Hirohide Yamaguchi: Path toward overcoming deflation and pursuit of monetary easing

Speech by Mr Hirohide Yamaguchi, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Hiroshima, 25 July 2012.

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Introduction

Thank you for giving me an opportunity to exchange views with administrative and business leaders in Hiroshima. And I express my gratitude to everyone for your cooperation in various business operations of the Bank of Japan's Hiroshima Branch.

Today, before exchanging views with you, I will first talk about the developments in overseas economies, including the European debt problem, followed by a short-term outlook and medium- to long-term challenges Japan's economy is faced with, while focusing on the recent developments in domestic demand. Finally, I will talk about the recent monetary policy conduct of the Bank of Japan.

I. Developments in overseas economies: future recovery that stands back to back with a big risk

Let me start with the developments in overseas economies. While the economies were recovering after around mid-2009 from the Lehman shock in autumn 2008, the pace of recovery has somewhat slowed after the second half of 2011 and they still have not gotten out of a deceleration phase.

By region, the U.S. economy has been moderately recovering, partly supported by accommodative financial conditions. While there are cautious views in the market on the outlook for the U.S. economy as the growth in the number of workers has been slowing since early spring, private consumption has been increasing moderately and home sales, which remained low for a long time, have been showing signs of a pick-up. That suggests that the household sector's debt burden, which weighed on the economy after the Lehman shock, has been gradually easing. It is also expected that a decline in gasoline prices since early spring will increase households' real purchasing power and underpin an increase in private consumption. Therefore, while the pace of growth might not accelerate markedly, it is likely that a moderate recovery will basically continue without interruption.

The European economy as a whole has been stagnant, due partly to the European debt problem, which I will talk about later, and will continue to be in a severe situation for the time being.

In the meantime, in China, the economic slowdown has been still continuing. The year-on-year growth rate of real GDP was on a downtrend after it peaked at the beginning of 2010 at 12 percent, and fell below 8 percent in April–June 2012. Such developments were partly due to a tightening policy implemented by the Chinese policy authorities, who were concerned over an acceleration of inflation and a surge in asset prices. Such policy has had an impact to some extent and the inflation rate, which was over 6 percent a year ago, has fallen to about 2.0–2.5 percent. A decline in the inflation rate increases households' real purchasing power and encourages spending. In view of stable general prices and asset prices, the Chinese authorities have started to implement full-fledged economic stimulus both on the financial and fiscal fronts by reducing the policy rate for two consecutive months in June and July and deciding to make fiscal support to promote consumption, including energy-saving home appliances. While attention should be paid to the weakness in exports to Europe, which accounts for about 20 percent of China's total exports, the Chinese economy is likely to return to the moderate recovery path mainly led by domestic demand in the not too distant future.

Consequently, as for the outlook, overseas economies are likely to gradually escape from the current deceleration phase and gradually increase their growth rates with a moderate recovery in the U.S. economy and a pick-up in the Chinese economy as a driving force. However, there remains high uncertainty about the outlook for overseas economies, including the United States and China. In a way, a situation, in which a baseline scenario for economic recovery and a risk scenario have been standing back to back, has been continuing. Among others, the development in the European debt problem, which I will talk about next, is a risk factor that warrants most attention.

II. The European debt problem: still a bumpy road ahead

Let me now take some time to talk about the European debt problem. The trigger for the problem was the revelation of a massive hidden fiscal deficit of Greece in October 2009. Subsequently, concern over fiscal conditions spread to Portugal and Ireland, and, in the second half of 2011, further to southern European large countries, Spain and Italy.

In Spain, as a housing bubble burst triggered by the Lehman shock, an injection of massive fiscal funds became necessary for the disposal of financial institutions' nonperforming loans and for economic stimulus, despite a decline in tax revenue. As a result, in recent several years, fiscal conditions have deteriorated rapidly. In Italy, fiscal deficit has become chronic as the government has been supplementing a decline in domestic industries' external competitiveness with fiscal support. Against such a backdrop, with a bloat of government debt outstanding, the market has been concerned over weakening of the economy's growth potential.

Deterioration in fiscal conditions raises suspicion of the country's government bonds not being redeemed as promised, which leads to a decline in the government bond prices or, in other words, a rise in the government bond yields. In Greece, the government had not been able to raise funds on its own to redeem government bonds, and, after last December, yields on Greek government bonds once rose to a level more than 35 percent. Subsequently, in order to reduce the heavy fiscal burden itself, Greece was faced with a situation in February to request private investors to forgive part of their claims. Government bond yields in Spain and Italy have been unstable since the second half of 2011, and, in particular, those of Spain have recently risen to a level above 7 percent and hit a record high since the introduction of the euro.

As government bond yields of those countries, which were called peripheral countries, have risen substantially, namely, their prices have fallen sharply, assets of financial institutions in Europe that held a large amount of those government bonds have deteriorated significantly. Consequently, some financial institutions in Europe have lost market confidence and faced with an increase in funding costs or difficulties in funding themselves. Financial institutions that are struggling with funding become cautious in providing loans to firms, which will exert downward pressure on the real economy. A stagnant real economy will induce a vicious cycle by further worsening fiscal conditions, which will again adversely affect financial institutions' management through destabilizing developments in the yields of government bonds. It has become a big problem that such an adverse feedback loop among fiscal conditions, the financial system, and the real economy has been at work.

Therefore, what is necessary for the moment is to cut off the adverse feedback loop. At present, a focus has been on rehabilitation of Spanish financial institutions that shoulder a large amount of nonperforming loans, and, in June, the Euro members decided to provide financial support in the maximum amount of 100 billion euros. Since December 2011, the European Central Bank has been providing the financial market with three-year loans, which are an extraordinarily long-term fund provisioning by a central bank. Reflecting such a stance of the authorities, short-term money markets, in which financial institutions exchange funds with each other, have regained stability to some extent compared with around the end of 2011, when there was an elevated sense of crisis.

While those responses are essential as a first aid to stem the adverse feedback loop, it will not be a fundamental solution of the European debt problem. If one goes back to the cause of the problem in the peripheral countries, it is necessary for those countries to carry out drastic fiscal consolidation as well as economic structural reform toward strengthening their medium- to long-term growth potential. Europe as a whole is also faced with a challenge that, while using a single currency "euro," stability of the economies and financial systems can be achieved with each country's fiscal policy and bank supervision remaining separate. While this might be a somewhat crude analogy, you might be able to understand the difficulty of the problem if you imagine a situation in which each local government totally independently carries out fiscal policy and bank supervision in Japan where the same currency yen is used. Having said that, the problem is an essentially fundamental one of how to draw a future picture of political, economic, and social integration in Europe. Given the size and complexity of the problem and difficulty in each country's political decision making, we have to be prepared that it will take some time.

On the other hand, markets request conclusions in haste. They will not wait. While such difference in time frames has been leading to jittery responses by the markets, at the same time it might bring forward the solution of the European debt problem. The policy authorities are aware that tepid measures, if announced, will immediately induce disappointment in the markets and will be pressed for further measures. The international community that will be affected substantially by the European debt problem has been increasingly keeping a close eye, and Japan and many other countries have been requesting a swift solution of the problem at international conferences and other opportunities. Above all, through past discussions, the common recognition of not to let the euro fall apart has nurtured in Europe as a whole. Given such a situation, while the path is still rough, I hope that there might be progress toward the solution of the European debt problem in the not so distant future.

III. Fiscal problem and long-term interest rates: importance of efforts toward fiscal consolidation

I have so far talked about the European debt problem. In relation to the problem, let me touch on Japan's fiscal condition and the recent developments in long-term interest rates before moving on to Japan's economic developments.

The ratio of gross government debt outstanding to GDP in Japan is now exceeding 200 percent. That is extremely high internationally and exceeds that of even Greece, which is 130 percent. Seizing that point, some people voice concern that, as things stand, Japan might tumble into trouble like Greece. However, in reality, Japanese government bonds (JGBs) have been issued smoothly and their yields have been stable at extremely low levels.

As a reason for that, it has been frequently said that, in Japan, households and firms have ample savings, and thus there is no need to worry, for now, about lack of money to purchase JGBs. To be sure, that is a factor supporting a smooth issuance of JGBs. But if a situation arises in which prices of JGBs decline significantly or people worry about repayment of the principal, nobody will be willing to purchase JGBs even though the Japanese public has ample savings at present. To begin with, amid rapid progress in the demographic vortex, there is no guarantee that such ample savings will last, and thus discussions that rely on the continued existence of ample savings might not necessarily be appropriate.

Then, why have JGBs been issued smoothly? I believe that it is because there is confidence in Japan's future policy conduct. Namely, despite deterioration in fiscal balance, market participants believe that "the Japanese have the will and ability to eventually address fiscal consolidation." In fact, such efforts are steadily underway. That is the critical difference between Japan and Greece. As efforts to ensure fiscal sustainability have been progressing, in my view the public also believes that monetary policy has been conducted toward fulfilling the intended purpose of achieving sustainable economic growth with price stability. Namely, the public believes that the Bank's money will not be used for facilitating government financing.

Worldwide, since the Lehman shock, global investors have increasingly become more risk averse than before, and that has also caused Japanese government bonds' prices to rise and yields to fall. Credibility of securitized products in the United States, which used to be considered as safe assets with little risk, and government bonds in peripheral European countries, has declined and the supply of financial assets, internationally, that can meet investors' propensity for safety has declined substantially. Against such a backdrop, investors worldwide have channeled funds into the Japanese government bond market in pursuit of limited safe assets, having led to a recent rise in government bond prices. One major reason for the persistent yen appreciation seen in recent several years has been such flow of funds.

As mentioned earlier, the source of credibility in JGBs is the confidence in Japan's fiscal and monetary policy. As Japan's government debt outstanding is extremely high to begin with, if Japan's fiscal discipline is questioned, being triggered by some cue, credibility of government bonds could decline and long-term interest rates could rise. To avoid such a situation, I recognize that the policy authorities have always been required to make sincere efforts to maintain market confidence and, based on those efforts to achieve fiscal consolidation itself.

IV. Short-term outlook for Japan's economy: moderate recovery and associated uncertainty

Now I will move onto the state of Japan's economy. After experiencing a plunge caused by the Great East Japan Earthquake in March 2011, Japan's economy recovered toward the summer much earlier than initially anticipated thanks to the efforts by firms and the public. Since early autumn 2011, economic activity has been more or less flat, reflecting the effects of a slowdown in overseas economies and the appreciation of the yen as well as the flooding in Thailand, but has recently started to gradually pick up again.

An assessment of recent developments will be, in short, that domestic demand has been somewhat stronger than expected and external demand somewhat weaker. As overseas economies have yet to get out of a deceleration phase, Japan's exports have also been slightly lagging expectations.

On the other hand, domestic demand has been somewhat stronger than expected. The first reason for that is an increase in reconstruction-related demand, which includes an increase in public investment and demand for repair and rebuild of disaster-stricken facilities and houses, as well as a recovery in demand that had been restrained due to the effects of the disaster, namely, manifestation of pent-up demand. Investments in strengthening earthquake resistance and the purchase of disaster prevention goods and energy saving products, triggered by the earthquake, can also be considered as reconstruction-related demand in a broad sense. Policy support, including subsidies for eco-friendly cars, has also been effective. An improvement in business sentiment due to a recovery in corporate profits, and ensuing cease of decline in wages and income, seem to have exerted positive effects on recent investment and consumption. In addition, there has recently been a marked increase in consumption of the baby-boom generation and other elderly people. With some reflection, a grave trial for Japan's economy, including progress in aging and the earthquake disaster, has also brought a substantial change in firms' and households' behavior. And that is becoming new buds for new demand. Let me explain that later in detail.

As for the outlook, the Bank assumes that the firm domestic demand will support the moderate recovery of Japan's economy. However, there is a possibility that the budget for the subsidies for eco-friendly cars will run out as early as this summer, and pent-up demand will gradually subside. Against such a backdrop, in order to ensure the positive developments in the economy as a whole, it is necessary that exports steadily gain momentum while firm domestic demand is supporting the economy.

Taking account of those points, the Bank recently published its latest economic outlook for the next two years. The real GDP growth rate for fiscal 2012 was projected to be slightly above 2 percent due to firm domestic demand. The growth rate for fiscal 2013 was projected to maintain 1.5 to 2 percent because, while reconstruction-related demand will gradually subside, exports will start to recover as overseas economies pick up.

On the price front, the year-on-year rate of change in the consumer price index (CPI) of all items but volatile food is currently about 0 percent. The rate of change is projected to remain at around 0 percent for the time being, and gradually rise to a range of above 0.5 percent and less than 1 percent toward fiscal 2013, as the economy returns to a recovery path and the aggregate supply and demand balance improves. The Bank's goal for the time being of 1 percent will be achieved in the not so distant future from fiscal 2014 onward. From a longer term perspective, Japan's economy is expected to return to the moderate recovery path with price stability. However, such an outlook is associated with various uncertainties. In particular, the effects of developments in the European debt problem and fluctuations in foreign exchange rates on Japan's economy continue to warrant close attention. In addition, even if economic activity and prices develop as projected, it will be fiscal 2014 onward that the year-on-year rate of change in the CPI reaches 1 percent, and thus still some time is needed to overcome deflation.

V. Medium- to long-term challenges to Japan's economy: nascent bud for growth

I have so far explained the outlook for Japan's economy. From now on, let me consider medium- to long-term challenges Japan's economy is faced with. Japan's economic growth rate has been on a downtrend amid unprecedented rapid progress in aging. Therefore, there is an aspect that firms' and households' growth expectations, in other words, spending appetite has been restrained, and that induced a chronic demand shortage. In order to overcome deflation, it is necessary not only to achieve short-term economic recovery but also to strengthen medium- to long-term growth potential of Japan's economy and remove structural downward pressure on demand.

At individual firms' level, there are not a few initiatives to strengthen their own growth. While the earthquake disaster and the nuclear accident were big challenges for Japan, those at the same time changed the public recognition of energy and environment. Changes always bring business opportunities to firms. Recently, in addition to next generation cars that have superior environmental designs, renewable energy supply and "smartization-related" projects have gradually started to take the form of a full-scale business. Growth in those areas is expected to have large spillover effects on firms, including small firms, which provide cutting-edge materials and nanotechnology.

The challenge of rapid aging Japan's economy is faced with could, from firms' perspective, provide a new business opportunity. The elderly, who are 60 or over, account for more than 40 percent of private consumption, and, among them, the baby-boomer generation has a remarkably higher propensity to consume than the previous and next generations. Such elderly people vary from individual to individual in financial resources, life styles, health conditions, and hobbies, and are with diverse values. There are many promising areas, ranging from travel and leisure, medicine and nursing care, and construction of houses and cities that correspond to the aging society. In fact, in the *Tankan* survey released at the beginning of July, business sentiment of industries, including accommodation, eating, and drinking services, improved substantially, and that was partly attributable to the fact that an improvement in the quality of services for the elderly has turned out be successful.

As explained, the recent firm domestic demand seems to reflect the fact firms have been positively tackling challenges Japan's economy is faced with, including aging and energy constraints, and tapping new demand. If that is the case, the current strength in domestic demand might not only be a recovery factor in the economy for the time being, but also the start of a larger wave that will lead to future strengthening of potential growth, and have the possibility to serve as a trigger to solve the medium- to long-term challenges Japan's economy is faced with. In the periods ahead, it is necessary to carefully nurture such buds for growth.

Growth-fostering areas are not exclusive to Japan. Aging and energy constraints are problems that other Asian countries have to face in the near future. In China, it is said that the working-age population will start to decline as early as around 2015, and the number of elderly people, who are 60 or over, will reach 300 million. It would be a waste not to utilize know-how accumulated at home in the neighboring giant market. A decline in the working-age population might, in the near future, accelerate China's investment in resource conservation, and that area could be a new business field for the Japanese machinery industry. In a grand trend of increasing infrastructure demand and transition to low carbon society, needs for Japan's cutting-edge energy technology will gradually increase in the future.

Strengthening growth potential of Japan's economy will become possible through, above all, efforts of firms that have a great deal of fighting spirit. Of course, to that end, financial institutions' support on the financial front will be necessary and, to the extent of preparing an environment that facilitates such challenges, the role of the government will be important. If private firms, financial institutions, and the policy authorities continue their efforts in line with their respective roles, it might be possible to successfully nurture nascent buds for growth and let them fully bloom.

VI. Bank of Japan's conduct of monetary policy: pursuing monetary easing and supporting strengthening growth potential

Finally, let me talk about the Bank's recent monetary policy conduct.

The Bank recognizes that Japan's economy faces the critical challenge of overcoming deflation and returning to the sustainable growth path with price stability. Based on that recognition, in February the Bank clarified its monetary policy stance toward overcoming deflation. Specifically, the Bank clearly stated that it will continue pursuing powerful monetary easing with the aim of achieving the goal of 1 percent inflation in terms of the year-on-year rate of increase in the CPI until it judges the 1 percent goal to be in sight.

To actually pursue monetary easing, the Bank has been implementing a program to purchase financial assets called "the Asset Purchase Program." It is a measure to encourage a decline in longer term interest rates and risk premiums through purchasing government bonds and a wide range of financial assets from the market, and lead to a decline in firms' funding costs. The Bank expanded the total amount of the Program in February and April so that the amount outstanding of the Program will reach about 70 trillion yen by the end of June 2013. The current amount outstanding of the Program is 53 trillion yen. We are now in the process of increasing the amount outstanding of the Program toward 70 trillion yen and the effects of monetary easing will strengthen in a continuous manner day after day as the process continues.

In retrospect, the Bank's monetary policy stance since the Lehman shock has been changing according to the state of Japan's economy. Initially, inclusive of the Lehman shock and the subsequent earthquake disaster, the policy stance was geared toward mitigating repeated downward pressure on economic activity and underpinning the economy. Afterwards, Japan's economy gradually escaped from such shocks and reached a situation in which an outlook of returning to the sustainable growth path with price stability can be shown. The reason the Bank strengthened monetary easing in February and April nevertheless was to, together with the cumulative effects of past monetary easing, further ensure the outlook to materialize. At present, while daily purchasing assets under the increased total amount of the Program, the Bank is deliberately examining the effects of monetary easing as well as the outlook and risks for economic activity and prices. Of course, due to some shocks, when the outlook turns out to be weaker than expected or the risk associated with it intensifies, the Bank will not hesitate to implement additional monetary easing. The Bank will continue to strive for proper monetary policy conduct.

As I mentioned earlier, to overcome deflation, in addition to the measures I have mentioned, efforts to strengthen growth potential by private firms, financial institutions, and also by the policy authorities will be necessary. In that regard, the Bank has been implementing a "fund-provisioning measure to support strengthening the foundations for economic growth," a measure extraordinary for a central bank. It is 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 measure was introduced two years ago, expanded sequentially, and, in March 2012, small-lot investments and loans less than 10 million yen, which used to be not eligible, were made eligible for the Bank's support. In addition, the Bank decided to provide U.S. dollar loans for financial institutions' investments and loans denominated in foreign currencies. As a result, at present, the total size of the measure stands at 5.5 trillion yen. As part of it, the first fund provisioning for small-lot investments and loans was made last month, in an amount of 3 billion yen for nine financial institutions. Utilizing the measure, financial institutions have been making loans and investments to back up growth in firms in wide-ranging areas, such as medicine and nursing care, environment and energy, agriculture, forestry and fisheries, and tourism. Not a few financial institutions made investments and loans to support opening of new businesses. Although the fund provided was yet small as it was the first time, the Bank intends to contribute to nurturing new buds for the growth of Japan's economy. The Bank strongly anticipates that, such measure being a catalyst, the private sector's efforts to strengthen growth potential will further expand both in terms of region and industry.

Concluding Remarks

As time is running out, let me conclude my speech today while touching on the economy of Hiroshima Prefecture.

Hiroshima Prefecture is one of the major industrial prefectures in Western Japan, with a variety of industries located, including automobile, machinery, and steel. Also in recent periods, firms' high technical expertise has been fully displayed as seen in the development of a next generation engine that has a superior environmental design. In addition, many firms, including those in nonmanufacturing such as logistics and men's apparel, have been actively expanding businesses overseas, mainly in Asia. Furthermore, this region has tourism resources with two world heritage sites and rich natural surroundings as well as a worldwide high recognition as a cosmopolitan area, and, in fact, Hiroshima city and Miyajima have recently received a record high number of tourists. The local administration has also been actively supporting the private sector's positive efforts. I have heard that, to promote innovation in local firms, Hiroshima Prefecture was the first local government to establish a wholly government-owned operating company to manage a regional support fund, and the first firm to invest in was decided in April. The firm aims at becoming an international leader in a niche business area through the development of a unique non-contact inspection system that could be applied to smartphone displays. On the financial front, through efforts, including increasing the number of staff in the consulting section or actively holding meetings for business matching, local financial institutions have been supporting local firms' growth and launch of new businesses. Several financial institutions have been participating in the Bank's "fund-provisioning measure to support strengthening the foundations for economic growth."

In order to further encourage positive efforts of local firms, we appreciate it if you could utilize the measure effectively.

The Bank expects you to make efforts to meet challenges ahead and will continue to provide utmost support as a central bank.