Koji Ishida: Recent economic and financial developments in Japan

Summary of a speech by Mr Koji Ishida, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Kagoshima, 21 June 2012.

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I. Economic activity and prices in Japan

A. Recent developments

1. Japan's economy

First, I will talk about recent developments in economic activity and prices in Japan.
Economic conditions in Japan worsened sharply in the wake of the severe global contraction that followed the failure of Lehman Brothers in 2008. Thereafter, the economy showed signs of recovery as a result of various policy measures taken as well as efforts made nationwide, but it plunged again due to the Great East Japan Earthquake, which occurred on March 11, 2011. This was followed by additional shocks such as the European debt problem and the flooding in Thailand, making the year 2011 an extremely severe one for Japan's economy.

Since the beginning of 2012, Japan's economic activity has started picking up moderately as domestic demand remains firm, supported mainly by reconstruction-related demand after the earthquake. Public investment has been increasing with the progress in the implementation of government budgets earmarked for reconstruction related to the disaster. Business fixed investment has been on a moderate increasing trend with corporate profits improving. Against the background of improvement in consumer sentiment, private consumption has continued to increase moderately due to the effects of measures to stimulate demand for automobiles. A high degree of uncertainty remains regarding exports, but they have shown signs of a pick-up. Reflecting these developments in demand, production has started picking up moderately.

Price developments in terms of the consumer price index (CPI; all items less fresh food) indicate that, after reaching a historical trough of minus 2.4 percent in the middle of 2009, the year-on-year rate of decline has continued to slow. In recent months, the rate of change has been at around 0 percent.

2. Overseas economies

Next, I will talk about recent developments in overseas economies.

With regard to the U.S. economy, business fixed investment is maintaining its uptrend, supported by firm corporate profits, and private consumption is also increasing moderately. The employment situation continues to recover modestly as a whole so far, although it appears that the effects of the boost from a record-breaking warm winter are starting to dissipate.

On the other hand, the economic activity in the euro area has been sluggish despite signs of a pick-up in exports, because domestic demand there has been stagnant reflecting severe fiscal financial conditions in some peripheral countries, and this has acted as a drag on economic activity. Meanwhile, disparities among countries regarding economic sentiment are widening further. For example, the unemployment rate for April had registered a historically low level of 5.4 percent in Germany since the reunification of East and West Germany, whereas that in Spain was over 20 percent for all workers and over 50 percent for those aged 15–24.

Emerging and commodity-exporting economies have been maintaining somewhat high growth rates as a whole, but the pace of growth has been slowing somewhat recently. The Chinese economy continues to show relatively high growth; however, exports have been negatively affected by the sluggishness in the European economy, and the rates of increase particularly in durable goods consumption and private real estate investment have decelerated to some extent, due in part to the effects of measures to restrain the increase in real estate transactions and monetary tightening implemented so far. In the NIEs and the ASEAN countries, the pace of economic growth has begun to pick up, reflecting the restoration following the damage caused by the flooding in Thailand, in a situation where private consumption and business fixed investment remain firm.

Overseas economies on the whole still have not emerged from a deceleration phase, but some improvement has been observed, including the recovery, albeit at a moderate pace, of the U.S. economy and some emerging economies.

B. Outlook for Japan's economy and prices

I will now turn to the outlook for Japan's economy. Semiannually, in April and October, the Bank of Japan releases the *Outlook for Economic Activity and Prices*, known as the Outlook Report, in which it makes public its forecasts for economic activity and prices for the next two to three years. According to the projections in the Outlook Report that the Bank released in April this year, the economy is expected to return to a moderate recovery path in the first half of fiscal 2012 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 gradually strengthens.

With the economy moderately recovering, the outlook for prices in terms of the year-on-year rate of change in the CPI is expected to gradually rise to a range of above 0.5 percent and less than 1 percent toward the latter half of the projection period through fiscal 2013 as the aggregate supply and demand balance improves.

Expressing this outlook in terms of the median of individual Policy Board members' forecasts, Japan's real GDP growth rate is projected to be 2.3 percent for fiscal 2012 and 1.7 percent for fiscal 2013. The year-on-year rate of change in the CPI is expected to be 0.3 percent and 0.7 percent for fiscal 2012 and 2013, respectively.

Looking at the current state of Japan's economy, while the pace of recovery in overseas economies has been slower than expected in the April 2012 Outlook Report, domestic demand in Japan has been relatively stronger, and therefore Japan's economy as a whole so far is generally in line with the forecast in the April Outlook Report.

C. Uncertainties about the outlook

The outlook I have just mentioned is the scenario for economic activity and prices considered to be the most likely by the Bank, or the baseline scenario. In the April 2012 Outlook Report, the Bank raised the following four risk factors concerning this outlook as warranting attention: developments in overseas economies, especially the European debt problem; uncertainty with regard to reconstruction-related demand; possible changes in firms' and households' medium- to long-term growth expectations reflecting the shift of production sites to overseas as well as problems concerning the supply and demand of electric power; and problems regarding Japan's fiscal sustainability.

At present, the chief concern is developments in overseas economies, especially the European debt problem. Tensions in global financial markets rose rapidly in the second half of 2011, but eased somewhat from the start of 2012 due to the massive liquidity provision by the European Central Bank (ECB), in addition to the decision on the second financial support program for Greece by the European Union (EU) and the International Monetary Fund (IMF), the signing of the European Fiscal Compact by EU member states, and the agreement to raise the lending capacity of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). From February to March 2012 in particular, sentiment in global markets was "risk on," leading to purchasing of stocks and selling of the yen.

However, market sentiment thereafter shifted gradually to a "risk off" mode and risk aversion among global investors has been increasing again as a result of growing concerns about the political situation in Greece, as well as the health of Spanish banks and the consequent deterioration in Spain's fiscal condition. Yields on government bonds issued by countries with debt problems have risen, while yields declined on Japanese, German, and U.S. government bonds, which are regarded as safe assets. Stock prices have fallen and the yen has resumed its rise in the foreign exchange market.

The efforts made by Germany and other core European countries are expected to ultimately help avert a significant worsening of the problems in Europe, leading to a period of brief respite. However, a comprehensive solution will take quite a while. This is because at the root of the European debt problem lies a structural problem: countries with large disparities in fiscal conditions and economic strength share a single currency without having an integrated fiscal policy, making it difficult to adjust imbalances in these countries.

A key element in the Bank's baseline scenario for Japan's economy is that, while domestic demand supports the economy, external demand will strengthen, prompting the virtuous circle of production, income, and spending to start operating before reconstruction-related demand begins to decline. The economy is very likely to follow this main scenario, barring an unexpected worsening of the situation in Europe. This is because the U.S. economy is expected to continue growing at a moderate pace, and the growth rate of the Chinese economy – one of the main emerging and commodity-exporting economies – is expected to stop decelerating, with the economy likely heading toward a recovery due to the fine-tuning of the current set of restrictive policies.

If the European and U.S. economies become unstable, however, this would weigh heavily on emerging and commodity-exporting economies, exerting a large negative impact on Japan. Therefore, due attention should be paid to developments in the United States and Europe.

II. The bank's conduct of monetary policy

Next, I will outline the measures currently implemented by the Bank to pursue powerful monetary easing. The Bank recognizes that Japan's economy faces the critical challenge of overcoming deflation and returning to a sustainable growth path with price stability.

A. Pursuit of powerful monetary easing

Based on this recognition, the Bank has been pursuing powerful monetary easing through the comprehensive monetary easing measures.

In February this year, the Bank introduced "the price stability goal in the medium to long term" and announced that it would pursue powerful monetary easing until the price stability goal was in sight. With the aim of achieving the goal of a 1 percent year-on-year rate of increase in the CPI, the Bank announced that it would encourage a decline in longer-term market interest rates and a reduction in various risk premiums. Specifically, the Bank announced that it would (1) continue its virtually zero interest rate policy of encouraging the policy interest rate to remain at around 0 to 0.1 percent; and (2) implement the Asset Purchase Program (hereafter the Program) mainly through the purchase of various financial assets, such as government securities, commercial paper (CP), corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs).

Since the establishment of the Program in October 2010, the Bank has expanded its size successively. After the start of 2012, the Bank increased it in February and April, and the outstanding amount of the asset purchase is to reach about 65 trillion yen by around the end of 2012 and about 70 trillion yen by around the end of June 2013. The outstanding amount of the Program stands at approximately 51 trillion yen as of June 10, and thus the Bank will increase it by approximately 14 trillion yen – at a pace exceeding 2 trillion yen per month on average – by the end of this year. The amount of the Bank's purchases of assets, including those of Japanese government bonds (JGBs) conducted regularly at the pace of 1.8 trillion yen per month, will total as much as 4 trillion yen per month on average.

Due to such pursuit of powerful monetary easing, market interest rates in Japan have been moving at an extremely low level. For example, yields on JGBs with maturities of up to three years have been at around 0.1 percent, which is almost equivalent to money market interest rates, and those on ten-year JGBs have been below 0.9 percent. In these circumstances, firms' funding costs, as measured by lending rates, and credit spreads in corporate bond and CP markets, have both been moving at low levels. These rates, unlike those in the European and U.S. markets, have been stable at low levels even when market concerns about the European debt problem intensified significantly. The Bank will continue to pursue powerful monetary easing with the aim of achieving the goal of a 1 percent year-on-year rate of increase in the CPI so that firms and households can gain easier access to loans at a lower interest rate.

B. The bank's efforts to strengthen the foundations for economic growth

I will now talk about the fund-provisioning measure to support strengthening the foundations for economic growth (hereafter the Growth-Supporting Funding Facility), which has been implemented concurrently with the Bank's measures to pursue powerful monetary easing. The measure was introduced in June 2010 with the aim of supplying long-term funds at a low interest rate to financial institutions in accordance with their efforts in terms of lending and investment to strengthen the foundations for economic growth. The initial ceiling of the total amount of loans was set at 3 trillion yen. Subsequently, in June 2011, the Bank established a 500 billion yen new line of credit, separate from the existing one, for equity investments and asset-based lending (ABL), in which assets such as accounts receivables and inventories are used as collateral, based on the consideration that it was essential for the Bank to devise ways to encourage the provision of equity-like funds, such as equity investments, and of loans without conventional collateral or guarantees. In March 2012, the Bank decided to enhance the Growth-Supporting Funding Facility by (1) increasing the ceiling for the total amount of loans from 3 trillion yen to 3.5 trillion yen; and (2) establishing special rules for a new lending arrangement of 500 billion yen for small-lot investments and loans, as well as those for a new U.S. dollar lending arrangement of 12 billion U.S. dollars (equivalent to 1 trillion yen) for foreign currency-denominated investments and loans.

Looking at the amount of loans disbursed so far under the Growth-Supporting Funding Facility, the outstanding balance of the total loans stands at approximately 3.2 trillion yen as of the beginning of June 2012. With regard to loan disbursement under the special rules for the U.S. dollar lending arrangement, the first disbursement of loans is to take place in September 2012. A breakdown of financial institutions' individual investment or lending in April 2010–March 2012 by the areas for strengthening the foundations for economic growth shows that their investment and loans covered a wide range of areas; in particular, almost 30 percent of the total funds was provided to environment and energy business and almost 20 percent was provided to medical, nursing care, and other health-related business.

The Bank expects that this facility will act as a catalyst to promote financial institutions' loans without conventional collateral such as real estate collateral as well as investment and lending to growth areas using long-term funds provided at a low interest rate. The Bank expects that this will lead to an increase in the number of entrepreneurs and firms starting new businesses, and that this will in turn enhance the growth potential of Japan's economy.

III. Growth strategy for japan

These are the recent economic and financial developments and the Bank's policy measures taken in response. I will now take a look at Japan's economy from a longer-term perspective. Similar to Europe, Japan faces a structural problem, although in Japan's case the problem is declining growth rates amid population aging. I will also touch upon this issue.

A. Growth rates in the past two decades

Looking back at Japan's economic growth from a long-term perspective, the annualized GDP growth rate averaged more than 10 percent during the high-growth period of the 1960s. In the 1970s and 1980s, the rate did not reach double-digit figures but was stable, averaging an annualized 4 to 5 percent. Subsequently, the economic bubble burst and low growth ensued, moving around 1.5 percent in the 1990s and falling below 1 percent during the 2000s.

The stagnation of the 1990s can be largely attributed to the bursting of the economic bubble and malfunctioning of the financial system. It was widely believed that the economy would regain strength once the nonperforming-loan (NPL) problem was resolved. In reality, however, economic growth did not return to the previous levels, even after the mid-2000s, when the NPL problem had largely been resolved. The periods of persistent low growth during the 1990s and 2000s have together been called the "two lost decades,'' but I believe the slumps in these two periods had different causes.

Contributions to economic growth come from increases in both labor productivity and the labor force. Growth in labor productivity, measured by the rate of growth in real GDP per worker, had been on a downward trend throughout the 1990s and has been sluggish recently, although it remains narrowly in positive territory. The labor force measured by the rate of change in the number of workers, on the other hand, started to decline in the 2000s. The lackluster economic performance during these two decades reflects the different contributions of these two factors.

Turning to the issue of future growth, if we assume that the current labor force participation rate in Japan does not change, then the number of workers based on the long-term demographic forecast is expected to decline by 0.6 percent during the 2010s, and further by 1.2 percent during the 2030s. Assuming that productivity growth remains at around 1 percent, which has been the average over the past two decades, the growth rate from 2010 onward may be forecast at an annualized average of about 0 to 0.5 percent. During the 2030s, negative growth is likely to become the norm.

B. Measures to counter the declining population

Given that this situation is clearly foreseeable, the utmost efforts must be made to improve it.

Currently, the real GDP growth rate per worker is fairly high in Japan compared with other countries. If no action is taken, however, the rate per capita will decline as a result of the lower ratio of workers to population caused by population aging. Real GDP growth per capita serves as a benchmark of national wealth. Thus, it is possible that the current standard of living and welfare, achieved through hard work over many decades, will not be enjoyed by our children and grandchildren. In order to avert this situation, it is imperative to increase labor productivity per worker and ensure that the number of workers is maintained despite the declining population.

1. Increasing labor productivity

In order to raise labor productivity, it is generally agreed that the following steps must be taken: (1) develop new technology, products, and services; (2) ensure the full application of information technology, while redistributing resources from sectors and firms with low productivity to those with higher productivity; and (3) facilitate regeneration of industries. I will not elaborate on this broad subject today, but will focus instead on the issue of measures to halt the decline in the number of workers.

2. Increasing the number of workers

As often pointed out in the past, given the declining population – which is an undeniable and unavoidable development – it is necessary to increase the labor participation of women and create job opportunities for the elderly in order to stop the number of workers from declining.

a. Women

In 2011, the number of Japanese women aged 25–64 without jobs and not seeking employment averaged as many as 10 million (women under 24 are assumed to be at school and are excluded). A breakdown of the labor force participation rate by age group shows that the rate dips in Japan for women in their 30s, indicating the burden of raising children. Consequently, the data represented in a line graph are "M-shaped." There has been an increase in recent years in the number of nursery schools to address the serious shortage in Japan of such schools, which has prevented mothers from working. Some consider this an aspect of social welfare policy, but I believe it is also an economic policy for growth.

Raising children in Japan, which used to be seen as a mother's full-time role at home, could be passed on to those undertaking it as a job, allowing mothers to continue their jobs outside the home. This would be a division of labor at work. Subsequently, the number of jobs would expand, and together with a rise in income, payers of taxes and social insurance premiums would increase, contributing greatly to the growth strategy. Furthermore, it is not just an increase in the number of nursery schools in Japan that is needed for the raising of children. Schools and employers need to take steps to remove various obstacles in the way of working mothers. Families described as "double income with two kids" – a term heard recently – could become the basic unit of society, and existing structures and systems should be changed so that women would feel secure in their balance of work and raising children. The removal of some of the barriers to having children would raise the labor force participation rate of women, and also help stop the decrease in the birth rate.

b. The elderly

The share of the elderly seeking employment falls sharply in Japan from 65 years of age onward. Statistics show that in 2011 the labor force participation rate averaged 78 percent for people aged 50–59 and 60 percent for those aged 60–64. It went down to 38 percent for those aged 65–69, and declined further to 23 percent for those aged 70–74. This trend could be attributed to the fact that in Japan corporate pensions are paid from the age of 60, and the widely held perception that the elderly – who are often defined as those aged 65 years or more – do not work or are not expected to work.

Many studies, however, show that the percentage of healthy people aged 65 or more is increasing. Data from the World Health Organization (WHO) as of 2007 revealed that healthy life expectancy, which is the average number of years a person can expect to live in full health, was 76 years in Japan, the highest in the world. Another study shows that the capacity of judgment and understanding, acquired through education and training, peaks at around 60 and gradually declines thereafter. Apparently, however, findings show that such capacity for those in their 80s roughly equals that of people in their mid-20s. In fact, in the agricultural sector 60 percent of workers are aged 65 or above, and in the fishing sector the proportion is more than 30 percent. This is evidence of the capability of people at 65 or more to continue to work. According to the Organisation for Economic Co-operation and Development (OECD), an increasing number of countries have raised the pension age to 67 or above.

Therefore, although it is not immediately possible, it seems necessary to change Japanese society's definition and perception of the elderly. If the nation's working-age population is redefined to include the population up to 69 years of age, the number of employable population would increase by slightly less than 8 million. The working-age population up to 64 years of age is 82 million at present and is expected to decline. If the population up to 69 years of age is included in the working-age population, we would have approximately ten more years before it approached the present level of 82 million and started to decrease. In order to bring about the acceptance of new social perceptions of age and work that I have just mentioned, it is necessary to change various social structures and systems substantially. In Japan, with its rapidly aging population and fall in childbirth, it is essential to construct cooperative networks and systems that encourage older members of society to join forces with the rest of the working population.

C. Increasing job opportunities

In order to both increase the labor participation rate of women and draw on the labor of the elderly, it is necessary to significantly expand the number of available jobs. Various opinions have been expressed on how to deal with the current decrease in the workforce caused by population aging with fewer children. Among them is the suggestion that Japan should accept more immigrant labor from overseas. At present, however, there are not enough job opportunities on offer to meet an increase in the workforce. Although improvements have been made recently, the ratio of job offers to applicants in April 2012 was 0.79, while the unemployment rate was 4.6 percent. The number of unemployed was 3.15 million (seasonally unadjusted), and if figures are added for the hidden unemployed – who are willing to work but not actively seeking a job – the total number of unemployed amounts to about 7.53 million.[1] To promote growth of the economy, new job openings must be created to accommodate these unemployed people, in addition to more women and the elderly.

In view of the current imbalance between supply and demand of goods and services, with demand falling short of supply, it is necessary to respond to the changing social structure and create demand by replacing old products and services with new ones. The structure of consumption, or spending patterns, has also changed largely reflecting the population aging with fewer children. The outcome of competition among firms now depends on how they adapt to such changes. New job opportunities will be created in the process of such corporate endeavors.

It is also essential to seek overseas demand, since the population in Japan is declining. Rapidly expanding Asian markets are located close to Japan. In view of an expected rise in income levels in the area, these markets are likely to become extremely important for high-quality goods produced in Japan that offer superior features in terms of safety and reliability, although production of "volume-zone," widely used goods, may have to be done overseas. Moreover, looking further ahead, it is very likely that Japan will be able to offer products and services developed for its aging society to other Asian nations, since their populations too are bound to mature. With this favorable outlook in mind, stepping up investment for growth would lead to a larger flow of funds, an expanded job market, and ultimately sound economic growth in Japan as well as Asia.

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1 The data for April 2012 were taken from the Labour Force Survey released by the Ministry of Internal Affairs and Communications. The number of "hidden unemployed" represents those "wishing to work" in the category of "not in the labour force." A breakdown of figures for those "not in the labour force" is not published on a monthly basis, and therefore, the simple average of three months for the period between January through March 2012 (4.38 million) was used.

D. Regional areas

Viewed from a different perspective, the decline of the population is likely to have a larger effect on regional areas than on urban ones. If job opportunities in these areas are insufficient, youthful job seekers will leave, causing a population drain and leading to a further shrinkage of regional economies. To respond to this situation, it is important to make full use of the resources unique to each region, in addition to human resources of the elderly and women: for example, to draw on the labor of the elderly in the areas of nursing care, where demand is growing, or of childcare; and to revitalize the primary industry. Business opportunities may also lie in agricultural and food industries in rural Japan. It is possible that the supply-demand conditions for food will tighten worldwide reflecting the rapid growth of emerging economies, and as the income levels of emerging economies rise, demand is likely to increase for Japan's expensive but safe, reliable, and high-quality food products, in which the country has a competitive edge. Efforts to expand exports of agricultural and marine products to other Asian countries could bear fruit through, for example, selective breeding of grain species and improvement in aquaculture technology by means of effectively utilizing fallow and abandoned fields, as well as Japan's coastline, which is the sixth longest in the world. The agricultural and fisheries industries by themselves account for a relatively small share of Japan's GDP, but if related businesses such as food processing, transportation, and distribution are included, they contribute a great deal to regional economies.

Furthermore, regional areas in Japan possess scenic and cultural resources unrivaled by many other countries: you can find mountains, volcanoes, hot springs, valleys, beaches, lakes, a mild climate with four seasons, historic sites, cultural events such as festivals, and safe towns with hospitable people, all in this small country. Unfortunately, despite such abundant tourist attractions, Japan ranks only 30th or so in terms of the number of foreign tourists. Considered another way, however, this implies that there is much room for growth in tourism. If Japan's regional areas could capture tourism demand from other countries in Asia that have a great potential for growth, this would have a significant impact on employment.

In order to strengthen such efforts, local governments need to take detailed measures. Support from local financial institutions is also important, as funds from various sources will be required. As I mentioned earlier, the Bank supports the efforts of financial institutions through the Growth-Supporting Funding Facility. The amount of funds provided through the facility to such businesses as tourism and to childcare services is still small, and there is much room to increase the funding provided to these businesses as well as to others. The Bank thus expects greater use of the facility.