# Ryuzo Miyao: Economic activity, prices, and monetary policy

Speech by Mr Ryuzo Miyao, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Yamaguchi, 5 September 2012.

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## Introduction

Thank you for giving me this opportunity to exchange views with people representing Yamaguchi Prefecture, who have taken time to be here despite their busy schedules. Allow me to also express my gratitude for your cooperation with the activities of the Bank of Japan's Shimonoseki Branch.

Today I will review economic activity and prices in Japan, whose economy is heading toward recovery despite the effects of the global economic slowdown, and then discuss the Bank's monetary policy. My concluding remarks will touch briefly on the economy of Yamaguchi Prefecture. Following my speech, I would like to listen to your views on the actual situation of the local economy and your candid opinions.

## I. Recent developments in economic activity and prices

### *A. Overview*

After the turn of the year, economic activity in Japan started picking up moderately; domestic demand has been firm, supported mainly by reconstruction-related demand and policy effects. While overseas economies as a whole are still in a deceleration phase, domestic economic activity has also been firm. Domestic demand – including private consumption, public investment, and housing investment – has been improving and this improvement has compensated for a delay in recovery in production and exports due to a slowdown in external demand.

As for the outlook, while Japan's economy is expected to return to a moderate recovery path as domestic demand remains firm and overseas economies emerge from their deceleration phase, there is an increasing risk that a recovery in overseas economies will be delayed, which warrants attention.

I will first review the recent developments in overseas economies, followed by the current situation of and the outlook for Japan's economy.

### *B. Overseas economies*

Economic sentiment, mainly in the corporate sector, has become cautious globally, and there is an increasing risk that the slowdown in the global economy will be a protracted one.

In the European economy, particularly in Spain, Italy, and other peripheral countries, an adverse feedback loop encompassing the fiscal situation, the financial system, and the real economy has been operating, and a sense of stagnation has been increasing as a whole. In addition, given that a decline in demand in peripheral countries has started to affect household and business sentiment in core countries such as Germany, partly through a decline in intra-regional exports, and that long-term interest rates in Spain and Italy have remained high, there appears to be an increasing risk that economic recovery will be delayed.

As for the European debt problem, since the Greek crisis that began in May 2010, for more than two years a process has continued in which governments respond only intermittently to pressure from the markets. If this process continues into the future, stagnation in peripheral countries might start to feed back into core countries and the stagnation in the European economy might become even more prolonged and aggravated, weighing on the global economy. This is a matter of concern.

Looking at the background of this problem from a longer-term perspective, we need to recognize the merits and demerits of the single-currency euro in the 13 years since its introduction. On the merit side, one can point out that the absence of foreign exchange risks within the region and reduced transaction costs stimulated intra-regional trade and investment, and that the converging low level of interest rates in member countries for more than ten years induced an expansion in economic activity. On the demerit side, one can point out that the converging low level of interest rates encouraged loose fiscal spending, and this, together with an optimistic economic outlook, led to a bubble in the real estate market. In addition, necessary structural reforms, including labor market reform aimed at containing labor costs, did not progress and the disparity in competitiveness within the region was left unaddressed. In a sense, we can say that the European debt problem represents the surfacing of the demerits accumulated over a period of more than ten years, so it should not be a surprise that the resolution of the problem will take a long time.

Having said this, with an aim of resolving the problem as quickly as possible, it is necessary for European leaders to respond appropriately to the challenges, such as improving fiscal conditions in peripheral countries and enhancing growth in Europe, as well as to present a specific roadmap for the longer-term challenges of forming a banking union, issuing Eurobonds, and pursuing fiscal integration, and thereby dispelling uncertainties regarding the euro zone economies. In this regard, while some gradual achievements have been made, the European leaders are expected to show further leadership.

While the U.S. economy has been recovering moderately, supported by accommodative financial conditions, the pace of the recovery seems to be slowing somewhat. The real GDP growth rate for the April-June 2012 quarter (seasonally adjusted; the annualized growth rate compared with the previous quarter) rose to only 1.7 percent, and growth decelerated in domestic demand, including private consumption, business fixed investment, and housing investment. While economic indicators since July have been mixed, what concerns me is that there seem to be signs of weakening in the buoyant corporate sector, which has been supporting the recovery in the household sector.

Let me amplify this point. In the household sector, private consumption has been firm on the back of moderate improvement in employment and income, and housing starts and sales have shown signs of bottoming out, while a balance-sheet adjustment has been progressing as seen in a gradual decline in the ratio of debt to disposable income. On the other hand, in the corporate sector, sluggishness in exports and deterioration in business confidence have become apparent, reflecting the European debt problem and a slowdown in the Chinese economy. So far, given that corporate profits and business fixed investment have been firm and the household sector has been generally solid, it seems that the recovery mechanism originating from the corporate sector remains active. However, I recognize that attention should be paid to the possibility that employment and business fixed investment will be hampered by a further worsening in business confidence, thereby leading to an economic slowdown.

As for a future risk to the U.S. economy, in addition to a delayed economic recovery in Europe and China, I would point to the “fiscal cliff” problem. While a cut in fiscal spending and expiration of a tax reduction are downside factors for economic activity, the range and size of the factors are highly uncertain at present, and are factored into the U.S. economic outlook differently by private research institutions. Some point out that because of uncertainty associated with the problem, firms have already been deferring investment and new hiring, and we need to be alert to how the situation will evolve going forward.

In the meantime, in U.S. financial markets, stock prices have bounced back to a level prior to the Lehman shock, and long-term interest rates – despite rising somewhat – have generally been hovering at low levels.

As for the Asian emerging economies, a decelerated pace of growth has become somewhat protracted due to the recent slowdown in exports to Europe, but the economies are likely to pick up the pace of growth led by China. Attention should be paid, however, to the possibility that the timing of a recovery will be delayed to the autumn or later.

As for the Chinese economy, the effects of the authorities' policy measures have started to emerge, including an increase in new lending and the bottoming out in housing prices, but future economic indicators need to be monitored carefully, since stagnation in the European economy has been spreading to the Chinese economy through trade and concern over an increase in inventories has not been dispelled.

As for the NIEs and the ASEAN economies, domestic demand has been strong, but it is a matter of concern that indicators related to exports and production have recently been sluggish or deteriorating in economies like South Korea and Taiwan. I believe that a key to the future of these economies will be whether China regains its pace of growth and their exports recover.

From a longer-term perspective regarding the sound development of the global economy, it is critical that the Asian emerging economies maintain a balance between economic growth and price stability. In particular, for China – which is expected to lead the global economy together with the United States – careful attention should be paid to future developments, including whether economic policy management is maintained smoothly following the appointment of the new Chinese leadership.

### *C. Economic activity and prices in Japan*

In Japan, economic activity as a whole has been picking up moderately, with domestic demand improving mainly due to reconstruction-related demand and policy effects, which has compensated for a delay in recovery in production and exports due to a slowdown in external demand. The real GDP growth rate (seasonally adjusted; the annualized growth rate compared with the previous quarter) was high at 5.5 percent in the January-March 2012 quarter and maintained steady growth in the April-June quarter at 1.4 percent.

To elaborate on this, amid the continued slowdown in overseas economies, a pick-up in exports has been slowing and production – affected by the slowdown in exports – has also been relatively weak. As for domestic demand, public investment has continued to increase and business fixed investment has been on a moderate increasing trend with improvement in corporate profits. Private consumption has continued to increase moderately due partly to the effects of measures to stimulate demand for automobiles, and housing investment has generally been picking up.

At the same time, there are signs of concern. There is some inventory stockpiling on the back of the continued slowdown in exports and production; machinery orders, a leading indicator of business fixed investment, have shown signs of weakening; the coincident index in the Indexes of Business Conditions has been shifting from "improving" to "weakening"; and indicators of business sentiment are showing signs of weakening. While the economy as a whole has been improving, causes for concern seem to have increased in number.

As for the outlook, Japan's economy is expected to return to a moderate recovery path as domestic demand remains firm and overseas economies emerge from their deceleration phase. Such a scenario can be confirmed in the forecasts of the majority of the Policy Board members; in terms of the median forecast as of July 2012, real GDP was projected to grow at 2.2 percent in fiscal 2012 and 1.7 percent in fiscal 2013.

These forecasts are associated with upside and downside risks, and I am paying greater attention to the downside risks, as follows.

First, there is a risk of overseas economies slowing further. As I have already mentioned, the risk that the economic slowdown in Europe, the United States, and Asia will become protracted has increased somewhat, and if the slowdown actually becomes protracted, it will weaken Japan's move toward a self-sustaining recovery in which increases in exports and production lead to an increase in income and spending.

Second, there is a risk of further appreciation of the yen. While a positive case can be made for yen appreciation to a certain extent, excessive appreciation will worsen the competitiveness and profits of exporting firms again and act as a headwind against firms. If a trend of falling stock prices intensifies, together with the trend of yen appreciation, then firms' and households' confidence will deteriorate and currently solid business fixed investment plans and private consumption will be contained, which will weigh on Japan's economic recovery.

Third, there is a risk related to the first and second risks: a risk that the timing of recovery in exports and production will be delayed and the transition from domestic demand to external demand will not occur as expected. Since subsidies for environmentally friendly cars have already used a large portion of the budget and growth in reconstruction-related demand is likely to slow down from the second half of fiscal 2012 onward, we need to carefully monitor whether external demand will recover by compensating for a slowdown in domestic demand. In addition, attention should be paid to whether ambitious business fixed investment plans will be steadily implemented and whether the moderate improving trend in employment and income conditions will be maintained.

In the meantime, consumer prices (all items less fresh food; on a year-on-year basis) have so far been hovering around 0 percent in 2012. A baseline scenario for the outlook for prices is that the year-on-year rate of change in consumer prices will hover around 0 percent for the time being, and subsequently increase moderately as aggregate supply and demand balance improves. In the forecasts of the majority of the Policy Board members, in terms of the median forecast as of July 2012, the year-on-year rate of increase in consumer prices was projected to be 0.2 percent in fiscal 2012 and 0.7 percent in fiscal 2013.

While there are also upside and downside risks to prices, I am paying greater attention to downside risks, given that concern over the economic outlook has been increasing and a decline in commodity prices during the first half of fiscal 2012 will put downward pressure on prices for the time being. Attention should also be paid to the effects of the continued low short-term inflation expectations on future price developments.

## II. Monetary policy

### *A. Conduct of monetary policy*

Let me now discuss the Bank's efforts to enhance monetary easing. The Bank introduced comprehensive monetary easing in October 2010, and has subsequently been enhancing monetary easing. Comprehensive monetary easing comprises three measures: the virtually zero interest rate policy of maintaining the uncollateralized overnight call rate at around 0 to 0.1 percent; purchases of financial assets through the Asset Purchase Program (hereafter the Program); and the clarification of the policy time horizon, that is, the clarification that such measures will remain in place until the Bank judges that price stability is in sight.

At the February 2012 Monetary Policy Meeting, to further clarify the Bank's stance toward overcoming deflation, it introduced "the price stability goal in the medium to long term." That is an inflation rate the Bank judges as consistent with price stability sustainable in 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 at 1 percent for the time being." On this basis, the Bank will continue pursuing powerful easing until it judges that the 1 percent goal is in sight.

The Program was established with the aim of encouraging a decline in longer-term interest rates and various risk premiums mainly through the purchase of financial assets. The Bank established the Program on its balance sheet and has been purchasing various financial assets, such as government securities, commercial paper (CP), corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs) as well as conducting the fixed-rate funds-supplying operation against pooled collateral. Since its establishment, the total size of the Program has been increased from time to time. It was expanded further in February and April this year, and at present the Bank is scheduled to increase the outstanding amount of the Program to about 65 trillion yen by around end-2012 and to about 70 trillion yen by around end-June 2013, thereby pursuing powerful monetary easing. In particular, for asset purchases, the total size has expanded from 5 trillion yen at the time of introduction to 45 trillion yen, and the purchase of long-term government bonds has increased substantially from 1.5 trillion yen to 29 trillion yen.

At the April Monetary Policy Meeting, the Bank decided to extend the remaining maturity of government bonds and corporate bonds to be purchased under the Program from "one to two years" to "one to three years." In addition, in July, with the aim of ensuring that the target outstanding amount of the Program is met, the Bank removed the minimum bidding yield (previously 0.1 percent per annum) for outright purchases of treasury discount bills and CP, and revised the composition of the Program. The outstanding amount of the Program as of August 20, 2012 stood at about 58 trillion yen, and a further increase of about 12 trillion yen will be necessary by around end-June 2013. The Bank will continue to steadily increase the outstanding amount of the Program as scheduled.

Under such powerful monetary easing, market interest rates have been at extremely low levels. The overnight call rate has been at a level below 0.1 percent, yields of government bonds with remaining maturities up to three years are around 0.1 percent, and yields on 10-year government bonds are at the extremely low level of around 0.8 percent. As for firms' funding costs, the average contracted interest rates on new bank loans and discounts have declined to about 1 percent and spreads of corporate bonds and CP have been stable at low levels. As a result, financial conditions viewed from the fund-raising side have been accommodative.

## B. Monetary policy and long-term interest rates

In considering the effects of such monetary easing, let me summarize the relationship between monetary policy and long-term interest rates. This is also important for understanding the background of the current historic low levels of long-term interest rates in advanced countries.

Let us recall how long-term interest rates are determined. Long-term interest rates are considered to be determined mainly by two factors: first, the forecast of future short-term interest rates, and second, an extra interest rate required for risk associated with long-term bond investment. Regarding the first factor, if the future economic growth rate or the future inflation rate is forecasted to increase, for example, then the future path of short-term interest rates will rise accordingly and one can expect a higher return by investing repeatedly in short-term bonds. As a result, demand for long-term bonds will decline and prices of the bonds will fall and yields will increase. As for the second factor, long-term bond investment is associated with risks. It might become necessary to exchange bonds for cash before maturity is reached, and in such a case there will be uncertainty about the selling price. As compensation for taking such risks, an extra yield – the risk premium or term premium – is required and the long-term interest rate will rise to that extent.

Based on such a mechanism, let me summarize the effects of a central bank's asset purchases, more specifically purchases of long-term government bonds, in two parts.

First, there is the effect through the aforementioned risk premium, which focuses on supply and demand in asset markets. This effect is called the "portfolio balance channel." When a central bank purchases government bonds in the bond market and absorbs the amount of bonds in circulation, the bond price will rise and the yield will decline. In this case, as the price change is due to the supply and demand factor, the risk premium will decrease and long-term interest rates or longer-term interest rates in general will fall.

Second, there is the effect through the risk-neutral forecast of future short-term interest rates. If an implementation or announcement of a nontraditional policy action of asset purchases is interpreted as a signal that a central bank's economic and price forecasts have worsened further, then the forecasted duration of a zero interest rate might lengthen and the future path of short-term interest rates will decline, and longer-term interest rates – mainly in the short- to medium-term zone – will decline accordingly. Or if a central bank's asset purchases are received as a signal that a central bank's future policy stance has changed – for example, a central bank takes more aggressive policy responses in the face of developments in economic activity and prices, or there is an adjustment in the policy goal – the forecasted path of short-term interest rates will decline, and longer-term interest rates – mainly in the short- to medium-term zone – will decline accordingly.

Both of these effects encourage a decline in longer-term interest rates. What is more important, however, is whether such a decline leads to an improvement in a wider range of financial conditions and, through an increase in spending, eventually stimulates economic activity and prices. If such transmission mechanism is forecasted to work, then it will put upward pressure on long-term interest rates in terms of both effects.

Let me elaborate on this point. As one effect of a decline in longer-term interest rates due to government bond purchases, it is expected that confidence will improve among investors, firms, and households, thereby encouraging a shift of investment from government bonds and other safe assets to a wider range of risk assets, such as corporate bonds, equities, and overseas assets, and this in turn will lower risk premiums of these assets and increase asset prices. This can be considered a portfolio balance effect in a broad sense and means an improvement in wide-ranging financial conditions. In such a situation, demand for government bonds will decline and there will be a certain amount of upward pressure on term premiums of government bonds (that is, a rise in the extra interest rate required for risk associated with long-term bond investment). In addition, if spending is forecasted to increase with a longer and variable time lag, thereby stimulating economic activity and prices, it will shift upward the forecast path of short-term interest rates, steepen the yield curve, and put upward pressure on long-term interest rates (that is, a rise in the forecast of future short-term interest rates). While encouraging a decline in longer-term interest rates on one hand and expecting a rise in long-term interest rates in the longer run on the other hand seems contradictory at first glance, in fact it is nothing of the kind.

Then, how should we understand the fact that long-term interest rates in advanced countries have been hovering at historic low levels? It seems that a declining trend in these countries' long-term interest rates involves the effects of powerful monetary easing, including asset purchases.

More recently, the trend of risk aversion on the back of concern over a slowdown in the global economy and the European debt problem has been further encouraging a decline in long-term interest rates. Some say that a 1 percent yield on 10-year government bonds in the United States and Europe is quite low, based on a general recognition of the long-term potential growth rate and inflation expectations. In the United States, the level of the target policy interest rate in the longer run is expected to be about 4 percent, according to the economic projections by Federal Open Market Committee (FOMC) members. If such views are correct, this can be interpreted to mean that risk aversion, or a preference for safety, in the government bond markets has been firmly maintained. And this might work as a headwind for what I mentioned earlier, the transmission mechanism of stimulating economic activity and prices through the portfolio balance effect in a broad sense.

Naturally, greater attention is warranted as to whether the current sources of concern regarding the slowdown in the global economy and the European debt problem will return to normal or continue to weigh on the global economy and cause further deterioration.

### *C. The need to strengthen growth potential*

For Japan's economy to overcome deflation and return to a sustainable growth path, both support from the financial side and efforts to strengthen growth potential are necessary. Thus far, I have discussed support from the financial side. To strengthen growth potential, it is important for every member of society, from his or her standpoint, to make positive efforts steadily to boost growth potential. Such steps will also help increase the stimulative effect of powerful monetary easing on economic activity and prices.

Of course, to genuinely strengthen growth potential, a certain period of time is necessary, since such efforts need to occur in concert with other measures, including implementation of economic and fiscal structural reforms. This is obvious even without citing the example of Europe, and if growth potential increases through the simultaneous pursuit of aggressive efforts from the financial side to overcome deflation and economic and fiscal structural reforms, it will lead to favorable effects on the fiscal side, including an increase in tax revenue.

In this regard, in July 2012, the government compiled the Comprehensive Strategy for the Rebirth of Japan, which prioritizes key issues. These comprise policy packages such as the "Green Growth Strategy" (aimed at realizing an innovative energy and environment-oriented society), the "Health/Life Science Growth Strategy" (aimed at achieving a society with the world's leading health and medical care and welfare), and the "Agriculture, Forestry and Fisheries Revitalization Strategy" (which seeks to double the vitality of regions driven by agriculture, forestry and fisheries). The government has presented specific strategies and their timetable. In addition, bills related to the comprehensive reform of the social security and taxation systems passed recently in both the House of Representatives and the House of Councillors, marking an important step forward in maintaining public confidence in medium- to long-term fiscal sustainability.

The Bank has also been implementing the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth, and has been supporting financial institutions' individual initiatives. The measure provides long-term funds for up to four years at a low interest rate – currently 0.1 percent – to financial institutions carrying out lending and investment in growth areas, and was launched in June 2010 with the initial ceiling on the outstanding amount of loans at 3 trillion yen. Subsequently, the Bank introduced a new lending arrangement for the measure, through which it extends loans to financial institutions for their equity investment and asset-based lending (ABL) without conventional collateral or guarantees. This year, the Bank increased the ceiling for the outstanding amount of loans under the main rules for the measure from 3 trillion yen to 3.5 trillion yen, and established special rules for another new lending arrangement for small-lot investments and loans as well as for a new U.S. dollar lending arrangement. The current outstanding balance of the total loans disbursed by the Bank, including those extended under the special rules, is approximately 3.3 trillion yen. The Bank will continue to do its utmost to contribute to strengthening the foundations for economic growth.

I have now discussed recent monetary policy in Japan. In the actual conduct of monetary policy, the outlook for economic activity and prices should be carefully examined and, if judged necessary, meticulous and decisive measures should be taken. The Bank will continue to steadily pursue powerful monetary easing by increasing the outstanding amount of the Asset Purchase Program as scheduled. The Bank will strive to conduct proper monetary policy, and closely monitor developments in international financial markets and do its utmost to ensure the stability of the financial system in Japan.

### Concluding remarks: The economy of Yamaguchi Prefecture

My conclusion will touch on the economy of Yamaguchi Prefecture.

In my view, the economy of Yamaguchi Prefecture enjoys a number of competitive advantages. The first is its location, since it is close to other East Asian countries where demand has been expanding markedly. Second, it enjoys a concentration of basic materials industries with growth potential – mainly the chemical industry, which accounts for more than 40 percent of the industrial production index. And third, the prefecture has the nation's highest labor productivity, mainly in basic materials industries.

Recently the region has experienced a series of negative events, such as accidents at the plants of major chemical manufacturers, together with the withdrawal and closure of factories of several electronics components manufacturers. On the positive side, however, amid concern over the hollowing out of domestic industries due partly to the appreciation of the yen at the national level, firms in the prefecture as a whole – comprising mainly manufacturers – have maintained their vigorous investment stance. In fact, the Bank's Shimonoseki Branch's *Tankan* (Short-Term Economic Survey of Enterprises in Japan), released on July 2, showed that the business fixed investment plan of Yamaguchi Prefecture's firms for fiscal 2012 was likely to maintain a substantially higher growth rate than that of Japan as a whole. The prefecture recorded a year-on-year growth rate of 12.4 percent, compared with Japan's a year-on-year growth rate of 4.0 percent. In fiscal 2011, the business fixed investment plan of the prefecture's firms also exceeded that of Japan.

As specific examples of this, in fields related to chemicals, next-generation energy, and medical care, there have been moves among local firms to pursue overseas expansion in existing fields with potential for an increase in global demand in the medium to long term, and some local firms are actively conducting additional investment to increase capacity or research and development in high-value-added areas with potential for growth. For example, in connection with the growing need for energy conservation by firms and households, small and medium-sized construction firms have entered the geothermal air-conditioning business. An increasing number of firms have been making such moves. I expect that local firms, by utilizing their characteristics and strengths, will proceed with reforms to nurture new areas with potential for growth, achieving further development.

In addition, Yamaguchi Prefecture enjoys extremely bountiful resources for tourism, with numerous attractive sightseeing areas as well as scenic spots and historic sites, and many excellent structures, including the historic Kintai Bridge, which harmonizes beautifully with its surrounding natural landscape. Efforts are proceeding to draw on these ample resources for tourism, mainly by the prefectural government and cities, and thereby promote the tourism industry. I expect that by coordinating its regional characteristics and strengths, the tourism industry will generate further momentum.