

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, Toyama, 21 July 2010.

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Introduction

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

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

Before exchanging views with you, I will talk about the recent economic and financial developments as well as the conduct of monetary policy.

I. Global economic developments

Advanced economies and the balance-sheet problem

Before talking about Japan's economy, I will begin with the developments in the global economy.

In the past several years, the global economy experienced a great turmoil. On the financial front, starting with the subprime mortgage problem in the U.S. housing market, the global financial crisis broke out in the autumn of 2008, triggered by the failure of Lehman Brothers. Hand in hand with that, the global economy deteriorated rapidly and significantly. Since the spring of 2009, the global economy has been emerging from such plunge. However, the improvement in economic conditions in the United States and Europe has been modest, and international financial markets have recently become increasingly volatile triggered by the fiscal problem in Greece and some European countries.

The financial crisis and the fiscal problem I have just mentioned might seem to be a different phenomenon at a glance, but, in fact, they have a common underlying factor that has shaped a big picture of the global economy in the past several years. That was the problem of "balance-sheet adjustment" associated with the burst of a credit bubble in the United States and Europe. In those economies, toward the mid-2000s, households and firms made excessive borrowing on the premise that asset prices such as housing Prices would rise and, in retrospect, made excessive investments and consumption. In response, financial institutions lent aggressively and continued to increase credit. In such a process, not only mortgages but also financial activity in general overheated, including new types of transactions such as in securitized products. Such phenomenon has spread internationally and capital inflows to European peripheral countries, including recently highlighted Greece, have overheated. Such developments were reversed rapidly once asset prices such as housing prices started to fall. In those circumstances, households and firms had to cut back on their consumption and investments to reduce their borrowing that had accumulated, namely to repair the impaired balance sheets. Moreover, financial institutions had to struggle with the disposal of massive impaired assets, and were thus forced to take a cautious stance in new lending. That was exactly a process of balance-sheet adjustment Japan suffered in the 1990s after the burst of the bubble economy.

When the economy shoulders such a problem, its effects would manifest themselves in two ways. First is the so-called "chronic symptom" and strong downward pressure would continue

to be put on financial markets and the economy until there appear prospects for balance-sheet adjustments to complete. The other is a sudden change in conditions triggered by some factors. The global financial crisis following the failure of Lehman Brothers was indeed a shock that corresponded to such “acute symptom.” While the economies in the United States and Europe have managed to recover from the “acute symptom,” thanks to various policy measures by the national governments and central banks around the globe, it can be said that the “chronic symptom” still weighs heavily on those economies.

Here, let me touch on the recently highlighted issue of concern over fiscal deterioration, which is called sovereign risk using the word sovereign that means nation. While the Greek problem has been taken up in this connection, fiscal deficits in Greece did not worsen all of a sudden. The fact was that the massive borrowing from overseas Greece made in excess of its capacity amid the global investment boom toward the mid-2000s has surfaced following the burst of the credit bubble. Although the sheer size of the Greek economy is only some 2 percent of the European economy, it generated a connotation in the market that there might be other countries that have also heavily been relying on unrealistic external borrowing. As a result, in the financial markets, the creditworthiness of the government bonds issued by those countries has declined, leading to a hike in interest rates and concern over adverse effects on financial institutions that held those government bonds. Meanwhile, the fiscal balance in the major advanced economies in the United States and Europe also deteriorated rapidly in the process of crisis responses, since they increased fiscal spending significantly by assuming risks and debts of the private financial institutions that were suffering from balance-sheet adjustments. Through the responses to the crisis, the problem of balance-sheet adjustments has partly shifted from the private sector to the public sector. That also intensified the market’s concern over sovereign risk. It can be seen that the sovereign risk problem that has become one destabilizing factor in international financial markets also closely relates to a big wave of the burst of a credit bubble and ensuing balance-sheet adjustments.

High growth of and challenges for emerging and commodity-exporting economies

Another critical axis in gauging the picture of the global economy is the developments in emerging and commodity-exporting economies. Looking at the *World Economic Outlook* by the International Monetary Fund (IMF), the global economy is expected to grow at a fairly high rate of more than 4 percent in 2010 and 2011 after recording the first negative growth in the post-war period in 2009. Of the growth, indeed 70 percent is attributable to emerging economies, which shows that those economies are the driving force for the global economy.

Several factors are at play behind the robust growth in emerging economies. First, those economies are in the process of catching up with advanced economies in living standards, and thus they are characterized by strong potential demand for consumer durable goods and infrastructure investments. In addition, unlike the United States and Europe, those economies do not have the burden of balance-sheet adjustments and thus a virtuous cycle between production, income, and expenditure has worked effectively, resulting in strong growth in domestic demand including private consumption and business fixed investment. Second, Asian emerging economies including China have become a global production base for IT-related goods. Demand for new IT products such as smart phones and flat-screen televisions has recently been increasing globally. Asian emerging economies have been taking full advantage of a growth opportunity that can be called “a new IT boom.” Third, funds that could not find good investment opportunities in advanced economies have been flowing in massively to emerging economies, which have been stimulating the economies through assets transactions and investment activity. While such inflow of funds from advanced economies would be an appreciating factor for the foreign exchange rate, many emerging economies are adopting fixed foreign exchange rate policies and are containing the appreciation of the foreign exchange rate. That has further reinforced accommodative monetary conditions. While I do not go into details today, there is an aspect that the low

interest rate policy in advanced economies has had a greater economic stimulus on emerging economies than on their own economies through cross-border capital flows.

While emerging economies are growing faster than expected against a backdrop of the above factors, they are now facing a critical turning point. In those countries, as a result of continued high growth and active capital inflows, the overheating of the economy, including a rise in inflation and asset prices, has become pronounced. Thus, in many of those countries, monetary policy has been tightened mainly by raising policy rates and flexibility in the foreign exchange rate policy has been enhanced. It is also critical from a perspective of the global economy whether such policy conduct turns out to be effective and enables those economies to secure sustainable growth while containing the overheating.

II. Developments in Japan's economy

Economic conditions

Based on the developments in the global economy, I will next talk about Japan's economy. Like the global economy, Japan's economy bottomed out in the spring of 2009 and has been picking up, and we judge now that it shows further signs of a moderate recovery. The driving force for the recovery is an increase in exports and production. Namely, exports have been increasing on the back of especially high growth in emerging economies and global expansion in demand for IT-related goods, and production has been increasing in a wide range of areas such as automobiles, electrical machinery, and capital goods. Therefore, profits in the manufacturing sector have been improving rapidly. According to the June *Tankan* (Short-Term Economic Survey of Enterprises in Japan) released recently, current profits at large manufacturers for fiscal 2010 are expected to increase by 44 percent from the previous year. Moreover, the improvement in manufacturing firms' profits has been leading to the improvement in business conditions of their trading partners, namely, some nonmanufacturing firms engaged in, for example, transportation and information services. Furthermore, such improvement in business performance has gradually started to encourage favorably firms' spending activity including business fixed investment. The *Tankan* showed that business fixed investment by large firms is expected to increase, year on year, for both manufacturers and non-manufacturers, and that of manufacturers is expected to increase, year on year, for all firms including small firms.

Compared with such improvement in the corporate sector, as for the household sector, the improvement in the employment and income situation has been lagging. Nevertheless, overtime payments have been increasing, in tandem with the increase in production, and some large firms have started to increase their bonuses from this summer. In those circumstances, private consumption, especially that of consumer durable goods, has been picking up due mainly to the effects of various policy measures such as those to support the purchase of eco-friendly cars and the eco-point system for electrical appliances. Therefore, induced by the improvement in overseas economic conditions, positive moves of increase in exports spreading to domestic private demand have gradually been seen.

When we compare the recent real GDP growth rates on an annualized basis, they were 4.6 percent for Japan, 5.6 percent for the United States, and 0.5 percent for the euro area in the October–December quarter of 2009, and 5.0 percent for Japan, 2.7 percent for the United States, and 0.8 percent for the euro area in the January–March quarter of 2010, respectively. It might be surprising, but in fact the recent growth rate of Japan's economy has been, on average, the highest among the advanced economies. Nevertheless, many might not realize that. There might be several factors in the background. Although Japan's economy shows further signs of a moderate recovery, the level of economic activity has not sufficiently increased. Or, since the recovery is export-led, depending on whether the benefits would spread directly, there are great differences according to regions and industries. Perhaps the greatest factor might be that people are concerned about the fact that

they cannot have future growth prospects for Japan's economy, or, in other words, it has become difficult to create a growth picture. While I will later talk about our views and policy responses on this issue, let me next explain price developments in Japan as a topic closely related to the issue.

Prices

As for prices in Japan, the year-on-year rate of decline in the consumer price index (CPI) has been gradually slowing, after registering the largest decline of 2.4 percent in the summer of 2009. A special one-off factor of subsidy for high school tuition has been pulling down the year-on-year rate of change in the CPI by around 0.5 percentage points since April 2010, and the latest figure, excluding such effects, has showed that the rate of decline slowed to 0.7 percent. There are mainly two factors behind the slowing pace of decline in consumer prices, namely the improvement in the aggregate supply and demand balance of the domestic economy as a whole, and an uptrend in commodity prices represented by crude oil prices.

The aggregate supply and demand balance of the economy as a whole has been improving moderately since the spring of 2009. Since the past experience tells us that, once the supply and demand balance starts to improve, its effects start to influence prices with a time lag of around one year, the effects of the picking up of the economy since last year have finally surfaced on the price front. As for the outlook, although it is difficult to foresee developments in commodity prices, the aggregate supply and demand balance is likely to continue to improve if the economy follows a recovery path. Therefore, the year-on-year rate of decline in the CPI is expected to continue to slow, and likely to enter positive territory in fiscal 2011. What is important here is whether Japan's economy will return to a sustainable growth path, and, through such a process, the aggregate supply and demand balance that lies behind the price developments will improve in a sustainable manner. Put metaphorically, prices are the body temperature of the economy. A fundamental reason of deflation, namely, a continuous price decline, is a lack of basic strength, or, in other words, growth potential of the economy. Therefore, to fundamentally overcome deflation, it is essential to increase the growth potential of Japan's economy from a medium- to long-term perspective.

Interim assessment

Let me now touch briefly on the interim assessment of the April 2010 *Outlook for Economic Activity and Prices* (the Outlook Report). The Bank publishes the outlook for economic activity and prices over the next two years every quarter – April and October Outlook Report and interim assessments in between. In the interim assessment released last week, the forecast of the real growth rate for fiscal 2010 became higher than what had been projected in April. That was mainly due to the faster than expected increase in exports against a backdrop of acceleration of growth in emerging economies. As for fiscal 2011, the growth prospects remain broadly unchanged. The median of the Policy Board members' forecasts was 2.6 percent for fiscal 2010 and 1.9 percent for fiscal 2011.

With regard to prices, the CPI (excluding fresh food) is expected to develop broadly in line with the projections presented in April. Specifically, the median of the Policy Board members' forecasts, the year-on-year rate of change, was minus 0.4 percent for fiscal 2010 and plus 0.1 percent for fiscal 2011.

We need to be attentive to the fact that those forecasts are associated with both upside and downside risks. With regard to economic activity, there are some upside risks such as an even faster growth in emerging and commodity-exporting economies. As downside risks, international financial developments warrant attention. In particular, attention should be paid to the effects of developments in fiscal and financial conditions in some European economies on international finance and the global economy. Such upside and downside risks to deviate from the forecasts have become somewhat large in both directions compared with the time of

April. With regard to prices, there is a possibility that inflation will rise more than expected due to a rise in commodity prices brought about by higher growth rates in emerging and commodity-exporting economies, while there is also a risk that the rate of inflation might decline due, for example, to a decline in medium- to long-term inflation expectations.

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

Japan's economic growth rates in medium to long term

Now let me turn to the issue of medium- to long-term growth of Japan's economy.

The annual growth rate of Japan's economy declined significantly from around 4.5 percent, on average, in the 1980s to around 1.5 percent in the 1990s, and to less than 1 percent in the 2000s. Even considering that the adjustment process since the 1990s after the burst of the bubble has been grueling, the decline in the economic growth rate has been conspicuous.

Gross domestic product (GDP), which is the fruit of a country's economic activity, is the multiplication of the number of workers and the value-added that workers per capita produce in one year, namely, productivity on a value-added basis. Therefore, economic growth, or the increase in GDP, will be determined by two elements: growth in the number of workers and the growth in productivity. When viewing the decline in Japan's economic growth rate from such a perspective, one can see that a key challenge for Japan's Economy is how to raise productivity in the future.

Japan's labor force, namely, the population between 15 and 64 years old, already started to decline from the second half of the 1990s, and the number of actual workers has started to decline slightly, on average, since 2000. To maintain and raise growth rate when the number of workers is unlikely to grow, there is no way but to raise productivity. Raising productivity itself is an important issue, regardless of change in demographics, and it becomes increasingly important in a situation when it is difficult to expect growth in the labor force.

Specifically, the productivity growth rate measured by the aforementioned per capita value-added has been declining from an annual average of 3.2 percent in the 1980s to about 1 percent since the 1990s. Such a decline in productivity is attributable to the following factors.

At the time of the 1990s, the global economy was at a critical juncture of dramatic development in information and communications technology and the intensification of global competition. However, Japan's economy was busy with adjusting excess facilities and debts that had piled up during the bubble period, and thus was not able to make positive efforts in response to the structural changes taking place in the global economy. Therefore, it could be the case that Japan was not able to develop technology or tap the market to expand new demand, which might have resulted in lowering the productivity of the economy as a whole. Moreover, it could also be the case that, during that period, metabolism had not proceeded sufficiently in the process of reducing "excesses," and that might have resulted in keeping inefficient parts of the economy. Furthermore, the fact that the economy tumbled into a vicious circle – a declining trend in the growth rate lowered firms' and households' growth expectations in the future, which in turn further withered firms' and households' spending activity – also seems to be a reason for the decline both in the economic growth rate and productivity during that period.

To raise productivity

Then, what should be done to raise productivity in the future in a sustainable manner? What is important on this point is how individual firms tap new demand. A rise in productivity is sometimes interpreted as producing the existing products more efficiently or reducing costs.

While a rise in productivity indeed has such aspects, it is not necessarily limited to those. Moreover, it appears difficult to raise the productivity of the economy as a whole only through such rationalization in the production process of the existing products or reduction of costs including labor costs. Amid consumer needs becoming diversified and evolving, it is important for firms to tap new demand and prepare a supply system that will meet such demand, thereby increasing their sales and profits. Japan's challenge of raising productivity requires tapping potential demand and creating new value-added, and thus is an issue that relates to both the demand side and the supply side of the economy.

Let us consider the case of cell phones as an example. On the back of an explosive spread of cell phones, there seems to have been potential needs of consumers to make phone calls any time at any place. What embodied such potential consumer needs into a product of cell phone was the firms' efforts. Firms strived to develop information technology and prepare a supply system including building production lines of portable terminals. As a result, demand for cell phones increased explosively, and cell phones prevailed rapidly in a short period. Consumers have now obtained the convenience of making phone calls any time at any place. Also, profit opportunities for telecommunications firms and portable terminal manufacturers have increased, resulting in raising productivity of the economy as a whole.

In tapping potential demand, high technology as represented by cell phones would not be the only key. In fact, there are not a few local firms that have succeeded in tapping potential demand by utilizing unique expertise, local specialty goods, and a home-court advantage.

While the main players that make such efforts are business managers, as a factor to support such efforts, financial institutions also play a critical role. By focusing on that point, the Bank has started a new policy initiative. In closing, let me move on to the Bank's conduct of monetary policy.

IV. Policy actions by the Bank of Japan

The Bank's monetary policy since the Lehman shock in 2008 can be summarized in three types. First, measures to repair financial markets in response to the financial crisis; second, aggressive monetary easing in response to the economic plunge; and third, a new approach toward strengthening the foundations for economic growth.

Various temporary measures to repair market function

First, measures to repair the market function. Having been affected by the global financial crisis since the autumn of 2008, the market functioning of Japan's financial markets also declined rapidly, although the overall market sentiment has been significantly stable compared with that in the United States and Europe. The issuance of CP and corporate bonds became difficult and corporate funding became tight. To cope with such a rapid decline in market functioning, the Bank promptly introduced various extraordinary measures such as outright purchases of CP and corporate bonds. Subsequently, due partly to the coordinated actions of central banks, the global financial turmoil stabilized and the functioning of Japan's financial markets improved, and those measures have been phased out since the end of 2009. Ensuing financial market developments illustrate that market transactions have rather become active after the completion of those measures. However, as I have mentioned earlier, due mainly to the fiscal problems in some European countries, strains increased in the U.S. dollar money market in May. Therefore, the Bank, in coordination with major central banks, re-established the U.S. dollar funds-supplying operations that were once completed in February 2010. Including those fiscal and financial developments in Europe, there remain the factors that warrant attention in international finance. The Bank will, in coordination with other central banks, continue to make every effort to ensure financial market stability.

Aggressive monetary easing

Second, to address the critical situation following the failure of Lehman Brothers and under the recognition that Japan's economy faces the critical challenge of overcoming deflation and returning to a sustainable growth path with price stability, the Bank has been continuing with aggressive monetary easing.

Specifically, the target level for the overnight call rate, the policy rate, was reduced to 0.1 percent in December 2008 and has remained unchanged since then. The effective zero interest rate of 0.1 percent is the lowest policy rate among the central banks around the globe. Moreover, to encourage a decline in longer-term interest rates, the Bank introduced in December 2009 a new funds-supplying operation to provide 3-month funds to financial institutions at a low interest rate of 0.1 percent, the same as the policy rate. The amount provided by that measure has now reached 20 trillion yen. With a series of those measures, borrowing interest rates for firms and households have been declining. The stimulative effects from the low interest rates would further increase, due to the improvement in corporate profits.

As I have mentioned earlier, Japan's economy shows further signs of a moderate recovery. Based on high growth in the global economy as the IMF forecasts, the baseline scenario for Japan's economy is likely to be that the recovery trend will be maintained in the future. At the same time, there are still many uncertainties such as developments in the U.S. and European economies and volatile developments in international financial markets reflecting fiscal and financial conditions in Europe. The Bank will consistently maintain extremely accommodative financial conditions and thereby will aim at contributing to the recovery of Japan's economy.

Fund-provisioning to support strengthening the foundations for economic growth

And third, the Bank took a new approach to addressing the most important challenge Japan's economy is facing, namely, to raise medium- to long-term growth potential. In this regard, the Bank introduced a new fund-provisioning framework to support, from the financial side, private financial institutions' own efforts toward strengthening the foundations for economic growth. The Bank is preparing to make the first fund-provisioning at around the end of August. On June 25, the Bank selected counterparty financial institutions for the fund-provisioning through public application, which were as many as 66. Not only mega-banks but also a wide range of financial institutions, including regional banks I and II as well as *shinkin* banks, became counterparties. I have hoped a variety of financial institutions, both in terms of business and in terms of region, to use the fund-provisioning framework to make positive efforts toward strengthening the foundations for economic growth, by utilizing their business and regional characteristics. Therefore, it was quite encouraging to see a number of financial institutions applying for the fund-provisioning framework.

The new fund-provisioning measure supplies long-term and low interest rate funds to private financial institutions in accordance with their efforts in terms of lending and investment toward strengthening the foundations for economic growth. We expect private financial institutions to utilize the fund-provisioning measure, taking it as an opportunity to expand lending and investment to businesses that will contribute to raising productivity and creating new demand. Strengthening the foundations for economic growth is not necessarily limited to promoting technological revolution. The measure can also be used for loans and investment projects that would support positive efforts by regional small firms including regional revitalization business. We highly expect regional firms, in cooperation with financial institutions, to launch positive efforts toward tapping demand and raising productivity.

The Bank's decision to implement the fund-provisioning measure was based on the recognition that merely maintaining accommodative financial conditions as the Bank has been pursuing could not directly address Japan's medium- to long-term challenge of the declining trend in growth potential. Normal monetary policy assumes a transmission

mechanism in which a central bank provides liquidity, thereby lowers market interest rates as a whole and stimulates economic activity. When productivity has been declining, it would be difficult to raise the growth rate in a sustainable manner even if market interest rates and lending rates have declined. Deflation in Japan is, as I have mentioned earlier, a phenomenon that Japan's problem of trend decline in productivity is directly related. If the fund-provisioning measure serves as a "catalyst" for private financial institutions in pursuing efforts toward strengthening the foundations for economic growth, it would contribute to raising productivity of Japan's economy and consequently to overcoming deflation.

While the fund-provisioning measure is one new measure to support strengthening the foundations for economic growth, the ways to support strengthening the foundations for economic growth are not necessarily limited to the measure the Bank has introduced. For example, if market participants consider schemes such as securitizing loans and investments that would relate to the strengthening of foundations for economic growth, the Bank is willing to actively cooperate in establishing a market for such purposes. Moreover, if such securitized products are to be nurtured, there will be room for exploring ways to accept those securitized products as eligible collateral for the Bank's operations. We will continue to make sufficient considerations while exploring various possibilities.

Concluding remarks

Today I have talked about Japan's economic situation, its challenges, and the Bank's conduct of monetary policy. In closing, I will offer my impression about Toyama's economy.

Looking at the industrial structure of this region, against a backdrop of ample water resources, diligent people, active attraction of enterprises, and improved infrastructure, this region is one of the best "manufacturing prefectures" on the Japan Sea where the manufacturing businesses such as chemicals like medicine, general machinery, electrical machinery, and metal products like aluminium building materials have been locally integrated. In addition, this region is famous for "a business of Etchu Toyama traveling medicine salesperson," which has a history dating back more than 300 years. The business had systems such as the fare collection system, which hands drugs first and collects money later for the amount of drugs actually used, and use of books, which contain various kinds of customer and sales information. Those systems could be said as a revolutionary business model that leads to credit card business, customer data management, and inventory management at present. Such tradition of making cutting-edge approaches toward industrial promotion and economic development has been handed down from generation to generation.

As for the recent economic situation of the regional economy, the branch informed me that "it has been steadily picking up, led by the manufacturing industry, although there is still some lingering severity on the employment front." This region has growth potential including "the integration of manufacturers with high technology," "comparative advantage in being located close to Japan Sea rim countries that have been growing rapidly," and "rich tourism resources." Upon thoroughly utilizing the fund-provisioning scheme we newly introduced, I expect this region to fulfil its growth potential and expect you all to continue to strive for the development of the regional economy.

For firms to be able to have bright prospects for future growth, the Bank will consistently make efforts as a central bank.