

# **Yoshihisa Morimoto: Economic activity and prices in Japan and monetary policy**

Speech by Mr Yoshihisa Morimoto, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Ishikawa, 2 August 2012.

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## **I. Recent financial and economic developments**

### **A. Global financial markets and overseas economies**

#### *1. Global financial markets*

I would like to start with developments in global financial markets and overseas economies, which affect Japan's economy.

Global financial markets have recently been characterized by a repetitive pattern of rising and declining pessimism reflecting developments in the European debt problem. From the middle of 2011 toward the end of the year, strains in markets increased due to concerns over the sustainability of public finances in peripheral countries. From the turn of 2012 toward early spring, there were phases of easing strains due to the introduction of measures to strengthen fiscal discipline in the member states of the European Union (EU), the decision on the second financial support program for Greece by the euro area member states and the International Monetary Fund (IMF), and the agreement to raise the lending capacity of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). Nevertheless, markets became nervous again from early spring: there was talk of a euro crisis due to the turmoil in the domestic political situation in Greece, and in Spain yields on 10-year government bonds temporarily rose above 7 percent due to concerns about the stability of its financial system.

Subsequently, a new government was inaugurated in Greece, and the EU and eurozone summits at the end of June emphasized the need to strengthen growth and agreed to take steps to establish a single supervisory body for eurozone banks with a view to making it possible for the ESM to recapitalize banks directly. These decisions raised hopes that the vicious circle between uncertainty over Spain's financial system and increasing government debt would be broken, and markets temporarily regained stability. This situation, however, did not last long. At present, yields on 10-year Spanish government bonds are hovering at around 7 percent. On the other hand, interbank funding markets have generally been stable since the beginning of 2012 due to the abundant liquidity provision by the European Central Bank (ECB). It appears, however, that it will take some more time until uncertainties are dispelled over the fiscal and economic structural reforms as well as over measures regarding the financial system in Europe. Thus, developments in the European debt problem continue to warrant careful attention.

#### *2. Overseas economies*

Under these circumstances, overseas economies have shown some improvement, albeit moderate, but on the whole they have not emerged from a deceleration phase. By region, economic activity in the euro area continues to be sluggish, despite signs of a pick-up in exports, because domestic demand in the area has been stagnant. Peripheral countries in particular have fallen into a vicious circle, in which the downturn in economic activity due to fiscal austerity measures and the deterioration in financial conditions lead to a further worsening of the financial conditions of governments and financial institutions. As a result, disparities between economic sentiment in core countries such as Germany and in peripheral countries are widening. For example, the unemployment rate in Germany stands at around 5 percent, which is a historical low since the reunification of East and West Germany, while in Spain it has reached well over 20 percent and the youth unemployment rate is in excess of

50 percent. Moreover, the deterioration in the economies of peripheral countries is affecting business sentiment in core countries, and thus the European economy is likely to remain sluggish for the time being.

Next, the U.S. economy is generally continuing to recover at a moderate pace. Private consumption has been firm due in part to an increase in real purchasing power reflecting the decline in gasoline prices, and the housing market has shown some signs of picking up. Business fixed investment has recently maintained its uptrend against the background of solid corporate profits. However, signs of weakness have been observed in business sentiment, and the momentum of growth in employment has recently been slowing. Furthermore, amid persisting strains from balance-sheet adjustments, households and firms are not likely to increase their spending due to concerns over the adverse impact of the European debt problem as well as uncertainty regarding the “fiscal cliff,” that is, fiscal spending cuts scheduled to be implemented at the beginning of 2013 and the handling of tax cuts set to expire at the end of 2012. Taking these factors into account, the U.S. economy is likely to recover at only a moderate pace.

Emerging and commodity-exporting economies still have not emerged from a phase of sluggishness, but on the whole these economies have maintained relatively high growth backed by firm domestic demand. The pace of growth in the Chinese economy has slowed reflecting the deceleration in private real estate investment as a result of monetary tightening earlier, but there are also signs that the slowdown is bottoming out, such as the increasing trend in exports and bank lending. The Chinese government has accelerated approvals for infrastructure investment and introduced subsidies for energy-saving electrical appliances and other goods. With the pace of consumer price inflation decelerating, the authorities have also started stimulating the economy on the monetary front, lowering the benchmark lending rates for two consecutive months. Looking ahead, the growth rate of the Chinese economy is unlikely to reach dramatic levels, but it is likely to rise gradually as these policy measures start producing effects. In the NIEs and the ASEAN economies, exports have been affected by the slowdown in Europe and China, but domestic demand has been firm on the whole, and production has been recovering moderately. As for the outlook, including other emerging economies such as Brazil, the growth rate of emerging and commodity-exporting economies will likely increase gradually reflecting accommodative financial conditions and a recovery in real purchasing power following a decline in inflation rates.

## **B. Japan's Economy**

### *1. Economic activity*

I will now explain the current state of, and outlook for, Japan's economy based on the overseas economic developments I have just outlined. Until the beginning of autumn 2011, Japan's economy picked up steadily following the plunge caused by the Great East Japan Earthquake, which struck just as the economy was recovering from the Lehman shock. Thereafter, however, it remained more or less flat on the whole until around the early spring of 2012 mainly due to the adverse effects of the slowdown in overseas economies and the appreciation of the yen. More recently, with domestic demand remaining firm – led by reconstruction-related demand and private consumption – and exports continuing to show signs of picking-up, economic activity on the whole has started picking up moderately.

The firmness in domestic demand is attributable to the following factors. Demand for restoration and reconstruction of social infrastructure and of disaster-stricken facilities and homes has led to increases in public investment, business fixed investment, and housing investment. Reconstruction-related demand has also been underpinned by changes in the behavior of firms and households triggered by the disaster. Examples are efforts to strengthen the earthquake resistance of buildings and facilities and to bolster business continuity systems, investment in the area of new energy sources, and the purchase of energy-saving products. Meanwhile, private consumption has been boosted by pent-up demand, that is, a recovery in demand following the temporary restraint due to the effects of

the disaster, and by policy measures such as subsidies for purchasers of environmentally friendly cars. Private consumption has also been pushed up by an increase in spending on products and services provided by businesses targeting the elderly reflecting firms' efforts to enhance their line-up in this area.

Although considerable uncertainty remains regarding the outlook, Japan's economy, with domestic demand remaining firm and overseas economies emerging from their phase of deceleration, is expected to return to a moderate recovery path, as also shown in the June 2012 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) and the *Regional Economic Report*. Given this situation in demand at home and abroad, the economy is likely to register a relatively high rate of growth in fiscal 2012, supported by a gradually increasing momentum in the virtuous circle of growth in production, income, and spending. In fiscal 2013, with overseas economies continuing to see relatively high growth on the whole, the economy is expected to be firm, although the growth rate is expected to be somewhat lower than that in fiscal 2012, because the positive effects from reconstruction-related demand will gradually diminish. In the Bank of Japan's projection released in July 2012, the median of the Policy Board members' forecasts for Japan's real GDP growth rate is 2.2 percent for fiscal 2012 and 1.7 percent for fiscal 2013.

## 2. *Prices*

Next, I will talk about price developments. International commodity prices softened somewhat from autumn 2011, reflecting the slowdown in the global economy. After a slight rise in early spring of 2012, especially in crude oil prices against the backdrop of heightened geopolitical risk, they then fell back again through June 2012, and remained more or less flat thereafter. Most recently, prices of crude oil have bottomed out, while those of grains have risen due to unseasonable weather. As for the outlook, international commodity prices as a whole are expected to rise at a moderate pace in line with the growth in overseas economies. Under these circumstances, the year-on-year rate of change in the domestic corporate goods price index (CGPI) has recently been negative. The CGPI is expected to decline moderately for the time being and then start to rise slowly reflecting the expected moderate increase in international commodity prices and the improvement in the negative output gap.

Turning to the consumer price index (CPI) for all items less fresh food, the year-on-year rate of change since summer 2011 has been around 0 percent and is expected to stay at this level for the time being. Assuming that medium- to long-term inflation expectations remain stable, 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 in fiscal 2013 as the negative output gap improves. Thereafter, it will likely be not too long before the rate reaches the Bank's current "price stability goal in the medium to long term" of 1 percent. In the Bank's projection released in July 2012, the median of the Policy Board member's forecasts for the year-on-year rate of increase in the CPI (all items less fresh food) is 0.2 percent for fiscal 2012 and 0.7 percent for fiscal 2013.

## **C. *Risks to the baseline scenario***

The baseline scenario for Japan's economy described thus far is subject to both upside and downside risks. By far the most important risk is uncertainty regarding the outlook for overseas economies, and particularly the European debt problem. Although concerns about the stability of Spain's financial system had temporarily subsided thanks mainly to the agreement reached at the EU and eurozone summits, in order to fundamentally resolve the debt problem it is nevertheless necessary in Europe to break the underlying negative feedback loop among fiscal balances, the financial system, and economic activity. At the same time, it is crucial that countries on the European periphery, whose international competitiveness has declined, steadily work on fiscal and economic structural reforms. Moreover, as part of the efforts toward deeper integration in the euro area, discussions are ongoing within the EU with the aim of establishing a banking union and a fiscal union, and I believe it is important to press ahead with these steps. In this situation, if reforms make

steady progress, this would strengthen market confidence, which in turn would push up global economic growth. However, in core countries such as Germany, there are concerns that the financial burden of providing support to peripheral countries through, for example, greater fiscal integration would increase. Hammering out concrete steps, therefore, is likely to involve a great deal of complication. If in the meantime the European debt problem worsens, or the considerable sense of uncertainty continues for a prolonged period, this could weigh on the economic recovery in other areas such as the United States and China. External demand for Japan's exports is expected to once again become the driving force of Japan's economy after the earthquake-related reconstruction demand peaks out, but if exports remain sluggish, a virtuous circle may not take hold. For this reason, overseas economic developments warrant close attention.

Next, risks stemming from domestic factors include uncertainty with regard to reconstruction-related demand as well as both upside and downside risks in how medium- to long-term growth expectations will be affected by the supply and demand balance of electricity and by innovation in energy-related technology. Another issue is the sustainability of Japan's public finances, concerns over which restrain consumer spending due to anxiety about the future and affect long-term interest rates. Given that social security spending will continue to exert upward pressure on fiscal expenditure, it is necessary to push ahead with structural reform of public finances on both the expenditure and the revenue side and maintain the public's confidence in fiscal discipline. Efforts to restore Japan's public finances are underway and are something that I will keep a close eye on. Both upside and downside risks persist also in import prices, particularly international commodity prices.

## **II. Monetary policy**

Next, I would like to turn to the Bank's conduct of monetary policy under the current economic situation.

In order for Japan's economy to overcome deflation and return to a sustainable growth path with price stability, efforts to strengthen the economy's growth potential and support from the financial side are of the utmost importance. Based on this recognition, the Bank is currently providing support to raise Japan's growth potential through its fund-provisioning measure to support strengthening the foundations for economic growth, while at the same time pursuing powerful monetary easing continuously by steadily providing funds through, for example, purchasing financial assets. Moreover, the Bank is doing its utmost also to ensure stability in financial markets.

In what follows, I will explain the Bank's measures in greater detail.

### **A. Pursuit of powerful monetary easing**

I will begin with the Bank's pursuit of powerful monetary easing. In October 2010, the Bank introduced the comprehensive monetary easing policy, and has been easing financial conditions continuously since then. The comprehensive monetary easing policy consists of three measures: the implementation of a virtually zero interest rate policy by setting the target for the policy rate, the uncollateralized overnight call rate, at around 0 to 0.1 percent; the purchase of financial assets and funds-supplying operation through the Asset Purchase Program (hereafter the Program); and the clarification of the policy time horizon, that is, the clarification that these measures will remain in place until the Bank judges that price stability is in sight.

In this context, financial conditions in Japan have continued to ease. The overnight call rate has been below the 0.1 percent level. With regard to long-term interest rates, yields on Japanese government bonds (JGBs) with a remaining maturity of three years or less are 0.1 percent, and those on 10-year government bonds are at the lowest level in about nine years. Firms' funding costs have also declined moderately, as shown, for example, by the

fact that the average contracted interest rate on new loans and discounts is in the region of only 1 percent.

1. *Clarification of the policy time horizon based on “the price stability goal in the medium to long term”*

At the Monetary Policy Meeting held in February this year, the Bank introduced “the price stability goal in the medium to long term” as a part of its efforts to further clarify its determination to overcome deflation. “The price stability goal in the medium to long term” is the inflation rate judged by the Bank to be consistent with price stability sustainable over the medium to long term. At present, the Bank judges “the price stability goal in the medium to long term” to be within a positive range of 2 percent or lower in terms of the year-on-year rate of change in the CPI and, more specifically, sets a goal of 1 percent for the time being. On this basis, the Bank has stated that for the time being it will aim to achieve the goal of 1 percent inflation in terms of the year-on-year rate of increase in the CPI through the pursuit of powerful monetary easing, which I mentioned earlier. As you can see, by presenting its commitment regarding the policy time horizon, the Bank has further clarified its determination to pursue monetary easing.

2. *Expansion of the Asset Purchase Program*

The Program currently implemented by the Bank was established to further enhance monetary easing by encouraging a decline in longer-term interest rates and various risk premiums in a situation where there was little room for a further decline in short-term interest rates. Established on the Bank’s balance sheet, the Program is used to purchase various financial assets – such as government securities, CP, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs) – and to conduct fixed-rate funds-supplying operation. Since the establishment of the Program, the Bank has expanded its size successively, including in February and April of this year, so that the outstanding amount of asset purchases would reach about 65 trillion yen by around the end of 2012 and about 70 trillion yen by around the end of June 2013, thereby contributing to the pursuit of powerful monetary easing.

Furthermore, in April, in order to encourage a decline in longer-term interest rates, the Bank decided to extend the remaining maturities of JGBs and corporate bonds to be purchased under the Program from “one to two years” to “one to three years.” And in July, the Bank decided to remove the minimum bidding yields for outright purchases of treasury discount bills (T-bills) – which had previously been 0.1 percent per annum – and of CP in order to ensure that the outstanding amount of asset purchases under the Program would reach the planned amount. For the same reason, the Bank also revised the categories of assets purchased and loans provided through the Program. The outstanding amount of the Program stood at 53 trillion yen as of July 20, and the Bank will continue to proceed with powerful monetary easing by steadily increasing the outstanding amount of the Program by about 17 trillion yen by around end-June 2013. It is expected that the effects of the continuing purchases of financial assets under the Program will strengthen further as the economy recovers.

**B. *The Bank’s efforts to support strengthening 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).

The Bank introduced this measure in June 2010 to support strengthening the foundations for economic growth for the purpose of providing support for the critical challenge of enhancing the growth potential of Japan’s economy, and has been providing long-term funds at a low interest rate to financial institutions in accordance with their efforts in terms of lending and investment for strengthening the foundations for economic growth. The maximum duration of loans is four years, and the loan rate is currently set at 0.1 percent. The initial ceiling of the

outstanding amount of loans was set at 3 trillion yen. Subsequently, in June 2011, the Bank introduced a new lending arrangement of 500 billion yen for the measure, through which it extends loans to financial institutions for their equity investments and asset-based lending (ABL). The loans for ABL allow financial institutions to use their expertise to identify and lend to potential growth firms without conventional collateral or guarantees.

In March 2012, the Bank decided to further enhance the Growth-Supporting Funding Facility by (1) increasing the ceiling for the outstanding amount of loans from 3 trillion yen to 3.5 trillion yen; (2) establishing special rules for another new lending arrangement of 500 billion yen for small-lot investments and loans; and (3) establishing special rules for a new U.S. dollar lending arrangement of 12 billion U.S. dollars – equivalent to 1 trillion yen – using the U.S. dollar reserves already held by the Bank, for foreign currency-denominated investments and loans.

The outstanding balance of the total loans disbursed by the Bank, including those extended under the special rules, stood at approximately 3.2 trillion yen as of the beginning of June. The first disbursement of U.S. dollar loans under the special rules is to take place in September. A breakdown of financial institutions' individual investment and lending for strengthening the foundations for economic growth in the period April 2010–March 2012 by designated business area shows that 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,” but funds were also provided to business areas falling under the category of “others,” such as lending or investment to revitalize local industries. A wide range of financial institutions have been making a variety of efforts targeting their specific customer base or the region they serve, such as establishing new dedicated funds to support economic growth, so that the amount of lending and investment actually provided by financial institutions using the Growth-Supporting Funding Facility greatly exceeds the amount of loans disbursed by the Bank. The Bank, with its steady disbursement of loans, will continue to support the flow of funds to growth areas in order to contribute as much as possible as the central bank of Japan toward strengthening the foundations for economic growth.

### **C. *Measures to ensure financial market stability***

In addition to pursuing the measures just described, the Bank has been doing its utmost to ensure financial market stability by making use of various funds-supplying operations. Immediately after the earthquake in March 2011, the Bank provided ample funds on an unprecedented scale, exceeding the amount provided immediately following the Lehman shock. When the European debt problem worsened at the end of November 2011, the Bank lowered interest rates on U.S. dollar funds-supplying operations as part of coordinated measures among six major central banks in order to ensure stability in financial markets. At the same time, the central banks agreed to establish bilateral swap arrangements enabling the provision of liquidity in any of their currencies in addition to the already available U.S. dollar.

## **III. *Issues related to strengthening the growth potential of Japan's economy***

### **A. *The importance of strengthening the growth potential to overcome deflation***

Earlier, I touched on the Bank's efforts to support strengthening the growth potential of Japan's economy. Let me elaborate on the challenges we face in strengthening the growth potential. Japan's economic growth rate has been trending down due to the effects of the low birth rate and the aging of the population as well as to a decline in its international competitiveness. Consumption and investment have been restrained as a result of a decline in households' and firms' growth expectations, so that aggregate domestic demand has remained below the aggregate supply capacity of the economy for a prolonged period, exerting downward pressure on prices. With economic activity picking up,

the output gap – that is, the difference between aggregate supply capacity and aggregate demand – has recently been narrowing. Nevertheless, aggregate demand continues to fall short of aggregate supply capacity by about 2 percent. While price developments are subject to various factors, including developments in international commodity prices, in order for Japan's economy to overcome deflation it is important to address the problem of insufficient demand, which is the key factor underlying deflation in Japan. At the same time, in order to achieve sustainable economic growth amid the low birth rate and aging of the population, it is important to maintain sufficient supply capacity to meet new sources of demand.

## ***B. Capturing global demand and creating demand through innovation***

To resolve the problem of insufficient demand, it is essential to capture global demand, including demand from emerging economies, and to tap latent demand both at home and abroad.

With respect to capturing global demand to overcome the shortage of demand at home, in addition to making efforts to increase exports it is important to increase income from overseas investment. While income from foreign direct investment is not included in GDP, it does contribute to gross national income (GNI). Moreover, advances in the international division of labor likely contribute to strengthening the economy's growth potential through the associated increase in exports of related goods and the shift of the domestic labor force into areas with growth potential.

Tapping latent demand, the other essential element in addressing insufficient demand, also requires efforts on a continuous basis. Markets for new types of goods and services usually grow only slowly at the initial stage. They then enter a phase of rapid growth until demand is saturated and growth slows again. In order to maintain the growth potential of the economy as a whole, it is therefore important to continuously secure demand both at home and abroad. To this end, it is necessary to accelerate innovation that taps latent demand for goods and services and consequently creates demand, which will give depth to areas with growth potential. The demographic change resulting from the low birth rate and the aging of the population is also prompting changes in the demand structure. For example, consumption expenditure by households headed by a person aged 60 years or older, including the baby-boomer generation, now accounts for more than 40 percent of total private consumption. Therefore, an important challenge is to supply goods and services that meet the needs of this generation in a timely manner.

Corporate profits and business sentiment at Japanese firms have been on an improving trend recently. This reflects not only the positive effects of subsidies and earthquake-related reconstruction demand, but in my view also shows that firms' active efforts to tap latent demand and address social challenges are paying off. Examples are businesses targeted at the elderly and in the areas of information and telecommunications as well as environment and energy, where challenges in terms of energy creation, energy saving, and energy storage need to be addressed with urgency. For example, in the automobile industry, environmentally friendly cars – such as hybrid cars with better environmental efficiency – have been selling briskly, and it is expected that related markets, such as those for rechargeable batteries, will also expand. In the field of information and telecommunications, smartphones are coming into widespread use, providing the infrastructure for not only the distribution of digital books and music but also a whole range of new services. One example is the use of the Internet and the Global Positioning System (GPS) to provide services such as giving information on cafes and restaurants in the vicinity and guiding smartphone users there. In the convenience store industry, the number of stores was said to be near saturation at one time. However, by expanding the range of products and services aimed at women and the elderly, such as introducing home deliveries, convenience stores have been able to increase their sales per store. Looking ahead, it is extremely important that efforts toward innovation do not come in spurts but are sustained across a wide range of fields.

### **C. *Maintaining the labor supply and improving productivity***

In order to strengthen Japan's growth potential, it is also important to ensure that supply capacity is commensurate with demand. While the recent employment situation has been on an improving trend, labor supply still exceeds demand. There still remain problems that need to be solved, such as the extremely severe employment conditions for the young. However, Japan's working age population will continue to decline, and in the medium to long term labor supply may fall short of demand. Economic growth can be decomposed into two components: the rate of growth in the number of workers and that in productivity per worker. Assuming that the labor force participation rate remains unchanged, the negative growth contribution of the decline in the number of workers is forecast to increase to around 1.0–1.5 percent by the 2030s. Meanwhile, the average annual increase in labor productivity has been around 1 percent in recent years, so if things remain the same, Japan's potential growth rate will fall into negative territory.

In order to mitigate the impact of these developments as much as possible, with regard to the labor force, it is important to increase labor market flexibility to allow workers to change industries more easily and to boost labor market participation of the elderly and of women who wish to work but are not currently working. On the other hand, regarding labor productivity growth, this is actually quite high in Japan when compared with other major countries and may be difficult to raise further. However, since labor productivity is the ratio of aggregate value added to labor input costs, productivity growth could be improved if growth areas provide sufficient opportunities for the creation of high-value-added goods and services, so that firms can generate sufficient profits. This could then produce forward momentum through generating income, thus mitigating the impact of the decline in the working-age population.

Given that Japan has a low birth rate and the fastest aging population in the world, achieving such a strengthening of the growth potential is extremely difficult and represents a challenge that requires the efforts of the nation as a whole, since it requires raising demand, labor supply, and productivity to the limits of Japan's potential. Based on this perspective, the Japanese government has compiled the "Strategy for Rebirth of Japan" to create an environment allowing firms to meet the challenges of the task. The strategy places priority on eleven areas. These areas include "green innovations," which focuses on Japan's aim to lead the world in the energy revolution and create new industries and employment related to this field; "life innovations" with the aim of turning businesses related to medical services and nursing care into growth industries, fostering new related industries and markets, and developing markets overseas; human resources development; and turning Japan into a tourism nation. In order to boost the efforts undertaken by firms, support from the financial side is essential, in addition to the creation of the right environment. With this in mind, the Bank will continue exerting itself in its role together with firms, financial institutions, and the government.