Hidetoshi Kamezaki: Recent economic and financial developments in Japan

Speech by Mr Hidetoshi Kamezaki, Member of the Policy Board of the Bank of Japan, at a meeting with Business Leaders, Kochi, 25 March 2010.

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I. Economic developments

A. Global economy

First, let me provide an overview of economic developments worldwide until recently.

After the global economic slowdown due to the bursting of the IT bubble and the confusion over the severe acute respiratory syndrome (SARS) in the early 2000s, the global economy enjoyed a period of high growth led by strong demand from emerging economies. Industrialized countries also maintained relatively high growth, as the prolonged period of low interest rates stimulated investment and consumption. However, in the United States, amid the declining risk awareness among investors, loans to borrowers with a deficient credit history – that is, subprime mortgages – were extended based on the assumption of ever-growing home prices. Housing investment consequently increased, pushing up home prices further, which in turn encouraged homeowners both to take out loans using their houses as collateral, and to boost their spending. Behind this phenomenon, European and U.S. financial institutions purchased and pooled a large number of mortgage claims, restructured them into securitized products – for which credit ratings appeared high as a result of financial engineering – and then sold those products to investors worldwide.

However, when U.S. home prices started to fall after reaching a peak around the middle of 2006, the virtuous circle based on the assumption of ever-growing home prices began to reverse. U.S. households that borrowed beyond their means defaulted on their payment obligations, while there was a marked increase in the losses suffered by European and U.S. financial institutions as well as investors worldwide that had purchased mortgage-related securitized products, all as result of the decreased creditworthiness of mortgage-related products that backed those securitized products. This brought about the turmoil in European and U.S. financial markets around summer 2007, and against this background, the failure of Lehman Brothers in September 2008 triggered the global financial crisis. It led to a vicious circle – that is, an adverse feedback loop between financial and economic activity – in which the difficulties and failures of financial institutions and the turmoil in financial markets left funding for firms and households unstable, while the resultant deterioration in economic activity in turn had a negative impact on financial institutions and markets. In this phase, global economic conditions, including those of emerging economies, deteriorated substantially, although just before the emergence of the global financial crisis, it was widely acknowledged that there had been a decoupling between the economic slowdown in industrialized countries and the strength in emerging economies.

The subsequent aggressive monetary and fiscal policies taken around the world to support the economy helped initiate progress in the adjustment of excessive inventories, starting around spring 2009. Since then, the global economy as a whole – despite some national and regional differences – stopped worsening and headed toward a moderate recovery.

Looking at developments by region, the U.S. economy was recovering, albeit at a moderate pace, supported by the 780 billion U.S. dollar stimulus package and a rescue package for financial institutions that faced financial difficulties. However, there has been no notable improvement in weak areas of the economy, such as housing markets, commercial real estate markets, employment, and small financial institutions' business conditions. Therefore, there is concern that adjustments made by various economic entities to still-fragile balance sheets might continue to be a drag on economic growth.

In the euro area, albeit with some national differences, economic activity is picking up, supported by an increase in exports led by the global economic recovery. However, the pace of recovery in domestic demand is lagging, mainly due to weak private consumption reflecting anxiety about employment in the future. In particular, the expanding fiscal deficits in some countries, such as Greece, Spain, and Portugal, has caused concern in financial markets, thereby putting downward pressure on the economy in the euro area as a whole. Since all European Union member states, including these countries, are required to reduce fiscal expenditures as laid down in the Stability and Growth Pact, I will pay attention to future economic developments in the area, including the effects of expenditure reduction efforts. The U.K. economic activity has started to pick up, mainly due to an increase in exports boosted by the depreciation of the pound sterling.

In Asia, the Chinese economy has continued to grow at a relatively rapid pace, mainly because of the hike in fixed asset investment due to the 4 trillion renminbi stimulus measure adopted immediately after the Lehman shock. China's exports have also been growing recently, owing to the global economic recovery. The current concern, therefore, relates to the overheating of the economy, and the authorities have started to implement measures to restrain this. The economy is unlikely to decelerate in 2010, however, partly because of the effects of the World Exposition to be held in Shanghai. Nonetheless, if the measures to restrain overheating are insufficient, attention should be paid to the possibility that the rise in real estate prices might accelerate further, driving the economy into a full-scale bubble. Economic conditions in the NIEs and the ASEAN countries are recovering as a result of increased exports and production – supported mainly by demand from China – which are leading to improvement in private consumption and a pick-up in business fixed investment. The Indian economy has also continued to grow at a relatively rapid pace, with its exports and domestic demand being generally favorable.

In sum, the global economy as a whole is experiencing a moderate recovery, a trend that is likely to continue despite there being various risks. Yet, the contrast between the situations in industrialized countries and in emerging and commodity-exporting economies is likely to become even more striking. Specifically, in industrialized countries, the momentum of self-sustaining economic recovery is likely to be only moderate due to strong adjustment pressure persisting on various economic entities' balance sheets, while in the emerging and commodity-exporting economies, where there is no such pressure, strong growth has been achieved partly due to an indirect effect of fiscal and monetary policies taken around the world.

B. Japan's economy

I will now turn to Japan's economy.

The post-bubble period of Japan's economy is often referred to as the "lost decade" or the "15 lost years," but the economy actually experienced three phases of expansion during the period. In particular, the expansionary phase that began in 2002 lasted more than five years, marking the longest period of postwar expansion, supported by the high growth in the global economy. However, in autumn 2007, Japan's economy fell into a contraction phase, reflecting the downturn in the U.S. economy. Japan's economy then deteriorated rapidly, as if rolling downhill, following the turmoil in the financial markets triggered by the Lehman shock and the subsequent steep decline in exports and production.

Several points could be noted as reasons for the economy of Japan having deteriorated far more severely than that of the United States and Europe where the recent financial crisis originated. First, Japan's economy was hit hard by the downturn in the global economy because manufacturing industries of durable goods, such as general machinery, electrical machinery, and transport equipment, account for a large share of the overall economy, and the ratio of exports in such industries is high. Second, these manufacturing industries are linked to a wide range of domestic industries, and therefore the fall in exports broadly affected domestic industries, including those that do not directly engage in export-related activities.

Since then, as the global economy has stopped worsening and is headed toward recovery, Japan's exports and production hit bottom at the beginning of 2009, since when it has been recovering, mainly in the area of items meeting demand from China. Japan's economy has ceased to deteriorate and started to pick up, despite the increasingly severe employment and income situation, on the realization of the positive effects of the government's stimulus measures that favor energy-efficient products, such as tax reductions applied to purchases of environment-friendly cars and the eco-point system for electrical appliances. However, there has not yet been sufficient momentum for self-sustaining recovery in domestic private final demand.

In terms of economic outlook, it is expected that the effects of inventory restocking and policy measures, which have been driving growth, gradually will abate. Against this background and given the severe employment and income situation, there may be a leveling off in the area of private consumption, which has been picking up recently. Meanwhile, business fixed investment is likely to pick up gradually as firms can no longer postpone investment plans, especially in light of pressing replacement demand.

In sum, I expect that the trend toward gradual economic recovery will continue. The situation warrants careful attention, however, as many firms remain cautious about increasing domestic investment and employment due to uncertainty concerning the outlook.

II. Price developments in Japan

A. The recent situation and the outlook

Next, I will talk about price developments against the background of the recent economic situation I have just described. International commodity prices, which have a major impact on Japan's domestic prices, surged at the start of the new century as commodity markets tightened due to strong demand from and robust growth in emerging economies, compounded by an inflow of speculative funds. Commodity prices then plunged as a result of the rapid unwinding of speculative funds from commodity markets, prompted by the Lehman shock and the subsequent financial market turmoil and global economic deterioration. These commodity prices, however, have since resumed an upward trend in response to the recent moderate recovery in the global economy.

Some items in the consumer price index (CPI) excluding fresh food (the core CPI), such as the prices of petroleum products and food, started to show a definite rise around the end of 2007, reflecting the surge in international commodity prices. In the middle of 2008, the year-on-year rate of increase in the core CPI was around 2.5 percent, marking the largest rise since the early 1990s if we exclude the effect of the 1997 consumption tax increase. Subsequently, commodity prices fell, causing the year-on-year rate of change in the core CPI to a decline. In summer 2009, the rate of decline in the core CPI hit roughly 2.5 percent, marking the sharpest fall ever. The pace of decline in the core CPI has recently been moderating, underpinned by the rise in prices of petroleum products. However, in January the CPI excluding food and energy, or the core-core CPI, which is not usually susceptible to fluctuations in commodity prices, fell 1.2 percent year on year, marking the largest drop so far.

Regarding the outlook, the pace of decline in the core CPI is expected to slow, as the robust economic growth in emerging economies is likely to keep commodity prices high and the negative output gap is likely to narrow as the economy recovers. However, it is unlikely that an upturn in the trend of the core CPI will be achieved easily, since: the negative output gap has been narrowing only moderately; there have been declines in both the inflation rate currently perceived by households and that expected twelve months out; and the proportion of households expecting prices to be lower in a year's time has increased. Such perceptions could affect firms' price-setting behavior.

B. The cause of deflation

Japan's economy is currently experiencing deflation, a sustained decline in the general price level. While the inflation rates in major economies have been declining since the 1990s and marked a further fall after the Lehman shock, it is only in Japan that inflation has marked a high negative rate in terms of the core-core CPI.

1. Output gap

One cause of deflation in Japan is its large negative output gap. When demand falls well short of supply capacity for products, suppliers may opt to restrain rises in sales prices, or reduce prices, to attain sales volumes. If this happens across the economy, the inflation rate will falter. According to an International Monetary Fund (IMF) projection in the *World Economic Outlook*, the output gap in Japan has remained consistently negative since the second half of the 1990s, albeit with some cyclical fluctuations, and has been larger than in other major economies. I believe this can be attributed to the excess supply capacity – a legacy of the insufficient restructuring of industries, including their production facilities – that remained out of line with sluggish domestic demand.

There are a number of reasons for the weakness in domestic demand, but the major one is the lack of forward-looking investment since the bursting of the economic bubble, as a result of the prolonged balance-sheet adjustments conducted by various economic entities. In particular, the delay in financial institutions' disposal of impaired assets has weakened their financial intermediary functions, thereby impairing their ability to provide sufficient funds for new areas of growth. Although balance-sheet adjustments had been progressing significantly from around 2005, the Lehman shock, which occurred before such adjustments had been completed, triggered a plunge in overseas demand and, subsequently, a rapid widening of the negative output gap, which in turn led to the present deflationary situation.

2. Inflation expectations

Although movements of the output gap and the inflation rate do not show a clear correlation, a close look at data of the past phases reveals that a widening of the negative output gap was followed by a decline in the inflation rate. However, over the long term, the actual inflation rate has edged down even when the output gap has remained at the same level. It is assumed that this is due to a decline in the medium- to long-term inflation expectations among various economic entities. No one would rush to buy a product when he/she expects its price to fall or remain almost unchanged. In such a situation, suppliers would set lower prices to stimulate consumers' spending appetite. If this trend spreads across the economy, the actual inflation rate will decline even when the output gap is at the same level.

The reason for the decline in medium- to long-term inflation expectations in the period from the 1970s to the first half of the 1990s is that a rise in the prices of goods and services, together with inflation expectations for the general price level, were contained by a combination of factors such as stable crude oil prices, the continued appreciation of the yen and resultant pressure to reduce the difference between domestic and foreign prices, as well as deregulation and other measures to promote competition.

Nevertheless, since the latter half of the 1990s, the correlation between the output gap and the actual inflation rate has been stable. At present, it seems that there is no major change in medium- to long-term inflation expectations. However, as I noted earlier, there has been a decline in the inflation rate that households anticipate twelve months out, and the proportion of households expecting prices to be lower in a year's time has increased. If such a view leads to a decline in medium- to long-term inflation expectations, it could become difficult to overcome deflation. Therefore, a change in inflation expectations is an important factor that requires careful monitoring.

C. The cost of deflation

The main reason for Japan's current deflationary situation is the widening of the negative output gap. Deflation is disadvantageous for suppliers of goods and services but advantageous for consumers. This phenomenon seems like a zero-sum game on the surface, so, why is deflation said to have negative effects on the economy?

Price fluctuations, whether declines or otherwise, give rise to extra costs for society. For example, sales price revisions incur costs for deliberations and negotiations prior to settling on a price, and then for changing price tags. Such extra costs must be borne by some entities within the economy. Furthermore, price revisions for a large number of products at varying times and differing scales could hinder the efficient allocation of economic resources, while uncertainty regarding price fluctuations would also add risk premiums to transactional costs. In some cases, it might become difficult to conclude long-term contracts, thereby affecting plans for consumption and investment. In addition, if price fluctuations cause a change in the value of financial assets and liabilities that are fixed in nominal terms, or in the real value of transactions and wages, distortions would arise in income distribution. Such distortions would give rise to a sense of unfairness among those in different functional roles, such as lenders and borrowers, or employers and employees. The possible loss of trust in social fairness and equality would affect work ethic and incentives.

One of the costs unique to deflation is that real interest rates cannot decline to the level corresponding to that of economic activity, since nominal interest rates do not fall below zero. Furthermore, a rise in the real value of debt and the resultant increase in the burden on the debtor may eventually lead to economic deterioration. In such a case, the real value of creditors' assets would increase, but, since debtors' propensity to consume out of income is generally higher than creditors', consumption in the overall economy would shrink. Therefore, attention should be paid to the fact that there are costs unique to deflation.

III. Measures taken by the Bank

The Bank is gradually ending the measures that have been implemented to deal with the "acute symptoms" manifested in the rapid contraction of financial market activity following the Lehman shock in September 2008. At the same time, the Bank is putting forward additional measures to dispel "chronic illness," namely deflation. Next, I will elaborate on the Bank's monetary policy measures implemented since the Lehman shock.

A. Measures to address the acute symptoms, or the rapid financial contraction

Immediately after the failure of Lehman Brothers, financial market participants throughout the world became overly cautious about their counterparts' creditworthiness, and there were cases where even financially sound institutions found it difficult to acquire funds. During such a rapid financial contraction, which we have described as acute symptoms, a central bank is the sole provider of liquidity. Thus, from the day after the failure of Lehman Brothers, the Bank successively injected abundant liquidity into the money market by conducting same-day funds-supplying operations. Subsequently, it implemented measures to provide ample liquidity to financial markets, such as increasing the amount of outright purchases of Japanese government bonds and introducing U.S. dollar funds-supplying operations against pooled collateral.

In Japan, it was the CP market that faced a particularly serious shortage of liquidity as market participants withdrew their funds from the market, fearing the risk of corporate failures. Firms that could no longer acquire funds through CP issuance flocked to banks for financing. As banks tried to respond to the increased demand for loans, they found themselves unable to afford to supply sufficient funds for small firms or firms with low credit ratings, or for repo transactions. In this way, the liquidity shortage spread to various markets. To address this situation, the Bank, in addition to increasing the frequency and size of CP repo operations, introduced outright purchases of CP as a temporary measure. This was a highly exceptional step, in that a central bank took on the credit risks of individual private firms. The underlying objective was to facilitate corporate financing and resolve the liquidity shortage in the CP market by helping to restore confidence in CP underwriting among market participants. In addition, the Bank introduced a series of temporary emergency measures to facilitate corporate financing, including: (1) the easing of the rating requirement for corporate debt to be accepted as eligible collateral; (2) the special funds-supplying operation to facilitate corporate financing (hereafter the special operation), through which the Bank provided longer-term funds for an unlimited amount against the value of corporate debt pledged as collateral at a very low fixed interest rate; and (3) outright purchases of corporate bonds with a short residual maturity.

Furthermore, in order to ensure the accommodative financial environment, the Bank reduced the policy interest rate – that is, the uncollateralized overnight call rate – from 0.5 percent to 0.1 percent, which is the lowest level in the world. In order to provide ample liquidity through maintaining the policy interest rate at this low level, the Bank also introduced the complementary deposit facility, whereby interest is made payable on excess reserve balances held at the Bank by financial institutions.

At the same time, the Bank introduced temporary measures to secure the stability of the financial system, given that the strains in global financial markets and the subsequent fall in stock prices and rise in credit costs have greatly affected financial institutions' intermediary function and financial soundness. Such measures include the stock purchases held by financial institutions to help them reduce the market risk associated with stock holdings and the provision of subordinated loans to banks to help them maintain sufficient capital bases.

B. Completion of measures to address acute symptoms after markets regained stability

Subsequently, as the economy stopped worsening and headed toward recovery, while financial markets regained stability, the amount of financial institutions' bids for central bank funds started to fall short of the offered amount in the Bank's outright purchases of CP and corporate bonds. In the CP market in particular, the issuance rates on high-rated CP occasionally fell below yields on treasury bills, which in theory must command greater creditworthiness. Furthermore, auction rates on ordinary funds-supplying operations tended to decrease to such low levels that the advantages of the relatively low rates offered in the special operation were eliminated. As a result, the Bank decided to end some of the temporary measures adopted to deal with the acute symptoms. For instance, the Bank decided in October 2009 to complete outright purchases of CP and corporate bonds, as well as the special operation, at the end of December 2009 and March 2010, respectively.

C. Measures to address chronic illness, or deflation

The Bank is firmly committed to continuing its policy of maintaining the extremely accommodative financial environment, given the moderate pace of economic recovery and weak momentum for price increases. In fact, the policy interest rate is being maintained at a low level of 0.1 percent and the complementary deposit facility remains in operation. Furthermore, on December 1, 2009, in order to enhance easy monetary conditions, the Bank introduced a new fixed-rate funds-supplying operation against pooled collateral (hereafter the fixed-rate operation), whereby a large amount of funds totaling approximately 10 trillion yen are to be provided at an extremely low fixed interest rate. This operation has contributed to encouraging a decline in longer-term interest rates. On March 17, 2010, the Bank decided to expand the measure to encourage a decline in these rates by increasing the amount of funds to be provided through the fixed-rate operation to approximately 20 trillion yen, from the previous amount of approximately 10 trillion yen.

Meanwhile, the Bank emphasized its stance on fighting deflation. Regarding the "understanding of medium- to long-term price stability" (the level of inflation that each Policy Board member understands, when conducting monetary policy, as being consistent with price stability over the medium to long term; hereafter "understanding"), the Bank made it clear that the Policy Board does not tolerate a year-on-year rate of change in the CPI equal to or below 0 percent, and that the midpoints of most Policy Board members' "understanding" are around 1 percent.

IV. Moving toward sustainable economic growth

As I have just explained, the Bank is making use of various policy tools to maintain the extremely accommodative financial environment to overcome deflation. In the money market, the interest rates applied for the Bank's funds-supplying operations have declined to 0.1 percent, and there are even cases in which financial institutions' bids fall short of the Bank's offers. Market participants have become increasingly confident that they can acquire sufficient funds at a low interest rate. Various types of interest rates have declined, including those for funds transactions between financial institutions, market rates on Japanese government securities, corporate bonds, and CP, as well as loans extended to firms and households. It is hoped that the effects of monetary easing will further spread to other types of interest rates, encourage vigorous activity by various economic entities, and in due course lead to economic growth. However, a decline in interest rates alone may not be enough to stimulate activity by private sector entities, namely, firms and households, and thereby raise the level of overall economic activity.

So, what is necessary to encourage vigorous activity on the part of firms and households? My belief is that the various economic entities need to free themselves from concerns about the future and regain confidence in their ability to achieve sustainable economic growth. In the post-World War II period, Japan has achieved high economic growth supported by the continuous efforts of the Japanese people, who are hard-working by nature, and the belief that they could achieve their high aim of catching up to the economic standards of European countries and the United States. Yet, it seems that the Japanese people were unable to set a new target once the goal of catching up had been achieved, and the ambition to achieve further economic growth has weakened. This may be a factor behind the significant economic slowdown since the 1990s.

In this situation, the government's "New Growth Strategy (Basic Policies)" released in December 2009 is very meaningful, as it presents the objective with which the public would seek to achieve sustainable economic growth. The measures laid down in the new policies include Asia-focused strategies geared to benefit from growth in Asian markets; measures to boost domestic demand – an issue requiring immediate action – with particular focus on sectors related to environmental protection, energy, and an aging population with fewer children, as well as farming and other food-related sectors. This is very much in line with my viewpoint, as neglecting these sectors would inevitably lead to a decline in Japan's overall economic strength, whereas proper attention would surely lead to the development of promising businesses within these sectors. However, concrete plans for the new policies have not yet been announced. I understand that such plans will be provided in the "Growth Strategy Implementation Plan," which is scheduled to be released by June 2010 with more specific and additional measures. I look forward to the release of the effective plans, so that concrete measures aimed at new economic growth can be set in motion as early as possible.

Growth strategies – however ideal they might appear – can only serve to raise suspicions regarding future sustainable growth, as well as add to the fears of fiscal bankruptcy and a large increase in taxation, if they result in a further ballooning of the fiscal deficit, because

Japan suffers from by far the largest government debt of any industrialized country. Thus, it is very important that the government's medium-term fiscal framework and fiscal management strategy, also to be ready by June 2010, include measures to establish a sustainable fiscal structure and present fiscal restructuring measures to ensure future economic and fiscal soundness, thereby maintaining market confidence.

I am always aware that the Bank should implement policy measures proactively when necessary, and its decision on March 17, 2010 to take an additional measure to enhance easy monetary conditions was based on such thinking. The Bank will continue to make the utmost effort to encourage various economic entities to regain confidence in their ability to attain sustainable economic growth.