Ryuzo Miyao: Economic activity and prices in Japan and monetary policy

Summary of a speech by Mr Ryuzo Miyao, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Tokushima, 22 September 2010.

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I. Economic activity and prices

A. Overview

First, I will talk about the current situation of the Japanese economy. At present, an issue of concern is the possible negative impact of instability in foreign exchange and stock markets on corporate profits and business and consumer confidence. In this environment, there has been a slowing of exports to East Asian and other emerging economies that have driven the recovery from the sharp decline after the bankruptcy of Lehman Brothers. Private consumption, meanwhile, remains relatively firm, supported by the extremely hot summer this year and a last-minute increase in demand for durable consumer goods ahead of the expiration of government subsidies. On the whole, Japan's economy shows further signs of a moderate recovery.

B. Developments in overseas economies

Let me now look at developments in those overseas economies that are influencing Japan's export-driven recovery. Among the emerging economies, the Chinese economy has been boosted by fixed asset investment – comprising business fixed and real estate investments – as well as private consumption, as a result of major stimulus measures to the value of 4 trillion renminbi. Since the rapid growth accelerated speculative investment in real estate, making it difficult for middle-class citizens to buy housing, the authorities implemented a series of measures, including window guidance, to restrain the increase in real estate transactions. Subsequently, real estate investment slowed down and production and fixed investment in sectors related to construction decelerated. Still, the rate of economic growth remains high. With respect to those neighboring Asian nations whose economies have been spurred by exports to China, although the rate of expansion is showing signs of deceleration, growth remains high with domestic demand still robust.

With regard to economic activity in the euro area, production has expanded due to increasing exports to emerging economies, although the growth differs by country. For example, in Germany its strong recovery has been the main driving force, with real GDP for the April–June quarter of 2010 having grown at an annualized 9 percent from the previous quarter. By contrast, Greece, which is saddled with the burden of fiscal consolidation, has recorded negative growth; and Spain, with its burst housing bubble, has not been able to find a way out of a low growth predicament. For the euro area as a whole, domestic demand, such as business fixed investment, is weak and the pace of economic recovery remains moderate. Moreover, with the slowing pace of growth in emerging economies, particularly in China, the growth rate of the euro area may slow down starting with exports, which have been the main engine driving recovery.

Taking a look at recent developments in the U.S. economy, production has recovered due to both an increase in exports reflecting a weaker dollar and inventory rebuilding, although the household sector is under pressure from excessive debt and a delay in recovery in employment. Consumption and business fixed investment have experienced moderate recovery, reflecting a sharp improvement in the business performance of firms that have undergone restructuring and the effects of fiscal measures to stimulate the economy. At present, however, the pace of recovery is decelerating as the effects of stimulus measures wane.

Regarding the outlook for overseas economies in the near future, it is expected that the pace of growth in emerging economies, particularly in China, will continue slowing, while the moderate pace of recovery in the U.S. economy will probably continue, due to slower growth in exports to emerging economies and weakening of the effects of economic stimulus measures. Starting in 2011, the growth rate of emerging economies is expected to pick up, which will help the U.S. and European economies resume a path of moderate recovery.

Recently, however, I have become increasingly concerned about downside risks, mainly because the risk is rising that the U.S. economy may experience a protracted period of low growth. In the GDP data released in July, the growth rate of private consumption was revised sharply downward, revealing that the real value had yet to regain the pre-Lehman shock level. Furthermore, the personal saving rate was revised substantially upward, marking the highest level in the past 20 years, excluding periods of temporary increases (Chart 1). Meanwhile, housing investment, which had been recovering moderately, has resumed a sharp slide since the expiry of tax credits for homebuyers at the end of April, while monthly home sales have been at historically low levels. In the area of employment, the increase in the number of private-sector employees in the April–June quarter of 2010 has slowed to around 70,000 per month, while the growth in household income has been very slow. Initial claims for unemployment insurance have been at a high level of around 500,000 per week. These economic indicators suggest that the U.S. household sector has become extremely cautious about spending, reflecting the strong repayment pressure on those who purchased homes during the housing bubble, while the unemployed are having a hard time finding jobs. In this environment, the corporate sector cannot be confident of future economic expansion. This has made firms reluctant to increase employment or fixed investment even though their profits are increasing. This is why the risk is increasing that a recovery in household consumption will be delayed.

In addition, changes may be taking place in areas that once were considered the main advantages of the U.S. economy. For example, while labor productivity may not attract a lot of attention, I keep a close watch on its data. Labor productivity is calculated by dividing real quarterly GDP by hours worked by the total number of employees. The data reflect growth in technological progress and increases in capital stock, and indicate a nation's potential growth capability (Chart 2). During 2009, labor productivity in the United States rose sharply to the level of 2000 to 2005, the years of the "productivity growth explosion," as a result of drastic corporate restructuring by means of personnel cuts in response to the economic crisis following the Lehman shock. Productivity growth, however, had been lackluster during the prosperous period of 2005 to 2008, and slipped into negative territory in the April–June quarter of 2010. It has been said that the strength of the U.S. economy lies in its high productivity backed by its ability to generate technological innovation. Over the past several years, however, excluding a short period in 2009, longer-term growth potential has tended to be sluggish. Thus, in the middle of August, the yield on the 10-year U.S. Treasuries declined to around 2.5 percent, probably due to the decrease in the expected economic growth accompanied by lower inflation over the longer term, rather than expectations of a temporary economic slowdown (Chart 3).

C. The current situation of Japan's economy

Based on my views that I have just described regarding overseas economies and accompanying risk factors, I will now turn to the current state of Japan's economy. Market participants are accelerating their yen-buying activity to avert risks, reflecting concern about the outlook for the U.S. economy as well as fiscal and economic conditions in Europe, while stock prices remain weak despite the favorable outlook for corporate profits, partly due to the appreciation of the yen (Chart 4). The negative effects of Japan's current market conditions warrant attention since, if they continue, they would have a significant negative impact on corporate profits, as well as business and consumer confidence. At present, however, the mechanism for Japan's self-sustaining economic recovery remains intact.

Looking at recent developments in economic activity in more detail, exports continue to be on an uptrend, although there has been a deceleration in those to East Asian and other emerging economies that had supported Japan's high export growth. Meanwhile, production has been increasing as a trend, although the pace of increase has been decelerating gradually when the effects of the distortion in seasonal adjustments are taken into account. Among domestic demand components, business fixed investment is showing signs of picking up, given the favorable business performance. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly*, business fixed investment started to increase in the April–June quarter of 2010, after having declined throughout the January–March quarter. Private consumption has been generally picking up, as shown by (1) an increase in consumer spending on such items as beverages and air conditioners due to this year's extremely hot summer, and (2) a significant increase in car sales in August, reflecting a last-minute increase in demand ahead of the termination of government subsidies for purchasers of environment-friendly cars. At the same time, housing investment has been leveling out: the number of housing starts increased for two consecutive months, and the contract rate on newly built condominiums in the Tokyo metropolitan area remains above 70 percent. There are signs that employment and income are improving, although the ratio of job offers to applicants remains low and the unemployment rate is relatively high. That said, household income has been improving moderately, reflecting the year-on-year rise in summer bonus payments.

In assessing the trend in the consumer price index (CPI), it is necessary to exclude fresh food, the prices of which tend to be volatile, as well as the effects of subsidies for high school tuition, which are a one-off downside factor and part of the government's economic stimulus measures to reduce the cost of high-school education. The CPI, excluding these two factors, has recently been hovering around minus 0.6 percent. It declined significantly in summer last year, but it now appears to be recovering. The year-on-year rate of decline has been narrowing mildly, and this trend is likely to continue, reflecting the narrowing negative output gap.

Regarding the outlook for Japan's economy, movements toward a self-sustained recovery are expected to continue. While the pace of improvement is likely to slow temporarily, partly due to a temporary slowdown of overseas economies and the waning effects of various demand-boosting policy measures, exports are likely to increase, reflecting the high growth in emerging economies such as in China, while business fixed investment and private consumption are expected to recover as corporate profits increase.

As noted earlier, a downside risk that might necessitate revision of the above outlook is the growing possibility that the U.S. economy will see protracted low growth. Were this to happen, the outlook for the world economy would have to be revised downward. The resulting decrease in exports would adversely affect Japan's economy and probably lead to increased risk aversion, thereby discouraging business fixed investment, new businesses, and household consumption. The deteriorating business and consumer sentiment could lead to prolonged sluggish economic activity.

Despite the manifest downside risks outlined above, the emerging economies have shown impressive growth. It is true that, for the present, the economies of some Asian economies appear to be decelerating, mainly because of China's economic slowdown. Yet this means that the risk is declining that an overheating economy might hurt sustainable economic growth. This might be compared to "speed control," conducted for a limited period to ensure a higher rate of growth over the long term. If this were the case, it would be an upside risk for Japan's economic outlook, given that Japan is strengthening its ties with other Asian countries. An upswing in these countries could partly offset the negative effects even if the U.S. economy experiences a period of low growth.

D. Effects of foreign exchange markets on Japan's economy

Next, in order to understand the effects foreign exchange markets have on Japan's economy, let me put the activities of foreign exchange markets in context. When prices of goods are stable or falling in a given country, the value of that nation's currency is stable or rising and, other things being equal, the value of this particular currency should rise against other currencies. This is the basic idea of "purchasing power parity." So, if we look at the purchasing power parity of the yen against the U.S. dollar (the ratio between prices in Japan and the United States), we see that the yen has been appreciating fairly consistently against the dollar, reflecting the weakness in Japanese prices relative to those in the United States since the introduction of a floating exchange rate regime in 1973 – even though the actual dollar/yen exchange rate is determined by a number of factors in addition to prices (Chart 5).

Needless to say, a yen that is strong against the U.S. dollar curtails the profits of export-oriented firms, many of which are experiencing adverse business pressure that is affecting stock prices. As a result, the Bank of Japan is closely monitoring the impact of the strong yen and weak stock prices on the Japanese economy. Conversely, the appreciation of the yen pushes up profits of import-oriented firms and serves as a tailwind for those firms considering expanding operations by acquiring overseas firms. However, it should be remembered that a balanced view is important when discussing the effects of a strong yen.

I will now give you an example of just such a balanced view. Trade statistics show that the weight of U.S. dollars used as settlement currency for exports declined slightly from 52.4 percent in the second half of 2000 to 48.6 percent in the first half of 2010, while that used for imports remained largely unchanged at slightly above 70 percent (Chart 6). However, looking at the value of dollar-denominated trade settlements, one can see that net imports have increased sharply. This is because trade with the United States, a large buyer of Japanese exports, is decreasing, while exports to and imports from rapidly growing Asian countries are growing and imports from the Middle East are increasing sharply. This expansion in net imports, in dollar terms, indicates the possibility that Japan's settlement and trade structure now is less vulnerable than before to the negative effects of a strong yen.

II. Monetary policy

A. Recent conduct of monetary policy

Japan's economy shows further signs of a moderate recovery, with exports increasing, albeit at a slower pace, and demand components such as private consumption and business fixed investment generally picking up. However, amid heightened uncertainty about the future especially for the U.S. economy, foreign exchange and stock markets have recently been unstable. Accordingly, the Bank held an unscheduled Monetary Policy Meeting on August 30, 2010 and decided to introduce a six-month term in the fixed-rate funds-supplying operation against pooled collateral and start providing additional funds amounting to approximately 10 trillion yen with a six-month term. The Bank believes that the monetary easing measure, together with the government's efforts, will be effective in further ensuring Japan's economic recovery.

Downside risks to Japan's economy, however, still require close monitoring amid the growing uncertainty about the future, especially for the U.S. economy. The Bank recognizes that Japan's economy faces the critical challenge of overcoming deflation and returning to a sustainable growth path with price stability. With such recognition, the Bank has been striving to pursue powerful monetary easing. The Bank will continue to carefully examine the outlook for economic activity and prices and, if judged necessary, will take policy action in a timely and appropriate manner.

B. *Fund-provisioning measure to support strengthening of the foundations for economic growth*

The strong easing measure discussed so far is designed to work on short-term cyclical economic activity, but it is important that Japan maintain and enhance its medium- to long-term economic growth potential. Recognizing this, the Bank sought a way of contributing to such a task as the central bank, and in June 2010 introduced the fund-provisioning measure to support strengthening the foundations for economic growth, with loans totaling 3 trillion yen. This measure has the same characteristics as other fund-provisioning measures, in that it supplies funds against eligible collateral submitted to the Bank, but it differs in that the maximum duration of loans is four years and loans are provided to each counterparty based on the counterparty's actual amount of lending and investment carried out as part of the plan to strengthen the foundations for economic growth submitted to the Bank.

The fund-provisioning measure does not aim to fully fund the foundations for economic growth, but to act as a catalyst for financial institutions to make efforts toward strengthening the foundations for economic growth. The first new loan disbursement was carried out at the end of August 2010, involving more than 460 billion yen provided to 47 borrower financial institutions, ranging from major banks to *shinkin* banks, that span a wide range of business areas and regions. Records of individual investment or lending by these institutions submitted to the Bank, making them eligible to receive funds from the Bank's first loan disbursement, show that investment and lending were conducted in broad areas: investment or lending in "environment and energy business" was particularly prominent, followed by investment or lending in "development and upgrading of social infrastructure," "medical, nursing care- and other health-related business," "business in the content creation industry," and "disaster prevention business." The results of the first new loan disbursement also show that loans were made for long-term investment or lending, and this meets the objective of the measure: the distribution of individual investment or lending by duration reveals that more than 80 percent of the investment or lending is designed to be carried out over a period of more than four years, with an average investment or lending term of 8.2 years. The new measure, intended to act as a catalyst for financial institutions, has gotten off to a relatively smooth start.

As pointed out with regard to the U.S. economy, expectations for economic growth and expanded productivity have played an important role in achieving sustainable economic growth. In other words, without prospects for increases in income and demand, firms remain cautious about investing and households remain cautious about increasing consumption. The Bank recognizes that Japan's economy faces the critical challenge of overcoming deflation and returning to a sustainable growth path with price stability, and that strengthening the foundations for economic growth implies improving productivity through innovation and structural changes.

Improved productivity may give the impression that an increased supply of goods and services would widen the output gap – that is, the differential between supply and demand – and make it more difficult to overcome deflation. However, as many here will know, innovation and the application of technology often generate new high-value-added goods and services, thereby creating new demand. For example, the development of light emitting diodes (LEDs) – which have been produced in large quantities here in Tokushima Prefecture as light sources – has created new demand for products such as liquid crystal display televisions, fluorescent-type LED lamps for the home, and LED lighting for use on fishing vessels. Improved productivity thus means creating higher-value-added goods by making use of increased efficiency in labor and capital. As a scholar, even before I became a member of the Bank's Policy Board, I have been very much interested in the effects of productivity on the economy. Using data available on Japan to conduct empirical studies, I found that improved productivity, while increasing supply, results in a major increase in demand and narrows the output gap.

Bearing in mind the future for Japan's economy, it is vital to create an environment that enables firms – from a medium- to long-term perspective – to show their "animal spirits" and willingness to meet challenges head on in order to achieve both greater competitiveness that could lead to higher productivity and create new value added. As I have said, the Bank's fund-provisioning measure to support strengthening the foundations for economic growth is a catalyst for financial institutions, while its measures to enhance monetary easing – including the new market operation introduced in August – have helped the private sector achieve the same objective.

Chart 1

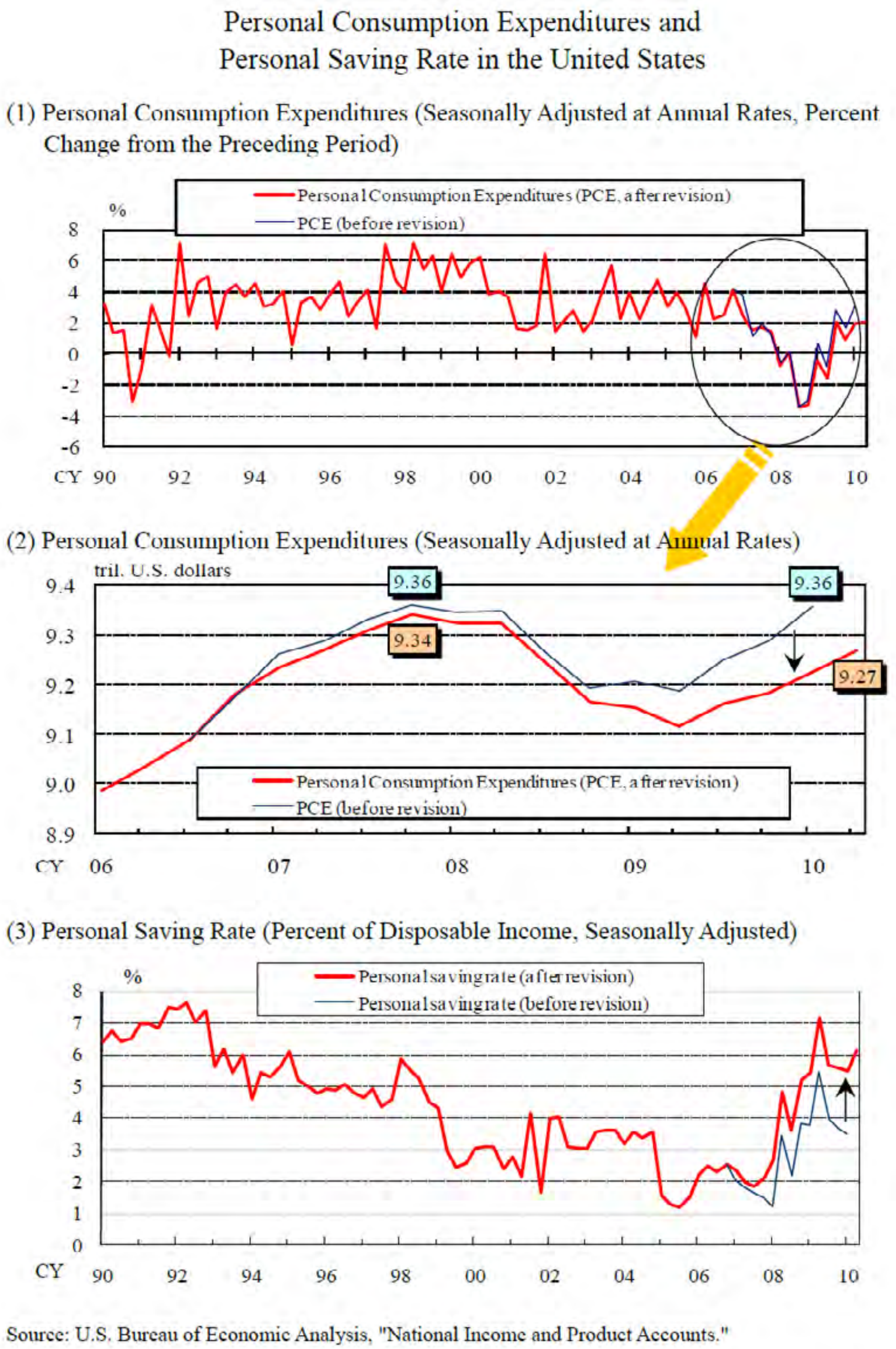
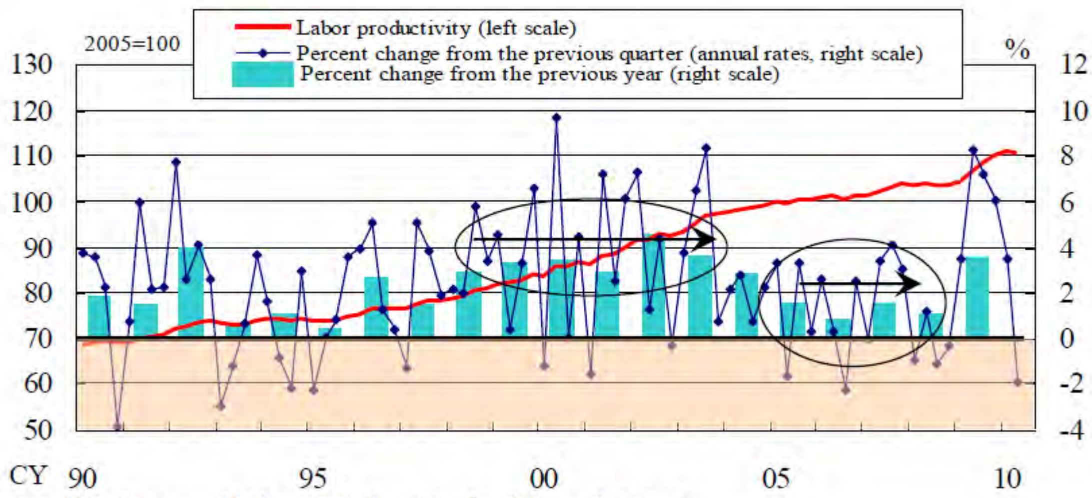


Chart 2

Labor Productivity in the United States



Source: U.S. Bureau of Labor Statistics, "Productivity and Costs."

Chart 3

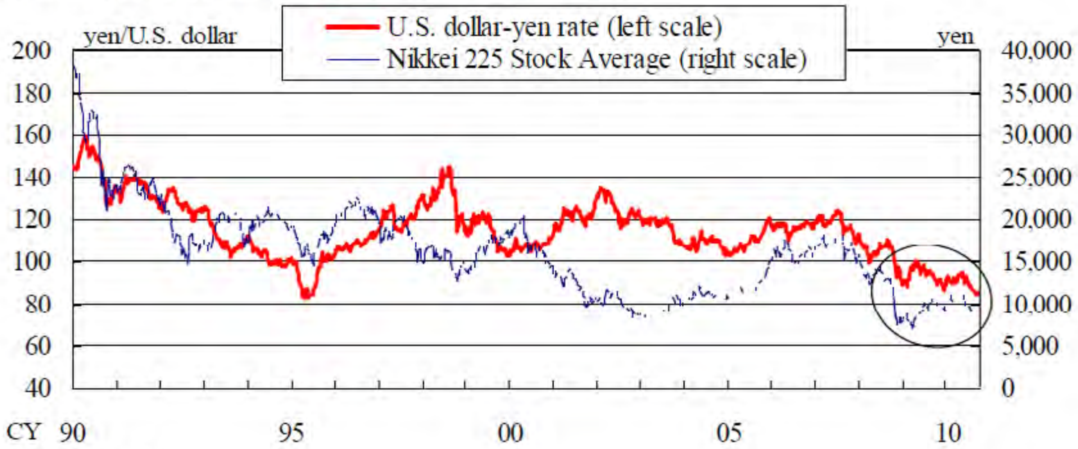
Yield on 10-Year U.S. Treasuries

Source: Bloomberg.

Chart 4

Developments in Financial Markets

(1) U.S. Dollar-Yen Rate and Nikkei 225 Stock Average



Source: Bloomberg.

(2) Corporate Profits and Stock Prices

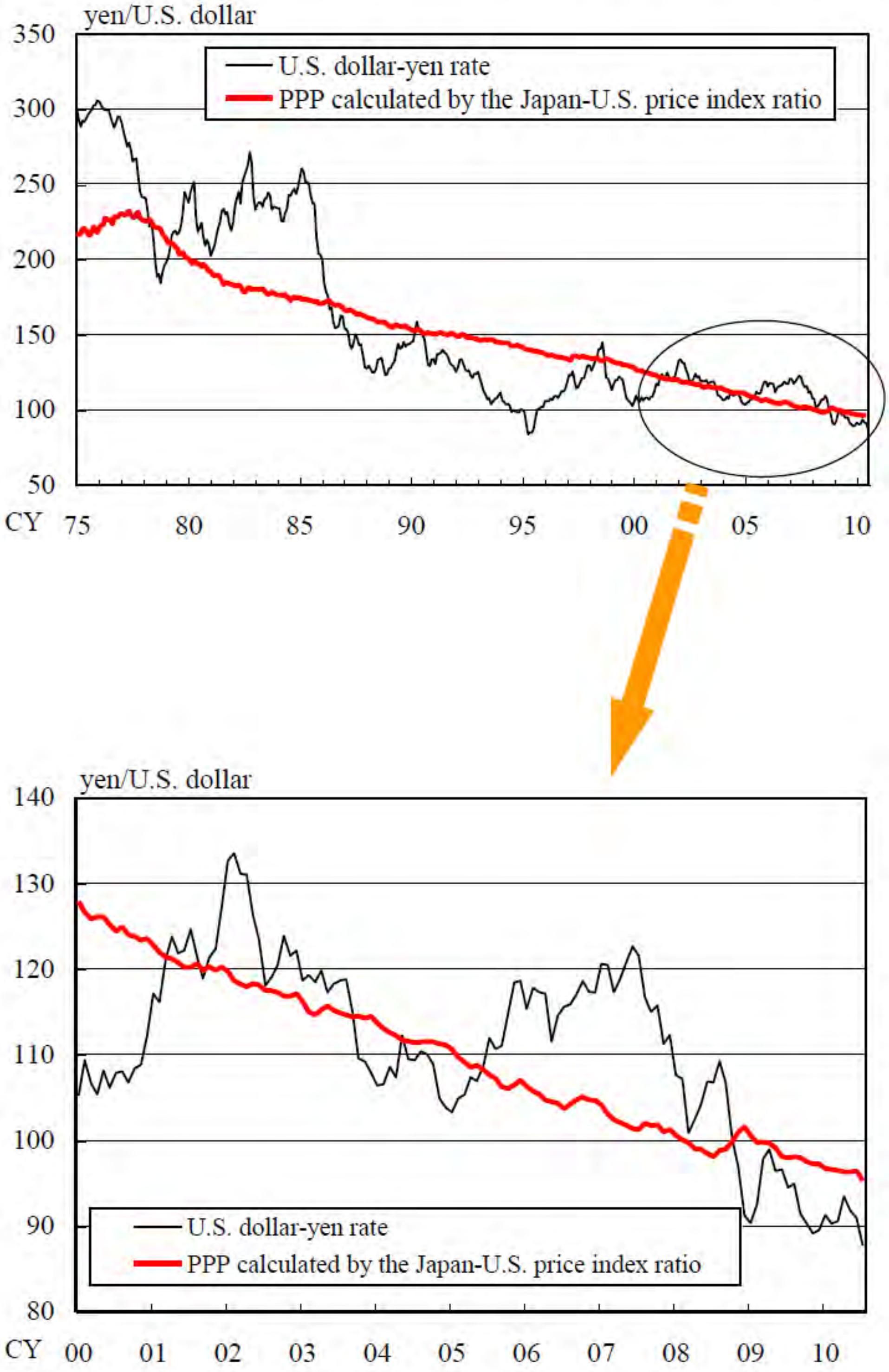
Corporate profits (y/y change, percent)				Stock prices (yen, U.S. dollar, percent)			
	CY 2008	CY 2009	CY 2010		Aug. 31, 2008	Sep. 17, 2010	% change
Japan (ordinary profits)	-33.7	-9.4	+70.0	Nikkei 225 Stock Average	13,072	9,626	-26.4
United States (profits before tax)	-16.4	-0.4	+27.4	Dow Jones Industrial Average	11,543	10,607	-8.1

Note: Annual figures for corporate profits for calendar year 2010 are calculated by multiplying the total figures for the first half of the year by two.

Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly"; U.S. Bureau of Economic Analysis, "National Income and Product Accounts."

Chart 5

Purchasing Power Parity (PPP) and U.S. Dollar-Yen Rate



Note: PPP is calculated using the consumer price indexes of Japan and the United States.
Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index";
U.S. Bureau of Labor Statistics, "Consumer Price Index."

Chart 6

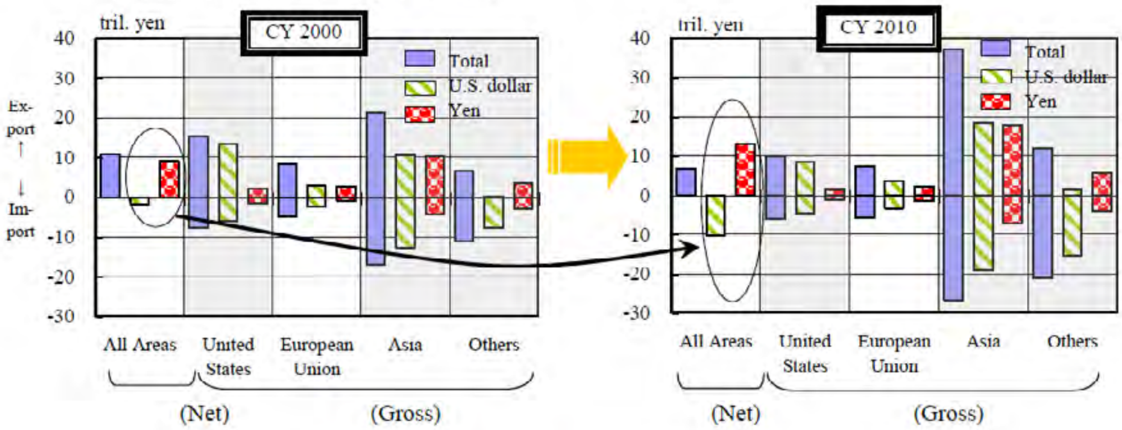
Currency Composition and Value of Japan's International Trade

(1) Currency Composition

	Second half of CY 2000 (%)				
	Total exports	United States	European Union	Asia	Others
U.S. dollar	52.4	86.7	36.2	50.0	1.1
yen	36.1	13.2	33.5	48.2	53.7
	Total imports	United States	European Union	Asia	Others
U.S. dollar	70.7	78.7	49.7	74.0	69.6
yen	23.5	20.8	17.5	24.8	26.1

	First half of CY 2010 (%)				
	Total exports	United States	European Union	Asia	Others
U.S. dollar	48.6	85.9	49.9	49.9	12.4
yen	41.0	14.1	30.1	48.1	48.2
	Total imports	United States	European Union	Asia	Others
U.S. dollar	71.7	78.1	58.0	71.7	73.6
yen	23.6	21.4	28.0	26.8	19.0

(2) Value (Declarations to Customs)



Note: Annual figures for the trade value for calendar year 2010 are calculated by multiplying the total figures for the first half of the year by two.
Source: Ministry of Finance, "Trade Statistics," "Currency Composition of International Trade."