduct of policy.

I. Developments in the global economy

I will start with the global economy. While many factors were pointed out to be in the back of a sharp deterioration in the global economy since the autumn of last year, I summarize those based on the following two factors.

First, the global accumulation of excesses up to the mid-2000s and balance-sheet adjustments that occurred in the process of unwinding those excesses. Up to the mid-2000s, the global economy had enjoyed, in retrospect, extremely benign conditions of high growth, low inflation rates, and low interest rates for a long period. In such an environment, the housing investment boom in the U.S. and European economies and the global increase in demand for durable consumer goods occurred. On the financial front, a rapid expansion in credit, as represented by the subprime mortgage problem, and a surge in leverage took place. While various excesses in economic and financial activities piled up during such a process, the excesses could not last for a long time. The essence of what we see now mainly in the United States and Europe is the process of solving the problems such as households' excess debts, firms' excess production capacity, and financial institutions' impaired assets. That is, the process of restoring and adjusting balance sheets. During the process, economic entities will restrain spending activity and downward pressure would be persistently exerted on the global economy, especially the advanced economies.

Second, the panicked financial contraction triggered by the failure of Lehman Brothers and the ensuing plunge in economic activity. The financial intermediary function deteriorated significantly around the world and the funds necessary for economic activity were not provided sufficiently, causing a rapid contraction of economic activity not only in the United States and Europe, but also in the emerging countries.

Following such a severe economic downturn, the global economy started to level out around this spring, but the developments thereafter vary among the regions. The projections of the International Monetary Fund showed that the growth rate of the global economy would

increase by four percentage points, to 3.1 percent in 2010 from -1.1 percent in 2009. Something striking is that the contribution of emerging economies to the growth of global economy in 2010 became larger than that of advanced economies, with the advanced economies accounting for 30 percent and emerging economies accounting for 70 percent.

In the United States and Europe, while the panicked contraction of economic and financial activity settled down mainly due to the provision of ample liquidity by the central banks, public capital injections to financial institutions, and large-scale fiscal expenditure, chronic downward pressure on the economy is likely to continue in the form of balance-sheet adjustments. Therefore, although the economies are picking up, the pace of recovery is generally moderate.

In emerging and commodity-exporting economies, the underlying trend of domestic demand in many of them is generally strong, reflecting the buoyant consumption associated with an improvement in the standard of living and the need for improving social infrastructure. Moreover, as emerging economies, unlike the U.S. and European economies, do not face large-scale balance-sheet adjustments, the increase in fiscal expenditure has led to high multiplier effects in stimulating domestic demand. In addition, the funds raised in advanced economies, where interest rates have remained low, have been flowing into emerging economies and has bolstered growth through, for example, an increase in bank lending and a rise in asset prices. However, the developments in those countries and regions have not been even. Careful monitoring is warranted according to the respective countries' specific situations including the effects of the financial crisis to date, the developments in the outflow and inflow of funds between advanced economies, and conduct of macroeconomic policy.

II. Current state of and outlook for Japan's economy

Based on the state of the global economy I have just mentioned, I will next explain the current state of and the outlook for Japan's economy.

After the autumn of 2008, against a backdrop of the economic downturn in the United States and Europe, Japan's exports and production plunged, and Japan's economy suffered an unprecedented large fall. From the spring of 2009, Japan's exports and production have been increasing due to the progress in inventory adjustments at home and abroad as well as the effects of economic stimulus measures. Moreover, thanks to the increase in public investment and recovery in private consumption, the flash estimate of Japan's real GDP in the July–September quarter increased by an annualized quarter-on-quarter growth rate of 4.8 percent, which was an increase for the second consecutive quarter. The increase in private demand was deemed being largely supported by various policy measures. Therefore, the Bank of Japan judges that the momentum for self-sustaining recovery in private demand remains weak while Japan's economy is picking up.

As for the outlook, the pace of improvement in Japan's economy is likely to remain moderate until around the middle of fiscal 2010, as pressures for adjusting employment and wages are likely to remain. It is always a difficult task in terms of communication to decide what words are the most appropriate to express the current state and outlook for the economy in a short phrase. The expression I have just mentioned, "moderate improvement," is used to also convey cautious judgments that, while the economy has gotten out of a deteriorating phase, the level of economic activity remains low and the pace of future recovery will not likely to be smooth. In fact, it cannot be denied that there is a possibility that the momentum for Japan's economic recovery will temporarily slow at around the spring of 2010, when the effects of economic stimulus measures will wane at home and abroad.

Having said that, given that the advanced economies including Japan are firmly keeping a stance to support the economy and the growth of emerging economies is robust, a possibility that the momentum for economic recovery at home and abroad will stall seems not so significant. Thereafter, in the second half of fiscal 2010 onward, it is likely that the

improvements in the corporate sector originating from exports will spill over to the household sector and the growth rate of Japan's economy will start to rise gradually. While the outlook for the global economy, which lies behind such a view, is basically similar with that of other central banks in advanced economies and not the Bank's unique view, the Bank thoroughly recognizes that the outlook is associated with considerable uncertainty. In that regard, the Bank pays due attention to the effects of the recent rapid appreciation of the yen on business sentiment of the firms that are on the road to recovery, as well as to the effects of international financial developments since last week on the financial markets. It would be important, above all, for a central bank to examine the economy without prejudice.

Meanwhile, prices have been fluctuating substantially since 2008, like the United States and Europe, due to the effects of the changes in the prices of petroleum products. The year-on-year rate of change in the consumer price index (CPI) in Japan rose to 2.4 percent in the summer of 2008, but it became negative from the spring of 2009, and registered the largest-ever decline of minus 2.4 percent in August 2009. The year-on-year rate of decline in the CPI somewhat moderated to minus 2.2 percent in October, and it is expected that the pace of decline is likely to moderate to approximately minus one percent toward the beginning of next year, as the effects of the previous year's surge in the crude oil prices abate. The question is beyond that point. While it is expected that the pace of decline will gradually moderate as the economic slack dissipates, it is likely that downward pressure on prices will remain for an extended period reflecting a moderate improvement in the economy.

Therefore, in the *Outlook for Economic Activity and Prices* issued at the end of October, the Bank released a grim outlook that the price decline will likely continue until fiscal 2011, albeit the pace of decline gradually moderating. While the Government expressed recently its view that the Japanese economy was in a mild deflationary phase in that the decline in prices was continuing, the Bank's judgment on prices presented at the end of October is based on the same recognition with such Government's view.

III. Conduct of monetary policy

Based on the recent economic and financial developments, let me explain next the Bank's monetary policy management. In terms of monetary easing, the Bank had reduced the policy interest rate to 0.1 percent toward the end of 2008, in order to steadily support economic activity on the interest rate front. As a result, short-term interest rates in Japan are now at the lowest levels in the world. While those low interest rates have power to support economic activity of firms and households, the potential economic stimulus effects of low interest rates tend to increase as the economic environment improves. In October this year, the Bank expressed again its aim to maintain the extremely accommodative financial environment and provide steady support for Japan's economy, and I will emphasize again today that the Bank firmly maintains such a stance. The Bank will thoroughly check the future developments in the economy and prices and take appropriate policy responses to bring Japan's economy back to a sustainable growth path with price stability.

In terms of the effects of monetary easing, it is important to ensure the stability of financial markets. To ensure the stability of the financial markets is a responsibility as a central bank, and I will reemphasize that the Bank is always prepared to act promptly and decisively if judged necessary to ensure the stability of financial markets.

IV. Responses to deflation

In relation to the policy management, I will now describe the basic thinking on coping with the issue of deflation. As previously mentioned, the Bank has been doing its utmost as a central bank to meet the challenge of getting out of the state of continued decline of prices, namely, deflation, and put Japan's economy back to a sustainable growth path with price stability, and made it clear to continue with such stance.

To begin with, at the root of a continued decline in prices, there is a fundamental factor that demand is weak compared with the supply capacity of the economy as a whole. The starting point of the current price decline was the rapid contraction of financial and economic activities since the autumn of last year, and, as a result, the supply and demand balance deteriorated significantly. In order to deal with such situation, it is necessary to prepare an environment conducive to a sustainable expansion of final demand, such as business fixed investment and private consumption. In other words, on a policy front, it becomes critical to make households feel secure about their future and firms able to have expectations about the future growth. At the same time, as long as there will be no recurrence of the excessive booms in the United States and Europe, it will be essential also for firms to convert their supply system into a new one that is in line with consumers' needs in a new era.

As such, steady efforts on the part of the policy authorities as well as the private economic entities are necessary for coping with the issue of deflation, and such a process necessarily takes some time. In the meantime, it is also important to avoid a situation in which the decline in prices induces adverse effects on economic activity, which in turn leads to a further decline in prices, namely, a vicious circle between economic activity and prices. History shows that most of the cases, in which a decline in prices induced contraction of economic activity and resulted in a vicious circle between economic activity and prices, took place during the period when the financial system became extremely instable through bank failures and others, namely, during the period of financial contraction. In such a situation, firms that faced funding difficulties made fire-sales of their own products to meet day-to-day funding needs or could not maintain employment. That in turn led to a decline in prices and wages, resulting in further deterioration of the economy. While that might be an extreme case, a valuable lesson in history is that it is critical to ensure the stability of the financial system in preventing a vicious circle between the economy and prices.

As described, in coping with deflation, what becomes a key is first, to keep improving the supply and demand balance of the economy as a whole, and second, to prevent a vicious circle between economic activity and prices, especially to maintain the stability of the financial system. Based on such thinking, the Bank will do its utmost to overcome deflation both in terms of monetary easing and ensuring the stability of the financial markets.

V. Toward sustainable growth

I have been explaining the thinking on policy responses to deflation. Given that the essence of the issue is the deterioration in the supply and demand balance of the economy as a whole, efforts to overcome deflation overlap the efforts to strengthen the potential of Japan's economy, namely, to strengthen the growth potential itself. To that end, I will next touch on the challenges toward a sustainable growth of Japan's economy.

Sustainable growth of the economy is achieved through a sustained expansion in final demand, and an associated expansion in the supply capacity. In the economic analysis, economic growth viewed from the supply side is often analyzed by looking into three factors, namely, growth in capital stock, growth in labor force, and growth in productivity. This is a method referred to as growth accounting. By using the method, I will review the source of growth during the period when Japan's economy was growing at a much higher rate than now. Typical study in this regard is the analysis by Professor Masahiro Kuroda, the former President of the Economic and Social Research Institute, Cabinet Office. According to the analysis, in the 25 years between 1960 and 1985, Japan's annual growth rate was 6.8 percent on average, of which growth in capital stock, labor force, and productivity accounted for 3.7 percent, 0.9 percent, and 2.2 percent, respectively. While both expansions in demand and in supply capacity are of course necessary for achieving a sustainable economic growth, in meeting such expansion from the supply side, growth in labor force accounts for a surprisingly small degree, and an increase in capital stock and a rise in productivity are significant. In that regard, the efforts to tackle the population decline and the associated

problems are without doubt important, and, similarly, we are left with two key factors. First, where to expect a source of demand expansion. And second, how to achieve a rise in productivity.

First, in terms of source of demand expansion, significant challenges are to foster households' confidence about their future and prepare infrastructure conducive to expansion of domestic demand, as well as, given a future decline in population, how to take in the expanding demand of emerging and commodity-exporting economies. Having said that, I am not insisting that Japan should increase its dependence on merchandise exports to emerging economies. Various ways can be considered to take in demand. In fact, in the past five years, the factors that account for Japan's current account surplus have been changing, and more than 70 percent of Japan's current account surplus now comes from the receipt of income from abroad associated with securities and direct investments. The important point is, in addition to merchandise exports, the efforts to strengthen the relationship with emerging economies in various forms, including vertical and horizontal specialization, are required.

The efforts to raise productivity from the supply side are also critical. Corporate managers have been working on the establishment of global production bases and the development of high-value-added products meeting the needs of consumers. Such moves will lead to exploring new demand. As is the case with the changes in demographic composition, new demand will surely be created as long as the economy and society consistently change. The challenge for firms is to make potential needs into actual demand. While the output gap has been often discussed in economic debates, the discussions have been done by comparing demand for products based on the existing needs with the supplying capacity of products that meet such needs. Given that the unprecedented global bubble has burst, it cannot be expected that demand will be created to meet the supplying capacity of the same products in the past. In that context, the oft-discussed output gap seems to have an aspect of an indicator of the mismatch between supply and demand. What is important is the corporate effort to make potential needs into actual demand. In addition, to support such firms' efforts, the systems or mechanisms should be reviewed so as to ensure the flexibility of Japan's economic structure according to the changes in society and in the global economy. For example, the rate of establishment of new firms and the rate of closure of the existing firms in Japan are less than half of those in the United States, suggesting that the metabolism of Japan's economy is low.

While consideration from various angles would be necessary in order to improve such a situation and prepare a mechanism through which production resources transfer smoothly to areas with strong needs, from the standpoint of a central bank, I will emphasize the role of financial markets, financial institutions, and institutional investors. The financial markets facilitate an efficient fund allocation according to profitability and potential of firms as well as risks, thereby play a role in enhancing the metabolism of the economy. In that regard, a more efficient fund allocation will be possible if versatile markets exist and various fund providers assess the profitability of firms and others. Therefore, to develop versatile and efficient financial markets is likely to play an important role also in raising the productivity of the economy as a whole.

Concluding remarks

Needless to say, economic growth is eventually achieved by the power of human will. In that regard, in Nagoya, there are many firms that have taken various changes in the environment as new opportunities and have achieved high growth by responding to the changes. Recently, there have been moves to develop and expand the production of high-value-added products including energy saving automobiles, which is reassuring. If such efforts are stepped up, it would pave the way to a sustained growth path for Japan's economy. The Bank will do its utmost to support your such efforts from the standpoint of a central bank. Thank you.