

Hirohide Yamaguchi: Japan's economy and monetary policy

Speech by Mr Hirohide Yamaguchi, Deputy Governor of the Bank of Japan, at a Meeting with Business Leaders, Kagoshima, 24 February 2010.

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Introduction

I am honored today to have this opportunity to speak and to exchange views with business leaders in Kagoshima Prefecture.

I will express my gratitude for your cooperation in interviews with the staffers from the Kagoshima Branch and for the Bank of Japan's surveys. Information obtained from these interviews and surveys is invaluable and utilized fully in assessing economic and financial developments and conducting monetary policy.

Kagoshima Prefecture and the Bank have a deep-rooted relationship. The founder of the Bank, Mr. Masayoshi Matsukata, and the first governor of the Bank, Mr. Shigetoshi Yoshihara, were both born in Kagoshima Prefecture. I have been looking forward to visiting the place which these two important figures, who were founding fathers to the Bank, hailed from.

Before exchanging views with you, I will talk about economic conditions and price developments in Japan.

I. Economic conditions in Japan

The current state of the economy

I will first talk about the current state of Japan's economy.

Japan experienced a sharp and substantial economic downturn from the autumn of 2008 to early 2009, which could be described as "falling off a cliff." Fortunately, however, the economy stopped worsening in the spring of 2009 and has been picking up since then.

There are three reasons behind the pick-up in Japan's economy.

First is the fact that overseas economies have started to recover. Especially emerging economies, such as China, have been growing at a faster pace than expected. Currently, emerging economies are rushing to build infrastructures, such as roads and electrical power systems. Moreover, in China for example, the penetration rates of televisions and automobiles are gradually increasing along with the rise in people's income level. Emerging economies are experiencing a similar phenomenon as what Japan experienced during its high-growth period, when, along with an improvement in the transportation network, the so-called three major household items were penetrated into every family. Emerging economies are enjoying high growth due to the fact that, in addition to robust business fixed investment and private consumption, large-scale economic stimulus measures have been implemented to address the financial crisis since the autumn of 2008 and the effects of monetary easing around the world have been spreading.

How about the situations in the U.S. and European economies, where the financial crisis began? These advanced economies have also started to pick up, thanks to the implementation of large-scale fiscal policy measures and substantial monetary easing.

The financial crisis had inflicted serious damage on these economies, and they have been suffering from various after-effects. For example, financial institutions still hold a considerable amount of impaired assets, and remain cautious about extending loans. In terms of households, the hearty consumer appetite has now receded, because their purchased

housing has declined in value and they are heavily indebted at the same time. Those problems have been continuing to weigh on the U.S. and European economies in achieving a full-fledged recovery.

The second reason behind the pick-up in Japan's economy is that firms have been performing inventory restocking both at home and abroad. Firms have made rapid production and inventory adjustments in response to the fall in demand. Thereafter, as economies gradually regained stability, prospects for sales started to improve. Firms are now in the phase to increase inventories so as to attain an appropriate inventory level.

And the third reason is that domestic policy measures have been contributing significantly to the pick-up in Japan's economy. For example, supported by measures to promote the sale of durable consumer goods, such as the eco-point system and tax reductions on purchases of environmentally friendly cars, sales of electrical appliances and automobiles increased sharply. Moreover, due in part to successive implementation of economic measures, public works increased and contributed to the pick-up in the economy.

With those three reasons in the background, the continued increases in exports and production have been the driving force for the pick-up in Japan's economy. Hitting bottom in March 2009, exports have been increasing for nine consecutive months, and similarly, production has been increasing for ten consecutive months after hitting bottom in February 2009. By industry, the performance of automobile-related and electrical machinery industries has been particularly good. Furthermore, since wide-ranging industries are related to the industries of automobiles and electrical machinery, their good performance has contributed to the recovery in production in industries that supply materials and parts.

While exports and production have continued to exhibit a steady increase, so far, recovery in domestic private demand, including business fixed investment and private consumption, has not gained momentum.

Business fixed investment is only at a stage where its decline has been coming to a halt. According to the *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the Bank's quarterly survey on firms, many firms, regardless of size or industry, are still responding that they feel that their capital stock is excessive. Moreover, a cautious investment stance can be derived from their capital investment plans for the current through next fiscal years.

Household consumption is similar to business fixed investment in that it lacks momentum for recovery. The substantial reduction in winter bonus payments and the unemployment rate at an elevated level have also been accountable for this. While sales of electrical appliances and automobiles, which have been underpinned by policy measures, have been brisk, sales at department stores and supermarkets have continued to decrease. Moreover, as seen from the fall in sales in the food-service and travel industries, consumers have been tightening the purse strings.

As explained, the current state of Japan's economy exhibits a vivid contrast between brisk exports and production on one hand, and sluggish domestic private demand, on the other. Based on such recognition, at the Monetary Policy Meeting held last week, the Bank made an assessment, "Japan's economy is picking up mainly due to various policy measures taken at home and abroad, although there is not yet sufficient momentum to support a self-sustaining recovery in domestic private demand."

Outlook for the economy

Now, what is the outlook for the economy? It depends on how the two contrasting factors develop. Namely, whether exports and production can maintain their favorable conditions, and whether momentum will build up for a self-sustaining recovery in domestic private demand.

In that regard, it is likely that the pace of increase in exports and production is bound to slow down. The momentum for restocking is bound to diminish as inventory approaches an appropriate level. It will also become difficult to expect the economic stimulus measures taken at home and abroad to exert the effects that they have initially had. On the other hand, it appears to take some more time before we can see a visible improvement in momentum for self-sustaining recovery in private demand. As mentioned earlier, firms have been cautious for business fixed investment. Moreover, as anxiety over employment and income conditions is yet to be dispelled, it is difficult for households to loosen the purse strings.

Taking those points into account, the momentum for the pick up in the economy might decrease, albeit temporarily. At that point, the regions that depend heavily on public works might strongly feel that the pace of improvement in the economy is slow.

That said, the economy is expected to regain momentum from the summer of this year. Overseas, emerging economies are expected to continue growing at a high pace. In the United States and Europe, the growth rate is likely to increase as the after-effects of the financial crisis wear off. As a result, Japan's exports and production are expected to maintain their favorable conditions, and that benefit will spread to exporting firms as well as their related firms in Japan. If exports and production increase, firms' sales will increase and corporate profits will improve. Since capacity utilization will increase as the production level rises, the firms' sense of excessive capacity will fade away, albeit moderately, and their motivation for business fixed investment could be stimulated. Furthermore, such favorable conditions in the corporate sector are likely to spread to the household sector. As corporate profits further improve, expansion in new employment and recovery in wages will likely take place. Moreover, the decline in anxiety about employment and future income will also have positive effects on household consumption. As such, Japan's economy as a whole is expected to gradually increase its growth rate, with the improvements in the corporate sector originating from exports spilling over to the household sector. The Bank releases every quarter its outlook for economic activity and prices for about two years ahead. The real economic growth rate is projected to decline significantly in fiscal 2009 to minus 2.5 percent, but gradually go up to 1.3 percent in fiscal 2010 and 2.1 percent in fiscal 2011.

Of course, the economy changes daily. If the external environment and behavioral patterns of firms and households change, the outlook might be revised upward or downward. Of those uncertainties, let me touch on two factors that I consider to be especially important.

One is developments in overseas economies. As I have explained so far, Japan's economic outlook will be affected greatly by overseas economic developments. Of those, emerging economies including China have been recovering at an unexpectedly high pace. In that regard, it might well be the case that those economies grow more than expected again. However, as those emerging economies are growing at a high pace, we need to be aware of the risk that the economy might overheat. Since the United States and Europe still suffer the after-effects of the financial crisis, there is uncertainty about the outlook for their economies. In particular, there are varying views on how the impaired assets of financial institutions and excess debts of households will be cleared. In Japan, it took extremely long to resolve the impaired assets problem for financial institutions after the burst of the bubble. Whether such history will repeat warrants attention.

The other factor is whether firms can come up with a vision for the future. In the outlook I have mentioned earlier, firms are expected to decide on business fixed investment and new employment as the economy gradually improves. However, at present, it is even more difficult to foresee the future, due partly to the financial crisis. If a pessimistic view for the future spreads, firms' spending activity will contract more than necessary. While it is a fact that Japan's economy faces many challenges, it is critical to raise firms' expectations of growth to meet those challenges. I will come back to that point later.

II. Price developments in Japan

Current conditions and the outlook for prices

Before moving to a longer-term issue of firms' growth expectations, I will touch on the current conditions and outlook for prices in Japan.

The consumer price index (CPI) inflation rate, excluding fresh food and on a year-on-year basis, rose to 2.4 percent in the summer of 2008, but the pace of increase moderated thereafter, and has been in the negative territory since the spring of 2009. In particular, the decline accelerated toward the summer of 2009 to mark a record -2.4 percent decline. Thereafter, the decline gradually moderated, and has recently been about -1 percent.

On the back of such recent price developments, there are mainly two factors at work. One is the effects of developments in commodity prices, represented by crude oil prices. The other is the aggregate balance of domestic supply and demand.

The first factor, the prices of commodities such as crude oil, nonferrous metals, and grains, surged from the beginning of 2007 to the summer of 2008, followed by a sharp decline. In particular, since the autumn of 2008 when the financial crisis occurred, the decline in global demand and the sudden contraction of financial institutions' funds supply led to a plunge in commodity prices. That, through a decline in the prices of foods and petroleum products, such as gasoline and kerosene, reflecting a decline in import prices, exerted downward pressure on overall prices. The main reason why the rate of decline in the overall prices accelerated toward the summer of 2009 was that the plunge in commodity prices affected the prices with a time lag. Since then, however, commodity prices have been picking up as the global economy and financial markets have restored stability. Recently, prices of petroleum products are putting somewhat upward pressure on the overall prices. As such, the developments in commodity prices have affected Japan's prices substantially for the past one to two years.

The balance of aggregate supply and demand in the economy, the second factor, has been affecting the trend of price developments. Since the autumn of 2008, the economic downturn induced a state in which demand is well short of supply. Therefore, not only the prices of petroleum products and foods but also the prices of wide-ranging products declined. Of the items surveyed in compiling consumer prices, 60 to 70 percent registered a decline. While Japan's economy has been picking up during the past year, a significant imbalance between demand and supply has been continuing, reflecting the plunge in economic activity preceding the pick-up. Japan's economy is expected to continue improving, but given that the pace of improvement is likely to remain moderate, downward pressure on prices will persist for the time being. The Bank's outlook projects that the rate of change in the CPI, year on year, will remain slightly negative until fiscal 2011, although the pace of decline will continue to moderate.

While I have mentioned two factors that affect price developments, there is another important factor. That is people's view of future prices, or, put simply, price perspective. In the real world, many prices are set on a daily basis. Not to mention the prices of products and services, wages, which are compensation for labor, are also a type of prices. The outlook for prices will also have an effect on determining those prices. For example, if a view is entrenched that prices will decline significantly, such view will put downward pressure on the determination of actual prices and wages.

While people's price perspective is an important factor, one cannot directly observe firms' and households' views on prices. Therefore, the Bank tries to analyze and gauge such views by using various forms of research, including its own surveys, and financial market data. In light of such analysis, it is judged that firms' and households' medium- to long-term price expectations have not changed substantially.

I have so far explained the current state and outlook for prices. However, like the outlook for economic activity, the outlook for prices is also associated with various uncertainties. If you look at quite recent CPI developments, a pace that the decline in prices moderates seems to have been somewhat slower compared with the extent of improvement in the aggregate balance between supply and demand, although it is difficult to accurately gauge such aggregate balance. Moreover, since the constant price decline, namely deflation, has been persisting, whether the view on prices might shift downward warrants due attention. Inclusive of that point, the Bank will carefully check future price developments.

Issues regarding deflation

Now, I will briefly talk about the “deflation issue.”

The fundamental cause of deflation is deterioration in the balance between demand and supply. Somewhat metaphorically, prices are compared to the temperature of the economy. If we follow this metaphor, deflation, that is a situation in which the temperature of the economy has fallen, reflects the fact that the physical fitness of Japan’s economy has declined. Attention should not only be paid to deflation as an outcome, but also to the risk that deflation may deteriorate economic activity. Recently, it seems to me that there are increasing examples of discussions that relate various economic problems to deflation. Therefore, it is all the more important to carefully discuss what adverse affects deflation might have on the economy.

There are some problems that deflation can cause in the economy. For example, from the perspective of a central bank, there is a problem of the so-called “zero interest rate bound,” which is the problem that monetary policy actions are constrained since interest rates cannot be reduced to below zero. Today, I will discuss somewhat in detail the deflation issue particularly in terms of corporate management.

Since the cause of deflation is a lack in demand, sales will inevitably fall in volume. A fall in the prices of products, together with such a fall in the volume of sales, will substantially reduce firms’ sales. Of course, if firms manage to correspondingly reduce production costs and fixed costs, profits – the most important element in corporate management – will be secured despite a decline in sales.

The problem lies in the fact that reduction on various costs is difficult. Economic history reveals episodes in which deflation further aggravated economic deterioration. Such episodes show that, given that ex-post reduction in the nominal amount of corporate debts was difficult, economic activity deteriorated further through pressure on corporate profits and increase in the burden to repay debts.

Another problem is that a decline in sales and corporate profits might contract firms’ future growth expectations and firms might tend to refrain from challenging new business fixed investment or technological innovation. Famous U.K. economist John Maynard Keynes expressed entrepreneurs’ challenging spirit as “animal spirit.” In the economy under deflation, it becomes difficult to secure such animal spirit. For example, under deflation, firms tend to focus more on how to increase the price competitiveness of the existing products rather than developing a new field. We should recognize that such price competitiveness alone will make it difficult to gain momentum for growth.

So far I have pointed out, from the perspective of corporate management, several possibilities that deflation itself might induce deterioration in economic activity. To get back to what I was referring to the temperature of the economy, we are aware not only of a decline in temperature owing to bad health but also of a risk that a decline in temperature might worsen illness. The existence of such risk is what makes overcoming deflation all the more important.

To overcome deflation, it is necessary to consistently continue with therapy for the fundamental cause of a demand shortage. At the same time, to avoid creating a situation in

which the economy will be aggravated, originating from deflation, that is, deflation inducing deflation, it is important to act on firms so that their business sentiment will not weaken. In doing so, a key will be the recovery in private demand, including business fixed investment and household consumption. Raising firms' growth expectations will be the basic premise for the recovery, as I mentioned earlier. In that regard, the challenge of overcoming deflation is directly linked with the challenge for Japan's economy in a longer perspective.

III. Medium- to long-term challenge confronting Japan's economy

Japan's longer-term challenge is to regain the confidence of firms and households in the outlook for Japan's economy in the long term. To achieve this, we must discuss the issue of where to find Japan's source of energy to achieve sustainable growth over the long term.

It seems to me that those issues are frequently discussed by dividing demand into two large categories, namely domestic demand and external demand, and considering which of the two is of greater importance. In doing so, the phase of economic expansion from 2002 is often cited. Since the driving force for economic activity during this phase was the substantial increase in exports, it tended to give the impression that Japan's economy was led by external demand. The major reason why this phase of economic expansion ended was the sharp deterioration in overseas economies triggered by the failure of Lehman Brothers in the autumn of 2008. From that experience, what tends to be drawn out is a lesson that economic growth led by domestic demand is desirable rather than vulnerable economic growth that is dependent on overseas economies. However, we should not neglect the fact that, even though the economic expansion from 2002 originated from exports, there was active business fixed investment aimed at exports. Moreover, through the effect of creating employment and wealth effects from rising stock prices, private consumption also increased. In that light, I believe that we should not make a simple choice between domestic and external demand, but rather we should see them as two mutually important elements for growth, including their transmission mechanisms.

Currently, Asia is increasing its presence as the growth center of the global economy. Japan has a considerable advantage that it is closely located to the area with great growth momentum. To make the most of the benefits from globalization and capture demand from the area that is growing strikingly are the shortcut for Japan in gaining the energy for economic growth. There are also views that pay attention to the negative connotations of globalization, such as severe competition with overseas products and shift of production bases to overseas by business counterparts. However, income gained through globalization has been invested domestically, and as a result, it has exerted positive effects on the domestic economy, too. I believe that it is necessary not to turn away from globalization by claiming its negative aspects only, and to actually take globalization positively, actively taking its advantages.

The next question is how to capture the benefits from growth in overseas economies. To that end, it is important to increase exports to growing markets, such as those in Asia. In emerging economies, huge markets are being formed. From now on, as people's level of income increases further, the level of products and services that people seek is also likely to rise. This is a great opportunity for Japan, given its strength in relatively high-end products. It should be noted that the areas in which growth is expected are not limited to durable consumer goods and general machinery, which have been Japan's major exporting items, or the environment-related areas, where Japan currently takes the lead in technology. For example, quality agricultural products or unique local specialties are the areas in which potential demand is great. Also, while it may be difficult to conjure from the word "exports," tourism, which invites foreign tourists to Japan, also means exporting added value in the form of services. Considering these points, I believe that the areas that are rich in tourism resources have potential for high growth.

Moreover, there are other channels for capturing the benefits from overseas economies. Especially, profits from overseas investment are increasing substantially. If firms manage to tailor production technologies, which have been fostered in the severe environment for competition in Japan, and detailed services, such as logistics and retails that have responded to the high requirements of consumers in Japan, to the needs of overseas local markets, there is sufficient room for further raising their profitability.

Of course, it is also necessary to use the energy for growth, captured from overseas economies through these channels, to activate the domestic economy. In years to come, amid the low birth rate and the aging population, Japan will face an unprecedented shrinkage of population that no other country has experienced. If we look only at this aspect, it will be a burden in activating the domestic market. At the same time, however, there are business opportunities brought about by changes in the demographics. In this light, businesses targeted at the elderly, not only in terms of medical care and welfare, but also development of products and services tailored to the needs of the elderly, have substantial potential for expansion and diversification. I believe that there remains sufficient room for potential growth in Japan.

The question is how to convert growth potential into actual growth. This cannot be achieved without firms' technological innovations in accordance with changes in the demand structure. At the same time, I emphasize the significance of the roles of the finance and policy authorities in supporting firms' efforts to this end.

For example, to survive in growing markets, particularly those in Asia, firms around the world are fiercely competing against each other. In this situation, Japanese firms have the strength since their technological skills are high to start with and, assured by such skills, the quality of their products is also high. However, unless such strength matches the needs from new markets, it will not be possible to fully capture potential demand. Firms need to make technological innovations in various aspects, including thorough market research and price-setting strategies, in addition to product development. I used the term "technological innovations" to refer to the overall corporate efforts to capture such potential demand.

From the viewpoint of firms, the promotion of technological innovations means that there will be correspondingly additional costs, since they will need to invest in human and management resources. Looking back, since the 1990s, the growth rate of the economy and the inflation rate have remained low in Japan. And, while low interest rates continued for a prolonged period and large-scale public investments were implemented constantly, the metabolism of the economy tended to be low, and some firms and parts of the corporate sector with low productivity remained. As a result, firms' profit expectations overall seem to have declined, preventing their endeavors to promote drastic technological innovation. I believe it will also be necessary to reconsider what factors are needed to be effective in further encouraging firms' attempts to achieve technological innovations.

As a factor that will support firms' efforts toward technological innovations, I believe that finance plays one of the crucial roles. The basic function of finance is to search for businesses and projects with prospects, and allocate funds to them. For firms, who are the borrowers, the hurdle in embarking on a new business will be less difficult as they can gain funds from financial institutions and financial markets. At the same time, it is important for the financial side to encourage firms' efforts in improving profitability, by setting lending standards that correspond to projects with low profitability. There are many small firms with high technological skills in Japan. Surveys on firms show that the smaller the size of business, the more firms that answer that their financial positions are weak. If their technological skills are not fully used due to financial constraints, it will cause a significant loss for the overall economy, too. Therefore, I hope that financial institutions will make careful assessments and facilitate the smooth provision of funds to businesses and projects with prospects.

Of course, the authorities also play important roles. During the process in which firms promote technological innovation, not all the cases will lead to success. Moreover, if a sector grows by introducing new technologies, behind that might be a sector that has been left behind from the wave of technological innovation. For the economy as a whole, it is necessary that, through such a process, human resources and funds are transferred smoothly to more growing areas. However, it is not always true that a person who worked in a different area until yesterday can easily adapt to a new environment today. In that regard, I believe that the policy authorities should work to enhance economic metabolism through the smooth transfer of human and management resources, and to prepare a safety net to alleviate potential friction associated with such transfers.

IV. The role of the Bank of Japan

I have explained the challenges confronting Japan's economy. Those challenges should be tackled steadily by private firms and the authorities from their respective standpoints. Of course, the Bank should also play an important role in that context.

For the immediate challenge of overcoming deflation, the Bank considers the following two approaches as important and is steadily carrying them out.

The first is to aim at removing the fundamental cause of deflation. That means to resolve the disparity between supply and demand in a sustainable manner. Based on such a viewpoint, the Bank has been implementing drastic monetary easing.

The target level of the policy rate, an overnight interest rate, was reduced to 0.1 percent in December 2008 and has remained there since then. The 0.1 percent level of effectively zero interest rate is currently the lowest policy rate among central banks around the globe. Moreover, in December 2009, the Bank introduced a new funds-supplying operation to encourage a further decline in longer-term interest rates in the money market through provision of ample funds. As a result, the effectively zero interest rate is spreading to funds with even longer maturities. Through implementing those measures, the Bank aims at preparing an extremely accommodative financial environment and thereby promoting firms' capital investment and household consumption.

The other approach is to prevent people's view on prices from worsening. In that regard, the Bank further clarified the stance that it is important to achieve a state that the year-on-year rate of change in the CPI is positive. That is part of the approach to stabilizing people's view on prices.

For Japan's economy to overcome deflation and return to a sustainable growth path with price stability, the Bank will continue to consistently make contributions. And, if judged necessary, due, for example, to economic and price developments as well as changes in financial conditions, the Bank is always prepared to implement appropriate measures at an appropriate timing.

Moreover, as for the other medium- to long-term challenge of exploring a long-term vision of Japan's economy, the best contribution the Bank can make as a central bank will be to support the economy in achieving a sustainable growth with price stability. The Bank will strive to achieve economic and price conditions in which there is little future uncertainty, so that firms can actively expand their business with confidence.

Concluding remarks

I have been explaining Japan's economic conditions and the challenges confronting Japan. To conclude, let me talk about my impression about Kagoshima's economy.

Kagoshima's industrial structure may be characterized by the fact that the weight of export-related firms are little, compared with the national average, while that of the agriculture,

forestry, and fisheries industry and the construction industry is considerable. For that reason, it might perhaps be difficult to feel the pick-up in the economy originating from exports. In fact, I have been informed that, through interviews by the Bank's Kagoshima branch, many firms recognize the lagging improvement in the business environment, and express concern about the outlook for the economy.

Nevertheless, room for potential growth in this region is by no means small. First of all, this region has a big advantage over other regions in Japan since it is close to the growing East Asian region. For example, I have heard that efforts are being made to deepen the Shibushi port-based trade relationship with Asian countries. Since Asian countries are expected to continue to grow, Kagoshima has a great chance to make a leap forward through expansion of sales channels to these markets, and research on markets needs as well as development of products tailored to such needs. Kagoshima also has high potential for growth in exploring tourism demand from other areas in Japan as well as the Asian region since it is blessed with rich tourism resources such as a world heritage and many hot spring resorts. On this point, the start of Kyushu *shinkansen* line's full service will largely help to invite tourists from both within Japan as well as overseas.

Above all, Kagoshima's strength lies in its rich specialties, as represented by livestock products and liquor. I have heard that Kagoshima has been making a prefecture-wide agricultural promotion based on the key words of "foods and agriculture," and it is expected that such efforts will pay off. Those specialties will be traced back to various painstaking efforts to overcome severe agricultural conditions of volcanic ash soil. People of the region have overcome unfavorable conditions through various devices and have achieved the growth in Kagoshima's economy. That overlaps what is required for Japan's economy in the years to come. I hope that you will further make forward-looking efforts in search of new opportunities.

The Bank will also make consistent efforts so that firms can have bright visions toward the future.