Yoshihisa Morimoto: Economic activity and prices in Japan and monetary policy

Speech by Mr Yoshihisa Morimoto, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Nagasaki, 23 June 2011.

*   *   *

I. The current situation of and outlook for the world economy

The Bank of Japan released its latest *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) on April 29. The report presents the scenario for Japan's economy considered to be the most likely by the Bank. The Bank projects that the economy will return to a moderate recovery path in the second half of fiscal 2011. Although supply-side constraints – due to the damage to production facilities and the disruption of supply chains for parts and components caused by the Great East Japan Earthquake in March – as well as constraints on electric power supply are expected to weigh down the economy for a while, these downward pressures are expected to gradually ease, paving the way for a moderate recovery in production. Of course, this recovery in production will not be long-lived unless it is accompanied by a rise in sales. A key element in this scenario of a return to a moderate recovery, therefore, is the expectation that exports will increase based on an improvement in overseas economies. Consequently, before talking about the domestic economy, let me take a closer look at the world economy.

Following the recovery from the Lehman shock in the autumn of 2008, growth in the world economy temporarily slowed in the summer of 2010. From the end of autumn, economic growth then regained momentum, driven by strong growth in emerging and commodity-exporting economies. At present, the pace has slowed somewhat due partly to the effects of soaring crude oil prices. As for the outlook, a number of issues require careful attention, but basically it is expected that – fueled by rapid growth in emerging and commodity-exporting economies – the pace of global growth will soon pick up again and the global economy will continue to expand. The International Monetary Fund (IMF) in its World Economic Outlook released in April 2011 forecasts that the global economy will grow by around 4.5 percent in both 2011 and 2012.

A. Advanced economies

Looking at developments in the global economy in greater detail, it is useful to focus on advanced economies and on emerging and commodity-exporting economies separately. Let me start by considering advanced economies. In the United States, from the autumn of 2010 onward, various stimulus measures, such as monetary easing by the Federal Reserve and the extension of tax cuts introduced by the Bush administration, led to optimism regarding the U.S. economy. Caution, however, has returned as personal consumption has been curtailed by higher prices for gasoline and other daily necessities, leading to a slight decline in the growth rate of the economy overall. Moreover, job market data for May showed that nonfarm payroll employment was well below market forecasts, indicating that the recovery in the job market remains shaky. With balance-sheet adjustments continuing to be a burden and the path for addressing the fiscal deficit unclear, the need to pay attention to downward risks is increasing.

Even though upward momentum is currently weak, however, the Bank's main scenario, which expects the U.S. economy to recover moderately, remains unchanged. While developments up to the present are somewhat on the low side, they are within the range of expectations. As for the outlook, exports – mainly to emerging and commodity-exporting economies – are expected to follow an upward trend. Furthermore, the U.S. stock market, which has been in an adjustment phase for the past few weeks, remains firm from a longer-term perspective. In this environment, private consumption and business fixed investment are unlikely to deteriorate to any serious extent. In short, we should be aware of the downside risks without being unduly pessimistic.

Economic activity in the euro area is recovering moderately as a whole, although the contrast has been increasing further between the strong performance of Germany and the performance of peripheral countries with serious fiscal problems such as Greece and Portugal. As for the outlook, the situation as a whole is likely to remain unchanged, with the moderate recovery continuing. However, since around April 2011, doubts have emerged regarding the credibility of Greece's plans for fiscal reconstruction and funds procurement, leading to a surge in the yield on 10-year Greek government bonds to record levels of more than 15 percent. The surge triggered a rise in the yields on government bonds issued by other peripheral countries. Damage could spread from financial markets to economic activity. Therefore, it is necessary to closely watch fiscal developments in Greece and other peripheral countries, as well as the response of the European Union (EU) as a whole.

B. Emerging and commodity-exporting economies

Emerging and commodity-exporting economies are expanding steadily, led by firm domestic demand. Moreover, although these economies are likely to continue tightening their monetary policies in response to heightened concerns over inflation, they are expected to maintain relatively high growth, albeit at a slightly reduced pace. In China, for instance, consumer prices are rising at a rate of more than 5 percent and authorities are tightening monetary policy. The Chinese economy is expected to continue showing high growth, though at a somewhat slower pace, due to the continued increase in private consumption, housing investment, and investment in various infrastructures, reflecting higher household incomes and continuing urbanization. Economic activity in the NIEs and ASEAN countries is also likely to follow a recovery trend. It has been suggested that production is being affected by sluggish shipments of parts from Japan, but domestic demand – such as business fixed investment and private consumption – is expected to remain firm, and exports are expected to continue increasing. On the other hand, there is concern that growth in commodity-exporting economies may slow if international commodity prices drop. Any deceleration, however, is unlikely to be prolonged.

II. The Japanese economy

Keeping in mind the present situation of and outlook for overseas economies I just outlined, let me now talk about the Japanese economy and prices.

A. Economic activity

The pace of improvement in the economy slowed temporarily from the autumn of 2010, partly due to the expiration of subsidies for purchases of environmentally friendly cars. Thereafter, from the beginning of 2011, the economy started to gradually return to a moderate recovery path. The devastating earthquake that struck northeastern Japan in March, however, destroyed many production facilities, disrupted supply chains, and caused electric power shortages. Production of cars and other products came to a standstill even though demand was clearly present. The index of industrial production for March showed a decline of 15.5 percent from the previous month, the steepest fall ever for a single month since data started to be compiled. The cause of the decline in production differed from that after the collapse of Lehman Brothers, when demand simply evaporated. This meant that immediately after the earthquake, the usual mechanism for economic recovery – in which a recovery is preceded by an improvement in overseas economies that boosts Japanese exports and production – was partially paralyzed.

Supply-side constraints are still in evidence and downward pressure on production will remain for the time being, although there are also signs of recovery. Supply chains are likely to be restored earlier than previously anticipated due to the close cooperation among firms, especially in the car industry, and the wholehearted and coordinated efforts of workers on the ground. Another bright factor is that electricity demand in the Kanto and Tohoku regions this summer is expected to be lower than forecast earlier, although of course much depends on the weather. Initially, it was expected that supply constraints would ease from the beginning of autumn 2011, but now it appears that production will return to pre-earthquake levels in the July–September quarter and that supply constraints will be largely resolved by early autumn. From a somewhat longer-term perspective, uncertainties persist with regard to the supply of electricity. However, as the supply constraints ease, Japan's economy should continue to recover, driven by the increase in exports and production that the expected improvement in the global economy should bring with it. Moreover, by that time, restoration and rebuilding of infrastructure, buildings, and other facilities damaged by the earthquake should be in full swing, pushing the economy forward.

Looking at each demand component, exports, particularly of cars and car parts, declined as a result of supply chain disruptions. However, overseas demand in general is expected to continue to expand. Furthermore, exporters, particularly automobile makers, are working hard to resume shipments as quickly as possible. Therefore, although much depends on developments in the foreign exchange market, it looks increasingly likely that shipments will return to pre-earthquake levels sometime in the July–September quarter, which is earlier than previously expected. Exports are expected to follow an upward trend thereafter.

Business fixed investment bottomed out and started to recover moderately during the second half of fiscal 2009, reflecting increased production and a recovery in corporate profits. Although business sentiment deteriorated due to the impact of the earthquake, various indicators suggest that business fixed investment has remained surprisingly resilient. This shows that firms' growth expectations have remained stable. On this basis, business fixed investment, despite some fluctuations, is likely to remain firm against the backdrop of strong profits in fiscal 2010. It is likely to start to clearly turn upward from around the autumn of 2011, supported by the expected recovery in exports and production as well as rebuilding efforts in areas hit by the earthquake.

Turning to private consumption, the mood of restraint seen immediately after the devastation resulting from the earthquake has gradually eased, with department stores and retailers of electrical appliances voicing, albeit cautiously, the view that consumption is returning to more normal levels. Furthermore, various indicators point to a slight improvement in consumer sentiment. Therefore, private consumption is expected to head toward a gradual recovery. Needless to say, it is important to keep an eye on the effect, particularly in the service sector, of the supply and demand balance of electricity during the summer. In addition, consumer sentiment is likely to be dampened by the ongoing problems at the nuclear power plant and awareness of the need to save electricity. What is more, the employment and income situation, particularly the wage situation, is becoming more severe. The expected recovery in consumption is, therefore, bound to be modest.

B. Prices

The three key factors likely to shape the direction of prices for the time being are (1) the aggregate supply and demand balance; (2) medium- to long-term inflation expectations; and (3) international commodity prices. In the short term, the net impact on the aggregate supply and demand balance is unclear, since on the one hand supply capacity has declined as a result of the earthquake, while on the other demand has also fallen due to a deterioration in consumer sentiment. Nevertheless, in the longer run, the supply and demand balance is likely to follow an improving trend as the economy returns to a moderate recovery path. According to various surveys, medium- to long-term inflation expectations have been stable at around 1 percent in recent years. Prices of international commodities, such as crude oil, have been undergoing adjustments recently. However, there has been little change in the factors that have fueled the rise in commodity prices so far, such as the strong growth of emerging economies and the increased "financialization" of primary commodities.

Under these circumstances, with the aggregate supply and demand balance remaining on an improving trend in the longer run, and assuming that international commodity prices will increase moderately, domestic corporate goods prices are expected to rise. For the same reasons, the rate of increase in the consumer price index (CPI; excluding fresh food) is expected to remain slightly positive. The CPI, however, is very likely to be revised downward somewhat as a result of the planned change in August of the CPI base year to 2010.

III. Risks to the outlook

I would now like to turn to risks affecting the outlook for economic activity and prices.

A. Risks to economic activity

In the April 2011 Outlook Report, the Bank listed the following as risk factors concerning the outlook for economic activity: (1) uncertainty about the possible effects of the earthquake disaster on Japan's economy; (2) firms' and households' medium- to long-term growth expectations; (3) developments in overseas economies; and (4) the effects brought about by a possible further rise in international commodity prices.

As for the first risk factor, there is great uncertainty regarding the timing when supply-side constraints will be resolved, the timing and scale of the restoration of damaged capital stock, and the impact on the economy of possible changes in consumer and business sentiment caused by the disaster. The degree of the impact varies depending on future developments in the situation at the nuclear power plant, as well as on the outlook for corporate profits and the compensation of employees. In addition, if concern about the growth potential of the economy increases due to the effects of the disaster, and firms' and households' medium- to long-term growth expectations decline as a result, this could depress firms' and households' appetite for spending and act to reduce economic activity for a protracted period. On the other hand, medium- to long-term growth expectations by firms and households could rise if firms take the disaster as an opportunity to bolster efforts to implement growth strategies.

Risk factors regarding overseas economies, as I explained earlier, are increasing to some degree. In emerging economies, there are upside risks due to economic expansion, and although monetary tightening has continued in these economies, this has not sufficiently calmed concern over overheating or inflation. Therefore, there is concern that from a longer-term perspective sustainable growth may be undermined due to increased fluctuations in economic activity. In addition, if international commodity prices rise further, this could lead to a decline in the purchasing power of households and a deterioration in corporate profits, which could depress private domestic demand in Japan.

I believe that all of these risk factors are equally important. Although there is a possibility that the economy will grow faster than expected if supply-side constraints ease earlier than anticipated, it seems to me that the downside risks stemming from uncertainties regarding the effects of the disaster require the most attention, simply because the disaster involved an unprecedented tsunami and a nuclear power plant accident. Moreover, firms, particularly small firms, are concerned about whether the shift to overseas production will accelerate and the hollowing out of domestic industry will continue. This is an issue that I also feel requires attention.

B. Risks to prices

Next, turning to the risks to prices, these involve the materialization of the risks to economic activity that I have just described. Developments in the aggregate supply and demand balance play an important role in determining the outlook for prices, but because of the impact of the earthquake, these developments in the short term are not yet clear. Even if supply-side constraints cause supply shortages, firms will avoid making hasty decisions – such as raising prices of their products – that may result in losing customers, if firms judge the supply shortages to be temporary. On the other hand, if downside risks to the economy materialize, leading to a prolonged economic downturn, prices will be affected accordingly.

Other risk factors to prices include firms' and households' medium- to long-term inflation expectations, as well as developments in import prices, which are affected by fluctuations in international commodity prices and foreign exchange rates.

IV. Monetary policy

A. The bank's thinking behind the conduct of monetary policy

So far, I have talked about economic activity and prices in Japan. I would now like to turn to the Bank's conduct of monetary policy. The Bank recognizes that Japan's economy is faced with the extremely important challenge of emerging from deflation and returning to a sustainable growth path with price stability. Based on this recognition, the Bank has been doing – and is determined to continue to do – its utmost as the central bank, using a three-pronged approach consisting of (1) pursuing powerful monetary easing under the comprehensive monetary easing policy, (2) ensuring stability in financial markets, and (3) providing support to strengthen the foundations for economic growth. Furthermore, with a view to ensuring stability in financial markets, the Bank introduced a number of measures in the wake of the earthquake to address its impact on the economy and associated risks.

1. Pursuing powerful monetary easing under the comprehensive monetary easing policy

"Comprehensive monetary easing" is a policy package that the Bank introduced in October 2010, consisting of three measures. First, the Bank lowered its policy interest rate, that is, the target for the uncollateralized overnight call rate – the shortest interbank rate – to "at 0 to 0.1 percent", thereby indicating that it was pursuing a virtually zero interest rate policy. Second, the Bank clarified its commitment regarding the time horizon based on the "understanding of medium- to long-term price stability" (hereafter the "understanding"). The "understanding" is the level of inflation that each Policy Board member understands as being consistent with price stability over the medium to long term. The "understanding" at present falls in a positive range of 2 percent or lower, and the midpoints of most Policy Board members' understanding are around 1 percent. The Bank has made clear that it will maintain the virtually zero interest rate policy until it judges, on the basis of the "understanding", that price stability is in sight, on condition that no problem is identified in examining risk factors, including the accumulation of financial imbalances. And third, the Bank decided to establish the Asset Purchase Program. The Bank decided on this temporary easing measure to conduct outright purchases of various financial assets, such as Japanese government bonds (JGBs), and risk assets such as CP, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs). The Bank has been steadily conducting outright purchases of such financial assets, which are registered on its balance sheet, through the Asset Purchase Program.

2. Providing support to strengthen the foundations for economic growth

The fund-provisioning measure to support strengthening the foundations for economic growth supplies long-term funds at a low interest rate to private financial institutions in accordance with their efforts in terms of lending and investment to strengthen the foundations for economic growth. The Bank has provided 18 examples, including "environment and energy business", "medical, nursing care, and other health-related business", and "tourism business", as areas for which financial institutions' lending or investment would be funded by the measure, and in addition to these areas, a large amount of funds has been invested in the area categorized as "others", such as lending or investment to support local industries. The Bank decided to implement this measure based on the recognition that the decline in the economic growth trend since the 1990s has been the fundamental cause of deflation and that it was important to support various growth areas to overcome deflation. In other words, it is important not only for Japan's economy to achieve a cyclical recovery, but also to make efforts to raise Japan's economic growth in the long term. While the government, for its part, also has been implementing measures to support economic growth, such as its "New Growth Strategy" aimed at achieving renewed economic vigor, I believe that the Bank's measure to support the economy from the financial side – that is, to provide funds to support strengthening the foundations for economic growth – not only produces effects through the provision of funds, but also sends a strong message and raises awareness about the issues faced by Japan's economy.

The fund-provisioning measure to support strengthening the foundations for economic growth was decided at the Monetary Policy Meeting (MPM) held on June 14 and 15, 2010. On June 8, 2011, the Bank carried out the fourth loan disbursement under the measure, and the total amount of loans disbursed has reached nearly 3 trillion yen – the amount set as the ceiling for the measure. Therefore, given that the maximum amount of loans had almost been disbursed, Policy Board members at the MPM held on June 13 and 14, 2011 discussed how to proceed with the measure. If we assess the loan disbursements carried out so far, it could be said the measure has played its intended role as a catalyst in prompting financial institutions to develop their own initiatives to strengthen the foundations for economic growth. A wide range of financial institutions have been actively making a number of efforts targeting their specific customer base or the region they serve, such as establishing new dedicated funds that will support economic growth, so that the amount of lending and investment greatly exceeds the amount of loans disbursed by the Bank. However, the effects of the measure on equity investment and in terms of encouraging financial institutions to cultivate new business models have been insufficient, and it has been pointed out that a side effect of the measure is to intensify competition among financial institutions to lower lending rates.

Against this background, my view with regard to the future of this scheme was that it should continue to firmly support as broadly as possible the efforts of private financial institutions to build on their specific experience and expertise and devise their own ways to meet demand in the areas and regions they serve. This view was shared by other members of the Policy Board, and at the MPM held on June 13 and 14, 2011 the Bank decided that it would firmly maintain its stance of supporting financial institutions' efforts to strengthen the foundations for economic growth and take measures that would focus on boosting Japan's growth potential even further. Specifically, the Bank decided to establish a new line of credit for equity investments and asset-backed lending (ABL) aimed at encouraging smooth financing of firms that lack sufficient collateral or equity investment, and/or who so far have received very little financing from the existing fund-provisioning measure. In introducing this measure, the Bank decided to set long loan periods to make them easier for financial institutions to administer, and to lower the minimum amount per investment or loan to meet even small requests and sow the seeds for growth in even the smallest "nooks and crannies."

B. The bank's responses after the earthquake

Since immediately after the earthquake disaster, the Bank has been taking a range of measures in a timely manner, from three main perspectives: (1) maintaining the functioning of financial and settlement systems; (2) ensuring the stability of financial markets; and (3) supporting the economy. I would now like to discuss the Bank's response to the disaster.

1. Maintaining the functioning of financial and settlement systems and ensuring the stability of financial markets

In terms of maintaining the functioning of the financial and settlement systems, the Bank has been taking all possible measures to provide cash to the disaster areas and to operate Japan's major payment and settlement systems as usual, including the Bank of Japan Financial Network System, or BOJ-NET – the core settlement system for funds and Japanese government securities. In addition, to respond to the increase in precautionary demand for funds, the Bank provided ample funds to sufficiently meet market demand. More specifically, on Monday, March 14, the first business day after the disaster, the Bank provided a total of 21.8 trillion yen in funds, almost three times the largest daily funds provision during the financial crisis after the failure of Lehman Brothers. Thereafter, the Bank continued its ample provision of funds. As a result, the outstanding balance of financial institutions' current accounts at the Bank marked a historical high of 42.6 trillion yen as of March 24. Comparing this amount to the level before the earthquake of around 17 trillion yen illustrates well the amount of funds provided by the Bank after the disaster. Due to these measures taken by the Bank, financial markets remained stable following the earthquake.

2. Further enhancing monetary easing by increasing the amount of the Asset Purchase Program

At the MPM held immediately after the earthquake, on March 14, 2011, the Bank decided to take measures to further enhance monetary easing, with a view to preempting a deterioration in business sentiment and an increase in risk aversion in financial markets from adversely affecting economic activity. Specifically, the Bank decided to double the amount of asset purchases – mainly of risk assets, such as CP, corporate bonds, and ETFs – through the Bank's Asset Purchase Program from about 5 trillion yen to about 10 trillion yen. I also shared the view that it was extremely important for the Bank to decide on drastic further monetary easing to fully reassure market participants. I believe that the measure was effective in reassuring market participants in that it prevented a deterioration in business sentiment and an increase in risk aversion in financial markets: for example, issuance spreads on CP, which had expanded immediately after the earthquake, declined to more or less the same level as prior to the earthquake and issuing conditions for CP continue to be favorable. I should note, however, that there are signs that since the earthquake small firms have been facing some difficulties in obtaining funding, and I will pay close attention to this issue when assessing the financial environment.

3. Supporting financial institutions in disaster areas

In addition to the measures mentioned thus far, the Bank decided to conduct long-term funds-supplying operations to financially support initial response efforts by financial institutions in the disaster areas even before demand for the purpose of rebuilding and revival becomes full-fledged. Furthermore, with a view to securing sufficient financing capacity of financial institutions in disaster areas, the Bank decided to broaden the range of eligible collateral for money market operations.

I believe the Bank's bold measures, including the decision to quickly provide long-term funds to financial institutions in disaster areas to support firms in distress – particularly small and medium-sized firms – were timely and most appropriate. The damage caused by the recent earthquake has been much larger than that of the Great Hanshin-Awaji Earthquake in 1995, but the Bank has taken full advantage of the lessons learned at the time.

The first funds-supplying operation to support financial institutions in disaster areas took place in May, and the second such operation took place on June 21. The amount disbursed so far totals some 200 billion yen at a rate of 0.1 percent. In principle, the operations, whose expected maximum amount is 1 trillion yen in total, will continue every month until October this year.

These measures were put in place as an initial response to meet the demand for funds expected to emerge for rebuilding and revival. The Bank will continue to study further measures to help disaster areas recover, reconstruct, and move forward as quickly as possible.