

# **Hirohide Yamaguchi: Challenges to Japan's economy and monetary policy after the Great Earthquake – preparations for uncertainties and strengthening of growth potential**

Speech by Mr Hirohide Yamaguchi, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Nagano, 20 July 2011.

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## **Introduction**

I am honored today to have this opportunity to speak and to exchange views with administrative and business leaders in Nagano Prefecture. And I express my gratitude for your cooperation in various business operations of the Bank of Japan's Matsumoto branch and the local office in Nagano.

On a personal note, Nagano Prefecture is a place full of memories. I started my career at the Bank in 1974, and worked at the Matsumoto branch for two years from 1975. I frequently visited corporate managers and learned about the details of the conditions of the regional economy and finance. Speaking of 1975, Japan was in the face of adversity due to the oil shock, and was faced with a shift from a high growth era to a stable growth era. Against such a backdrop, firms in this region made tremendous efforts and honed their technical skills, which still strongly impresses me.

Japan's economy is also faced with a major turning point due to a demographic vortex. In addition, the Great East Japan earthquake occurred, and Japan's economy is faced with yet another challenge. Today, bearing in mind the medium- to long-term challenges Japan is faced with, I will talk about economic developments at home and abroad and the Bank's policy responses.

## **I. Outlook and risks for overseas economies**

I will begin with the developments in overseas economies. While the pace of growth in overseas economies has recently been slowing somewhat, growth rates remain high and those economies are expected to continue to achieve relatively high growth. In the following, I will talk about the recent developments, outlook, and risk factors associated with the outlook, by region.

### **A. The U.S. economy**

#### ***The recent deceleration is temporary***

The U.S. economy, while repeating somewhat strong and weak phases back and forth after the Lehman shock in the autumn of 2008, has been recovering moderately on average. Its recent deceleration is basically said to be attributable to the following two factors. First, the rapid rise in gasoline prices up to this spring. By that, households could not afford to make other spending, and private consumption weakened. Second, the effects of the earthquake disaster in Japan. In industries, particularly automobile, parts procurement from Japan delayed and a reduction in production spread. Those two factors were only temporary. Oil prices have been somewhat stable, and parts procurement from Japan has been returning to normal. It is widely viewed that the U.S. economy will gradually regain its pace of growth.

### ***Balance-sheet adjustment pressure will be a headwind in the medium to long term***

There are, to begin with, structural factors at play in the current U.S. economy, which makes it difficult to achieve a steady recovery. It is the after-effects of the collapse of the bubble. The Lehman shock resulted in a global financial crisis that involved countries including Japan. The reason for such a massive crisis is that the housing and financial bubbles that had bloated in the United States were extremely big. In the United States, even low-income families increasingly borrowed mortgages until after the mid-2000s. Financial products that assembled and securitized such subprime mortgages were sold as attractive investment products to investors around the world. In that process, financial institutions gained massive profits. The reason that everybody could enjoy such a banquet was the assumption that U.S. housing prices would continue to rise.

Once that assumption collapsed, everything was reversed. As a result, delinquent mortgages piled up, which plagued U.S. households and financial institutions. Since it is a problem that asset prices declined and liabilities became a heavy burden, or capital ran short, it is called “the balance-sheet problem.” Japan’s economy also experienced a similar problem in the 1990s. As one can tell from that experience, in the economy after the bursting of a huge bubble, the average economic growth rate will be contained over a protracted period. Since the U.S. economy is recovering against such a headwind, it is likely that weak resilience as witnessed recently might occur from time to time in the future.

## **B. European economy**

### ***Recover moderately with difference among countries***

In Europe, major countries including Germany have been basically buoyant albeit exports somewhat decelerating recently. Business fixed investment and private consumption have been increasing. Some countries including Southern European countries are weak in international competitiveness to begin with, and have to take fiscal austerity to address fiscal problems, which has been dragging the economies. While conditions in European countries vary substantially from country to country, the European economy has been recovering moderately as a whole.

### ***Sovereign debt problem continues to be a destabilizing factor for the international financial markets***

The European economy as a whole is expected to continue to recover moderately in the future. However, the concern about the creditworthiness of government bonds issued by countries including Greece and Portugal – the so-called sovereign debt problem – is likely to be a destabilizing factor for some time not only within Europe but also in the global economy.

The total economic scale of Greece and Portugal I have just referred to is less than 1 percent of the global economy. However, European financial institutions have a substantial amount of exposure to those countries. If the government bonds of those countries face default, anxiety about the soundness of European financial institutions might rise. In addition, some relatively large economies face similar fiscal problems, albeit lesser in magnitude than the countries including Greece. If there is a situation in which the creditworthiness of government bonds of large economies also declines significantly, the effects on financial institutions will also become far-reaching. As financial transactions have recently become extensive and complex, if anxiety is generated in some part of financial markets, anxiety could spread over the entire international financial markets. Investors might become increasingly risk averse and stock prices and foreign exchange markets might fluctuate substantially. We should be careful in that once any disruption occurs in Europe, Japan’s economy, seemingly distant, might also be involved in turmoil through a plunge in stock prices and appreciation of the yen.

The difficulty of the sovereign debt problem is that a country whose problem once becomes serious will be mired in the problem. Fiscal austerity leads to a decline in economic activity and tax revenue will increasingly decline. In addition, if financial institutions incur massive losses due to a decline in government bond prices, the real economy will be adversely affected and it will become necessary to augment capital of financial institutions by way of fiscal funds. As illustrated, three factors – deterioration in fiscal conditions, economic downturn, and the weakening of the financial system – are subject to an adverse feedback loop that mutually affects each other, and that delays the resolution of the problem. Given such characteristic of the European sovereign debt problem, that is likely to continue to be a destabilizing factor in the global economy over a protracted period.

## **C. Emerging economies**

### ***Emerging economies are leading the global economy***

Despite advanced economies being burdened with respective problems, according to the *World Economic Outlook* of the International Monetary Fund (IMF), the growth rate of the global economy is forecasted to register growth of around 4.5 percent both in 2011 and 2012. While I have mentioned that there had been a credit bubble for a protracted period before the Lehman shock, the average annual growth rate of the global economy for 10 years until 2007, which includes the bubble period, was 4.0 percent. Therefore, the forecast of “around 4.5 percent” for this year and next year can be considered to be rather robust growth. That is attributable to high growth in emerging economies including China.

For instance, China’s growth rate in 2010 was 10.3 percent and it is expected to be 9.6 percent in 2011 according to the IMF outlook. China has been growing at a high rate comparable to that of the high-growth era in Japan. As for the contents of growth, China had been called a “factory of the world” up to a little while ago, but as people’s income levels improved, it has also become a “world consuming market.” For reference, the number of new cars sold in China last year was 18 million, which exceeds the sum of those in the United States and Japan.

Such high economic growth is occurring not just in China, but also in India, Brazil and many other emerging countries. Naturally, they need a tremendous amount of energy and raw materials. As a consequence, buoyant demand for mineral resources including crude oil, ironstone, and nonferrous metals has been generated. In addition, as living standards of emerging countries rose, dietary habits have changed and people have come to eat more meat than before, so that demand for grains including those used to feed cattle and pigs has increased globally. An increase in global demand for various kinds of natural resources and food has brought about high growth in the so-called commodity-exporting countries, such as Canada, Australia, and Russia that produce primary commodities. A pattern that the global economy continues to grow led by emerging and commodity-exporting economies is likely to remain intact for some time.

### ***The challenge is to overcome inflationary pressure***

Emerging economies do have a blind spot. It is inflation. Even emerging economies have recently been decelerating basically because of the tightening of monetary policy against the rise in the inflation rate. But it is not yet known whether the tightening to date can sufficiently reduce inflationary pressure. Whether an increase in demand will be properly controlled and emerging economies will make a soft landing, in a manner that price stability successfully goes together with economic growth, is likely to remain highly uncertain for some time.

The inflationary pressure in emerging economies is partly induced by a rise in international prices of mineral resources and foods. In order for emerging economies, and eventually the global economy, to achieve high growth in the medium to long term without increasing

inflationary pressure, I believe it so important to make efforts on a worldwide basis in innovation of resource and energy saving as well as in improvement in food productivity.

Based on overseas economic developments, let me now turn to Japan's economy.

## **II. Economic activity and prices in Japan**

### **A. Current state and outlook for economic activity and prices**

#### ***Return to the moderate recovery path in the latter half of fiscal 2011***

After the Great East Japan Earthquake on March 11, Japan's economy once plunged. While, in many cases, an economic downturn is induced by a decline in demand, the plunge after the earthquake has basically been due to constraints on the supply side, including a shortage in parts and power. First, factories and distribution infrastructure have been damaged or destroyed by the earthquake and tsunami, and procurement of raw materials and parts necessary for production has been disrupted. A complicated network of the supply chain has been cut off and nationwide production, particularly automobiles that require many parts, has been greatly affected. Second, due to the nuclear power plant accident, the power generating capacity of Tokyo Electric Power Company and Tohoku Electric Power Company has once declined by 20 to 30 percent. The effects have spread over to various activities other than manufacturing: Events including concerts have been cancelled and department stores have shortened their business hours. Of course, not everything is due to the supply constraints, and the voluntary restraint associated with the earthquake disaster and the problem of radiation due to the nuclear plant accident have also adversely affected consumer sentiment.

Thereafter, supply constraints have been rapidly alleviated and production and exports have been recovering at a faster pace than expected by the concerned parties immediately after the earthquake. Firms' production activity is expected to return approximately to the level prior to the earthquake in the near future. Such rapid recovery is, after all, attributable to the firms' strenuous efforts. There have been moves of solidarity that go beyond the individual corporate framework, such as firms taking over the production on behalf of other firms in the same industry, and firms lending factories or machinery to the disaster-stricken small firms. A power shortage this summer is also not likely to constrain economic activity to the extent expected earlier.

Taking the recent developments into account, Japan's economy is expected to return to the moderate recovery path in the second half of fiscal 2011 onward amid the continued improvement in overseas economies. In the outlook the Bank released last week, Japan's economic growth will stay at a low rate of 0.4 percent in fiscal 2011 due to the effects of the plunge after the earthquake, but is forecasted to accelerate to 2.9 percent in fiscal 2012.

#### ***Inflation is expected to remain slightly positive***

Now, let me turn to prices. The year-on-year rate of change in the typical price indicator, the consumer price index (CPI), had been negative since shortly after the Lehman shock. As the effects of the shock subsided, the degree of negative had become gradually small, and the rate of change turned positive for the first time in 28 months in April and registered plus 0.6 percent in May.

Since the economy is expected to return to the moderate recovery path, the year-on-year rate of change in the CPI is also expected to remain slightly positive. More specifically, the outlook the Bank released last week forecasted a rise of 0.7 percent for both fiscal 2011 and 2012.

## **B. Uncertainties associated with future economic activity and prices**

### ***Overseas financial and economic developments require caution***

I emphasize that the outlook for economic activity and prices that I have mentioned is associated with various uncertainties. After the earthquake up to now, there has been high uncertainty concerning what extent the supply chain will recover promptly. Such risk has, as I mentioned earlier, been subsided considerably. Rather, from now on, economic activity will depend on whether demand itself continues to increase steadily. In that regard, consumer sentiment, which recovered considerably compared with that immediately after the earthquake, has yet to recover completely.

In addition, the most important assumption for Japan's economic recovery is a mechanism that overseas economies, particularly emerging economies, will continue to grow at a high rate, under which Japan's exports increase and positive effects spread to business fixed investment and employment. However, as I have mentioned earlier in detail, the outlook for the United States, Europe, and emerging economies is associated with high uncertainty.

### ***Increasingly uncertain power situation***

In the domestic area, uncertainty has rather increased about the somewhat longer term electricity supply beyond this summer. That is because nuclear power plants across Japan are not resuming operation smoothly after their regular inspections. Even if nuclear power is to be substituted by thermal power, the electricity costs are expected to rise.

After the earthquake, an earthquake risk in Japan has been recognized again, and firms at home and abroad have been increasingly diversifying their parts procurement from Japan's domestic suppliers to overseas suppliers. Partly due to the effects of the nuclear plant accident, the number of foreign tourists has plunged. On top of those, with the addition of anxiety against stable power supply and increase in costs, whether the hollowing out of industry, which is sometime called as "passing on Japan" or "avoiding Japan," might intensify or not warrants vigilance.

### ***Risk of delay in achieving price stability***

If economic activity becomes weaker than the aforementioned outlook due to various uncertainties, prices might be lower than expected. In addition, prices are associated with statistical uncertainty. The CPI is subject to revision every five years, and there will be a revision this year. The current index will be replaced in August by a new index, and the recent data will also be revised retroactively. While I have mentioned earlier that the year-on-year rate of increase in the CPI was 0.6 percent in May, it is likely to be revised downward to around zero percent by the index revision.

As the recent data will be revised, the outlook for the year-on-year rate of increase in the CPI, which was 0.7 percent for both fiscal 2011 and 2012, has to be read slightly lower. The Bank considers that a state in which the year-on-year rate of change in CPI hovers in a positive range of 2 percent or lower, centering around 1 percent, is closest to "price stability." The current outlook for prices suggests that it might take some more time to achieve such "price stability," and we need to monitor carefully how future economic developments and the index revision might affect the timing of price stability achievement.

## **III. Medium- to long-term challenges to Japan's economy**

### ***Long-term downward trend in economic growth is one cause of deep-rooted deflation***

Japan's deflationary trend has been continuing for a protracted period. That suggests that there might be a structural problem as well as cyclical weakness in economic activity on the back of deflation. Looking back at Japan's economic growth rate over time, the average

annual growth rate of Japan's economy declined from around 5 percent in the 1970s, to around 1.5 percent in the 1990s, and below 1 percent in the 2000s. When the economic growth rate follows a long-term downward trend, firms and households inevitably tend to consider that future growth will continue to be low anyway. Such decline in firms' and households' expectations for future growth have restrained actual demand, such as business fixed investment and private consumption, and thus might have been one cause of a deep-rooted deflation.

Deflation is not desirable, and, if the current low growth rate continues, it will become difficult to maintain fiscal conditions and social security in the future. Therefore, strengthening medium- to long-term growth potential was a major challenge to Japan's economy since before the earthquake. To tackle that challenge will lead to avoiding the after-effects of the earthquake disaster including the hollowing out of industry.

### ***Source of economic growth is each person's power to generate added value***

The demographic vortex might have had a substantial influence on the long-term downward trend in the economic growth rate. If that is the case, one natural solution to strengthen the growth potential is to correct the demographic vortex. Some examples include creating better conditions to support childbearing and rearing to reverse the downward trend in the birth rate or more actively accepting immigrants and labor force from abroad. However, even if we boost the birth rate now, it takes about 20 years before it leads to an increase in labor force. As strengthening the growth potential is a more urgent challenge to tackle, we cannot afford to wait for demographic changes to take place.

Let us go back to a simple mathematical formula. GDP, which is used to measure economic growth, is a multiplication of the number of workers and GDP per worker. Given that the number of workers will be to a large extent determined by demographics that cannot be changed easily, there is no way but to increase GDP per worker in order to increase GDP. GDP is, in other words, added value and is distributed in the form of corporate profits and household income. Therefore, creating added value is nothing more or less than firms increasing their own profit while raising employment and wages. In order to do so, it is necessary to tap potential demand of the field that is considered to have a good chance of success and create new markets. As specific directions, I mark four points that are deemed critical.

### ***Further tapping global demand***

First, drastic globalization. Incidentally, while the export share in GDP is about 50 percent in Germany and Korea and about 30 percent in China, it remains at about 15 percent in Japan. Moreover, the number of foreign tourists visiting Japan is only 10 percent compared with that visiting France, the United States, and China, and it ranks around 30th in the world, which is lower than Korea and Singapore. Depending on the ambition and creativity to open up the country, Japan seems to have room for capturing global demand and growing.

### ***Innovation in the areas of resources and energy***

Second, to make a leap in technology and know-how to enhance resource and energy efficiency. As I mentioned earlier, it seems to be tight supply and demand condition of resources, energy and food that may become a major constraint for the global economy to continue to grow strongly, especially in emerging countries, while avoiding inflation. Innovations including energy saving will contribute not only to a near-term domestic electricity shortage but also to medium- to long-term global economic growth.

### ***Tapping domestic potential demand***

Third, there appears to be plenty of unexplored need in the domestic markets where the demographic vortex and maturation are progressing, such as medical and nursing care as well as other areas. It is said more than often that Japan is already affluent and consumers do not want anything more. Arguably, if we look only at the existing goods and services, not a few of them might have already reached saturation point. Even so, in terms of people's potential desire, a desire to enjoy life more or to live a more comfortable life will not disappear. It is the real entrepreneurship to strategically tap potential demand that even consumers themselves are not aware of. Incidentally, the generation which is in the prime will peak out within 10 years in some Asian countries such as China and Korea, and aging will progress following the path of Japan. If Japan, as a country that faces the challenge ahead of other countries, is able to build a vigorous economy under aging, it could serve as a good role-model for other countries that will be faced with aging at a later stage.

### ***Strengthening financial power to provide risk money***

Fourth, roles which finance plays. Firms' aspiring approaches in tapping new demand do not necessarily succeed. To put it another way, challenging things that might fail will lead to exploring a chance of growth. Namely, a certain amount of risk is associated with growth and it is a role of finance to provide risk money to support the growth. Therefore, in order to enhance the medium- to long-term growth potential of the economy, it is necessary to reinforce the role of finance.

In sum, Japan's economy is faced with two challenges which have different time horizons. First, achieve a cyclical recovery in the economy that has plunged due to the earthquake disaster amid significant various uncertainties including the future of overseas economies. Second, tackle the strengthening of growth potential from a medium- to long-term perspective. The second challenge will further ensure the first challenge of achieving an economic recovery and contribute to bringing forward the escape from deflation. Based on the summarization, let me explain how the Bank's monetary policy is responding to the challenges.

## **IV. The Bank's monetary policy**

### ***Pursuing powerful monetary easing***

In order to support the cyclical economic recovery and achieve price stability as promptly as possible, the Bank is pursuing powerful monetary easing measures as follows.

First, the Bank set its policy interest rate at extremely low level of around 0 to 0.1 percent, and made a commitment that it would basically continue with the low policy interest rate until it judged that price stability was in sight. Moreover, since October 2010, the Bank has established a new framework called Asset Purchase Program and, through that program, it has been purchasing not only government bonds but also a wide range of risk assets – namely, CP, corporate bonds, exchange traded funds (ETFs), and Japan real estate investment trusts (J-REITs). By way of that, the Bank has been encouraging a decline in longer-term interest rates, and, at the same time, acting as a catalyst for risk money flowing into financial markets, thereby trying to generate favorable effects on the economy. The Program started at about 35 trillion yen in total, and was increased to about 40 trillion yen immediately after the earthquake in March, trying to minimize the deterioration of economic conditions.

### ***Providing support to strengthen the foundations for economic growth***

In relation to Japan's economy's other challenge of strengthening medium- to long-term growth potential, the Bank has been conducting the Fund-Provisioning Measure to Support

Strengthening the Foundations for Economic Growth since June 2010. This is a measure for the Bank to provide long-term funds with maturities of initially one year and maximum four years if rolled over at a low interest rate of 0.1 percent to financial institutions that tapped projects that would lead to strengthening medium- to long-term growth potential and made equity investment or lending. Since the introduction of the new measure, many financial institutions have been taking positive approaches such as establishing special sections devoted to devising and developing new areas of growth.

The scheduled total amount of loans – 3 trillion yen – had mostly been disbursed. Therefore, the Bank created a 500 billion yen new line of credit in June 2011. The new line of credit provides funds at a low interest rate of 0.1 percent for initially two years and maximum four years to financial institutions that make equity investment and conduct lending against accounts receivable and inventories as collateral.

Lending that takes accounts receivables and inventories as collateral is called asset-based lending (ABL) and is utilized widely in the United States. Compared with real estate collateral lending, the ABL is more difficult in terms of making collateral assessment. The value of assets that have been generated in the process of business cannot be assessed unless a borrowing firm and a financial institution share the thorough understanding of the business contents and developments in the industry. Nevertheless, aggressively putting such extra efforts will have a great merit in that it enables firms which do not own enough real estate collateral or personal guarantees to raise financial resources. To take advantage of such merit, the Bank expects that corporate managers and financial institutions will jointly make efforts to explore profit opportunities, and the hidden seeds for growth to sprout in Japan as a whole.

### ***Respond flexibly and decisively when risks manifest themselves***

As explained, the Bank has been pursuing powerful monetary easing and providing support to strengthen the foundations for economic growth, while stepping into an extraordinary territory for a central bank. However, as I have repeatedly mentioned today, the Bank is aware that uncertainties at home and abroad are significant. Upon carefully examining future economic and price developments, including the effects of the recent foreign exchange rate fluctuation, the Bank will, if judged necessary, take appropriate policy actions in a flexible and decisive manner.

### **Concluding remarks**

In conclusion, I will refer to Nagano Prefecture's economy.

The development of Japan's economy depends on what extent it can incorporate globalization and aging into its advantage. In that regard, Nagano's economy has been developing by always paying attention to global markets, from the prewar era of the silk industry to the postwar era of electric and precision machinery. Nagano's export share in manufactured goods shipments has been consistently above the national average most of the time since the 1990s.

Also in terms of responses to aging, Nagano Prefecture is one step ahead of other regions. Nagano is not only one of the leading longevity prefectures in Japan and but also known for its high employment rate of elderly people. While the national average of the percentage of people aged 65 or older at work is about 20 percent, it is more than 30 percent in Nagano and ranks top in the nation. Also here in Matsumoto City, a project is underway to enhance health and create a comfortable place to live under the initiative called "the city of long and healthful lives." Such efforts to create an environment that makes it easy for elderly people to work will also serve as a good reference for Japan as a whole.

I will offer my heartfelt support so that your wisdom and actions that go ahead of the times will further develop the region and pave the way for Japan's future.