Ryuzo Miyao: Economic activity, prices, and monetary policy

Speech by Mr Ryuzo Miyao, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Chiba, 28 March 2012.

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Introduction

Thank you for giving me this opportunity to exchange views with people representing Chiba Prefecture. Allow me to express also my gratitude for your cooperation with the activities of the Research and Statistics Department and other departments of the Bank of Japan.

I have been told that the Bank's meetings with business leaders have not been held in Chiba since October 2003, and thus I am looking forward to hearing your views. In my speech to you today, I will review economic activity and prices both overseas and in Japan – whose economy is heading toward recovery despite the effects of the global economic slowdown – and then present a few remarks on monetary policy. My concluding remarks will touch on the economy of Chiba Prefecture.

I. Recent developments in economic activity and prices

A. Overview

Japan's economy entered a soft patch around the turn of the year. While domestic demand has been firm, growth in external demand has been sluggish, reflecting the deceleration of the global economy – caused by the European economy's stagnation due to the European debt problem, a slowdown in the Chinese economy due to monetary tightening, and the flooding in Thailand – as well as the continued appreciation of the yen. As a result, Japan's economic activity as a whole has remained more or less flat.

However, it is expected that the pace of recovery in overseas economies will pick up slowly, led by emerging economies, and reconstruction-related demand after the Great East Japan Earthquake in March 2011 will gradually increase. Supported by these factors, Japan's economy is expected to gradually emerge from its soft patch and return to a moderate recovery path.

In what follows, I will present an overview of developments in overseas economies, and then discuss the current situation and prospects for Japan's economy.

B. Overseas economies

The European economy experienced severe strains in the financial markets and financial systems until around the end of 2011, because of the European debt problem. However, market conditions subsequently improved with the subsiding of tail risks such as the funding collapse at financial institutions. This positive development was partly the result of a reduction in the pricing on the existing temporary U.S. dollar funds-supplying operations by six central banks and 36-month longer-term refinancing operations (LTROs) with full allotment conducted twice by the European Central Bank. In particular, approximately 500 billion euros on a net basis were provided through each tranche of the LTROs, which facilitated the smooth redemption of corporate bonds and reduced the yields on government bonds through their purchase by financial institutions. With the recovery of stability in financial markets and financial systems, some financial institutions have begun issuing uncollateralized corporate bonds, and the situation has been steadily improving. In mid-March, debt restructuring with Greek government bondholders in the private sector was carried out successfully and the second tranche of financial assistance under the economic adjustment programme for Greece was agreed. The risk of anxiety sweeping through financial markets or rapid economic deterioration – which had been acknowledged in the phrase "Europe is the greatest risk" – thus appears to have been alleviated.

Nevertheless, the European debt problem itself has not been resolved, and concern over deleveraging – whereby financial institutions reduce lending and adversely affect economic activity – has yet to be dispelled. European financial institutions appear to be reducing their foreign currency-denominated lending, such as syndicated loans, in North and South America and Asia. It has been reported that these institutions have also been gradually reducing euro-denominated lending, particularly in some European peripheral countries. In the background, it seems that two factors are at work, namely, sluggish demand for funds by firms and households due to the economic downturn, and the need of financial institutions to improve their capital ratios. Future developments in both factors continue to require attention.

More fundamentally, Europe faces the critical challenge of pursuing both fiscal consolidation and structural reform at the same time and raising growth potential. The difficulty for the European countries is that they must pursue fiscal consolidation in the short run but at the same time boost private-sector vitality and enhance economic growth, while preventing fiscal consolidation from further harming economic activity. The European economy as a whole is likely to stagnate for the time being and subsequently return to a moderate recovery path. Given that disparities in competitiveness are becoming apparent among European countries, it is possible that the pace of recovery will be extremely slow. Due attention should continue to be paid to the risk that economic stagnation might become chronic or prolonged.

As for the United States, several favorable economic indicators have been released recently and the economy is recovering moderately. The year-on-year rate of change in the consumer price index (CPI) for all items less food and energy has been stable at about 2 percent. The general picture of the economy is that households' balance-sheet adjustments continue to weigh on economic activity, but the mechanism of economic recovery supported by the corporate sector is operating continuously and the momentum for a moderate improvement is being maintained.

Let me elaborate on this point for a moment. In the United States, housing prices have been sluggish, but firms' production, exports, and profits have been strong because they have succeeded in tapping global demand, and this has led to an improvement in employment and income conditions and steadily underpinned private consumption. Gradual materialization of pent-up demand, or potential demand, which had been contained after the Lehman shock and the Great East Japan Earthquake, seems to have also supported the economic recovery. Another advantage is the fact that spill-over effects of the European debt problem on economic activity have thus far been less serious than initially expected.

As for the outlook for the U.S. economy, a number of private research agencies hold the view that moderate growth of 2.0–3.0 percent is achievable. Given that housing construction and house sales are showing signs of bottoming out against the background of a solid expansion in employment and a gradual reduction in the ratio of household debt to disposable income, it appears that the burden of households' balance-sheet adjustments is gradually easing as a whole and the economy is gradually increasing in resilience to downside shocks.

Having said that, as a current risk to the U.S. economy I would point to the surge in gasoline prices stemming from an increase in crude oil prices. Thus far, the rise in crude oil prices is considered to be largely attributable to supply-side factors, including the situation in Iran, and thus the price hike is likely to be temporary. As natural gas prices have been declining in the United States due partly to progress in shale gas development, we might not need to be overly concerned about the rise in crude oil prices. However, if gasoline prices – which at present are 3.8 U.S. dollars per gallon – exceed 4 U.S. dollars, this is likely to adversely affect economic activity, mainly in the form of its impact on medium- to low-income families, and thus the situation warrants attention.

In the meantime, stock prices have recovered to their level prior to the Lehman shock and developments in U.S. financial markets have been favorable. Although long-term interest rates have not moved in tandem with the rise in stock prices and have been more or less flat for some time, they have started to rise recently, gradually reflecting the improvement in economic activity.

Asian emerging economies, led by China, have been maintaining high growth rates, and medium- to long-term growth expectations also appear to be high. In China, however, exports and imports declined and the pace of increase in production slowed around the turn of the year, due to the effects of monetary tightening to contain the rise in prices as well as to stagnation in the European economies associated with the debt problem. Consequently, exports have declined and the economies of the NIEs and the ASEAN countries have decelerated somewhat as well.

Asian emerging economies are leading the global economy, and the Bank's baseline scenario is that these economies will gradually recover, supported by buoyant domestic demand. At the same time, attention should be paid to the possibility that European financial institutions' credit contraction will spill over to trade credits and prolong the current economic slowdown. In terms of achieving sound development of the global economy in the longer term, a key factor will be how to maintain the balance between economic growth and price stability. In this regard, China's announcement that lowered the economic growth target from 8.0 percent in 2011 to 7.5 percent in 2012 was a favorable step toward achieving a soft landing of the economy, despite the weakened economic stimulus effect in the short term. At any rate, in 2012 uncertainty and changes in economic policy associated with the transition of leadership in China should be carefully monitored.

C. Economic activity and prices in Japan

One year has passed since Japan's economy experienced the Great East Japan Earthquake. Following the disaster, economic activity plunged due to the disruption of supply chains and constraints on electric power supply. Thereafter, as a result of strenuous efforts by the parties concerned, Japan's economy began to recover in the July-September quarter of 2011. However, in the October-December quarter, the economy faced downward pressure as exports and production grew at a sluggish pace due to a slowdown in overseas economies – on the back of the European debt problem, monetary tightening in China, and the flooding in Thailand – as well as the appreciation of the yen. The annualized quarter-on-quarter growth rate of real GDP on a seasonally adjusted basis in 2011 was minus 6.9 percent in the January-March quarter, minus 1.2 percent in the April-June quarter, 7.1 percent in the July-September quarter, and minus 0.7 percent in the October-December quarter.

In recent months, exports and production have remained more or less flat, but domestic demand has been solid. Business fixed investment has been on an increasing trend, albeit moderately, supported by the restoration of disaster-stricken facilities, and private consumption has firmed up due in part to the effects of measures to stimulate demand for automobiles. Housing investment has generally been picking up and public investment has stopped declining. Household and business sentiment appears to have stopped deteriorating in general. Thus, although the Bank judged that Japan's economic activity has remained more or less flat, it has shown some signs of picking up.

With regard to the outlook, the baseline scenario is that Japan's economy is expected to gradually emerge from the current phase of flat growth and return to a moderate recovery path as the pace of recovery in overseas economies picks up, led by emerging and commodity-exporting economies, and reconstruction-related demand gradually increases. It is desirable for such improvement to be as sustainable as possible.

From the viewpoint of achieving sustainable growth, it is desirable if, both in manufacturing and nonmanufacturing industries, high-quality capital that enhances value-added is accumulated domestically, investment increases, and the competitiveness of industries improves. It is important to maintain and enhance in the domestic economy the qualities necessary for manufacturing, while working to tap domestic demand that reflects the needs of the aging population.

Looking at developments in domestic private business fixed investment, we can see that it declined substantially after the Lehman shock and the ensuing pace of its recovery has been quite modest. The slowdown in overseas economies and the appreciation of the yen in the second half of 2011 might have put additional downward pressure on business fixed investment in the manufacturing industry. According to the Cabinet Office's "Annual Survey of Corporate Behavior in FY2011," however, firms are forecasting an annual growth rate of about 1.5 percent in real GDP and about 4 percent in business fixed investment for the next three years, which suggests that as a whole firms' medium- to long-term growth expectations have been maintained and their investment appetite has not declined. In the survey, firms' overseas production ratio is currently about 18 percent and is forecast to reach approximately 22 percent in five years, which suggests that the balance between overseas and domestic production will be maintained. In addition, as investment was reduced to the level below depreciation following the Lehman shock, this in turn is currently encouraging replacement investment. It can also be expected that firms will add investment spending to restore and reconstruct disaster-stricken facilities as well as to strengthen their earthquake resistance.

Given the situation I have described, it would be no surprise if domestic business fixed investment, compared with firms' cash flows or depreciation costs, became more apparent, and thus potential demand for investment is likely to have accumulated accordingly. If actual investment has been contained even though firms' investment appetite has not declined, this might mean that firms have been deferring investment decisions because of sluggish stock prices, the yen's appreciation, the slowdown in the global economy stemming from the European debt problem, and related uncertainty about the future.

Let me repeat that firms' forward-looking investment in projects that would enhance value-added is a major driving force in order to increase the growth potential of the economy and improve productivity. It would also contribute to overcoming deflation. Whether firms' investment spending will steadily increase – at a pace consistent with their growth expectations, both at home and abroad, in a balanced manner – is vital for Japan's economy to achieve sustainable growth and overcome deflation.

Turning to price developments, the year-on-year rate of decline in the CPI (all items less fresh food) slowed at a moderate pace in 2011, reflecting the improvement in the aggregate supply and demand balance, and has been hovering around 0 percent since the summer of 2011. The baseline scenario of the outlook for prices projects that the current situation is likely to continue for the time being, but the year-on-year rate of change in the CPI will gradually turn positive as the aggregate supply and demand balance improves.

While crude oil prices have recently been surging due partly to the situation in Iran, the price levels of other commodities have not necessarily risen compared with 2011. As this seems to be consistent with the currently still-weak recovery of the global economy, upward pressure on crude oil prices might be temporary due to supply-side factors. Since crude oil prices might remain high depending on developments in geopolitical risk, careful monitoring is required.

II. Monetary policy

A. Conduct of monetary policy

Let me now discuss the Bank's enhancement of monetary easing decided in February 2012. At the Monetary Policy Meeting held on February 13 and 14, the Bank – amid the continued high uncertainty surrounding economic developments both at home and abroad – judged it necessary to further support the recent positive developments from the financial side and better ensure the economy's return to a moderate recovery path. Accordingly, the Bank decided to introduce "the price stability goal in the medium to long term," clarify its monetary easing stance, and increase the total size of the Asset Purchase Program (hereafter the Program). In this regard, let me mention three points.

First, the introduction of "the price stability goal in the medium to long term." Prior to the introduction, the Bank had shown the range of inflation rates that each of the nine Policy Board members understood as price stability in the form of the "understanding of medium- to long-term price stability." At the Monetary Policy Meeting in February, the Bank replaced this to show the Bank's own judgment. Namely, it judges "the price stability goal in the medium to long term" to be within a positive range of 2 percent or lower in terms of the year-on-year rate of change in the CPI, and has set the goal at 1 percent for the time being.

Second, the clarification of the Bank's monetary easing stance. Based on the aforementioned goal, the Bank further clarified its powerful easing stance by clearly stating that, for the time being, it will continue to pursue powerful monetary easing by conducting its virtually zero interest rate policy and by purchasing financial assets, with the aim of achieving the goal of 1 percent in terms of the year-on-year rate of increase in the CPI, until it judges that the 1 percent goal is in sight.

Third, the increase in the total size of the Program. The Bank increased the purchase of Japanese government bonds (JGBs) through the Program by about 10 trillion yen, thereby increasing the total size of the Program from 55 trillion yen to 65 trillion yen. This demonstrates the clarification of the Bank's monetary easing stance in the form of action.

B. Channels through which the enhancement of monetary easing should lead to the overcoming of deflation

Based on the decisions I have just mentioned, let me now consider the channels through which deflation can be overcome. With regard to the transmission channels for the effects of unconventional monetary policy under the zero interest rate policy, enhancing monetary easing – by committing to continue the virtually zero interest rate policy into the future and by increasing asset purchases – would induce a decline in longer-term interest rates and risk premiums through both the interest rate channel and the portfolio channel. The declines would influence firms' borrowing costs, a range of asset prices including stock prices and foreign exchange rates, and bank lending, thereby influencing households' and firms' spending and eventually have positive effects on economic activity and prices.

Looking at the developments following the February decision based on this consideration – in the form of effects on longer-term interest rates and people's risk-taking appetite brought about by prospects, that is, valid expectations for future aggressive monetary policy conduct – the 2-year government bond yield has declined, the yen has depreciated, and stock prices have risen. The depreciating trend of the yen and the rise in stock prices were already evident prior to the February decision, reflecting the mitigation of global risk aversion, improvement in the U.S. economy, and Japan's trade deficit. The decision at the Monetary Policy Meeting in February also appears to have contributed to establishing the trend. The clarification of the Bank's powerful monetary easing stance and decisive policy action seem to have exerted a strong commitment effect and a policy duration effect. These spilled over and lowered longer-term interest rates – including the 5-year government bond yield – enhanced people's risk-taking appetite – lowering required risk premiums in turn – and thereby enhanced the effects to improve financial conditions.

I pointed out earlier that firms' investment spending might have been restrained due to sluggish stock prices, the appreciation of the yen, and the slowdown in the global economy. If the current improving trend in financial conditions continues in tandem with the improvement in overseas economies, these improvements could induce a favorable turn in corporate profits and business sentiment, increase forward-looking investment, and concurrently enhance growth potential and value creativity. The depreciation of the yen and the rise in stock prices might also lead to an improvement in consumer sentiment and an increase in tourists from abroad, thereby further stimulating domestic demand. Such developments would likely work to induce a sustainable economic recovery and a moderate rise in prices. As cautious views remain with regard to future uncertainties, the headwind Japan's economy faces is likely to continue. Nevertheless, what I have just discussed suggests one channel through which powerful monetary easing could lead to overcoming deflation.

If the path of improvement induced by powerful monetary easing can be forecast and grasped by market participants, the improvement in financial conditions thus far will not be short-lived but might reflect trends and sustainable movement consistent with economic fundamentals. The movements of financial indicators actually observed reflect a mixture of the effects of various short-term factors and underlying factors. While it is difficult to clearly distinguish between the two types of factors, we cannot rule out the possibility that further enhancement of monetary easing has been supporting the desirable trend.

C. The need to strengthen growth potential

In the policy decision made at the Monetary Policy Meeting held on February 13 and 14, 2012, the Bank clarified its commitment to aim at achieving 1 percent inflation and continue pursuing powerful monetary easing until it judged that the 1 percent goal was in sight. Further clarification of the commitment has the key merit of reducing forecasting uncertainties and further enhancing the credibility of monetary policy conduct. Having said that, however, if policy is conducted in a manner "only to achieve 1 percent inflation at any cost," it would be too rigid and would not be desirable for the sound development of the national economy. Overcoming deflation is an overriding issue and needs to be supported from the financial front. To this end, it is necessary for policy conduct to combine credibility and flexibility.

In pursing aggressive monetary easing going forward, one of the necessary flexibilities is proper attention to potential side effects.

The Bank's purchases of JGBs within the framework of the Program are monetary policy measures that have been judged necessary to overcome deflation, and are not conducted with the aim of financing the fiscal deficit. At the same time, Japan's enormous fiscal deficit and government debt outstanding are significant concerns that could elevate fiscal risk. A rise in government bonds' risk premiums and an increase in interest rates, in the absence of an economic recovery and a rise in stock prices, would indicate an unfavorable rise in interest rates. The manifestation of such fiscal risk must be avoided by all means.

To this end, first of all, medium- to long-term fiscal discipline must be ensured. Even if a central bank implements aggressive asset purchases and government bond purchases to overcome deflation, this could increase the probability of "unintended consequences" from fiscal risk manifestation unless key fiscal discipline is ensured.

Furthermore, I believe it is important for Japanese people to make efforts steadily to increase Japan's growth potential. If firms and households rein in such efforts because uncertainties regarding the outlook are not dispelled, the crucial growth potential will not increase. Focusing on savings without carrying out forward-looking investment might induce a substantial decline in growth potential and, as a result, larger negative impact on public finance, including a decline in tax revenue.

Confidence in government bonds is sometimes considered from the viewpoint of confidence in Japan's economy as a whole, by focusing on the current account balance and net external assets. There is a view that, as long as the trend of current account surplus is maintained, Japan can continue to accumulate net external assets, which currently total about

250 trillion yen. Therefore, for Japan's economy as a whole, including the corporate and household sectors, confidence has been maintained and net external assets will serve as a cushion against fiscal risk. In the sense that the current account surplus and net external assets might be factors inducing the yen's appreciation, these might contain to some extent the risks of a one-sided depreciation of the yen and capital flight. However, there is no simple one-to-one relationship between confidence in fiscal sustainability and the current account balance or the external position. In order to maintain confidence in fiscal sustainability, therefore, I believe it is ultimately necessary to ensure fiscal discipline and increase Japan's growth potential.

In order to increase growth potential, a reasonable amount of time is required to implement measures, including economic and fiscal structural reforms. This should be obvious even without reference to the example of Europe. On the relation between monetary policy and fiscal reform, there are views on one hand that fiscal structural reform cannot be promoted unless deflation is first overcome and, on the other, that further monetary easing – particularly purchases of government bonds – should be restrained unless fiscal structural reform progresses. I support neither of these views. Aggressive efforts from the financial side to overcome deflation, fiscal structural reform, and efforts to increase growth potential should all be carried out at the same time by the public as a whole, from the respective standpoint of each individual.

As for the Bank's policy taken to strengthen growth potential, the Bank has been implementing the "fund-provisioning measure to support strengthening the foundations for economic growth," and has been supporting financial institutions' efforts in this regard. At the Monetary Policy Meeting held on March 12 and 13, 2012, with a view to enhance support by broadening the base for the efforts, the Bank decided on the following measures. First, the Bank extended the deadline for applications for new loans by two years, to March 31, 2014. Second, it established a new arrangement for loans of 500 billion yen for small-lot investments and loans (1 million yen or more but less than 10 million yen). Third, the Bank raised the ceiling for the outstanding balance of loans under the existing arrangement from 3 trillion yen to 3.5 trillion yen. And fourth, with a view to support financial institutions' efforts also from the side of foreign currency funds provisioning, the Bank established a new arrangement for providing loans in U.S. dollars to the equivalent of 1 trillion yen, using the U.S. dollar reserves held by the Bank. Details of the measures will be examined at the next Monetary Policy Meeting to be held on April 9 and 10, 2012. As a result of the measures, the outstanding balance of loans under the arrangements will increase from 3.5 trillion yen to 5.5 trillion yen.

Up to now, I have described the Bank's efforts to overcome deflation and discussed things to keep in mind by focusing on the policy decisions made recently. In the actual conduct of monetary policy, based on the outlook for economic activity and prices, it is necessary to respond carefully and decisively by identifying the timing and measures while monitoring a range of conditions and possibilities. The Bank will continue to do its utmost as the central bank by pursuing powerful monetary easing to overcome deflation, ensure financial market stability, and provide support to strengthen the foundations for economic growth.

Concluding remarks: the economy of Chiba prefecture

In my conclusion, let me touch on the economy of Chiba Prefecture.

The Great East Japan Earthquake in March 2011 caused tremendous damage to the region, including fires, tsunami, and soil liquefaction. One year has passed since the disaster occurred. Let me express once again my heartfelt condolences to the victims of the disaster and their families. I also salute the local citizens, firms, and governments for their efforts to achieve restoration and reconstruction.

Chiba Prefecture is bounded by water on three sides, and it is blessed with mild weather and rich natural surroundings. It has a strong agricultural sector with an array of crops that rank first nationwide in terms of output, including peanuts, Japanese radishes, green soybeans, and Japanese pears, and its agricultural output as a whole ranks third in the nation. Chiba Prefecture also ranks high in terms of fisheries, with plenty of fishing ports, including the nation's largest, in the city of Choshi. The coastal area contains the Keiyo industrial zone, which serves as the nation's largest supply depot for raw materials and energy, such as chemical products, steel, and oil. More than six million people live in Chiba Prefecture, which also serves as a bedroom community in the Tokyo metropolitan area, and the many commercial and recreational facilities attract numerous visitors from other prefectures. Such diversity, offering something for everyone, is a key characteristic and strength of Chiba Prefecture.

Chiba also contains historic tourism resources including Narita-san, a Buddhist temple that has been a popular tourist attraction since the Edo Period. A number of efforts have been made to promote Chiba's attractions to people both within and outside the prefecture. The Chiba Aqualine Marathon, the first full marathon ever routed on an expressway over the sea, will be held this October, and a model cycling course has been set up to popularize cycling tourism. Other promising steps in the prefecture include an expansion of the number of annual departure and arrival slots as well as the introduction of low-cost air carrier service at Narita International Airport, which should boost exchanges with other regions.

I trust that Chiba Prefecture will develop even further through people's efforts to maximize the diverse strengths of their region.