

Masaaki Shirakawa: Japan's economy and monetary policy

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at a meeting with business leaders, Osaka, 27 September 2010.

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Introduction

I am privileged to be here today to speak and exchange views with business leaders from the Kansai region. I would like to take this opportunity to express my deep gratitude to you for your cooperation with the Bank of Japan's branches in Osaka, Kobe, and Kyoto.

At present, the greatest concern for the time being for you as business leaders must be the recent appreciation of the yen and its impact on Japan's economy. Before we exchange views, I will first outline developments in the global economy and associated trends in the foreign exchange markets. I will then speak about Japan's economic situation and the Bank's thinking on monetary policy.

I. Developments in the global economy

I will start with developments in the global economy.

Since the spring of 2009, the global economy, driven particularly by emerging economies, has continued to grow at about 5 percent on an annual basis. While it is natural to have high growth rates as the global economy has been recovering from the plunge following the Lehman shock, the growth rate figures have substantially exceeded the average annual growth rate of 3.9 percent over the 10 years prior to the Lehman shock. However, the pace of growth has slowed somewhat recently, partly because the effects of various demand-boosting policy measures introduced in response to the financial crisis in the advanced economies of the United States and Europe have started to recede and emerging economies have been shifting away from accommodative monetary policies.

In the United States, while production continues to increase on the back of buoyant exports, concern has increased about a possible slowdown in the U.S. economy as many indicators related to domestic demand, especially indicators of private consumption and housing, have been pointing since the second half of July to a slower economic recovery. Economic activity in the euro area is recovering moderately as a whole, but economic disparities in the area have widened: while exports and production in the main economies, especially Germany, have been boosted by the depreciation of the euro, economic growth in peripheral countries such as Greece has been sluggish as both the public and private sectors are mired in excessive debt. Meanwhile, emerging economies are growing robustly. In this situation, many emerging countries have been moving away from accommodative monetary policies as they seek to contain economic overheating and follow more sustainable economic growth paths.

Although the rate of global economic growth is still at a high level, it has been slowing. Nevertheless, the global economy's recovery trend appears to remain intact. The International Monetary Fund forecasts that the global economy will continue to achieve growth rates of over 4 percent in the coming years, projecting growth of 4.6 percent in 2010 and 4.3 percent in 2011. Nevertheless, the Bank considers that, regarding the outlook, the downside risks to the U.S. and European economies and their potential impact warrant more attention. The U.S. economy is burdened by balance-sheet adjustments similar to those experienced in Japan following the collapse of the bubble. Therefore, it has become more difficult for it to grow but easier for it to deteriorate. Federal Reserve Board Chairman Ben S. Bernanke has also expressed the view that the U.S. economy would continue to expand in the second half of 2010, albeit at a relatively modest pace, and it was reasonable

to expect some pickup in growth in 2011. He also stated that macroeconomic projections were inherently uncertain, and the U.S. economy remained vulnerable to unexpected developments.

II. Developments in the foreign exchange markets

Bearing these global economic developments in mind, we can now turn to the recent developments in the foreign exchange markets.

Looking back at movements in the U.S. dollar-yen exchange rate, the yen traded at around 90 yen against the U.S. dollar until the middle of 2010, but then appreciated since August and temporarily reached the range of 82–83 yen. The key factor behind the appreciation appears to be heightened uncertainty about the outlook for the global economy, particularly the U.S. economy. Until around the spring of 2010, there were discussions in the United States on how to make the shift away from the accommodative monetary policies put in place after the financial crisis. However, as indicators suggesting the weakness in the U.S. economy have been released successively since the summer, as I mentioned earlier, the discussions about monetary policy exit strategies have been put on hold. In these circumstances of heightened uncertainty over the global economy, investors worldwide have increasingly avoided risks and purchased currencies that are considered to be relatively safe. For example, since July, the yen has risen by 3 percent, and the Swiss franc by 8 percent, against the U.S. dollar. Moreover, the yen has appreciated not only against the U.S. dollar and the euro but also against fellow East Asian currencies: for example, it has traded at levels close to its record high against the Korean won.

Needless to say, the appreciation of the yen weighs directly on the profits and profitability of exporting firms. And in the current situation, it can also significantly affect business sentiment and consequently the outlook for Japan's economy, by increasing uncertainty over the global economy.

In these circumstances, an intervention was conducted in the currency markets for the first time in six and a half years. The Japanese government has made it clear that it will continue to pay due attention to developments in the foreign exchange markets, and will take decisive actions, including interventions, if it deems it necessary. Likewise, the Bank also has great interest in and will pay close attention to developments in the foreign exchange markets and their impact.

III. Developments in and medium- to long-term challenge for Japan's economy

Developments in Japan's economy

I will now move on to economic activity and prices in Japan.

The Bank assesses that Japan's economy shows further signs of a moderate recovery. Exports and production continue on an increasing trend, albeit at a slower pace compared with the pace of increase of more than 20 percent per year that had been seen since the spring of 2009. As for domestic private demand, business fixed investment is showing signs of picking up, albeit at a low level, as corporate profits continue to steadily improve. The employment and income situation remains severe, but the degree of severity has eased somewhat as the number of employees and wages have increased slightly. Private consumption has been picking up. Particularly, buoyed by the effects of the extremely hot summer this year, sales at convenience stores, especially of beverages, have been increasing recently, as have sales of air conditioners supported by the eco-point system. And as you know, there was also a last-minute increase in demand for automobiles ahead of the expiration of subsidies for purchasing energy-efficient cars.

As for the outlook, the pace of economic improvement is likely to slow for the time being due to the ending of the boost from the extremely hot summer and to the absence going forward of the recent last-minute increase in demand for durable consumer goods. Looking back, partly because Japan experienced the sharpest economic downturn among advanced economies following the financial crisis in the fall of 2008, Japan's economy subsequently recovered at the fastest pace. In any event, as factored into the forecasts presented in the *Outlook for Economic Activity and Prices* released in April, the Bank has been fully aware that the pace of economic recovery is likely to slow over the second half of fiscal 2010 as inventory restocking runs its course and the effects of policy measures wane. However, it should be noted that in Japan, unlike in the United States and Europe, balance-sheet adjustments are not weighing on the economy and both financial markets and the financial system are stable. This suggests that an accommodative financial environment has been in place to support the economic activity of firms and households. Given this, assuming that overseas economies maintain their moderate recovery, the trend of recovery itself in Japan is not likely to be interrupted.

On the price front, the year-on-year decline in the consumer price index (CPI) reached a record level of 2.4 percent in the summer of 2009 and has been moderating gradually thereafter. The decline has recently slowed to around 0.6 percent, if the effects of subsidies for high school tuition are excluded. The pace of decline is expected to continue to slow as the economy follows a recovery path and the aggregate supply and demand balance improves.

The outlook I have just described is the Bank's baseline scenario for economic activity and prices, but the Bank fully recognizes that this scenario contains a high degree of uncertainty. There is increasing uncertainty about the outlook for the global economy, especially the U.S. economy, and the foreign exchange and stock markets have been unstable. There is also a possibility that private consumption and production could decline substantially if the effects of the ending of the boost from the extremely hot summer and the absence going forward of the recent last-minute increase in demand for durable consumer goods such as automobiles are larger than expected. Based on these points, the Bank deemed it necessary to pay attention to the downside risks to Japan's economic activity and prices.

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

I have outlined the current situation of Japan's economy. At present, it shows further signs of a moderate recovery. But putting aside such short-term economic developments, what many people see as the greatest problem for Japan's economy is that they do not have confidence in Japan's medium- to long-term growth potential, or in other words, that they are finding it difficult to envisage a blueprint for growth.

In fact, Japan's economic growth rate is on a declining trend. Aside from the high-growth era when the average annual rate of economic growth was slightly below 10 percent, in the 1980s the average annual growth rate was around 4.5 percent, which exceeded the growth rates of other advanced economies. However, following the collapse of the bubble, Japan's annual growth rate declined significantly to around 1.5 percent in the 1990s. It has then increased somewhat since the turn of the millennium, but the trend decline in the growth rate continues. In this situation, people will have lower expectations concerning future income growth and their spending and investment will be restrained, which will in turn lead to price declines. The deflation in Japan should be understood as a manifestation of the fundamental problem facing the economy, namely the decline in growth expectations.

Even though Japan's economic growth rate is trending downward, the GDP growth rate per worker, or, in other words, the productivity growth rate, has been 1.6 percent per year on average over the past decade. The rate has declined from earlier levels but exceeds the 0.8 percent level in European countries and is still comparable to the 1.8 percent level in the United States. At present, the percentage of the population aged 15 or older that is in

employment, that is, the employment rate, is about 60 percent. If this rate declines further with the aging of the population, raising productivity will become an even more critical challenge. In attempting to raise productivity, it is important to recognize that, given the fierce global competition, doing so by cost reduction and improvement in cost structure alone has its own limits for the economy as a whole. For example, about 90 percent of the CPI inflation differential between Japan and the United States in the past 10 years was attributable to the difference in the rate of decline in service prices. This appears to reflect the fact that, in Japan, nominal wages have been adjusted flexibly. Of course, cost reduction should be an important part of firms' strategies to enhance competitiveness, and Japanese firms have achieved productivity rises through their drastic efforts to cut costs. However, in a situation where the population is declining and existing domestic markets are starting to shrink, it is essential to create new markets that can enable firms to enjoy high profits, in order to raise the productivity of Japan's economy as a whole. On this point, one view is that exploring new areas and creating new added value should be part of firms' growth strategies. These strategies of exploring new, uncontested market places are known as "blue ocean" strategies. The search for such "blue oceans" is essential for sustainable productivity growth. This can be achieved by private firms' innovative efforts and financial institutions' support in the form of providing funds for such efforts. The policy authorities also play an important role in creating such an environment. The Japanese government is making efforts to achieve its growth strategies for Japan's economy and I expect that they will be implemented steadily in the future.

At the same time, the Bank has been considering ways to contribute to raising Japan's growth potential by making use of the central bank's functions. As a result, in June 2010 the Bank decided to introduce a new fund-provisioning measure to support efforts to strengthen the foundations for economic growth.

IV. Thinking behind monetary policy

Let me now explain the Bank's thinking behind the conduct of monetary policy. As I mentioned earlier, Japan's economy faces the cyclical challenge of returning to a sustainable growth path with price stability and the medium- to long-term challenge of overcoming the trend decline in the growth rate. The Bank, while keeping in mind these two challenges, conducts monetary policy with a focus on the following three points.

First, pursuing powerful monetary easing. The Bank has lowered the policy interest rate to 0.1 percent, virtually zero. It also introduced a new funds-supplying operation, which is called the "fixed-rate operation," and by substantially increasing the amount of funds provided through the operation, has been encouraging a decline in market interest rates and further enhancing and spreading accommodative monetary conditions.

Second, ensuring financial market stability. If financial institutions face difficulty in smoothly raising funds from the markets, they excessively restrain their lending and other financial activities, and this in turn seriously affects economic activity. The Bank will continue to fulfill its critical role of ensuring financial market stability.

And third, supporting efforts to strengthen the foundations for economic growth. As I mentioned before, in June 2010 the Bank introduced a new fund-provisioning measure through which it will provide long-term funds at a low interest rate to private financial institutions that are making efforts in terms of lending and investment to strengthen the foundations for economic growth. At the beginning of September, the Bank conducted the first loan disbursement through the measure, providing 47 financial institutions with a total of 462.5 billion yen. The Bank anticipates that the measure will act as a catalyst to further stimulate private firms' efforts to strengthen the foundations for economic growth. The number of financial institutions that intend to participate in the fund-provisioning measure to make efforts to strengthen the foundations for economic growth has exceeded 100. In

addition, with the introduction of the measure, a considerable number of financial institutions established new dedicated funds as well as investment and lending schemes.

The Bank recognizes that Japan's economy faces the critical challenge of overcoming deflation and returning to a sustainable growth path with price stability. To this end, the Bank will continue to consistently make the utmost contributions as a central bank with a focus on the three points that I have just mentioned: pursuing powerful monetary easing, ensuring financial market stability, and supporting efforts to strengthen the foundations for economic growth.

From the second half of 2009 to the first half of 2010, during which time the global economy posted relatively high growth, based on the experience after the collapse of the bubble in Japan the Bank made a very conservative judgment that, as balance-sheet adjustments were weighing on the U.S. and European economies, the pace of recovery in the global economy was likely to remain moderate and downside risks were prone to increase. As such, the Bank is the only central bank among advanced economies that has further enhanced monetary easing since December 2009. The Bank has also introduced a new measure to support efforts to strengthen the foundations for economic growth. As these initiatives suggest, the Bank has been actively introducing various new measures to support Japan's economy from the financial side, aiming to overcome deflation and return to a sustainable growth path with price stability. The Bank will continue to carefully consider the outlook for economic activity and prices, and, if it deems it necessary, will take policy actions in a timely and appropriate manner upon considering the effects and side-effects of various policy measures.