Hirohide Yamaguchi: The European debt problem, Japan's economy, and monetary policy

Speech by Mr Hirohide Yamaguchi, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Kagawa, 2 February 2012.

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Introduction

Thank you for giving me an opportunity to exchange views with administrative and business leaders in Kagawa Prefecture. Today marks the 70th anniversary of the establishment of the Bank of Japan's Takamatsu branch. The branch has been operating steadily in this area for such a long time, thanks to your understanding and cooperation. I also express my gratitude.

Kagawa Prefecture is a memorable place for me. I worked at the Bank's Takamatsu branch as General Manager for about two years since May 1996. During my stint, I visited frequently many local business managers and learned about local economic and financial conditions in detail. Extraordinary managerial efforts I witnessed at that time still vividly remain in my memory. I will also never forget that I had delicious Sanuki udon here many times.

Today, I will talk about the outlook for Japan's economy and its medium- to long-term challenges, and viewpoints of the conduct of monetary policy, while focusing on the European debt problem which is the greatest concern for the global economy for the time being.

I. Developments in overseas economies and the current situation of the European debt problem

Overseas economies have been on a decelerating trend, and are expected to recover moderately in the future

Let me start with the developments in overseas economies. Following the Lehman shock in 2008, the global economy was recovering, led by emerging economies, but the pace of recovery has been slowing since around the middle of last year.

By region, the U.S. economy has been recovering moderately. Recently, there have been some bright signs in consumption and production, and the market's view has become somewhat optimistic. The foundations for sustainable growth remain vulnerable with the housing market in the midst of a protracted slump and the unemployment rate hovering at a high level of more than 8 percent. Therefore, the pace of economic recovery is likely to remain moderate for the time being.

The European economy has become increasingly stagnant as a whole on the back of the debt problem in Greece and other countries, which continues to be a great concern for the global economy. I will later talk about that problem in detail.

While emerging and commodity-exporting countries have been maintaining somewhat high growth rates as a whole, the pace of growth has been slowing recently and the degree of a slowdown in growth and the decline in inflation rates have started to differ among countries. For example, in India and Brazil, the inflation rates remain high despite a pronounced slowdown in economic activity. In China, a slowdown in growth and a decline in inflationary pressure have been progressing moderately, showing signs that the economy is heading toward a successful soft-landing, albeit lingering uncertainty.

According to the latest World Economic Outlook, which the International Monetary Fund (IMF) published last week, the global economic growth rate is projected to be 3.3 percent in 2012. While the projection has been revised downward, due mainly to the European debt problem, a view that the global economy will gradually recover led mainly by emerging and commodity-exporting economies has been basically maintained.

The European debt problem that became increasingly serious toward the end of last year

Let me turn to the European debt problem, which has been the focal question now. The problem started with the fiscal problem in Greece. In October 2009, as for Greece's fiscal deficit, it became clear that the existing statistics did not reflect the actual conditions and the actual deficit was much larger. Therefore, skepticism spread about whether Greek government bonds could be orderly redeemed, and the prices of Greek government bonds fell substantially. In other words, yields soared and have recently been hovering above 30 percent. As Greece could not raise funds under such circumstances, it has been implementing various fiscal reconstruction measures while receiving financial assistance from other European countries and the IMF. There has been a vicious cycle in that those measures in turn put downward pressure on the economy, thereby make fiscal reconstruction itself a difficult one. Therefore, in Greece, to reduce the heavy debt burden itself, discussions on how to handle the debt in the future are going on, including partial debt cancellation by private investors concerning their exposure.

The Greek problem spilled over to Portugal and Ireland which also had concern over fiscal conditions and those countries have also received financial assistance including that from the IMF. Market concern also heightened for fiscal conditions of larger countries such as Italy and Spain, the third and fourth largest economies in terms of GDP in the euro area. Italy faced a tough situation as the yield of Italian government bonds once surged to above 7 percent at around the end of last year. Thereafter, both in Italy and Spain, due partly to the announcement of fiscal reconstruction measures under new governments, the yield on government bonds has recently declined slightly. There is uncertainty whether the reconstruction measures will be surely implemented, and as massive past-issued government bonds will reach maturity through this spring, whether refunding will be smoothly made is drawing attention. With respect to Portugal, partly due to the notable downgrading of government bonds, concern over fiscal conditions has recently been increased and the yield of government bonds has been hovering at a high level exceeding 15 percent.

As the yields of European government bonds soared, in other words, the prices declined substantially, European financial institutions, which held a huge amount of government bonds on the assumption that they were safe assets, incurred huge losses. As a result, those financial institutions lost market confidence, facing a rise in funding costs and difficulties in funding themselves. The situation got worse toward the end of last year, and there was growing concern that financial institutions' behavior, including a credit crunch by institutions that struggle with funding, could further affect significantly the already stagnant real economy.

Strains have somewhat mitigated since the turn of the year, and yet vigilance is required

In such a situation, the European Central Bank (ECB) implemented a measure last December to massively provide extraordinarily long-term funds, a loan period of three years, to the financial market. Meanwhile, major six central banks in Japan, North America, and Europe have also made united efforts, including strengthening their supply of dollar funds, to stabilize international financial markets. As a result, market strains have somewhat mitigated since the turn of the year, such as a decline in interest rates of the dollar funds transactions. That is only slight mitigation of anxiety over funding for the time being, and European financial institutions are suspected of still being burdened with huge losses and, in relation to that, lacking capital. While they are required by the financial authorities to increase their capital ratios by the end of June, if they cannot secure sufficient capital, they have no choice but to reduce assets, which is the denominator in calculating the capital ratio, to raise their capital ratios. Such reduction of assets, the so-called deleveraging, has already started to occur, and attention should be paid to whether it further affects borrowers of funds, including firms, and emerging economies which have substantial borrowing from European financial institutions. In short, we should not lack vigilance about whether a vicious cycle – a problem which has originated on the fiscal front spreads over to the financial front and further to the real economy – will further expands globally.

II. Fundamental character of the European debt problem

Why is Europe burdened with the big problem? Broadly speaking, the problem has two aspects. One is a manifestation of a weakness that has said to be inherent in monetary union, in which 17 countries share the single currency "Euro". The other is an aspect common to other advanced economies, that is, worsening of fiscal conditions as a result of the burst of a global bubble that had been created until after the mid-2000s.

Discipline on public finance and competitiveness inevitable for monetary union did not function

Let us start with the issue of "Euro". In the euro area, which now consists of 17 countries, currency is unified under the single monetary policy, that is, the single policy rate, but, needless to say, countries remain separate. Therefore, if a difference in competitiveness between individual countries widens, trade surplus accumulates in countries with strong competiveness, while trade deficit accumulates in countries with weak competitiveness. If individual countries are using different currencies, through changes in the foreign exchange rate in which a currency of trade surplus country becomes strong and a currency of trade deficit country becomes weak, a difference in competitiveness will be narrowed, thereby might mitigate trade imbalances. As long as the single currency was adopted, one cannot expect such power of foreign exchange markets. In addition, individual countries cannot pursue different monetary policy according to the respective economic conditions. Of course, as those issues were understood from the outset, rules were made to encourage countries with weak competitiveness to increase competitiveness, so that there would be no significant difference in competitiveness. The "Stability and Growth Pact" that incorporated such obligations as containing fiscal deficit at 3 percent of GDP or lower, is one of such rules. It was considered that, if a limit on fiscal deficit was firmly set, it would become difficult to make up a decline in competitiveness with fiscal spending and countries had no choice but to strengthen their economic power.

However, in reality, the rule was not applied stringently, partly due to policy responses on the fiscal front after the Lehman shock, and fiscal discipline gradually became loose. As a result, a difference between countries with strong competitiveness, including Germany, and those with weak competitiveness, including Greece, became increasingly large, and trade imbalance bloated. The trade deficit countries have to cover their deficit by borrowing from other countries, and financial institutions and investors in other countries continued to purchase government bonds of Greece and others with low yields, partly because they did not need to worry about the risk of foreign exchange fluctuations under the single currency euro. Consequently, trade deficit countries increased borrowing from other countries more than their potential, and could not put a brake at an earlier stage. Thus, in the case of Greece, it became difficult for excessively issued government bonds to be repaid in full after all, and such situation surfaced as this time's debt problem.

There is also a problem of ballooning fiscal deficit after the Lehman shock, which is common to Japan, the United States, and Europe

Excessive government debt has been accumulated as there was a weakness in the mechanism of monetary union in the euro area. On the back of the European debt problem, there is also an aspect of deterioration in fiscal conditions due to the burst of a global credit bubble, which is common to other advanced countries.

Looking back, due partly to the rise of emerging economies and financial innovation, the global economy had been enjoying high growth without inflation until after the mid-2000s. That situation was also referred to as “Great Moderation”, and especially the U.S. and European economies became increasingly confident in their future. In the United States, however, the subprime mortgage problem aggravated and eventually led to the Lehman shock and it became clear that no small part of the past high growth was nothing more than an unsustainable bubble. Also in Europe, during the phase of global growth, real estate investment surged, mainly in Ireland and Spain, and real estate prices plunged with the burst of a credit bubble. As a result, massive public funds were used for bailing out financial institutions and for an economic stimulus, and fiscal conditions deteriorated rapidly. Also in the United States, fiscal deficit surged after the Lehman shock, and there were moves that a rating agency downgraded the U.S. government bonds from the highest AAA last summer. In Japan, while fiscal deficit has always been a grave problem due partly to rapid aging, fiscal conditions also further aggravated due to a series of economic stimuli after the Lehman shock.

In general, for fiscal reconstruction, namely, for reducing government debt, it is necessary not only to address the public finance itself on both the revenue and expenditure fronts, but also strengthen economic growth potential to secure tax revenue which is a resource to repay the debt. For example, in the cases of Portugal and Italy, the market is concerned about fiscal conditions and even more about weakness in growth potential.

As the global economic growth prior to the Lehman shock had been inflated by a credit bubble to begin with, the global economy cannot return again to such inflated state at this point. To steadily promote fiscal reconstruction, it is necessary to create a new growth model corresponding to changes in economic structure after the Lehman shock and strengthening growth potential over the future. While I talk about Japan later, that point is existing as a daunting challenge common to Europe, the United States, and Japan.

It will take time to solve the European debt problem

Keeping in mind the aforementioned situation, I will address measures toward the solution of the European debt problem. As I have said earlier, market strains have been somewhat mitigated, due partly to massive funds provision of the ECB and others. That is only an arrest of bleeding for the moment. Given the basic character of the problem, the following more fundamental responses will be necessary. First, as I said before, problem countries should tackle restoring fiscal soundness and strengthening growth potential. Second, prepare a sufficient mechanism on the funds front to support such efforts by the problem countries and to rebuild the financial system. Third, to avoid a recurrence of the problem, strengthen a governance mechanism so as to exert sufficient discipline on public finance and competitiveness. And fourth, avoid a financial crisis like that at the time of the Lehman shock.

While there have been some steps forward in the first through the third responses, given difficulties of the issues, it is likely to take a while to solve them. For example, to restore fiscal soundness, the government should make the public receptive to considerable patience. In addition, as measures to provide financial assistance to problem countries, the establishment of a new funds supplying framework called “the European Stability Mechanism (ESM)” and assistance measures from outside the region have been examined. As there is also a risk for fund providers, it is not going to be an easy examination. In terms of avoiding a recurrence of the problem, at the recent EU Summit, many member countries have moved forward in the direction of signing a new treaty that includes reinforcement of fiscal discipline, but there are issues, including specific steps to take from now on, that remain to be settled. Even that should eventually overcome the problem the euro area had from the outset, that is, to what extent one can intervene in each sovereign nation’s economic policy.

Keeping in mind the history of the euro area, which was established by holding an ideal of creating peace, prosperity, and stability in Europe and being supported by strong political determination, it is likely that monetary union will further go again toward the evolution of monetary union by using the crisis as a springboard. In fact, the European authorities are continuing to make exceeding efforts. Given a bumpy road to the end, we could not completely rule out a possibility that strains in financial systems will increase extremely triggered by some events or, in the worst case, a possibility that market confidence in the maintenance of monetary union itself will decline. We should pay close attention to future developments while recognizing a risk that has extremely low probability to manifest itself but will have a grave impact once it manifests itself, the so-called tail risk. I have earlier said, as the fourth response, that a crisis like the Lehman shock should be avoided, and that was indeed based on the awareness mentioned above.

I have so far described the current situation of the European debt problem and its fundamental character. Keeping those in mind, in the remaining time, I will refer to the developments in Japan's economy and the Bank of Japan's thinking of the conduct of monetary policy.

III. Prospects for Japan's economy and medium- to long-term challenges

From a somewhat longer-term perspective, the economy will return to the sustainable growth path with price stability

Japan's economy declined significantly following the earthquake disaster in March last year and thereafter recovered at a pace faster than envisaged thanks to efforts by firms and people. Since early autumn, the slowdown in overseas economies, the appreciation of the yen, and the flooding in Thailand have been affecting the economy, and Japan's recent economic activity has been more or less flat.

In such situation, the Bank published last week its latest economic outlook through fiscal 2013. In terms of the median of the Policy Board members' forecasts, the real GDP growth rate is projected to be at –0.4 percent in fiscal 2011 due mainly to the effects of the earthquake disaster and the slowdown in overseas economies. For fiscal 2012, the economy is expected to grow by 2.0 percent as the pace of recovery in overseas economies picks up, led by emerging and commodity-exporting economies, and reconstruction-related demand gradually materializes. The growth rate for fiscal 2013 is projected to be at 1.6 percent. Under such circumstances, the year-on-year rates of change in the consumer price index (CPI) for all items less fresh food are expected to remain at around 0 percent for the time being, but expected to gradually rise to 0.1 percent in fiscal 2012 and 0.5 percent in fiscal 2013. As just described, while it still takes some time to overcome deflation, from a somewhat longer-term perspective, Japan's economy is expected to return to the sustainable growth path with price stability.

However, there are high uncertainties, including the effects of the European debt problem

The outlook is associated with various uncertainties. While the biggest risk is the aforementioned European debt problem, there are other risks we should be aware of. The aforementioned recovery scenario for Japan's economy assumed that emerging and commodity-exporting economies would increase the pace of growth again, with a decline in inflationary pressure, thereby leading the global economy. Even for such basic assumption, we should monitor without prejudgment whether it will become a reality as assumed. Geopolitical risk concerning Iran is also a source of concern. If there is mounting tension and oil prices surge, it will be an upward pressure on prices in Japan, while economic activity will deviate downward from the baseline scenario through a deterioration in corporate profits. As a surge in oil prices could also lead to a slowdown in emerging economies, sufficient attention should be paid to future developments.

As for domestic factors, there is a possibility that conditions surrounding electric power supply and demand will become increasingly severe toward this summer in a wide area including the Shikoku region. In addition, if the overseas transfer of Japanese firms' production bases proceeds rapidly against a backdrop of the entrenched appreciation of the yen and a rise in electricity costs, medium- to long-term growth expectations could be lowered, which continues to require attention.

Medium- to long-term challenges for Japan's economy: strengthening growth potential and ensuring fiscal sustainability

The risk that medium- to long-term growth expectations might be lowered is not a new problem. In fact, Japan's economic growth rate has been on a downtrend and, especially since the 1990s, chronic low growth has been continuing. In my view, primary reason is that, despite rapid aging, Japan's economy has not been sufficiently equipped with power to quickly gauge changes in the demand structure and foster new industries. Given further population aging in the future and high-level government debt, Japan's economy is faced with an imminent challenge of becoming serious about strengthening medium- to long-term growth potential while promoting fiscal structural reform.

Strengthen growth potential by a two-pronged strategy of external and domestic demand

Strengthening medium- to long-term growth potential is not an easy task. Nevertheless, it should be achieved by all means while keeping in mind the following four.

First, incorporate global demand as much as possible. To that end, it is vital for firms to, through exports, and further more through aggressive overseas expansion, accurately gauge local needs and tap the market. As for firms' overseas expansion, unless the pace of expansion is too fast, it would not necessarily be a factor in causing the hollowing out of domestic employment. If a cycle will be established that firms increase profits overseas, pass them on domestically, and invest in research and development of new products and services, more high value-added jobs will be generated in Japan, thereby could contribute to strengthening foundations for economic growth. Efforts to increase foreigners who stay in Japan for the purpose of tourism and business and prepare an environment that attracts investment from overseas will also be an effective strategy in incorporating global demand and increasing domestic employment together.

Second, tap potential domestic demand. An aging society will have its own new potential needs, and there will be plenty of room for coping thoroughly with the diversified concept of values and life styles. There is much potential in the domestic market, let alone healthcare, including services for firms and households based on information technology. While I have earlier referred to concern over electric supply and demand, on the other hand, efforts to overcome such challenge, including saving energy and developing new alternative energies, could lead to a generation of new added-value.

Third, enhance the flexibility of the labor market. To lessen the likelihood of a labor shortage associated with aging being a binding factor for economic growth, it is necessary to promote employment of the elderly and women. Preparing an environment that facilitates job transfers and the start of new businesses will lead to the effective use of human resources or the activation of metabolism in the entire economy. Fostering global human resources will also be imperative.

Fourth, strengthen the function of financial and capital markets. For the development of new markets, it is critical to take risks. To support that, accepting risks by investors and financial institutions, namely, a provision of risk money is necessary. Japan's households have almost

1,500 trillion yen of financial assets, and there are ample deposits in financial institutions. It is important to steadily make efforts to transform even part of those deposits into risk money.

I have so far explained how to strengthen the growth potential of Japan's economy from several angles. While there might be more, a basic pillar to strengthen growth potential will be to tap new markets both in terms of external and domestic demand, as well as to promote activation of labor and capital markets that support such challenge.

Fiscal sustainability should be ensured before market confidence is lost

Together with strengthening growth potential, it is necessary to steadily make efforts to ensure fiscal sustainability. Japan's government debt outstanding exceeds 200 percent of nominal GDP, which is the highest level among advanced economies. Nevertheless, yields on government bonds remain low and stable. In my view, the most fundamental reason is that the market trusts that the Japanese people have a strong will to achieve fiscal soundness and thus Japanese government bonds will continue to be safe assets in the future.

Having said that, given that national debt is still increasing, one cannot rule out the possibility that confidence in the government bond market might collapse at once triggered by some cue. If that becomes a reality, there will be a significant impact on the financial system and the real economy, as the actual case of Europe proved. Given that increasing pressure on social security costs is likely to continue amid further aging, it is difficult to blaze a path for fiscal soundness just by strengthening growth potential. It is necessary to proceed with fiscal structural reform both in terms of expenditure and revenue before the market confidence is lost.

IV. Conduct of monetary policy

Pursuing powerful monetary easing toward overcoming deflation

Based on the aforementioned outlook and medium- to long-term challenges for Japan's economy, let me talk about the Bank of Japan's monetary policy. The Bank recognizes that Japan's economy is faced with a critical challenge of overcoming deflation and returning to the sustainable growth path with price stability. With such recognition, the Bank has been pursuing powerful monetary easing in the framework of "comprehensive monetary easing".

Specifically, first, the Bank lowered the policy rate to around 0 to 0.1 percent, which can be deemed a virtually zero interest rate.

Second, the Bank is clearly committed to continuing with this virtually zero interest rate policy until it judges that price stability is in sight. With respect to the meaning of price stability, the Bank clearly stated in a specific expression that "on the basis of a year-on-year rate of change in the CPI, it falls in a positive range of 2 percent or lower, centering around 1 percent". The Bank calls the expression "understanding of medium- to long-term price stability". The central bank of the United States newly introduced last week a "longer-run goal" with respect to the inflation rate and drew attention from the market. As is the case with the Bank of Japan, it also aimed at numerically clarifying the meaning of medium- to long-term price stability.

Third, the Bank established the "Asset Purchase Program", and purchases government bonds and other various financial assets. It is a measure to facilitate monetary easing to steadily spread to firms' funding costs through encouraging a decline in longer term market interest rates. The total size of the Program is about 55 trillion yen, which corresponds to more than 10 percent of Japan's GDP.

Tap external and domestic demand by utilizing extremely accommodative financial conditions

With such pursuit of powerful monetary easing, at present, ample liquidity is provided to Japan's financial markets and firms' funding conditions are quite accommodative. It is quite a contrast to international financial markets which are under enormous stain due to the European debt problem. If such domestic accommodative financial conditions are utilized aggressively for tapping external and domestic demand, I believe Japan's economy can emerge from deflation. In that regard, the Bank itself has been implementing a measure to supply long-term and low interest rate funds to financial institutions that made lending or investment which contributed to strengthening foundations for economic growth. Through the measure, the Bank has been supporting firms and financial institutions efforts to utilize the accommodative financial conditions.

Constantly review monetary policy conduct and prepare a system for a rainy day

Toward overcoming deflation and strengthen medium- to long-term growth potential, the Bank will consistently make utmost contributions as a central bank as well as strive to continue to take appropriate policy responses with due recognition that there is a high degree of uncertainty for the time being, including the effects of a slowdown in overseas economies and the appreciation of the yen. The Bank believes it is important to review its conduct of monetary policy constantly with composure and in an objective manner, including how communication with the market should be. Besides, as for the European debt problem, I have said that, while the possibility might be extremely low, we also need to prepare for a rainy day when financial markets become chaotic. In that regard, the Bank will continue to firmly monitor the financial system, payment system, and financial institution management, and, while closely working together with the government and central banks overseas, the Bank will cover all the bases so as to ensure financial market stability even in an emergency.

Concluding remarks

I am running out of time. Let me conclude today's speech, touching on the economy of Kagawa Prefecture.

There are many firms in this region that have the largest market share in the world in specific areas, and, during my visit this time, I was able to learn about the eagerness to further develop the growing markets from a global perspective. In addition, Kagawa Prefecture built a prefecture-wide medical records sharing system ahead of other prefectures in Japan, and, based on the system, "the Kagawa medical and welfare special zone" was established last December. I strongly expect that such joint efforts of the public and private sectors will tap potential demand from elders and others, and become a model case for the development of domestic demand.

To wrap up my speech, I quote the word "*dogan*" which Mr. Haruo Maekawa, who had been General Manager of the Takamatsu branch for about one and a half years from 1954 and later became Governor of the Bank, fondly used. The word is originally quoted from a line in Mr. Yukichi Fukuzawa's book and the meaning is "a goose who takes a role in paying attention to changes in the surroundings to protect neighbors from outside enemies". Mr. Maekawa often compared a central bank to "*dogan*" and emphasized that it is important for a central bank "not to be influenced by the flavor of the time but appeal to the world by anticipating changing times and future directions always from an objective viewpoint". In my view, the phrase holds true not only for a central bank but also for people who are in responsible positions in the region's administration, finance, and the economy. Amid globalization, the demographic vortex, and various challenges the regional economy is faced with, everybody here has been anticipating changing times with composure and exerting strong leadership to guide regional neighbors to perfect answers. The Bank will also steadily continue with its contribution as the central bank and support your positive efforts.