Kiyohiko G Nishimura: Toward overcoming deflationary pressures in Japan

Speech by Mr Kiyohiko G Nishimura, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Okayama, 18 April 2012.

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Introduction

I am privileged and honored to be here today to exchange views with administrative and business leaders in Okayama Prefecture. I deeply appreciate your continuing support and cooperation in taking part in interviews and surveys conducted by our Okayama branch. The quantitative and qualitative information from these interviews and surveys is invaluable to making timely assessments of economic conditions, and thus appropriate policy decisions. This can be especially true in the case of great uncertainty that follows events that profoundly alter economic and financial conditions, such as the Lehman Shock and the Great East Japan Earthquake. Although those events effectively render past statistical data uninformative or even utterly useless, the Bank cannot delay its policy responses just for the sake of waiting for new data to be released. Even in situations such as these, our regular contact with you provides us with valuable information about what is really happening in the real world in various respects. In fact, our colleagues at foreign central banks consider the Bank of Japan as fortunate and privileged in this regard. I would like to express my sincere gratitude and also ask for your continued cooperation.

Let me start today by discussing the economic outlook at present and its risk factors. After that, I would like to share the Bank's basic thinking on the necessary measures to overcome deflationary pressures. Furthermore, I will explain the Bank's policy responses geared toward this aim – as put forth during the February and March Monetary Policy Meetings – by answering frequently asked questions. In closing, I would like to touch upon some relevant issues for the economy in Okayama Prefecture.

I. Economic outlook at present and its risk factors

A. Economic outlook at present

Let me first describe the current domestic and overseas economic conditions and the outlook at present.

First, I will start with developments overseas. Despite the recent nervousness seen in the foreign exchange and stock markets, the funding environment for financial institutions in global financial markets has been calm and stable against the background of ample liquidity provision by the European Central Bank and certain progress in efforts to support Greece. However, overseas economies as a whole have yet to emerge from a deceleration phase. In the United States, although some improvements have been observed in consumption and employment, such positive movements have not yet gained momentum, as evidenced by the recent weaker-than-expected employment statistics. Against such a background, Japan's exports and production have not emerged from the phase of crawling growth, and thus the country's economic activity remains more or less in a lull. However, domestic demand has recently shown some signs of improvement. Steps toward restoration and rebuilding following the Great East Japan Earthquake are progressing, most notably in business fixed investment. Private consumption has firmed up due in part to the effects of measures to stimulate demand for automobiles, such as the reintroduction of subsidies for purchasing energy efficient cars and the release of popular models of new cars. Industrial production has begun to show signs of a possible improvement. As for the outlook, Japan's economy is expected to return to a moderate recovery path as the pace of recovery in overseas economies picks up, led by emerging and commodity-exporting economies, and as reconstruction-related demand after the earthquake disaster gradually strengthens.

B. Risk factors

Whether or not this projection is going to be realized depends on various risk factors. The one that the Bank is most concerned with is, in short, uncertainties regarding the global economy. Among them – including the prospects for the European debt problem, developments in international commodity prices, and the likelihood of emerging and commodity-exporting economies maintaining growth under price stability – I regard whether improvement in economic indicators in the United States can continue or not as particularly important and deserving of very careful monitoring, as this is attracting wide attention recently.

The sustainability of the ongoing U.S. recovery requires careful examination, for two reasons. First, in the United States, there is rising bifurcation of the labor market into two groups: (1) those who have no concern about their employment and (2) those who do. The recent firm economic indicators reflect a recovery in consumption by the former group, which benefited from a decline in mortgage rates and rising stock prices. However, the distinguishing feature of the current business cycle has been a large increase in the number of the latter group – i.e., those who have concerns about their employment – and its size has not decreased notably even in the recovery phase. This could weigh on the U.S. economic recovery ahead.

Second, there is a possibility that a seasonal adjustment method used for major U.S. economic data had created some distortions due to the effects of the Lehman Shock, causing the data for the period from winter to early spring to be overvalued and those for the period toward summer to fall to be underestimated. If this is the case, it means that the favorable data so far have exaggerated actual economic performance and the forthcoming data will be disappointing – showing a weaker picture than actual conditions. Attention should be paid to the risk that such distorted data could weaken expectations for recovery held by firms, households, and markets.

As a longer-run risk for many economies, prolonged stagnant economic performance coupled with the aging of a population could reduce the flexibility of the economy such as in terms of the mobility of people across sectors and regions, thereby making it more difficult for the supply side to respond smoothly to changes in the demand structure. As a result, growth potential could decrease. Such a reduction in the flexibility of the economy amid a situation of an aging population has become a serious problem not only in Japan but also in other advanced countries, such as the United States and Europe. Even emerging economies, including those in Asia, are not immune to this problem because the aging population problem is set to intensify considerably within the next ten years and it is not unimaginable that early indications of the problem could emerge in the very near future.

Bearing in mind that there are various risk factors, the Bank will conduct a thorough review of the outlook for economic activity and prices and will issue the results in our biannual outlook report, to be released at the end of this month.

II. Toward overcoming deflationary pressures

Next, I would like to turn to the challenge of overcoming deflationary pressures. In order for Japan's economy to make steady progress toward overcoming deflationary pressures, it is necessary to make efforts on the following two fronts.

The first one involves continual support of the recent momentum toward economic recovery to enhance the level of economic activity. In this regard, it is important to make steady progress in narrowing the negative output gap by firmly supporting positive developments at home and abroad.

Second, it is necessary to make efforts to tackle the long-term structural problem that Japan's economy has confronted of declining trend growth rates. It is no easy task to raise the growth potential of Japan's economy when the working population decreases due to aging. In order to raise the growth potential of Japan's economy by capturing new demand, it is crucial that business firms, financial institutions, the government, and the Bank each take decisive measures in their respective roles.

One possible direction is for Japanese firms to tap global demand, mainly in emerging economies, by undertaking a reappraisal of their comparative advantages, such as the capacity to develop new materials, "integral-type technology", production efficiency, and attentive customer service, in pursuit of a best mix of these advantages that fits with respective market demand. In this regard, manufacturers continue to expand their overseas business while reestablishing global production and sales networks. Recently, more firms in domestic demand-oriented industries have also started making efforts to capture global demand. What is important is to establish a favorable domestic business environment so that firms' active movements to capture global demand lead to enhancing the growth potential of Japan's economy rather than causing a hollowing-out of domestic industries. At the same time, efforts to stimulate domestic demand are also crucial. From the standpoint of enhancing the growth potential of Japan's economy, it is an extremely important challenge to make steady progress in regulatory reform to promote growth industries and in supplying risk money to them, so that seeds for growth are produced, sprout, and evolve into flourishing domestic demand.

III. The Bank of Japan's policy measures

Next, I would like to touch on the Bank's policy measures. As I have stated so far, in order to overcome deflationary pressures and achieve sustainable growth with price stability, it is vital to make efforts both to firmly support the recently observed upward momentum toward economic recovery and to strengthen growth potential. Based on its recognition of this point, the Bank launched a policy package to overcome deflationary pressures at the Monetary Policy Meetings held in February and March. I will briefly describe the essence of the package.

A. Policy measures in February: introduction of "The Price Stability Goal in the Medium to Long Term", clarification of the Bank's commitment regarding the policy time horizon, and expansion of the asset purchase program in size

At the Monetary Policy Meeting held on February 12 and 13, 2012, the Bank decided three measures.

First, it introduced "the price stability goal in the medium to long term". This represents the price stability that the Bank should aim to achieve using the year-on-year rate of increase in the consumer price index (CPI). The Bank judges the "goal" 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 it set a goal of 1 percent for the time being. In deciding a specific inflation rate, the Bank considered that (1) there is considerable uncertainty surrounding the prospects for Japan's economy because it is in a process of transition to a normal growth path following long-term stagnation, and therefore (2) deliberations should fully take into account the perception of price developments held by the general public, which is used to long periods of low inflation rates, including even the period of the financial bubble prior to the 1990s. As a result, the Bank decided to set a specific goal of 1 percent for the time being, and from a longer-term perspective, to express the goal with a degree of latitude as "a positive range of 2 percent or lower" given the possibility that the inflation rate the Bank should aim to achieve could rise due to changes in the economic structure at home and abroad.

Second, the Bank clarified its commitment regarding the time horizon for pursuing powerful monetary easing. By promising accommodative monetary policy in the future, based on certain conditions regarding the economic environment, the commitment aims to strengthen the immediate monetary easing effects by bringing forward future easing effects. In line with the introduction of "the price stability goal", the Bank decided at the February meeting that it will aim to achieve the goal of 1 percent CPI inflation and will continue the pursuit of powerful monetary easing until the goal is in sight, conducting its virtually zero interest rate policy and implementing the Asset Purchase Program mainly through the purchase of financial assets. The Bank clarified its stance to actively take policy measures by expressing the specific inflation rate of 1 percent as a goal and using the phrase "aim to achieve" with respect to said goal. The Bank also stated specifically that it will continue to not only conduct its virtually zero interest rate policy, but also implement the Asset Purchase Program mainly through the purchase of financial assets until the conditions in the commitment are met.

Third, the Bank made a decisive increase in the total size of the Asset Purchase Program, of 10 trillion yen. As a result, together with its regular purchases for the purpose of supplying currency consistent with underlying steady development in the economy, the Bank is going to purchase a large amount of JGBs until the end of this year, at the pace of about 40 trillion yen per year.

The aforementioned three measures are aimed at strongly supporting recent positive momentum from the financial side through a clarification of the Bank's policy stance to overcome deflationary pressures and an enhancement of its pursuit of powerful monetary easing.

B. Policy measures in March: enhancement of fund-provisioning measure to support strengthening the foundations for economic growth

At the subsequent Monetary Policy Meeting in March, the Bank decided to enhance the fund-provisioning measure to support strengthening the foundations for economic growth (hereafter referred to as "the Growth-Supporting Funding Facility"). The Growth-Supporting Funding Facility supplies long-term funds at a low interest rate to financial institutions in accordance with their efforts – in terms of lending and investment – toward strengthening the foundations for economic growth. Looking at the composition of the areas to which financial institutions have been lending and investing using this facility, "environment and energy business" and "medical and nursing care business" accounted for a large share. Let me share with you some examples of actual lending or investment based on information made public by financial institutions. For example, there was a project in which the manager of a nursing home for the elderly upgraded the air-conditioning system to an eco-friendly one that recovered waste heat. In another case, food manufacturers made investments for the purpose of expanding their production sites in emerging Asian economies, so as to respond to vigorous demand from such economies.

Taking into account the lending and investment conducted under the facility, the Bank decided to establish special rules, first, for a new lending arrangement for small-lot investments and loans and, second, for a new U.S. dollar lending arrangement for foreign currency-denominated investments and loans. The Bank also decided to increase the maximum outstanding balance of loans under the main rules for the facility, which raised the overall outstanding balance of loans available through the facility by 2 trillion yen. The Bank also decided to extend the deadline for applications for new loans under the facility, by two years.

Such measures are aimed at further enhancing the Bank's efforts to strengthen growth potential, which is another pillar for overcoming deflationary pressures.

IV. Has the Bank changed?

The series of policy measures by the Bank – especially its decision in February to clarify its policy stance and further enhance monetary easing – took many market participants by surprise, since few had predicted such responses. Following the Bank's decision, stock prices rose and the yen depreciated. These developments were of course significantly influenced by some new positive worldwide developments at that time, such as diminishing perceived risks from the European debt problem and relatively firm improvement in the U.S. economy. In addition, I believe that the Bank's clarification of its policy stance, which was taken as a positive surprise, also had a considerable impact on those market developments.

I am often asked whether the Bank's policy objectives, basic thinking behind the conduct of monetary policy, and policy stance have changed since its decision in February. Next, I would like to outline my understanding of what has changed and what has stayed the same with regard to the Bank's policy conduct.

A. Question: has the aim of the Bank's monetary policy changed?

With regard to the introduction of "the price stability goal in the medium to long term" in February, a frequent interpretation is that the Bank has finally adopted the so-called "inflation targeting framework". I would like to outline my reflections on this point by asking the following question: "has the aim of the Bank's monetary policy changed?"

The Bank's basic thinking about the price stability that a central bank should aim to achieve includes the following three elements. First, "price stability" is a state where economic agents such as households and firms may make decisions regarding economic activities without being much concerned about the fluctuations in the general price level. Second, central banks should pursue "price stability" over the medium to long term that should not be judged by short-term developments in the recent period. Third, "price stability" should be expressed in numerical terms using indicators that cover goods and services consumed by households and represent the public's true feelings regarding price developments. This basic thinking had been explained to the public before the introduction of "the price stability goal in the medium to long term", and has not changed with this introduction.

That being said, I believe that the introduction of "the price stability goal" in place of the old "understanding of medium- to long-term price stability" is significant as an effort to specifically express what the Bank pursues based on its basic thinking on price stability. When conducting monetary policy, each Policy Board member makes decisions based on their own thinking on price stability that should be pursued by the Bank. The old "understanding" showed the range of inflation rates that each Policy Board member understood as numerically expressing price stability over the medium to long term. There should be no confusion, since if inflation rates fail to be within this range, then it is obvious that price stability has not been achieved from any of the members' perspectives. However, there was a criticism that the old "understanding", which was a collection of individual Board members' views, did not represent the "price stability" that is the basis of the policy decisions of the Bank as an institution. In addition, there was some difficulty with the word "understanding", in that it failed to deliver the message that the Bank was making active moves toward price stability. Taking account of these problems, the Policy Board members have made a collective decision on how to express the price stability that the Bank should aim to achieve. They have also decided to use the word "goal", so that the Bank's policy stance can be understood clearly.

I would like to point out that there is a notable feature in the introduction of the "goal". That is, the "goal" for the time being is set differently from the "goal" from a longer-term perspective. The Bank has decided to set a specific inflation rate goal for the time being – a rate that it currently aims to achieve – even though there is considerable uncertainty surrounding the prospects for Japan's economy, such as in terms of changes in economic structures. At the same time, from a longer-term perspective, if the efforts to strengthen growth potential successfully boost real growth rates to an adequate level in a sustainable manner, then the medium- to long-term sustainable inflation rate – and consequently, the nominal growth rate – will gradually rise. Bearing in mind such a possibility from a longer-term perspective, the Board has decided to express "the goal for price stability in the medium to long term" with a degree of latitude as "a positive range of 2 percent or lower in terms of the year-on-year rate of change in the CPI" and to review the "goal" once a year in principle.

As long as the Bank's thinking behind the "the price stability goal in the medium to long term" is shared correctly, it is not essential to argue about what it should be called. I feel no discomfort in referring to the "goal" as a flexible inflation target.

B. Question: was the policy change in February based on the assessment from the "Two Perspectives"?

Next, let me take up the issue of how difficult it was to predict the February decision to enhance monetary easing. Since March 2006, in deciding the conduct of monetary policy, the Bank has been examining economic activity and prices from two perspectives. The first is in terms of whether the baseline scenario of the outlook for economic activity and prices follows a sustainable growth path with price stability. To put it another way, using the new framework, this is with regard to whether the economy is heading toward achieving the "price stability goal". The second perspective is in terms of what kind of risk factors are considered relevant to the baseline scenario. I would like to examine the market comments that the policy change in February was difficult to predict because such a decision could not be derived from the monetary policy framework based on the assessment from the two perspectives.

At the time of the February Monetary Policy Meeting, some positive developments were observed in domestic and overseas economies, such as receding tensions in global financial markets, some improvement observed in the U.S. economy, and the firm domestic demand due in part to reconstruction-related demand after the earthquake disaster. However, Japan's economic conditions continued to be harsh with the level of economic activity not having recovered from the plunge after the Lehman Shock, due to the slowdown in the overseas economies and the appreciating yen. At the same time, as you can find in the Minutes of the Monetary Policy Meeting in January 2012, the following recognition had been gradually spreading among Policy Board members during the process of discussing prolonged deflationary pressures: the Bank's intention in its conduct of monetary policy might not have been fully understood by firms, consumers, and markets since the Bank's communication had not been effective enough, and consequently the effects of powerful monetary easing have been considerably diminished. In addition, market participants and the media renewed their attention on the central bank's policy stance toward achieving price stability triggered by the U.S. Federal Reserve's decision on January 25, 2012 to set the inflation rate of 2 percent as its "longer-run goal".

Thus, the Bank faced a situation where, from the perspective of achieving the "goal", it needed to consider the risk that the effects of monetary easing that was designed to achieve the baseline scenario had been noticeably compromised. Taking into account such a situation, the Policy Board recognized that it was necessary to communicate the Bank's policy stance clearly in order to ensure the realization of the baseline scenario so that the "goal" would be achieved, and if the Bank did not take such action, more time might be needed to achieve the "goal". This led the Bank to make a policy decision at the February meeting. Also, to make its intention clear, the Bank decisively increased the total size of the Asset Purchase Program. It deemed that such a decision would strongly support the positive momentum observed at that time from the financial side, and that it would bring about visible effects of monetary easing.

Even after replacing the "understanding" with the "goal", the Bank continues to conduct monetary policy based on the assessment from the two perspectives. It had been quite unfortunate that, until last February, the Bank's policy stance was not well communicated in an effective manner and thus not fully understood. The introduction of the "goal" was received with some surprise partly because of this communication problem. The Bank introduced the "goal" with the clear aim of solving this problem, and will continue to make further efforts to enhance its communication.

C. Question: has the possibility of further monetary easing increased?

I will now make my best effort to provide an answer to the following difficult question. Has the Bank's monetary policy stance become more dovish after all? In other words, has the possibility of further monetary easing increased?

As I have already stated, the Bank's stance has not changed toward the conduct of monetary policy based on the "price stability goal" and the assessment from the "two perspectives". Allow me to repeat the Bank's current monetary policy stance: "[The Bank] will aim to achieve the goal of 1 percent CPI inflation and continue the pursuit of powerful monetary easing until the goal is in sight, conducting its virtually zero interest rate policy and implementing the Asset Purchase Program mainly through the purchase of financial assets." As stated in the Minutes of the Monetary Policy Meeting in February 2012, the described policy stance shows that the Bank is committed to implementing additional easing measures, if deemed necessary. The clarification of the Bank's determination to overcome deflationary pressures has been understood in financial markets more clearly and widely than before. I think this might have given the impression to some that the Bank has changed.

After all, the Bank's policy decision depends on the outlook for economic activity and prices and on the results of the assessment of risk factors in the context of achieving the "price stability goal". An examination of policy effects is also important. It is often said that there is considerable uncertainty regarding when the effects of monetary policy will emerge, because they often come with a variable time lag (sometimes long). Unconventional policy measures taken recently are no exception.

As I have stated, although positive momentum has been observed in Japan's economy, there remains considerable uncertainty, mainly regarding the outlook for the global economy. There is also non-negligible uncertainty about how the policy changes in February and March will affect the public's medium- to long-term expectations regarding economic activity and prices. The Bank would like to conduct appropriate monetary policy while taking fully into account such risk factors and examining the outlook for economic activity and prices.

Concluding remarks

Let me briefly touch upon some relevant issues for the economy in Okayama Prefecture.

I stated a short while ago that, in order to overcome deflationary pressures, (1) efforts to strengthen growth potential are crucial and (2) business firms, financial institutions, the government, and the Bank should make such efforts within their respective roles. From this standpoint, let me take a look at the efforts being made in Okayama Prefecture. Several projects have been actively conducted to develop industries that have growth potential – such as aircraft-related and medical and nursing care industries – into key industries, with the government and the private sector working together. Firms in the chemicals and steel businesses – which have been the main industries in this region – have been making efforts to develop new products and business plans targeted at environment- and energy-related sectors using the skills they have acquired so far. Meanwhile, financial institutions have taken steps to develop a system to firmly support, from the financial side, firms' efforts to strengthen growth potential while using the Bank's Growth-Supporting Funding Facility. In addition, I have heard that academics have made unique proposals for urban development using technological knowledge acquired from universities and university hospitals. I am thrilled to hear that substantive efforts to strengthen growth potential have been made in various areas. I truly hope that these various efforts align further with each other and lead to strong economic growth, not only in Okayama but in Japan as a whole.

Thank you for your kind attention.