Seiji Nakamura: Japan's monetary policy and developments in economic activity and prices

Speech by Mr Seiji Nakamura, Member of the Policy Board of the Bank of Japan, at a meeting with Business Leaders, Fukushima, 25 November 2010.

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I. The outlook report for October 2010[1]

A. The outline of the assessment

The Bank of Japan discusses economic activity and prices at the Monetary Policy Meetings (MPMs) held each month. Semiannually, in April and October, it releases the *Outlook for Economic Activity and Prices*, or the Outlook Report for short, in which the Bank makes public its forecasts for economic activity and prices for the next two to three years. At the MPMs held in July and January, three months after the release of the Outlook Reports, the Policy Board examines possible deviations from the scenario presented in the Outlook Reports.

The Bank's recent assessment of the Japanese economy was that it still showed signs of a moderate recovery, but the recovery seemed to be pausing. The Outlook Report released on October 29, 2010 projected that, in the second half of fiscal 2010, the pace of recovery was likely to slow owing to factors including the slowdown in overseas economies and the ending of the boost from policy measures targeted at durable consumer goods, as well as the recent appreciation of the yen. In fiscal 2011, albeit with some lingering effects of the yen's appreciation, the economy was expected to return to a moderate recovery path, given that exports were projected to continue increasing as the growth rates of overseas economies were likely to rise again, and that firms' sense of excessive capital stock and labor was likely to be dispelled gradually as corporate profits improved. In fiscal 2012, the Japanese economy was expected to continue growing at a pace above its potential growth rate, as the transmission mechanism by which the strength in exports and production fed through into income and spending would likely operate more effectively amid the continued relatively high growth in overseas economies, especially emerging and commodity-exporting economies.

Forecasts made by the nine members of the Bank's Policy Board in October were as follows. The median of the forecasts for Japan's real GDP growth rate was 2.1 percent for fiscal 2010, 1.8 percent for fiscal 2011, and 2.1 percent for fiscal 2012. Figures for fiscal 2010 and fiscal 2011 were revised downward by 0.5 percentage point and 0.1 percentage point, respectively, from the forecasts in July.

As for prices, the consumer price index (CPI) for all items excluding fresh food was projected to increase moderately due partly to the narrowing of the negative output gap as the economy picked up gradually and to a moderate rise in commodity prices on the back of the continued relatively strong growth in emerging and commodity-exporting economies. Meanwhile, attention should be paid to the possibility that the recent appreciation of the yen was likely to exert downward pressure on domestic prices by holding down import prices. The median of the forecasts for the year-on-year rate of change in the CPI was minus 0.4 percent for fiscal 2010, plus 0.1 percent for fiscal 2011, and plus 0.6 percent for fiscal 2012.

Regarding the above forecasts for economic activity and prices presented in the Bank's October 2010 Outlook Report, the following risks warrant attention.

[1] The fiscal year in Japan starts in April and ends in March.

First, if the pace of already robust growth in emerging and commodity-exporting economies accelerates further as a result of strong domestic demand and the continued inflow of risk money from advanced economies pursuing prolonged monetary easing, this may push up economic activity in Japan and result in stronger-than-expected growth. However, such growth could be followed by the unwinding of risk exposure, which may result in larger adjustments in financial and economic activity, thus posing a downside risk to the Japanese economy from a longer-term perspective.

Second, with regard to the advanced economies of Europe and the United States, the Bank feels that, overall, uncertainty remains high and risks are tilted to the downside. In the United States, the pace of recovery in the labor market is likely to be only moderate, and households in particular remain burdened by balance-sheet adjustments. Therefore, it will remain difficult for the self-sustaining virtuous circle of growth in production, income, and spending to operate properly. In Europe, there are concerns that, in 2011, the effects of economic stimulus measures could wane with the implementation of fiscal austerity programs. In addition, concerns over the sovereign risk of some European countries might have adverse effects on economic activity through a rise in long-term interest rates and a deterioration in market sentiment.

Third, turning to the situation in Japan, if uncertainty about the outlook for overseas economies heightens further and the foreign exchange and stock markets become unstable, this might lower firms' medium- to long-term growth expectations and lead to a deterioration in household sentiment, and economic activity in turn might be weaker than expected.

And fourth, with regard to risks specific to prices, consumer prices in Japan could deviate upward from the projection through higher import prices as a result of a rise in commodity prices caused by booming of emerging and commodity-exporting economies and excessive inflows of risk money into these economies.

Let me elaborate on these risks.

B. Overseas economies

Overseas economies as a whole have been on a moderate recovery trend, with the advanced economies continuing to recover moderately and emerging and commodity-exporting economies, despite a slight slowdown, continuing to register relatively high growth. In its October 2010 *World Economic Outlook*, the International Monetary Fund (IMF) revised its projection for world GDP growth in 2010 to 4.8 percent, up 0.2 percentage point from the July 2010 forecast. For 2011, it expects growth to continue at a relatively high rate of 4.2 percent.

Partly due to robust domestic demand and the inflow of risk money from other countries, emerging and commodity-exporting economies, particularly China, have continued to post relatively high growth, becoming the main growth engine for the world economy, accounting for about 70 percent of global GDP growth. However, the overall growth momentum of these economies has started to decelerate, due in part to the unwinding of accommodative monetary policies by authorities in these economies. The Chinese economy continues to show relatively high growth, with the year-on-year rate of GDP growth for the July–September quarter of 2010 marking 9.6 percent, but the rate has slowed from over 10 percent in the first half of 2010, mainly due to the introduction of government measures to rein in real estate transactions. Retail sales recorded high growth of more than 17 percent year on year in October for the ninth consecutive month, and car sales have also been strong. Meanwhile, with the rate of increase in the CPI accelerating for the fourth consecutive month to 4.4 percent in October, the People's Bank of China has raised the policy interest rate and the reserve requirement ratio. Reflecting partly such policy responses, the Chinese economy may decelerate for the time being but – given the virtuous circle of growth in production, income, and spending – is still likely to continue registering a relatively high pace of growth.

The U.S. economy has been recovering moderately and is likely to continue doing so. The real GDP growth rate for the July–September quarter of 2010 was 2.5 percent on an annualized, seasonally adjusted quarter-on-quarter basis, confirming this assessment. Steady growth in exports and private consumption, which accounts for about 70 percent of GDP, was the major factor behind the recovery. There has been other good news with regard to private consumption, such as the recovery in new car sales to a level exceeding 12 million cars on an annualized basis for the first time in 14 months. Nevertheless, activity in the housing market has been sluggish, and there has been little improvement in prices and sales or progress in inventory adjustments. Chairman Ben S. Bernanke of the Federal Reserve Board mentioned in his speech in late October that "now, more than 20 percent of borrowers owe more than their home is worth and an additional 33 percent have equity cushions of 10 percent or less, putting them at risk should house prices decline much further," and that borrowers' situation confirmed the severity of households' balance-sheet adjustments.[2] As for the labor market situation, the unemployment rate remains high at 9.6 percent. Regarding prices, the rate of increase in the personal consumption expenditure (PCE) deflator has been around 1 percent.

At the Federal Open Market Committee meeting held on November 3, 2010, the Federal Reserve decided on further monetary easing, announcing that it would purchase another 600 billion U.S. dollars of longer-term Treasury securities by the end of June 2011. Japan's experience suggests that the ability of monetary policy to stimulate economic activity at a time of balance-sheet adjustments is limited. Therefore, close attention should be paid to the effects of the Federal Reserve's recent monetary easing measures.

European economies on the whole have been recovering moderately, although performances differ, with Germany and France registering robust growth, while others are showing only slow growth. The moderate recovery trend was confirmed by the recently released year-on-year real GDP growth rate of 1.9 percent for the July–September quarter of 2010 for the euro area as a whole. As for the outlook, the euro area economy is expected to continue to grow only moderately because the sovereign risk problem with regard to countries such as Greece and Ireland continues to lurk and fiscal austerity programs will be implemented in the area from 2011.

C. The Japanese economy

The Japanese economy has continued to show steady growth, particularly in private consumption, as evidenced by the fact that the real GDP growth rate for the July–September quarter of 2010 was 3.9 percent on an annualized, seasonally adjusted quarter-on-quarter basis. Looking back, until around spring 2010, exports and production continued to increase against the backdrop of strong growth in emerging and commodity-exporting economies, and private consumption had been recovering partly because of increased corporate profits. Economic activity in Japan subsequently strengthened temporarily until around the summer of 2010, due mainly to temporary factors such as the last-minute rise in demand upon the expiration of subsidies for purchasers of environmentally friendly cars and the boost from the extremely hot weather. However, from around the end of summer, the pace of recovery in the Japanese economy has been slowing, reflecting the ending of such temporary factors as well as a slowdown in export and production growth on the back of the deceleration in overseas economies. In global financial markets, there was increased demand for the yen as a safe haven amid heightened uncertainty about future developments in overseas economies, especially the U.S. economy. As a result, the yen appreciated to a level close to 80 yen against the U.S. dollar, leading to increased concerns about downside risks to the

[2] For details, see remarks by Chairman Bernanke made at "Mortgage Foreclosures and the Future of Housing Finance," a Joint Conference Sponsored by the Federal Reserve System and the Federal Deposit Insurance Corporation, at Arlington, Virginia, on October 25, 2010.

Japanese economy through a deterioration in business sentiment. In response to this situation, the Bank swiftly decided in early October 2010 to implement the “comprehensive monetary easing policy.” I will discuss the details of this policy later. Private banks’ lending rates, in terms of the average contracted interest rates on new loans and discounts, have been on a declining trend, reflecting monetary easing measures implemented by the Bank to date.

Wages are showing signs of improving, albeit moderately, as evidenced by a year-on-year increase in overtime payments and a rise in special payments reflecting strong business performance. Although firms continue to regard their capital stock as excessive, business fixed investment is showing signs of picking up, partly reflecting replacement investment, which has been restrained in recent years.

As for the outlook, private consumption is expected to be temporarily weak until around the end of fiscal 2010, as the boost from policy measures targeted at durable consumer goods and the effects of extremely hot weather come to an end. Export growth is likely to be only moderate because of the temporary slowdown in overseas economic growth and the effects from the earlier appreciation of the yen. Production is also projected to remain weak for the time being. A key factor is when production in the car industry, which has been sluggish following the sharp rise prior to the expiration of subsidies, will recover; this is expected to happen in early fiscal 2011. From the beginning of fiscal 2011, as the growth rates of overseas economies, particularly emerging and commodity-exporting economies, start to increase again, it is expected that exports will regain momentum, manufacturers’ production will return to an increasing trend, and their profits will continue to improve. Firms’ sense of excessive capital stock is likely to be dispelled gradually as exports and production pick up, and business fixed investment is consequently expected to generally continue to pick up. As for nonmanufacturing firms, the effects of the improvement in manufacturers’ business performance have started to spill over gradually, and therefore corporate profits and business fixed investment in these firms are expected to pick up moderately. Supported by these factors, private consumption is likely to return to a moderate recovery trend.

II. Challenges facing the Japanese economy

So far, I have been talking about the outlook for domestic and overseas economies; I would now like to move on to discuss the challenges facing the Japanese economy. These include the low birth rate and population aging, the prolonged period of low economic growth and deflation, and the large fiscal deficit.

In 1968, Japan became the second-largest economy in the world, with its GDP surpassing that of West Germany. After holding onto second place for 42 years, however, Japan conceded that position to China in 2010. Looking back, in the 1960s the Japanese economy grew rapidly at an astounding pace, with the annual average growth rate reaching more than 10 percent, followed by a period of stable growth with an annual average rate of 4–5 percent from the 1970s to the 1980s. During that period, Japanese-style management was widely acclaimed. Since the 1990s, however, the economy has been growing at a slow pace on the whole, with the annual average growth rate hovering just above 1 percent, while Japanese government debt has increased sharply. The significant decline in the growth rate in the 1990s was triggered by a number of factors, particularly the bursting of the bubble economy and the malfunctioning of the financial system, but another major factor behind it seems to be structural changes that have affected the Japanese economy.

These structural changes include the lower birth rate and population aging in Japan, and – triggered by the fall of the Berlin Wall in 1989 – the surge in the number of economies participating in the global market economy and the resulting intensification of global competition. Furthermore, the rapid expansion of the market economy, together with the progress in IT and the ample inflow of capital to emerging economies, led to a rapid catch-up in industrialization among emerging economies and an increase in their domestic demand.

While these rapid global economic changes were occurring, Japan needed to devote substantial economic resources to dealing with the post-bubble adjustments. As a result, Japan was, in some respects, slow in adapting to these changes by, for example, achieving structural reforms and capturing demand from emerging economies, both of which bring about forward-looking investment. Following the collapse of the bubble economy, it seemed for a time that some firms had been successful in riding out the strength of the yen in 1995 and in ambitiously undertaking wide-ranging management reforms and restructuring to develop global business strategies. However, the changes in the global economy have been progressing even faster than such efforts, and for many firms the fruits of such endeavors have been limited.

In view of the situation I have described, I will now talk about three issues that Japan faces.

A. The low birth rate and population aging

In 2005, Japan's population for the first time in the postwar period registered a decline. The working-age population – that is, the population aged between 15 and 64 years old – in fact had already peaked in 1995 at 87 million and has been declining since then, due to the low birth rate and population aging. In the 15 years to 2010, the working-age population declined by 5.88 million. During the same period, the total population increased by about 1.61 million, with the population aging further. According to population projections made by the National Institute of Population and Social Security Research in 2006, the decline in the working-age population will continue to outpace that in the total population until the middle of the 21st century, and in 2055 the working-age population will have almost halved from the current level to 45.95 million in the medium variant projection. Unless the labor force participation rate and/or labor productivity increase, these trends will lower economic growth and exert downward pressure on the growth potential.

The decline in the working-age population restrains economic growth not only from the supply side but also from the demand side, by reducing the number of consumers earning wages. Thus, the decline in the working-age population is likely to depress domestic demand.

Looking at the labor force participation rate by sex and age group, that for men aged 25 to 59 years is more than 90 percent, decreasing to around 30 percent for men aged 65 years and above. The participation rate for women aged 20 to 55 years is 70 percent, but a closer look shows that the rate dips conspicuously to around 65 percent for women in their 30s. To address the continuing decline in the working-age population, it is important to raise the labor force participation rate by providing various measures for the overall population as well as for specific sex and age groups, namely the elderly of both sexes, and also women in their 30s who quit their job to look after their children.

The increase in the elderly population will expand potential demand in the medical care and nursing care fields. Moreover, the advance in population aging shows that the elderly have emerged as a new consumer group, bringing about business opportunities for firms. However, it is also often said that the spending behavior of this new group is rather unpredictable because of the diversity of their needs. Therefore, tapping the potential demand of this consumer group requires greater efforts and an appropriate response by firms.

B. Capturing emerging market demand

According to the IMF, the share of emerging and commodity-exporting countries' GDP in world GDP is currently about 50 percent. Their contribution to the year-on-year overall growth rate, however, amounts to about 70 percent. In view of the high rate of economic growth, emerging countries should not be considered merely as production bases for U.S. and European markets but as countries with great potential demand, the pace of expansion of which is beyond our imagination. Given the possible decline in demand in Japan due to the lower birth rate and further population aging, it is vital, for the growth of the Japanese economy, to devise measures in both the manufacturing and service sectors to capture emerging market demand. The following are some key considerations in this context.

As highlighted in the White Paper on International Economy and Trade 2010 published by the Ministry of Economy, Trade and Industry, Asia's middle-income population – households with disposable income of 5,000 U.S. dollars or more and less than 35,000 U.S. dollars – is forecast to expand in the next ten years. In 2000, Asia's middle-income population stood at about 200 million, but by 2010 it was estimated to have grown to almost 1 billion, exceeding the aggregate population of Japan, the United States, and the euro area. Furthermore, this middle-income population is forecast to double by 2020. Combined with the high-income population – households with disposable income of 35,000 U.S. dollars or more – the market is expected to be enormous, with a population of more than 2.2 billion.

In China, durable consumer goods such as color television sets, refrigerators, and washing machines have become quite common in urban areas, but are still not as widespread as in Japan. These goods are even less common in rural areas of China. As for personal computers, they are still rare even in urban areas. In urban areas of China, ownership of private cars is 10.9 cars per 100 households, one-eighth the level in Japan, and the gap is similar to the difference in the two countries' per capita GDP. Thus, it could be said that China is only at the dawn of motorization and the market is poised for further expansion.

With regard to the service sector, many Japanese firms have already ventured into emerging countries and have won high regard for the meticulous service they provide, but the market is expected to grow further reflecting improvements in living standards. On the other hand, an increasing number of Asian tourists have been visiting the Japanese hot spring town of Hakone near Tokyo recently, indicating that there is much scope for the domestic service sector to capture overseas demand through the provision of various high-quality services.

C. The psychological challenge

Recently the term "two lost decades" can be frequently heard, and it seems that this long period of low growth has shaken confidence in the future, possibly eroding managers' determination to raise corporate value and people's ambition to move up in the world. A survey by the Japan Youth Research Institute conducted in 2007 on the motivation of high school students in Japan, the United States, China, and South Korea reveals the inward-looking attitude of Japanese youths. According to the survey, only 44.1 percent of Japanese respondents said they wanted to move up in the world, compared with 66.1 percent of respondents in the United States, 85.8 percent in China, and 72.3 percent in South Korea. Asked whether they would like a relaxed lifestyle earning an adequate salary, 42.9 percent of Japanese respondents said they would very much like such a life, a conspicuously high figure compared with the 13.8 percent for the United States, 17.8 percent for China, and 21.6 percent for South Korea. And consistent with these survey results, I have heard that at firms, too, the number of employees rejecting offers of promotion or overseas assignments is on the rise. But with economic globalization set to continue, for the Japanese economy to grow it is necessary to nurture personnel who can negotiate on an equal footing with ambitious overseas counterparts.

Japan recovered from the devastation of World War II, tackled cases of environmental pollution, and overcame two oil crises as well as the sharp appreciation of the yen following the Plaza Accord. More recently, it went through the collapse of the bubble economy and financial crises. Each of these experiences enabled Japan to tackle the next challenge. Japan is close to the vast emerging markets of Asia and has a leading edge in areas such as environmental technology. Furthermore, the issue of a low birth rate and population aging is not limited to advanced countries; China and many other countries around the world face the same problem. If Japan can find a way to address this challenge, it could become a pioneer in this field. The government has presented its New Growth Strategy, which covers a wide range of areas. Even though the road to revitalizing Japan may be difficult, it can be achieved if all economic parties – aiming to raise the potential growth rate and productivity – face up to this reality and take bold measures in their respective roles, free from old habits and vested interests.

III. Conduct of monetary policy

Since the collapse of Lehman Brothers in autumn 2008, the so-called Lehman shock, the Bank has conducted aggressive monetary easing measures. These included the lowering of its target for the uncollateralized overnight call rate – the policy interest rate – from around 0.5 percent to around 0.1 percent and the continued provision of ample liquidity by increasing the annual amount of outright purchases of Japanese government bonds (JGBs) from 14.4 trillion yen to 21.6 trillion yen. As I mentioned earlier, with a view to overcoming deflation amid intense global competition and returning the Japanese economy to a sustainable growth path with price stability, the Bank has introduced new measures, which I will discuss in a moment. The Bank is determined to continue to carefully examine the outlook for economic activity and prices and take policy actions in an appropriate manner, as necessary, as the central bank.

A. Fund-provisioning measure to support strengthening the foundations for economic growth

The critical challenge facing the Japanese economy is to raise the potential economic growth rate and productivity. This can be achieved by exploring new areas of growth, and private firms, on their own initiative, should play the primary role in this regard to survive competition and attain growth. However, taking into account that the diminished growth potential of the economy is one of the fundamental problems underlying deflation in Japan, the Bank concluded that an effective way to use its functions as the central bank was to provide support to strengthen Japan's future foundations for economic growth from the financial side. The Bank expects that this measure will act as a catalyst and provide support for the efforts made by private firms and financial institutions on their own initiative.

Based on this thinking, the Bank decided in June 2010 to introduce the fund-provisioning measure to support strengthening the foundations for economic growth, through which it provides long-term funds at a low interest rate to financial institutions that are making efforts in terms of lending and investment toward strengthening the foundations for economic growth. This measure extends loans with maturities of up to four years at a low interest rate equivalent to the policy interest rate to financial institutions for their lending and investment in a broad range of areas and types of business that will eventually lead to the strengthening of the foundations for economic growth. The first new loan disbursement was carried out in September 2010, and loans totaling 462.5 billion yen were disbursed to 47 borrower financial institutions. The average amount per lending or investment project to be financed by such loans was 360 million yen, and the average duration of lending or investment projects was 8.2 years. Funds were provided to a broad range of areas such as "environment and energy business," "development and upgrading of social infrastructure," "medical care, nursing care, and other health-related business," and "regional and urban revitalization business." The second new loan disbursement will be conducted in the near future, and a significant number of financial institutions, about 140, have applied for the measure. Some financial institutions have already started actively exploring potential demand on their own initiative, bearing in mind their future utilization of the measure. The Bank therefore believes that the measure has made a rather good start, in that it has prompted financial institutions to explore new areas of growth in line with its intended purpose.

B. Comprehensive monetary easing policy

Next, I will talk about the "comprehensive monetary easing policy," which the Bank – with a view to further enhancing monetary easing – decided to implement on October 5. This policy is an extraordinary measure for a central bank to implement in that, taking into account that there was little room for a further decline in short-term interest rates, it aims to encourage declines in longer-term interest rates and various risk premiums using a combination of a number of policy measures.

The first measure was a clarification of the Bank's pursuit of the virtually zero interest rate policy.

The Bank changed the target for the uncollateralized overnight call rate from around 0.1 percent to around 0 to 0.1 percent, thereby clearly indicating that it was pursuing a virtually zero interest rate policy. If the interest rate were set at literally zero percent, financial institutions would lose the incentive to invest funds in the money market, incurring the risk of impeding the flow of funds in overall financial markets. Accordingly, the Bank decided to allow the overnight call rate to fluctuate in a range at or below 0.1 percent. For the same reason, the Federal Reserve set the target range for the federal funds rate, its policy rate, at 0 to 0.25 percent.

The second measure was a clarification of the Bank's commitment regarding the time horizon for maintaining the virtually zero interest rate policy.

In terms of the future conduct of monetary policy, the Bank clearly stated that it would continue the virtually zero interest rate policy until it judged, on the basis of the "understanding of medium- to long-term price stability" – the so-called "understanding" – that price stability was in sight.[3,4] This measure aims to boost corporate activity and private consumption and stabilize the public's medium- to long-term inflation expectations. On the other hand, a prolonged period of extremely accommodative financial conditions entails the risk of negative side effects such as an asset price bubble. Therefore, maintaining the virtually zero interest rate policy is subject to the condition that, upon careful examination, it does not give rise to the accumulation of financial imbalances, such as a surge in asset prices or excessive debt.

The third measure was the establishment of the Asset Purchase Program (hereafter the Program).

As I mentioned earlier, in order to achieve further monetary easing through the conduct of monetary policy, it is necessary to promote declines in risk-free, longer-term interest rates and in various risk premiums rather than in short-term interest rates, which have little room to fall further. Therefore, the Bank decided to purchase through the Program financial assets amounting to about 5 trillion yen – namely, Japanese government securities and risk assets such as CP, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs) – and provide longer-term funds amounting to 30 trillion yen at a fixed rate of 0.1 percent through the fixed-rate funds-supplying operation against pooled collateral. The aim of the asset purchases through the Program is not to raise the prices of these assets by adjusting the supply and demand balance in the market. Rather, the Bank's thinking behind the establishment of the Program is that the provision of funds through the Program will act as a catalyst in prompting a wider range of investors to purchase financial assets, reduce various risk premiums on these assets as a result of increased market transactions, and ultimately bring about positive effects on economic activity.

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3 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.

4 The midpoints of most Policy Board members' "understanding" are around 1 percent.

The Bank has started purchasing assets for which necessary arrangements have been completed: on November 8, it purchased JGBs amounting to about 150 billion yen as its first purchase, and on November 9 it purchased treasury discount bills amounting to about 150 billion yen as its second purchase.