Miyako Suda: The current situation of and outlook for Japan’s economy and the conduct of monetary policy

Summary of a speech by Ms Miyako Suda, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Yamagata, 1 December 2010.

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Introduction

It is a great pleasure to address this meeting on economic and financial matters. The topic I would like to discuss today is the current situation of, and outlook for, Japan’s economy and the Bank of Japan’s conduct of monetary policy. Let me begin by looking at developments in economic activity and prices in Japan.

I. Economic activity and prices in Japan

A. The current situation

Japan’s economy still shows signs of a moderate recovery, but the recovery seems to be pausing. Exports and production, which had been increasing reflecting the improvement in overseas economic conditions, have recently been decelerating as the pace of recovery in overseas economies is slowing down. Private consumption had continued to recover mainly due to the effects of various demand-boosting policy measures targeted at durable consumer goods, but more recently has been decreasing following the spike in demand before these policy measures expired. I will first look at developments in demand, economic activity, and prices overseas, and then make a more detailed examination of domestic demand in Japan.

1. Overseas demand, economies, and prices

Breaking down Japan’s real exports by destination, East Asia accounted for more than 50 percent, the United States and the European Union for slightly less than 30 percent, and other countries for the remaining 20 percent. Until recently, Japan’s real exports had been on an upward trend, led by the increase in exports to emerging and commodity-exporting economies. However, growth in exports has recently been decelerating due to a number of factors, including measures by the Chinese government to prevent an overheating of the economy, the effects of which have materialized with a time lag; inventory adjustments in IT-related goods, particularly with regard to those exported to the NIEs and ASEAN countries; and the appreciation of the yen.

a. Overseas economies

I will now move on to developments in overseas economies as a whole, which underlie the trends in Japan’s real exports. With inventory restocking – the driving force of the recovery after the Lehman shock – having run its course and the demand-boosting effects of fiscal policy measures waning, the pace of economic growth has been slowing since summer 2010.

Looking at developments by region, the U.S. economy is continuing to recover moderately although the pace has slowed. However, the situation in the housing market remains uncertain, and with home sales, housing starts, and home prices all remaining at low levels, there are persisting concerns about home foreclosures and buybacks brought about by mortgage delinquencies. Many homeowners suffer from negative equity, and balance-sheet adjustment pressures continue to weigh heavily on households. As for the employment and income situation, neither the unemployment rate nor nominal wages have shown a notable recovery. In these circumstances, private consumption on the whole lacks momentum.

Economic activity in the euro area as a whole is recovering moderately, with some differences in growth by country. Although the pace has recently slowed, exports have continued to increase, while private consumption has been rising gradually. However, market concerns regarding sovereign risk in some euro area countries have resurfaced amid uncertainty regarding the response of governments. Thus, financial markets in the United States and Europe partially show signs of instability and warrant continued attention.

On the other hand, though the pace has slowed somewhat, emerging and commodity-exporting economies continue to grow at a relatively rapid pace, led mainly by domestic demand. In China, economic growth has been accelerating again. The pace of increase in China's exports has been slowing due to the deceleration in overseas economies, but growth in private consumption has been firm due to households' higher income levels. Fixed investment continues to show high growth despite a slowdown partly due to government measures to rein in real estate transactions and energy consumption. With regard to economic conditions in the NIEs and the ASEAN countries, although growth in exports and production has slowed sharply due to the deceleration in overseas economies and adjustments with regard to IT-related goods, the recovery trend remains intact supported by firm domestic demand.

As for the outlook, though the pace of growth in overseas economies will probably continue to slow for the time being, the recovery trend itself is likely to remain intact, and from 2011 the growth rate will start to increase again. Looking at developments by region, emerging and commodity-exporting economies, including China, despite a temporary slowdown, will continue to grow at a relatively rapid pace, supported mainly by robust domestic demand. Meanwhile, the effects of balance-sheet adjustments will continue in the U.S. economy, but growth there is expected to accelerate again from 2011 on the back of a rise in exports, mainly to emerging and commodity-exporting economies, and a moderate recovery in business fixed investment and private consumption. Economic activity in Europe on the whole is likely to continue to recover moderately, although the pace of recovery will differ by country.

b. Overseas prices

As for the price situation in overseas economies, a significant divergence can be observed between advanced economies and emerging and commodity-exporting economies. The U.S. and European economies continue to experience disinflationary tendencies due to the slack in supply and demand conditions in the goods and service markets as well as in the labor market. For example, in the United States, the rate of change in the core personal consumption expenditure (PCE) deflator fell to 0.9 percent on an annual basis in October, and the rate of increase in the consumer price index (CPI) is likely to remain low for the time being. In this situation, following the speech made by Federal Reserve Chairman Ben S. Bernanke on August 27,[1] markets started to factor in possible additional monetary easing, and transactions based on the anticipation of a reversal in the disinflation trend increased – as evident from, for example, the rise in the breakeven inflation rate, which is a measure of medium- to long-term inflation expectations. Moreover, concerns about the risk of inflation have been raised following the Fed's decision on November 3 to conduct large-scale purchases of longer-term Treasury securities totaling 600 billion U.S. dollars.

As for emerging and commodity exporting economies, inflationary pressure has been increasing due to higher natural resource and food prices and greater utilization of production factors. In fact, in some countries, including China, inflation has already started to pick up. One reason is the acceleration of capital inflows to emerging economies caused by monetary

[1] See "The Economic Outlook and Monetary Policy," a speech made by Chairman Bernanke at the Federal Reserve Bank of Kansas City Economic Symposium in Jackson Hole, Wyoming, on August 27, 2010.

easing in advanced economies, especially the United States. This means that, given the so-called "trilemma of international finance" – the impossibility of simultaneously pursuing a stable exchange rate, free capital movements, and an autonomous monetary policy – in some countries, the conduct of monetary policy may be affected by interventions in the foreign exchange market to avoid a surge in the exchange rate, resulting in a delay of necessary adjustments in monetary policy.

2. Domestic demand in Japan

Turning to domestic demand in Japan, business fixed investment is showing signs of picking up, supported mainly by the improvement in corporate profits. Specifically, the aggregate supply of capital goods, a coincident indicator of machinery investment, has registered a moderate increase, while there has been a substantial increase in machinery orders, a leading indicator of machinery investment. The employment and income situation, although remaining severe, has eased somewhat, with a slight rise in the number of employees and in wages, as well as a gradual improvement in the ratio of job offers to applicants. In this situation, growth in private consumption until September turned out stronger than expected, reflecting the last-minute rise in demand ahead of the expiration of subsidies for purchasers of environmentally friendly cars and the increase in the tobacco tax, in addition to the boost from the extremely hot weather. Since the beginning of October, however, private consumption has dropped following the earlier spike in demand. Meanwhile, housing investment has stopped declining, with the number of housing starts (a leading indicator of housing investment) – especially those for the sale of real estate lots – generally picking up and sales of apartments in the Tokyo metropolitan area increasing. On the other hand, public investment has been declining since the second half of 2009.

Given this situation in domestic and overseas demand, domestic growth in production has lost momentum. Production dropped in September, mainly due to the decline in production of cars and semiconductor and related products reflecting the decrease in demand following the expiry of government measures. The drop was also seen on a quarterly basis.[2] Consequently, inventories have been increasing somewhat, mainly in durable consumer goods and in electronic parts and devices.

3. Prices in Japan

With regard to price developments in Japan, the CPI excluding fresh food is declining on a year-on-year basis due to the substantial slack in the economy as a whole, but the pace of decline has continued to slow. In October, the year-on-year pace of decline in the CPI slowed significantly due especially to the increase in the tobacco tax.

B. The Outlook

1. The October 2010 Outlook Report

As we have seen so far, Japan's economy is still showing signs of a moderate recovery, although the pace of recovery seems to have temporarily slowed. The key issue is how to come out of this temporary slowdown. Let us therefore consider the outlook for economic activity and prices in Japan, which the Bank released in the October 2010 issue of the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report).

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2 As a result of the revision to seasonal adjustments carried out in April 2010, it is likely that a portion of the significant drops in production in the October-December quarter of 2008 and the January-March quarter of 2009 is recognized as seasonal rather than actual movement. Such a seasonal adjustment method would push up future growth rates for the October-December and January-March quarters, but push down those for the April-June and July-September quarters. Therefore, it is necessary to assess actual terms for the April-June and July-September quarters by adjusting for such downward pressure.

Starting with the outlook for the economy, the pace of recovery is likely to slow temporarily in the second half of fiscal 2010 due to factors such as 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. The growth rate of the economy for the October–December quarter of 2010, in particular, is highly likely to turn out negative following the higher-than-expected growth in the July–September quarter. However, although the effects of the appreciation of the yen may continue to linger, the economy is expected to return to a moderate recovery path once we enter fiscal 2011, given that – with growth in overseas economies expected to pick up again – exports are projected to continue increasing and firms' sense of excessive capital stock and labor is likely to dissipate gradually. In fiscal 2012, Japan's economy is expected to continue growing at a pace above its potential amid the continued relatively high growth in overseas economies, especially emerging and commodity-exporting economies.

Although my view regarding the outlook is basically in line with the Bank's projection, I am concerned about the extent to which Japan's economy will be able to benefit from global economic growth. In fact, I have a growing sense that Japan has not yet enjoyed much success in this regard, given that the pace of growth in Japan's exports has been more moderate than that of other countries since the mid-1990s and that Japan's share in world exports has been declining since the mid-1990s despite trade liberalization in countries such as China. Moreover, Japan is likely to face an even tougher global competitive environment due not only to the recent rapid appreciation of the yen – in a situation where domestic capacity is yet underutilized – but also to factors unrelated to foreign exchange – such as the technological catch-up of emerging economies and the increase in free trade agreements concluded abroad – some of which I will discuss later. In addition, issues that directly affect the competitiveness of Japanese firms, such as various environmental constraints, the tax burden, and labor laws and regulations, still give cause for concern. Thus, attention should be paid to the growing possibility that the Japanese economy and Japanese firms will not be able to benefit from global demand to the extent commonly expected.

As for the price outlook, the year-on-year pace of decline in the CPI excluding fresh food is expected to continue slowing as the aggregate supply and demand balance is projected to continue improving gradually in a situation where medium- to long-term inflation expectations are assumed to remain stable. In the Outlook Report, the Bank projected that the timing of the year-on-year rate of change in the CPI entering positive territory would likely be sometime in fiscal 2011, and that thereafter the rate of increase would start rising through fiscal 2012. However, I have a more cautious view of future developments in prices. Let me explain why this is the case.

2. Views on the expected rate of inflation

When examining the outlook for price developments, key aspects to be considered are the size of the output gap, the expected rate of inflation, and import prices. In addition, empirical studies show that the current rate of inflation is also affected by past inflation. Thus, empirical analyses of inflation dynamics often use the following type of specification: Inflation rate for the current term

= γ × (the expected rate of inflation for the next term)

+ (1 – γ) × (the inflation rate for the previous term)

+ β × (the output gap for the current term)

+ α × the rate of change in import prices,

where α, β, and γ are parameters.

A frequent criticism of this type of specification is that the inclusion of the inflation rate in the previous term lacks microfoundations and its role is therefore difficult to interpret. However, one possible interpretation is that the rate of inflation not only is determined by medium- to long-term inflation expectations but also may be affected by short- to medium-term inflation expectations that are influenced by actual inflation in the past. According to this interpretation, the key question for Japan at the moment is which of the two influences is stronger – positive medium- to long-term inflation expectations or negative inflation rates in the past.[3]

It goes without saying that for Japan it is important to enhance the influence of medium- to long-term inflation expectations on the actual rate of inflation. However, I believe it will not be easy to do this given the prolonged deflation Japan has been suffering. Furthermore, it seems that Japan is not the only country where the influence of medium- to long-term inflation expectations is weak. Though the context differs, in the United Kingdom – where the inflation rate has exceeded the ceiling of the target for almost a year – the possibility of a rise in medium-term inflation expectations driven by past rates of inflation is considered a serious risk.[4] Furthermore, in the United States, concern has been voiced over the possibility of the current disinflation depressing medium-term inflation expectations.[5]

Moreover, given that inflation rates in the past were influenced by the output gap at the time, the fact that current inflation is affected by past inflation means that current inflation is determined not only by the output gap at present but also that in the past. Given that the utilization rate of Japan's economy remains low and growth in the third quarter of fiscal 2010 is expected to be negative, little improvement is likely in the output gap. The effect of this output gap on future inflation cannot be ignored, and the influence of medium- to long-term inflation expectations on current inflation is not likely to be very strong.

3. Japan's response to globalization

Needless to say, Japan's response to globalization is also an important factor when considering the outlook for price developments. The Japanese economy has stagnated for more than ten years and prices have been on a downward trend for much of that period, and it is clear that globalization – through the increase in low-priced imports and intensified competition – has played a role in this.[6]

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[3] The forecast for the medium- to long-term rate of inflation by economists has been stable at around 1 percent for the past few years.

[4] At a press conference in November 2010, Bank of England Governor Mervyn King stated, "And if the period of above-target outturns causes medium-term expectations to drift up, then the inflation outlook could be significantly higher" (Bank of England, *Inflation Report Press Conference Opening Remarks by the Governor, 10th November 2010*), and "If inflation expectations start to move away from target in a way that threatens the behaviour of inflation in the medium term, then we certainly would be concerned. And that is obviously the major upside risk and we talk about that at great length in the [Inflation] Report" (Bank of England, *Quarterly Inflation Report Q&A, 10th November 2010*). Moreover, at the Monetary Policy Committee meeting in November, it was stated that "some Committee members were concerned that recent inflation outturns and the higher near-term profile meant that the risk to inflation expectations was somewhat greater than previously thought" (Bank of England, "Minutes of the Monetary Policy Committee Meeting 3 and 4 November 2010").

[5] See, for example, William C. Dudley's speech entitled "The Outlook, Policy Choices and Our Mandate," given at the Society of American Business Editors and Writers Fall Conference at the City University of New York on October 1, 2010. At the Federal Open Market Committee (FOMC) meeting held on June 22 and 23, 2010, it was stated that "some participants judged the risks to the outlook for inflation as tilted to the downside, particularly in the near term, in light of [. . .] the possibility that inflation expectations could begin to decline in response to low actual inflation." Moreover, the minutes of the FOMC meeting held on November 2 and 3, 2010 stated that "participants citing downside risks noted concerns about the degree to which lingering resource slack in the economy was putting downward pressure on inflation, or about the possible effects that an extended period of low readings on actual inflation might have in reducing inflation expectations."

[6] For details on structural issues in Japan that form the background to the prolonged deflation, see the speech I delivered at the University of Tokyo on December 1, 2010 entitled "Seichoukiban Kyouka no Juuyousei to Kin'yuseisaku (The Importance of Strengthening the Foundations for Economic Growth and Monetary Policy)" (available in Japanese only).

With regard to globalization, one issue that I have recently been concerned about is the effect on Japan's economy and prices of the rapid technological catch-up of emerging countries with Japan. In recent meetings with corporate managers, I increasingly hear that firms from emerging economies have, for example, been acquiring at low cost facilities made redundant at Japanese firms through restructuring and absorbing production know-how by employing expert technicians retired from Japanese firms, including from small and medium-sized firms, enabling emerging economies to catch up rapidly with Japanese firms with respect to production technology and skills. If the production technology of emerging countries were to improve rapidly, this would not only further intensify global competition but, from Japan's perspective, also increase the impact of exchange rate fluctuations on exports due to the increased price elasticity of exports. In addition, the possibility of competitive disadvantages due to factors other than the exchange rate, such as tariffs, is increasing, so that exporting firms in particular will have no choice but to cut costs further in order to maintain their competitiveness. Traditionally, Japanese firms have tended to raise productivity through advances in labor-saving technology and cost cutting; however, given that there still remain significant wage differentials with emerging economies, it is possible that firms will seek to lower labor costs further by shifting more production bases overseas, replacing full-time employees with part-timers, and shortening working hours. For this reason, downward pressure on wages is likely to increase, in which case upward pressure on prices – including prices of services, which are affected by wages – will weaken. Considering the price-setting behavior of firms in a situation where competition with overseas firms is expected to increase, I cannot help but be cautious with regard to the outlook for prices.

In view of what I have described, I believe that the probability that the year-on-year rate of change in the CPI will leave negative territory during fiscal 2011 is not high and that it will take some time to attain conditions necessary to overcome deflation. The probability is pushed down further by the scheduled change in fiscal 2011 of the base year for the CPI to 2010, as explained in the Bank's Outlook Report.[7]

C. Risk factors

As stated in the introduction of the October 2010 Outlook Report, a careful analysis of both upside and downside risks is of great importance due to the high level of uncertainty in the current economic situation and the considerable risk that the economy may deviate from the scenario considered most likely by the Bank.

In the October 2010 Outlook Report, the following risk factors regarding economic activity were identified: (1) developments in advanced economies; (2) developments in emerging and commodity-exporting countries; (3) developments in business and household sentiment; and (4) firms' medium- to long-term growth expectations. Risks regarding price developments included (1) the materialization of upside and downside risks regarding economic activity; (2) medium- to long-term inflation expectations of firms and households; (3) the uncertainty in gauging the aggregate supply and demand balance and its impact on prices; and (4) developments in import prices.

I personally am also conscious of these risk factors. In what follows, I will consider them in greater detail.

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[7] See Footnote 8 in "The Bank's View" of the October 2010 Outlook Report, which stated, "This outlook for inflation is predicated on the 2005-base CPI. The statistics authority has announced that the base year for the CPI is scheduled to be changed to 2010 in August 2011, and year-on-year figures as far back as January 2011 are scheduled to be revised retroactively. This rebasing is likely to cause the year-on-year rate of increase in the CPI to be revised downward."

1. Risks concerning overseas economic activity and prices

I will first look at risks concerning overseas economies. In advanced economies, room for further fiscal stimulus measures is limited (and emphasis is in fact shifting to fiscal consolidation), and downside risks such as balance-sheet adjustments in the United States and Europe and a high level of uncertainty remain. On the other hand, in emerging and commodity-exporting economies, where governments have room for further policy actions, there are upside risks such as a further acceleration of the economy. Thus, at present, risks concerning overseas economies seem to be well balanced, although the level of uncertainty is high. However, as I mentioned earlier, considering the current economic situation and the level of asset prices in emerging and commodity-exporting economies, adjustments to the accommodative monetary policies there seem to be somewhat delayed. Against this background, upward pressure on prices, including those of commodities and food, is heightening. Thus, the risk of economic overheating and a subsequent rapid reversal appears to have grown slightly.

Although I mentioned that emerging and commodity-exporting economies seem to have fallen somewhat behind in adjusting accommodative monetary policies, it would be inappropriate to focus on these countries alone. The sharp contrast in price developments between advanced economies and emerging and commodity-exporting economies – with the former facing disinflation and the latter inflation – combined with global external imbalances poses great difficulties for policymakers in countries around the world. At the same time, I am increasingly concerned that when policy actions are taken they might – contrary to intentions – widen fluctuations in real economic activity and prices around the world. This is because the economic size of emerging and commodity-exporting economies as a group is approaching that of advanced economies as a group, and the closer the size of the economies of the two groups, the more their policy actions affect each other. In terms of policy effects, this means that the feedback effects of policies also increase accordingly through this external economic impact. However, given the lack of adequate information on the domestic economy and overseas economies, and due to differences in exchange rate regimes and in capital mobility, it is difficult to accurately gauge the impact of such feedback effects and the spillover effects from policies undertaken by other countries.[8]

2. Risks concerning the domestic economy

Next, I will talk about the risks concerning the Japanese economy. At present, financial markets cannot be described as stable due to the great uncertainty surrounding the economy and financial markets, and the volatility in the degree of risk tolerance in financial markets. Given the low capacity utilization in the economy, the recent appreciation of the yen, and the deterioration in corporate and consumer sentiment, there remains a high risk that the expected temporary weakness in the economy will persist.

From a longer-term perspective, a downside risk of concern is that the expected growth rate may fall much further than expected. Following the bursting of the bubble economy, Japan was preoccupied with addressing the legacy of the bubble and failed to take sufficient measures to deal with major issues such as the large fiscal deficit and the aging and shrinking of the population. And this, I believe, is the fundamental reason why Japan has been unable to raise the expected growth rate. Another major reason is that Japan has not responded sufficiently, or has been slow to respond, to structural changes in the global economy, in particular the rise of emerging and commodity-exporting economies. Put

8 Generally speaking, in a two-economy setting where one economy is large and the other small, the small economy will be affected by policy decisions of the large economy, while the policies of the small economy will not affect the large economy. However, if both economies are of a similar size, their policies will affect one another and it is therefore necessary to pay close attention to feedback effects. See, for example, chapter 18 of *International Economics* by Robert A. Mundell.

differently, as I pointed out earlier, Japan has not been able to benefit fully from global economic growth.[9]

Against this background, many Japanese firms have recently been developing new products and expanding international sales networks in order to capture infrastructure and consumption demand in emerging and commodity-exporting economies. Among these firms, some are aiming to restructure their business strategies from a global viewpoint by acquiring overseas firms, making use of the strong yen. Such a constructive approach could increase corporate confidence and dispel the prevailing sense of gloom, leading possibly to an increase in the expected growth rate. If, however, firms that are developing business overseas place priority on strengthening overseas production by shifting production abroad and/or closing down domestic bases altogether, the impact on the Japanese economy – and especially the direct impact on subcontractors and sub-subcontractors – would be quite severe because of the large spillover effects from exporters.[10] In fact, the Bank's *Regional Economic Report* released in October 2010, based on information gathered from its Head Office and branches, highlighted the concern raised by some that increased overseas production was restraining new hiring in Japan.[11] Thus, there is a risk that Japan's expected growth rate will decline unless all economic players take forward-looking action in their respective fields.

3. Risks concerning prices

The last issue is risks concerning prices. An increase in commodity prices brought about by high growth rates in emerging and commodity-exporting economies could cause prices in Japan to rise more than expected. At present, international commodity prices are on an upward trend, so it is necessary to carefully monitor the impact of import prices. However, the risk of a downturn in the rate of inflation cannot be ruled out because of factors such as a decline in medium- to long-term inflation expectations.

Regarding the outlook for prices, the crucial point, as I mentioned earlier, is how well current inflation is anchored to stable medium- to long-term inflation expectations. I personally take a cautious view on this issue. I am also wary about the effectiveness of the comprehensive monetary easing policy that I will explain later, and therefore believe that, on balance, risks concerning prices are weighted on the upside.

II. Conduct of monetary policy

A. Background to the Bank's decision to implement a comprehensive monetary easing policy

Next, I will outline the Bank's current conduct of monetary policy. 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, it will continue to consistently make contributions as the central bank, namely, strive to pursue powerful monetary easing, ensure financial market stability, and support strengthening the foundations for economic growth. At the same time, it will carefully examine the outlook for economic activity and prices, and if

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[9] According to the 43rd *Opinion Survey on the General Public's Views and Behavior* conducted by the Bank in October 2010, the proportion of respondents who replied that they expected the Japanese economy to grow at about the current rate decreased to 33 percent, while the proportion of those who answered that they expected it to grow only at a lower rate increased to 64 percent.

[10] See Kozo Kiyota, "Nihon no Yushutsu to Koyou (Japan's Exports and Employment)," RIETI Discussion Paper No. 10-J-29, Research Institute of Economy, Trade and Industry, April, 2010.

[11] See the summary of the *Regional Economic Report* released by the Bank in October 2010.

judged necessary, take policy actions in a timely and appropriate manner.[12] The Bank examined the outlook for economic activity and prices at the Monetary Policy Meeting on October 4 and 5, 2010, and judged that it had become more likely that the return of Japan's economy to a sustainable growth path with price stability would be delayed. Based on this assessment, the Bank decided to implement comprehensive monetary easing as an additional policy measure to further enhance monetary easing.[13]

In recent months, following the Monetary Policy Meeting in July 2010, at which the Policy Board members conducted an interim assessment of the Bank's view presented in the April 2010 Outlook Report, I have been thinking in more detail about the outlook for economic activity and prices through fiscal 2012. By September, I had become increasingly concerned about the downside risks to the economic outlook, especially for fiscal 2011 and thereafter, and concerned that the recovery in prices might be weaker than expected. Therefore, my view was that the Bank should take drastic policy action using unprecedented measures. Looking back, it seems that other Policy Board members, each from their own perspective, have had a similar or acute view. It is these concerns that prompted the decision to introduce the comprehensive monetary easing policy.

B. Objectives of the comprehensive monetary easing policy

The comprehensive monetary easing policy consists of three measures: a change in the guideline for money market operations; a clarification of the commitment regarding the time horizon for maintaining the virtually zero interest rate policy based on the "understanding of medium- to long-term price stability" (hereafter "understanding"); and the establishment of the Asset Purchase Program. Next, I will explain the objectives of these measures in detail. For clarity, I have classified the objectives into four categories, which are to achieve (1) lower interest rates, (2) quantitative easing, (3) qualitative easing, and (4) to affect market expectations.

1. Change in the guideline for money market operations

The first measure was to change the guideline for money market operations. The Bank decided to change the target for the uncollateralized overnight call rate from previously "around 0.1 percent" to "around 0 to 0.1 percent." The Bank has pursued a virtually zero interest rate policy since the policy change in December 2008, setting the target for the rate at around 0.1 percent. However, because it was not necessarily clear by how much the Bank would allow the rate to deviate from 0.1 percent in its daily market operations, it decided to clarify this point. While the Bank has been committed to providing ample funds since the Lehman shock, it will further enhance the provision of liquidity through measures such as the implementation of the Asset Purchase Program, which I will explain later. In addition, given that the transaction volume in the call market has declined as the ample provision of funds by the Bank increasingly replaced private interbank transactions, the uncollateralized overnight call rate may fall considerably below 0.1 percent. Since the Bank considered that explicitly allowing the overnight call rate to fall below 0.1 percent would enhance the effectiveness of its policy, it decided to adopt the change in the guideline for money market operations.

However, while the aim of the change in the guideline for money market operations was to allow the overnight call rate to fall below 0.1 percent, the interest rate applied to the complementary deposit facility has been maintained at 0.1 percent. Some may feel that if the interest rate paid on financial institutions' excess reserve balances were lowered, this would result in a decline in interest rates. However, since an excessively low call rate would deprive financial institutions of profit opportunities, it could result in a decline in interbank transactions

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[12] See "Statement on Monetary Policy" released by the Bank on September 7, 2010.

[13] See "Comprehensive Monetary Easing" released by the Bank on October 5, 2010.

and ultimately lead market participants to exit the market, as happened when the quantitative easing policy was implemented. Thus, the functioning of financial intermediation could be impaired, which would in turn hamper the effects of monetary easing. Therefore, weighing up the advantages and disadvantages I have mentioned, the disadvantages of further lowering the interest rate for the complementary deposit facility at this point in time would be greater. Chairman Bernanke made a similar point in his speech on August 27, 2010.[14]

2. Clarification of the duration of the virtually zero interest rate policy

The second measure taken by the Bank was to clarify the duration of the virtually zero interest rate policy. Specifically, the Bank explicitly stated that it would continue the virtually zero interest rate policy until it judged that price stability on the basis of the "understanding" was in sight. However, the continuation of the virtually zero interest rate policy is subject to the condition that no problem will be identified in examining risk factors, including the accumulation of financial imbalances, because if monetary policy focused only on price developments, other risk factors might be overlooked.

With regard to the four objectives I mentioned earlier, this measure meets the fourth and the first ones; that is, it aims at affecting market expectations and prompting a decline in interest rates. To explain this in more detail, the importance of trying to influence market expectations follows from what is called "expectations theory" with regard to long- and short-term interest rates. Specifically, this theory suggests that long-term interest rates are determined by the average rate of the expected series of overnight rates in the corresponding period. Thus, if the Bank announces to the markets that it will continue with its virtually zero interest rate policy until it judges that price stability is in sight and this is recognized by market participants, they will form the expectation that the overnight call rate will stay around zero percent as long as deflation is expected to continue, and term rates and medium- to long-term rates will stabilize at extremely low levels as a result. This effect of monetary easing is called the "duration effect."

When the Bank, in March 2006, terminated its quantitative easing policy, which was accompanied by such a duration effect, it introduced a new framework for the conduct of monetary policy and decided to conduct monetary policy based on its "understanding" – that is, 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 – expressed in the form of a numerical value. Moreover, in April 2007, the Bank presented in the Outlook Report its assessment of the outlook for price developments based on the "understanding," and in December 2009 it provided further clarification with regard to the numerical value in the "understanding."[15] With regard to the current comprehensive monetary easing, the time horizon of the policy is clarified by making it explicit that the "understanding" is the basis for the judgment regarding the duration of the virtually zero interest rate policy.

3. Establishment of the Asset Purchase Program

The third measure of the comprehensive monetary easing policy, the Asset Purchase Program, aims at encouraging a decline in longer-term interest rates and various risk premiums to further enhance monetary easing. Specifically, through the Program, the Bank will purchase a total of about 5 trillion yen of various financial assets, such as government securities, corporate bonds, commercial paper (CP), exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs), and will conduct fixed-rate funds-supplying

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[14] See Chairman Bernanke's speech cited in Footnote 1.

[15] The "understanding" in terms of the year-on-year rate of change in the CPI was made clearer by changing the expression from each Policy Board member's "understanding" "falls in the range approximately between 0 and 2 percent, with most Policy Board members' median figures at around 1 percent" to "falls in a positive range of 2 percent or lower and the midpoints of most Policy Board members' "understanding" were around 1 percent."

operation against pooled collateral worth approximately 30 trillion yen. Taking on credit risks of individual firms is an extraordinary measure for a central bank, and the reason for establishing the Program was to make it easier for the Bank to grasp the risk profile of the assets purchased and to increase the transparency of the management of these assets by separating the assets purchased through the program from those purchased through regular money market operations. The Bank has already started purchasing some types of assets for which necessary arrangements have been completed. In addition, on November 8 it started to purchase Japanese government bonds (JGBs). Purchases of all other types of assets are planned to start by the middle of December.

With regard to the four policy objectives, this measure mainly meets the third and the first ones, namely, to achieve a decline in risk premiums and in longer-term interest rates. Market participants have tended to focus on the size of the Program, but let me underline here that the direct objective has not been quantitative expansion; rather, the measure seeks to encourage a decline in longer-term interest rates and various risk premiums resulting in quantitative expansion. Efforts to achieve a decline in risk premiums under the Program do not mean that risk assets are purchased in substantial quantities to underpin prices. Rather, the aim is for the purchase of various risk assets by the Bank to act as a catalyst to increase the demand for and supply of riskier financial assets in the market and spur the effective use of the ample funds that have been already provided to the market so as to provide a boost to the economy.

The Bank's decision to encourage a decline in longer-term interest rates and various risk premiums through comprehensive monetary easing was based on its experience with the quantitative easing policy[16] during the five years from March 2001 through March 2006. Since one of the ways in which quantitative easing worked was through the policy duration effect, it is difficult to clearly isolate the effects of quantitative expansion itself in assessing the overall effect of the policy. However, most subsequent empirical studies suggest that although quantitative easing contributed to stabilizing the financial system, the impact on economic activity and prices was limited.[17] Moreover, preliminary assessment indicates that the extent to which the decline in interest rates resulting from the policy duration effect of the quantitative easing policy affected the yields of other financial assets – the so-called "portfolio rebalancing effect" – was limited. Given these results, the Bank judged that – in a situation where there was little room for a further decline in short-term interest rates – the most effective policy to achieve additional monetary easing would be to try to directly effect a decline in longer-term interest rates and various risks premiums, meaning that this policy pursues the first and the third of the objectives outlined earlier, that is, to lower interest rates and achieve qualitative easing.

However, I did not concur with all the measures of the Bank's comprehensive monetary easing policy. Specifically, I disagreed with the inclusion of government securities as assets to be purchased through the Program. The main reason is that I believe it would be more effective to strengthen efforts to effect a decline in risks premiums, which remain at a high level – that is, to focus on qualitative easing – than to focus on longer-term interest rates at a time when financial institutions were raising the weight of government securities in their

[16] The Bank's quantitative easing policy consisted of four measures: (1) the main operating target for money market operations was changed from the uncollateralized overnight call rate to the outstanding balance of the current accounts at the Bank; (2) the new procedures for money market operations would remain in place until the rate of change in the CPI (excluding perishables, on a nationwide statistics) on a year-on-year basis was stable at or above zero percent; (3) the Bank raised the target for the balance outstanding at the Bank's current accounts to around 5 trillion yen; and (4) the Bank would increase the amount of its outright purchase of long-term government bonds from the then 400 billion yen per month, if it considered this to be necessary for the smooth provision of liquidity.

[17] See Hiroshi Ugai, "Effects of the Quantitative Easing Policy: A Survey of Empirical Analyses," *Monetary and Economic Studies*, 25 (1), Institute for Monetary and Economic Studies, Bank of Japan, 2007.

portfolios and both short- and long-term interest rates were declining anyway (the yield on 2-year instruments in the past month has been in the range of only 0.130–0.200 percent). In fact, I think that even before the implementation of comprehensive monetary easing, a lowering of longer-term interest rates had already been achieved to a substantial extent through the Bank's lowering of the policy interest rate to 0.1 percent, through policy duration effects from previous policies, and through the provision of ample funds. Therefore, I felt that increasing the purchase of government securities to achieve a further decline in longer-term interest rates would only have limited positive effects[18] and would increase the risk of overheating in the bond market; moreover, excessively low interest rates could deprive financial institutions of profit opportunities and instead hamper the effects of monetary easing, so that any positive effects might be outweighed by the potential negative side effects. Another reason why I disagreed with the purchase of long-term government bonds through the Program is that – in a situation where there is uncertainty over government finances in the medium to long term – making an exception to the principle that the outstanding amount of the Bank's holdings of JGBs should be kept below the outstanding amount of banknotes in circulation could arouse suspicions in the market that the Bank had taken a step toward engaging in government debt financing, which in turn could adversely affect long-term interest rates.

4. Ensuring the Bank's financial health

Next, I would also like to mention the disadvantages of risk asset purchases by the Bank. Excessive intervention by the Bank may distort price formation in the market and deprive financial institutions of profit opportunities. Moreover, the Bank, too, may ultimately incur losses from the purchases. As you may know, any revenues the Bank makes derive from the issuance of currency based on having the sole right to do so, and this is referred to as seigniorage. As seigniorage revenue essentially belongs to the public, it is transferred to the government's general account and the Bank has no right to use it at its own discretion. To put it differently, any losses the Bank incurs will ultimately have to be borne by the public. Moreover, any damage to the Bank's financial health could undermine the independence of the Bank and prevent it from taking policy actions in a timely and appropriate manner, undermining confidence in the currency. This is why the Bank has sought the government's understanding regarding the way in which the Bank would treat any losses incurred under the Program.[19] I believe that particularly when the Bank pursues unconventional monetary policies that come close to fiscal policy, it is important to take the view of the public into account.

C. The fund-provisioning measure to support strengthening the foundations for economic growth

So far I have been talking about the Bank's comprehensive monetary easing policy introduced on October 5, 2010, but it is of course also necessary to continue with medium- to long-term measures aimed at sustainably overcoming deflation. Based on various assumptions regarding trends in the overall population and the labor force participation rate (the number of persons willing and able to work divided by the number of persons aged 15 years and over), and using the recent rate of labor productivity growth per employee

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[18] One of the reasons for my disagreeing with the policy change on August 30, 2010 (the introduction of a six-month term in the fixed-rate funds-supplying operation against pooled collateral and a substantial increase in the amount of funds to be provided through the operation) was that such policy action would produce only limited easing effects.

[19] Specifically, the Bank's statement released after the Monetary Policy Meeting held on October 28, 2010 stated, "The Bank intends to ensure its financial soundness by managing risks stemming from the purchases of various financial assets under the Program and by properly recording loss provisions and appropriately treating losses if they are incurred. The Bank seeks the government's understanding in this regard."

(around 1 percent for the past 20 years), the economy is estimated to grow at a rate of little more than 1 percent, even with a rise in the labor force participation rate of women and the elderly. As you can see from this, if things continue as they are, and unless the nation as a whole makes the utmost effort to raise labor productivity, Japan is unlikely to achieve a rise in the potential growth rate and a sustainable expansion in demand. By introducing the fund-provisioning measure to support strengthening the foundations for economic growth, the Bank has raised awareness of this issue and, in my view, should continue with the measure in the future.[20]

Although the measure has met with severe criticism that it has prompted a race among financial institutions to lower lending rates, financial institutions' lending stance to firms – regardless of their size, from small ones to large ones – for investment in new growth areas fortunately appears to have turned more active. Moreover, I am informed that a growing number of firms have been approaching financial institutions to borrow funds through this measure. All this suggests that the measure is beginning to bear some fruit. Meanwhile, I am told that regional financial institutions, too, are supplying funds for business start-ups – a development that I find extremely encouraging. One factor underlying Japan's prolonged deflation seems to be a growing tendency to avoid risks and a reduced willingness to take on new challenges. I therefore hope that this fund-provisioning measure to support strengthening the foundations for economic growth, together with the Bank's purchase of various risk assets under the Asset Purchase Program, will be one step in resolving the structural problem of deflation.

[20] For details, see section 3 of the speech mentioned in Footnote 6.