

Hirohide Yamaguchi: Agenda for Japan's economy and challenges facing small and medium-sized enterprises

Speech by Mr Hirohide Yamaguchi, Deputy Governor of the Bank of Japan, at the Japan Chamber of Commerce and Industry, Tokyo, 19 April 2012.

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Introduction

It is my great honor to have an opportunity to speak in front of front-line business leaders.

The Bank of Japan and the chamber of commerce and industry have had a close relationship for more than a century. The first president of the Tokyo Chamber of Commerce, Japan's first chamber of commerce and industry, was Mr. Eiichi Shibusawa, who is called the father of Japan's capitalism, and his grandson was Mr. Keizo Shibusawa, the 16th Governor of the Bank of Japan. The 15th Governor Mr. Toyotaro Yuuki was President of the Japan Chamber of Commerce and Industry (JCCI) before taking office as Governor. The Bank also received valuable advice from the successive Presidents of the JCCI as Counsellors, and staffers of the Bank have been exchanging views directly on various occasions with the regional Chamber of Commerce members and firms. Financial and economic information obtained on those occasions has been valuable in the Bank's policy conduct, and I take this opportunity to thank you for your cooperation.

Today, I will review the recent developments in Japan's economy, followed by challenges facing it, while bearing in mind the activities of small and medium-sized enterprises (SMEs). Then, I will explain the Bank's recent monetary policy conduct.

I. Recent developments in Japan's economy

Recent economic developments and outlook for the immediate future

Let me start with the recent economic developments in Japan (Chart 1). Japan's economy rapidly recovered from the plunge following the Great East Japan Earthquake through last summer. While the economy has subsequently been more or less flat due partly to the effects of a slowdown in overseas economies and the yen's appreciation, there have recently been some signs of a pick-up. Public investment has started to increase and private consumption has firmed up due in part to the effects of measures to stimulate demand for automobiles. Overseas economies on the whole still have been in the deceleration phase, but some improvement has been observed, including continued moderate improvement in U.S. economic conditions. As for the outlook, we expect that Japan's economy will resume a moderate recovery as overseas economies will pick up, led by emerging and commodity-exporting economies, and reconstruction-related demand after the earthquake disaster increases.

Uncertainties about the outlook

Such economic outlook is associated with various uncertainties. Today, I will point out three uncertainties that require special attention.

The first uncertainty surrounds developments in overseas economies, especially the European economy. Thanks to massive liquidity provision by the European Central Bank and financial support to Greece, the possibility that the European debt problem will induce turmoil in global financial and capital markets through funding problems of financial institutions has at least lessened. However, it is not yet known whether European peripheral countries can smoothly carry out more drastic measures of fiscal and economic structural reform. Recently,

Spain's struggle with fiscal reform has started to be recognized as a new destabilizing factor to financial and capital markets.

The second uncertainty surrounds developments in international commodity prices, including crude oil prices. A rise in crude oil prices will put downward pressure on Japanese firms' profits and households' real purchasing power. If inflationary pressure increases globally, we cannot rule out the possibility that overseas economies, in which some improvement has started to be seen, will slow down again.

The third uncertainty surrounds the domestic electricity situation. The electric power supply and demand situation might become increasingly severe, mainly during the summer. There is also a problem of an increase in electricity costs associated with a shift to thermal power. Those will increase future uncertainty particularly for the SMEs, which lack self-defense tools including privately-owned electrical power facilities. If the severe electricity situation becomes protracted, it may become an incentive for firms, which aim at the optimal division of labor at home and abroad, to expand production and business overseas. Unless alternative domestic production is generated, Japan's growth potential might decline.

In relation to the first uncertainty about developments in overseas economies, let me touch on developments in foreign exchange markets. While the yen has been weakening somewhat since February, it remains at a substantially high level compared with that prior to the Lehman shock. That is because global investors have become increasingly risk averse partly in response to the Lehman shock and the ensuing aggravated European debt problem, and have thus purchased assets including the yen, which were considered to be relatively safe. In the current phase of high uncertainty about the outlook for overseas economies, the Bank believes special attention should be paid to the possibility that the yen's appreciation will have a negative impact on Japan's economy through a decline in exports and corporate profits as well as a worsening of business sentiment. The yen's appreciation has various merits, including reduction in import costs. Nevertheless, it might be difficult even for domestic demand-oriented firms, which are supposed to benefit from the yen's appreciation, to step out and take positive action utilizing the merits in the current situation, in which they struggle to visualize future growth.

Uncertainty about the future of the economy will, to some degree, put a brake on firms' current economic activity. In that sense, medium- to long-term economic developments and firms' views on those developments are reflected in the current economic activity. Keeping those points in mind, from a somewhat longer-term perspective, I will review developments in Japan's economy and consider the agenda for its revival.

II. Medium- to long-term agenda for Japan's economy

Downtrend in economic growth rate

Japan's economy achieved a high real growth rate of an average of about 10 percent during the high-growth period. While the growth rate subsequently declined, a relatively high average growth rate was maintained at about 5 percent in the 1970s and 4–5 percent in the 1980s. It fell substantially to around 1.5 percent in the 1990s and further to less than 1 percent in the 2000s (Chart 2). Such decline in the economic growth rate is partly attributable to the ending of Japan's process of catching up with advanced economies, which had continued since the high-growth era, and a decrease in the working-age population associated with progress in aging.

Even when the population of workers declines, if added value earned by a worker, namely, labor productivity increases, the growth potential of the economy as a whole can be maintained. However, as economic globalization has been progressing rapidly since the 1990s and emerging economies have become rivals, Japan's economy has not been able to adapt sufficiently to such a changing environment and Japanese firms' international competitiveness and productivity have declined. For two major reasons Japanese firms were

unable to adapt to the changing environment. First, the effects of the bursting of the bubble overlapped. Japanese firms were busy resolving “three excesses” of debt, employment, and business capacity that had piled up during the bubble period, and did not have leeway to pursue proactive economic activity. Second, economic structural reform was delayed, namely, labor and capital did not smoothly move from low-productivity areas to high-productivity areas. In the case of Japan, aggressive fiscal and monetary policies continued to underpin the economy since the 1990s. In the meantime, while the need for drastic structural reform was pointed out many times, in reality the reform did not progress except for deregulation in some areas. It could be one reason for the downtrend in Japan’s economic growth rate since the 1990s that structural reform, which was essentially necessary in strengthening growth potential, did not progress smoothly.

Low growth and deflation

Such downtrend in growth potential is also one reason for Japan’s long-standing problem of deflation. If the downtrend in the economic growth rate becomes protracted, people will become unable to have confidence in or expectations for future growth. As I mentioned earlier, concern over future growth shrinks people’s current spending. If that results in a decline in the actual growth rate, it forms a vicious cycle of once again lowering people’s future growth expectations. Such structural vicious cycle will induce a chronic demand shortage. When there is a lack of demand compared with the supply of goods and services, normally, prices will fall. Since the second half of the 1990s, Japan’s economy experienced a downturn three times triggered by the financial system crisis, the bursting of the IT bubble, and the Lehman shock. Whenever Japan was faced with a substantial decline in the economy, the aforementioned vicious cycle was strongly recognized, and, even in the ensuing economic recovery phase Japan repeatedly encountered the situation in which growth expectations did not sufficiently rise and it could not escape from a demand shortage. The result was a protracted deflationary trend.

Output gap and a mismatch between demand and supply

According to an estimate by the Cabinet Office, the current annualized output gap is about 15 trillion yen. As it was estimated to be about 40 trillion yen immediately after the Lehman shock, the gap has narrowed considerably but has remained substantial. In that regard, some point out that if economic activity is stimulated by fiscal or monetary policy to create a demand of 15 trillion yen, the output gap will be filled and Japan’s economy can immediately overcome deflation. It is not that simple. The output gap in numerical terms is the difference between the size of demand for the existing goods and services and the existing production capacity to supply those goods and services. However, in reality, people’s demand itself has been changing due to structural changes in society, including aging. If the supply side has not been able to sufficiently meet such new demand, then it might not merely be the problem of an output gap but the problem associated with a mismatch between demand and supply, namely, demand has not been meshing well with supply. For example, in medical and welfare industries, it has been often said that, despite expectations for further demand due to aging, sufficient services have not consequently been provided due to various regulations and a labor shortage in the field. In addition, if there is a case in which, even while recognizing the expansion of Asian markets or an increase in foreign tourists as business opportunities, firms are unable to establish systems for export expansion or sales strengthening due to a lack of market information or the difficulty in finding suitable personnel, thereby letting the demand just pass, it is also a kind of mismatch.

Based on such line of thinking, it is obvious that the idea of merely filling the output gap is insufficient. It is necessary to change the supply structure, namely, reduce supply capacity in areas where future demand is not expected on one hand, and expand a supply system that meets people’s new demand on the other. If potential demand leads to actual added value, corporate profits and productivity will rise and, as a result, the growth potential of the

economy as a whole will increase. In the following I will consider firms' efforts toward the revival of Japan's economy.

III. SME's challenges for revival of Japan's economy

Looking at the productivity of the Japanese manufacturing industry over the past 20 years, the rate of growth in productivity, both of large firms and SMEs, stagnated in the 1990s. After entering the 2000s and up to the Lehman shock, the growth rate of large firms' productivity increased again due partly to an increase in exports, while that of SMEs' productivity continued to be more or less flat (Chart 2). Therefore, during that period, the profitability difference between the large firms and SMEs widened more than ever. However, in retrospect, the increase in exports during that period was partly supported by the credit bubbles in the United States and Europe as well as the substantial depreciation of the yen. Namely, in my view, the middle of the 2000s was a period especially in favor of large firms, and the strength of SMEs did not get weaker than it used to be and their underlying strength was firmly maintained. In fact, there have recently been not a few episodes that strongly impress the underlying strength of SMEs, such as "only one" companies that have honed their skills and leaped to the world level and "competitiveness in the field," or *genbaryoku*, that enabled a rapid recovery from the earthquake disaster.

What is necessary for the revival of Japan's economy is that individual firms continue to meet challenges so that such underlying strength will be exerted as the strength of Japan's economy to the maximum extent.

The first challenge is to utilize the wide trend of globalization (Chart 3). SMEs that started to export or make foreign direct investment have achieved a relatively high rate of productivity growth, compared with those that did not. In that regard, according to the *White Paper on Small and Medium Enterprises*, while the average productivity growth rate of SMEs that made foreign direct investment was about 1.8 percent, the growth rate of those that did not was about 1.0 percent. Utilization of imports, incorporation of inbound foreign tourists, utilization of foreign personnel, and transactions with foreign firms are also effective ways to utilize globalization. With an increasing unification of markets at home and abroad, there are plenty of catalysts for growth around us in terms of personnel and goods.

The second challenge is to tap domestic demand (Chart 4). While various areas, including environment and energy, can be considered, aging and the demographic vortex are also creating great business opportunities. Looking at the entry rate of SMEs by industry, recently, the entry rate has been relatively high in such industries as medical and welfare services, in addition to information and communications, diet, accommodations, and education and learning support that have started to incorporate the elderly as new customers. People who were called baby-boomers are known to have a high propensity to consume, compared with the previous or next generations. Inclusive of such generation, now called the "active seniors," those 60 years old or older already account for more than 40 percent of private consumption.

In meeting new challenges, it is important to utilize the strength unique to SMEs. Merits of SMEs are "quick in decision-making" and "can turn on a dime." Because of their small size, SMEs can make bold decisions according to changes in the surrounding environment, and thus have potential for a great leap forward. "Able to make finely-tuned responses" is also a merit of SMEs. I have heard that, as aging progresses, the locally-based business of providing services by visiting homes has been received well. Such face-to-face business is a promising area for SMEs that large firms cannot easily imitate.

Firms' challenges sometimes bring changes to regional economies. For example, we have often heard an opinion that how to maintain local employment will become an issue as for the outward shift of firms' production bases. However, in tandem with exploitation of overseas demand, if the review of a division of labor at home and abroad as well as an enhancement of domestic business is pursued, that will consequently have a positive impact on local

employment. On that point, the *White Paper on Small and Medium Enterprises* pointed out that “in firms that made direct investment overseas, the number of workers once decreases by about 10 percent after the investment, but in six to seven years, domestic workers increase compared with firms that did not make investment” (Chart 3). What is important is to consider, from a long-term perspective, how a firm can grow and the regional economy can be vitalized. I hope people here representing the regional economy and the Chamber of Commerce in each region will exert strong leadership.

IV. Conduct of monetary policy

Finally, let me talk about the Bank of Japan’s recent monetary policy conduct.

The Bank recognizes that Japan’s economy is faced with the critical challenge of overcoming deflation and returning to the sustainable growth path with price stability. Based on the recognition, the Bank implemented in February and March 2012 the following two measures.

In February, the Bank clarified its monetary policy stance and further enhanced monetary easing (Chart 5). Specifically, the Bank introduced “the price stability goal in the medium to long term” and, on that basis, will aim at achieving the goal of 1 percent in terms of the year-on-year rate of increase in the CPI, and will continue with the powerful easing until it judges the 1 percent goal to be in sight. And to confirm the policy stance not only by word but also by action, the Bank decided to increase the total size of the Asset Purchase Program by purchasing an additional 10 trillion yen in government bonds.

Subsequently, in March, to support private firms’ efforts to strengthen the growth potential, the Bank decided to substantially enhance the fund-provisioning measure to support strengthening the foundations for economic growth, “the Growth-Supporting Funding Facility” in short, both in terms of the yen and a foreign currency (Chart 6). The Growth-Supporting Funding Facility was introduced two years ago as a measure for the Bank to provide financial institutions making investments and loans that contribute to Japan’s economic growth with long-term and low interest rate funds. The March decision has two points. First, the Bank established special rules for a new lending arrangement of 500 billion yen for small-lot investments and loans that had not been deemed eligible in the past being less than 10 million yen. Regional financial institutions have been expressing that, even among small-lot borrowers, there were not a few SMEs that could make a great leap forward depending on their efforts to meet the challenges. Such opinion was a trigger for setting the special rules. Second, the Bank established a new U.S. dollar lending arrangement of 1 trillion yen equivalent (12 billion U.S. dollars) for financial institutions’ investments and loans denominated in foreign currencies. That aimed at supporting the efforts to strengthen domestic growth potential by utilizing the trend of globalization. In that regard, it is not only large firms but also SMEs that have been making efforts in overseas expansion and import increase. Therefore, the Bank crafted the arrangements, including setting a maximum amount of foreign currency-denominated loans per project, so that the new arrangements will not be used heavily on large projects but to a wide range of projects including small and medium ones.

The Bank believes that, in order for Japan’s economy to overcome deflation, the efforts to increase the economy’s growth potential and support from the financial side are both necessary. The February and March measures implemented on the basis of such recognition are a policy package toward overcoming deflation. The Bank considers that those measures will work together to encourage moves to achieve the goal of overcoming deflation and returning to the sustainable growth path with price stability.

Concluding remarks

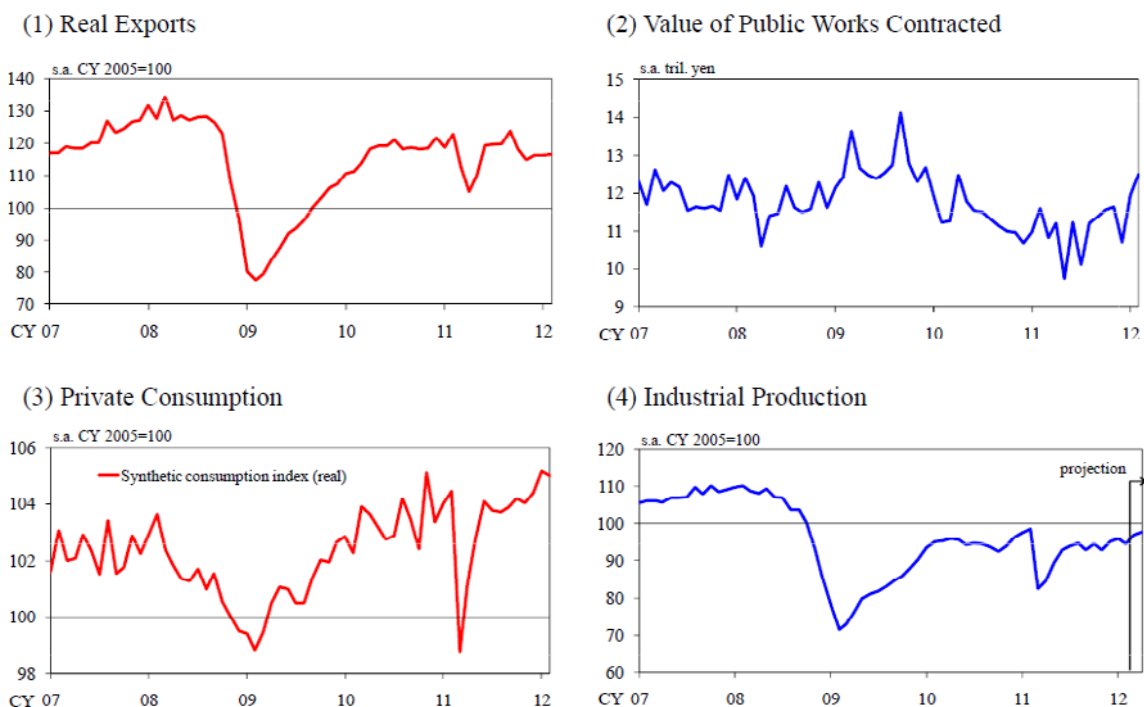
I have today mainly spoken about the challenges facing Japan’s economy and efforts to meet them. While the severe business environment has been continuing since the burst of

the bubble in the 1990s, even against such a backdrop, I have heard that there are many SME managers who promote the utilization of women and the elderly and actively pursue “work-life-balance.” Such, on the surface, behind-the-scenes activity will also, through increasing the retention rate, consequently lead to an improvement in productivity and an increase in competitiveness. Furthermore, such efforts have been providing many people that have the will and ability to work with various employment opportunities that suit individual lifestyles and life stages. Japanese SMEs are an engine for the richness of public life that cannot be measured only by numbers, such as GDP and productivity. Also from such a perspective, unless SMEs get vitalized, Japan will not be vitalized. The Bank will steadily support firms’ activities through taking appropriate policy action if necessary in the powerful monetary easing stance.

Chart 1



Recent Developments in Japan's Economy

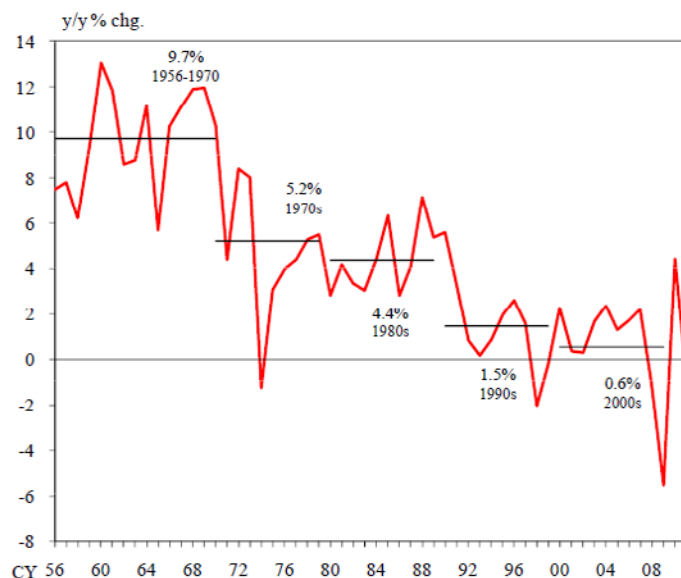


Sources: Cabinet Office; Ministry of Economy, Trade and Industry; East Japan Construction Surety etc.; Bank of Japan

Chart 2

Economic Growth and Productivity

(1) Japan's Real GDP Growth Rate¹



(2) Change in Labor Productivity of Manufacturing Industry²

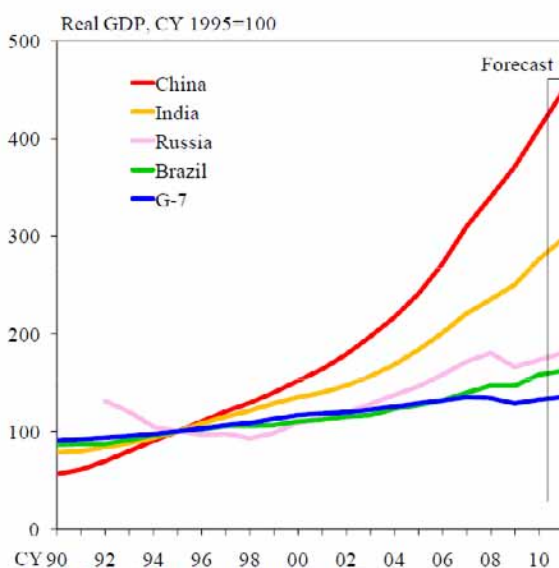
	avg. y/y % chg.	
	Large enterprises	SMEs
1970s	14.1	11.9
1980s	4.1	4.4
1990s	0.8	0.2
2000s		
2000-2007	2.9	0.3
2000-2009	-0.7	-0.6

Notes: 1. Data up to 1980 are based on the 68SNA (System of National Accounts) while those from 1981 are based on the 93SNA.
 2. Labor productivity is value added / number of workers. Large enterprises are enterprises with capital of 100 million yen or more and SMEs are enterprises with capital of 10 million yen or more and less than 100 million yen.
 Sources: Cabinet Office; The Small and Medium Enterprise Agency (recompiled from Ministry of Finance, *Financial Statements Statistics of Corporations by Industry, Annually*.)

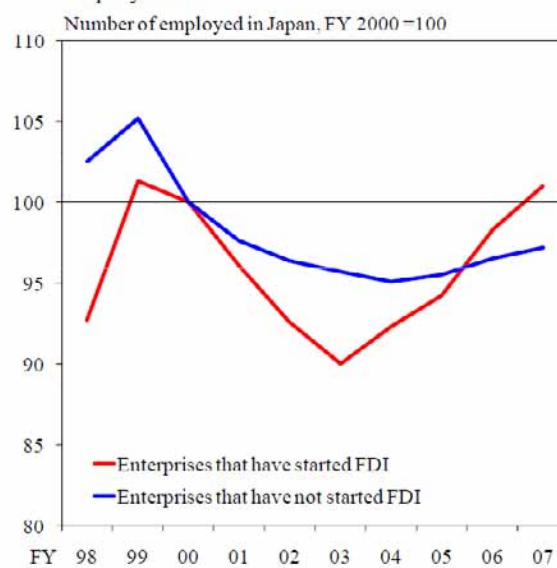
Chart 3

Utilization of the Trend of Globalization

(1) Growth of Emerging Countries¹



(2) Foreign Direct Investment and Domestic Employment²

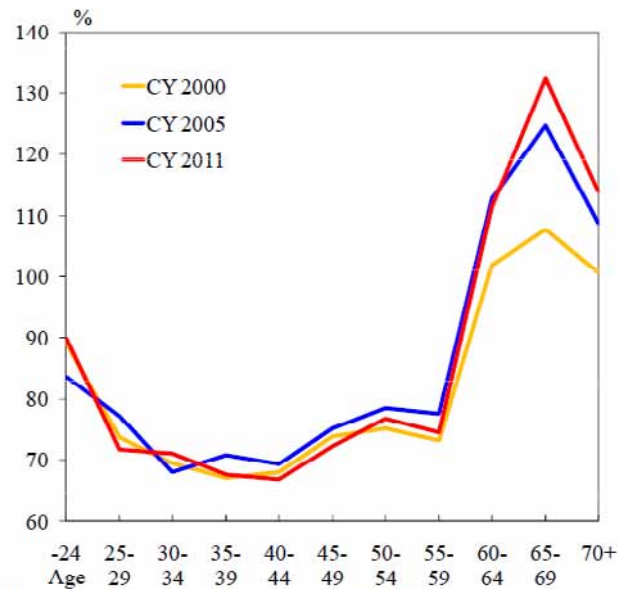


Notes: 1. Figures for 2011 are projections by the IMF.
 2. Enterprises that have started FDI are small and medium-sized enterprises that started FDI in fiscal 2000 and continued doing so through fiscal 2007. Enterprises that have not started FDI are small and medium enterprises that did not engage in FDI at all between fiscal 1995 and fiscal 2007. Only enterprises that responded continuously from fiscal 1994 to fiscal 2007 are included. Small and medium-sized enterprises are defined under "Basic Survey of Japanese Business Structure and Activities" of Ministry of Economy, Trade and Industry.
 Sources: IMF; The Small and Medium Enterprise Agency (recompiled from Ministry of Economy, Trade and Industry, *Basic Survey of Japanese Business Structure and Activities*.)

Tapping of Domestic Demand

(1) Entry Rates by Industry¹

CY 2006-2009, %	
	Entry rate
Information and communications	3.9
Medical, health care and welfare	3.8
Eating and drinking places, and accommodations	3.7
Finance and insurance	3.2
Education and learning support	2.2
Retail trade	1.7
Wholesale trade	1.6
Construction	1.3
Transport	1.3
Real Estate	1.2
Manufacturing	1.1

(2) Propensities to Consume by Age²

Notes: 1. Entry rate is annual average number of entering small and medium-sized enterprises / number of small and medium-sized enterprises at the beginning of period. Small and medium-sized enterprises are defined under "Economic Census: Basic Survey" of Ministry of Internal Affairs and Communication.

2. Figures for propensity to consume are calculated by the consumption expenditure and disposable income those are the weighted averages by workers' households and no-occupation households.

Sources: The Small and Medium Enterprise Agency (recompiled from Ministry of Internal Affairs and Communication, *Economic Census: Basic Survey*); Ministry of Internal Affairs and Communication.

Enhancement of Monetary Easing (Feb. 14, 2012)

The Bank decided to clarify its monetary policy stance and to further enhance monetary easing at the Monetary Policy Meeting, at Feb. 14, 2012, in order to overcome deflation.

1. Introduction of "the Price Stability Goal in the Medium to Long Term"

- ✓ The inflation rate consistent with price stability sustainable in the medium to long term.
- ✓ A positive range of 2 percent or lower in terms of the year-on-year rate of change in the consumer price index (CPI). A goal of 1 percent is set for the time being.

2. Clarification of the Bank's Determination to Pursue Monetary Easing

- ✓ Aiming at achieving the goal of 1 percent in terms of the year-on-year rate of increase in the CPI.
- ✓ Pursuing powerful monetary easing by conducting the Bank's virtually zero interest rate policy and by implementing the Asset Purchase Program mainly through the purchase of financial assets until the Bank judges that the 1 percent goal is in sight.
 - On the condition that the Bank does not identify any significant risk, including the accumulation of financial imbalances, from the viewpoint of ensuring sustainable economic growth.

3. Increase in the Asset Purchase Program

- ✓ About 55 trillion yen → about 65 trillion yen. (The total size of the Program is increased by about 10 trillion yen, with the increase earmarked for the purchase of Japanese government bonds.)
 - In addition to purchases under the Program, the Bank regularly purchases Japanese government bonds at the pace of 21.6 trillion yen per year.

Enhancement of Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth (Mar. 13, 2012)

The Bank decided to substantially enhance the fund-provisioning measure to support strengthening the foundations for economic growth both in terms of the yen and a foreign currency.

Provision of funds to financial institutions, equivalent to the actual amount of lending and investment carried out with a view to strengthening the foundations for economic growth, over a long term (maximum duration of 4 years) and at a low rate (currently 0.1 percent).

1. Main Rules

- ✓ 3.0⇒3.5 tril. yen (Eligible Investments and Loans: 10 million yen or more)

2. Special rules for small-lot investments and loans

- ✓ Newly 0.5 tril. yen (Eligible Investments and Loans: 1 million yen or more but less than 10 million yen)

3. Special rules for a new U.S. dollar lending arrangement

- ✓ Newly 1.0 tril. yen <12 bil. U.S. dollar> (Eligible Investments and Loans: denominated in foreign currencies)

With special rules for ABL (Eligible Investments and Loans: equity investments and asset-based lending), total amount is 5.5 tril. yen. Deadline for applications for new loans is March 31, 2014.