Masaaki Shirakawa: Toward sustainable growth with price stability

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the Kisaragi-kai Meeting, Tokyo, 12 November 2012.

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Introduction

It is a great honor to have the opportunity to address you today.

As you are well aware, the Bank of Japan undertook further aggressive monetary easing for two months in a row, in September and October 2012. Today, I will begin by explaining these policy measures while outlining our assessment of the underlying economic activity and prices. I will then discuss various issues regarding deflation and monetary policy conduct and explain our thinking behind these issues.

I. Developments in overseas economies

Let me start with developments in overseas economies. Overseas economies entered a deceleration phase in the second half of 2011. Recently, many countries and regions – in particular, their manufacturing sectors – have moved deeper into that phase. As forecasts by international organizations and economists in the private sector show, the outlook for the global economy has been downwardly revised rapidly since this summer (Chart 1). There are two factors behind this.

First, the effects of the European debt problem have been spreading. Since the second half of 2011, concern about government debt stemming from Greece has spread to Spain and Italy. As a result, the negative feedback loop among fiscal balances, the financial system, and the real economy is in effect. Since the beginning of 2012, such negative effects have spread to core countries such as Germany. The real GDP growth of the euro area remained negative for three consecutive quarters, from October–December 2011 through April–June 2012, and it is believed that negative growth cannot be avoided for the July–September quarter. As such, the effects of the economic recession in Europe have been exerting downward pressure on the global economy not only through a decline in trade activities – a direct channel – but also through cautious business activities resulting from heightening uncertainty.

Second, the deceleration in the Chinese economy has been more prolonged than expected. In China, exports to Europe have declined and private real estate investment has slowed. Against the backdrop of such weakening of demand at home and abroad, inventory adjustment has been prolonged, especially in materials industries with excess production capacity. While the annualized real GDP growth rate is still somewhat high, it has been declining for seven consecutive quarters through this past July–September. In response, authorities have carried out economic stimulus measures on the monetary and fiscal fronts. So far, however, they appear to maintain a cautious policy stance toward achieving sustainable growth even when they are at the crossroads of changing their policy stance toward easing, partly based on past experience – namely, the large-scale policy measures following the Lehman shock that in the end brought about an excess in capacity and overheating in the real estate market.

At the G-20 meeting that I attended last week, it was noted that economic activities in some regions have reportedly stopped deteriorating and started to show signs of stabilization. On the whole, however, my impression is that momentum for recovery in the global economy following the Lehman shock has been weak. Looking back at where we came from, strong growth in the United States and Europe toward the mid-2000s owes much to the credit bubble, which had reached an unprecedented level, and the amount of debt in the private sector has increased markedly (Chart 2). At present, the United States and Europe are in the process of adjusting excess debt, and until such adjustment is completed, these economies will suffer from a low growth rate, based on our experience from the aftermath of the bubble bursting. Indeed, from the perspective of the recovery in real GDP after the bursting of bubbles, economic performance in the United States and Europe has been worse to date in those economies than that of Japan after its bursting of the bubble, notwithstanding the aggressive monetary policies of central banks, including the Federal Reserve (Chart 3).

Based on such recognition, overseas economies are likely to remain in a deceleration phase for the time being, but will gradually emerge from that phase and turn toward a moderate recovery thereafter. Factors behind this scenario include an improving trend in U.S. housing investment, reflecting the bottoming-out of house prices, and monetary easing effects underpinning momentum for recovery. As for the European debt problem, a safety net has been put in place, which includes such moves as the European Central Bank (ECB)'s decision to launch a new government bond purchasing program and the establishment of the European Stability Mechanism (ESM). Against this background, a number of policy measures for economic and fiscal reform are expected to make progress gradually, which would improve business and household sentiment. In China, the effects of economic policy measures as well as continued inventory adjustment are expected to materialize. In fact, in its projections for global economic growth released last month, the International Monetary Fund (IMF) has forecasted that the global economy will gradually post higher growth, from 3.3 percent in 2012 to 3.6 percent in 2013, and further to 4.1 percent in 2014.

I fully recognize, however, that such projections regarding overseas economies rest on considerable uncertainties, including future developments in the European debt problem, the outcome of the problem surrounding the "fiscal cliff" in the United States, and the likelihood of economic deceleration in China being prolonged further. The Bank will closely monitor these developments.

II. Developments in Japan's economy

Next, I will outline the current situation of and the outlook for Japan's economy, taking into account the developments in overseas economies I have touched upon.

As for recent developments, exports have shown a marked decline in the July–September quarter of 2012 following a rapid increase in April–June, and industrial production has decreased for two consecutive quarters, as overseas economies have moved deeper into the deceleration phase. Looking at exports by destination, those to the European Union (EU) have been declining for four consecutive quarters and those to China have recently shown a notable decline (Chart 4). The implications of the relations between Japan and China have begun to affect Japan's economy, reflected in areas such as trade activities and tourism. Whether the implications of Japan's relations with China will expand any further requires close attention.

In contrast, domestic demand had been relatively firm on the whole until recently, mainly against the background of an increase in demand related to reconstruction following the Great East Japan Earthquake. Effects of the weakness in exports have gradually appeared in the employment situation, however, as seen in the fact that the number of new job offers in the manufacturing sector has been negative on a year-on-year basis since June. Private consumption has also lost some of its momentum compared with the period leading up to early summer, partly due to the ending of subsidies for the purchase of environmentally friendly cars. As for business fixed investment, firms' investment plans for fiscal 2012 in the September *Tankan* (Short-Term Economic Survey of Enterprises in Japan) have posted relatively high growth for that time of year. Nevertheless, attention needs to be paid to whether firms might abandon their business fixed investment plans. Taking this situation into account, the Bank has continued to revise downward its assessment of Japan's economy as a whole, and assessed at the Monetary Policy Meeting on October 30 that the economy has been "weakening somewhat."

Going forward, developments in Japan's economy will basically depend on those in overseas economies. Using the outlook for overseas economies I mentioned earlier as an assumption basis, Japanese economic activity is expected to be more or less flat for the time being. Exports and production are likely to remain relatively weak for the time being, and domestic demand as a whole is unlikely to increase at a pace that will outperform the weakness in exports.

Under such circumstances, the Bank decided to undertake further aggressive monetary easing at the Monetary Policy Meeting on October 30. As for the outlook for economic activity after incorporating the effects of such monetary easing and those of the government's efforts to invigorate the growth potential, the economy, which will be more or less flat for the time being, is expected to return to a moderate recovery path in due course. Expressing this in numerical terms, the median of the Bank's nine Policy Board members' forecasts for the annualized growth rate is 1.5 percent, 1.6 percent, and 0.6 percent for fiscal 2012, 2013, and 2014, respectively (Chart 5). Reflected in these figures, however, are the effects of the front-loaded increase and subsequent decline in demand prior to the consumption tax hike, and adjustment of such effects brings the median of the forecasts to 1.0–1.5 percent for both fiscal 2013 and 2014. The output gap is therefore expected to improve steadily, given that these forecast figures exceed the potential growth rate, which appears to be around 0.5 percent.

This naturally affects price developments as well. The year-on-year rate of change in the consumer price index (CPI) for all items less fresh food is currently around 0 percent. It is expected to hover around that level for the time being, but will start rising gradually thereafter as the output gap that I just mentioned narrows. In terms of the median of the Policy Board members' forecasts, figures for fiscal 2012 and 2013 are –0.1 percent and 0.4 percent, respectively, and 0.8 percent for fiscal 2014 excluding the effects of the consumption tax hike (Chart 6). The Bank publishes, in a numerical form, "the price stability goal in the medium to long term," which is the inflation rate that it aims to achieve in conducting monetary policy. In concrete terms, the Bank judges "the price stability goal in the medium to long term" to be in a positive range of 2 percent or lower in terms of the year-on-year rate of change in the CPI, and has set a goal of 1 percent for the time being.[1] The Bank is determined that it will continue with the current powerful easing until it judges the 1 percent goal to be in sight, but on the condition that it identifies no significant risk to the sustainability of economic growth, such as from the accumulation of financial imbalances. The forecast that I have provided suggests that, in fiscal 2014, it appears likely that the rate will move steadily closer toward this goal of 1 percent. At the same time, we have not reached a stage where the 1 percent goal is in sight.

Such an outlook is attended by considerable uncertainties – in particular, the future developments in overseas economies described earlier – that could deviate either upward or downward from the projection, and relatively closer attention should be paid to the downside risk for the time being.

III. Bank of Japan's conduct of monetary policy

I will now move on to the Bank's conduct of monetary policy. The Bank's implementation of further aggressive monetary easing on October 30 marks the fourth time this has been done, counting from the beginning of this year – in February, April, September, and October. At its Monetary Policy Meeting on October 30, the Bank made the following two decisions. First, it

[1] For details on the introduction of the Bank's "Price Stability Goal in the Medium to Long Term," please see Masaaki Shirakawa, "The Bank of Japan's Efforts toward Overcoming Deflation" (Speech at the Japan National Press Club in Tokyo), February 17, 2012. http://www.boj.or.jp/en/announcements/press/koen_2012/data/ko120217a1.pdf.

decided to increase the size of the Asset Purchase Program (hereafter, the Program) by about 11 trillion yen, from about 80 trillion yen to about 91 trillion yen. Second, it established a new lending facility called the "Stimulating Bank Lending Facility."

In the following, while I will mainly discuss our monetary policy decision on October 30, in order to facilitate a better understanding of the aim and content of such a decision, I will start by concisely explaining how a monetary easing policy permeates the economy and prices. The monetary transmission mechanism can be divided into two stages. The first stage is the transmission of monetary easing effects from the realm of monetary policy to the financial environment, where firms and households can achieve necessary financing from financial markets and financial institutions at low costs. The second stage is the transmission of effects from the financial conditions to economic activity and prices; in other words, the extent to which firms and households can take advantage of the accommodative financial conditions to increase their investment and spending.

Increase in the size of the Asset Purchase Program: stimulating the first stage of the Monetary Transmission Mechanism

Among the decisions at the Monetary Policy Meeting on October 30, the increase in the size of the Program is aimed at stimulating the first stage of the transmission mechanism more forcefully (Chart 7). The Program was introduced in October 2010 in order to generate further easing effects in a situation where the overnight call rate – that is, the Bank's target rate – had already been at virtually zero percent. Through the Program, the Bank purchases not only Japanese government bonds (JGBs) and T-Bills but also various types of risk assets, including CP, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs). Such purchases of risk assets are unprecedented for a central bank (Chart 8). The aim of the Program is to encourage a decline in longer-term market interest rates and a reduction in risk premiums.

Since the introduction of the Program, longer-term market interest rates have been declining steadily (Chart 9). Government bond yields up to three years have declined to an extremely low level of 0.1 percent. The 5-year bond yields have come to nearly 0.2 percent. Reflecting such developments in the market rates, bank lending rates have also been declining. Recently, these rates, both in the short term and long term, have hit 1.0 percent – an unprecedented level. The lending attitudes of financial institutions as perceived by firms have also improved clearly, and have reached a level that exceeds the average since the 2000s. The issuing conditions for CP and corporate bonds are also accommodative on the whole. The Bank decided to increase the size of the Program with additional purchases of a wide range of assets that comprise not only JGBs but also risk assets including ETFs. Through such measures, the Bank intends to firmly maintain extremely accommodative financial conditions, even after entering next year, and support Japan's economy forcefully from the financial side.

Establishment of the Stimulating Bank Lending Facility: stimulating the second stage of the Monetary Transmission Mechanism

On top of this, the extent to which the private sector can make use of such accommodative financial conditions – in other words, the second stage of the transmission mechanism – becomes crucial. On this issue, while firms' profitability relative to total assets – i.e., ROA – has recovered to 3–3.5 percent, the average interest rate paid by firms declined to nearly 1.5 percent, and the gap between these two indicators has become large (Chart 10).

Why is it the case that business activity has not necessarily been invigorated even though it is profitable for firms to raise funds and make business outlays? Among several reasons that I can think of, the first reason owes to the difference in profitability between existing and new investments. The ROA that I just mentioned indicates the profitability of past investment. If the profitability of new investment is lower than that in the past, firms are unlikely to invest. The second reason is that, as a result of prolonged periods of low growth, business sentiment has become cautious and there is not enough risk-taking activity in the corporate sector. As for the third reason, it is far more profitable to invest overseas than at home (Chart 11).

The Bank hears from many corporate managers that there are only a few attractive investment opportunities at home. Unless we somehow manage to change this view, it will be difficult to stimulate business investment. The flipside is that investment will increase if we are able to change this view. While the first stage of the monetary transmission channel is the process of encouraging a further decline in market interest rates, we also need efforts to raise "natural interest rates," if I may use an economist's jargon.

In order to encourage the second stage of the transmission mechanism, it is vital that a wide range of economic entities, including firms, financial institutions, and the government, play their respective roles with a view to invigorating the growth potential of the economy. However, the Bank also strongly asserts that we will also do our best, making every possible effort from the perspective of monetary policy. This assertion led to the introduction back in 2010 of the Growth-Supporting Funding Facility, which is now generating some positive outcomes. Moreover, the Bank decided to establish the "Stimulating Bank Lending Facility" in October in order to promote the proactive lending activity of financial institutions and help stimulate the credit demand of firms and households (Chart 12).

Under this facility, the Bank will provide yen-denominated funds – up to an amount equivalent to the net increase in lending – to financial institutions, at their request. The total amount of funds provided by the Bank will be "unlimited" – that is, there shall be no upper limit. In calculating net increases in loans, only those extended to the non-financial private sector will be counted, and this can take the form of either yen-denominated lending or foreign currency-denominated lending. This is because firms' overseas activities and financial institutions' encouragement of such activities through lending have important implications for the development of Japan's economy in the midst of globalization. Loans with a duration of up to three years can be chosen by the banks, and loans can be rolled over up to four years at the request of these banks. Furthermore, the interest rate charged by the Bank will be 0.1 percent per annum for now. Thus, financial institutions can borrow funds at a long-term fixed rate equivalent to the Bank's target for the uncollateralized overnight call rate.

The size of this facility will be determined by the voluntary efforts of depository institutions to increase lending. According to data for the 12 months up through August 2012, the amount of loans increased by a total of approximately 15 trillion yen for financial institutions that saw a rise in their lending. Of this, 11 trillion yen constitutes loans that originated at domestic branches and 4 trillion yen at overseas branches (Chart 13). Going forward, if these institutions manage to increase their lending more aggressively, the amount of funds that can be provided by the Bank will rise accordingly. At present, the Bank is in the process of making the necessary arrangements. We plan to release the details of this facility before the end of the year and start its operation as soon as possible.

The Bank decided to call the combination of the Stimulating Bank Lending Facility and the aforementioned Growth-Supporting Funding Facility the "Loan Support Program." The aim of this program is to vigorously push forward use of the accommodative financial conditions by the private sector. In doing so, the importance of the Growth-Supporting Funding Facility will not be undermined at all. Under this facility, the Bank – irrespective of whether or not lending has increased – continues to encourage financial institutions to carry out lending or investment in support of invigorating the foundations for Japan's economic growth, and to ensure that the public is well aware of the need to raise the growth potential.

IV. Issues concerning the overcoming of deflation

Next, in order to facilitate a better understanding of the Bank of Japan's conduct of monetary policy, I wish to go "back to basics" and describe what it really means to overcome deflation, and what is necessary to accomplish this goal, by referring to several issues.

Relationship between overcoming deflation and the rate of price rises

The first issue is the relationship between overcoming deflation and the rate of price rises. In general, the term "deflation" is used to describe a continued decline in prices. Thus, to overcome deflation means to achieve a state in which such a drop in prices comes to a halt or in which prices start rising at a very moderate pace, if one looks at the definition of deflation from the opposite angle. According to the Bank's forecasts that I touched upon earlier, prices are expected to rise moderately from fiscal 2013 toward fiscal 2014. Given that its price stability goal of 1 percent for the time being has not come in sight, the Bank is committed to continuing with aggressive monetary easing. In any case, when we say that overcoming deflation is an important challenge, we are not simply looking for a pick-up in the price index. On this point, we can derive important implications from the *Opinion Survey on the General Public's Views and Behavior* that the Bank conducts, based on the responses collected from individuals (Chart 14). Among the respondents who felt that prices had gone up, more than 80 percent viewed the price rise as "rather unfavorable." In contrast, among those who felt that prices had gone down, about one third deemed the price decline as "rather favorable." The results of the survey may seem odd at first sight, considering the broadly shared goal of the Japanese population to overcome deflation. On second thought, however, they may not come as a surprise at all. Respondents in the former group may have chosen "unfavorable" when they were asked solely about prices; they had to base their response on a situation where prices rose without the associated increase in wages.

Our goal is to overcome deflation and have Japan's economy return to sustainable growth with price stability. In other words, in overcoming deflation we are not merely aiming to achieve a state in which prices simply rise, but one where better economic conditions are realized on the whole by increasing corporate profits, employment, and wages. There may also be a state in which the economy is overheating but the inflation rate is low. The bubble period in the second half of the 1980s is a typical example. The rate of change in the CPI remained below 1 percent for three years starting from 1986, but nobody refers to that period as one in which Japan was in a state of deflation (Chart 15). In short, what is necessary is to check economic activity, prices, and the financial environment in a balanced manner from the perspective of realizing sustainable growth.

Reality of inflation expectations

The second issue regarding the overcoming of deflation concerns inflation expectations. Counter to the view that economic growth is necessary to overcome deflation, we hear the argument that the priority should be to lift inflation expectations in order to improve the economy, and that this is exactly what a central bank should do. The mechanism underlying this argument is that lifting inflation expectations in the private sector will lead to a decline in the real interest rate, which is derived by subtracting the inflation expectation rate from the nominal rate, which will in turn stimulate the economy.

Nonetheless, in an environment where neither prices nor wages have risen for a number of years, it is not realistic to believe that the general public's inflation expectations will go up all of a sudden, or that we can manage to lift these expectations somehow. We can think of a situation where inflation expectations alone go up – for example, when the economy is hit by oil shocks – but this is not exactly the same as the overcoming of deflation that we seek.

According to the opinion survey that I have just mentioned, the fact that most of the respondents viewed the price rise as "rather unfavorable" suggests that there is a possibility of wide acceptance in the public realm that it is normal for prices not to rise, or that price rises cannot be tolerated. In fact, looking at detailed consumer price data for the last 15 years or so, in the United States, those items for which prices pick up at the rate of 2.5–3.0 percent have the largest weight, whereas in Japan, those items for which prices pick up at the rate of 0–0.5 percent have the largest weight (Chart 16). On the whole, the CPI is slightly less than 0 percent, but this is due in part to the fact that, compared to the United States, there are a few items – such as televisions and personal computers – for which, for the purpose of statistics, prices are deemed to be declining significantly in reflection of their improved qualities.

The general public's common understanding on prices – or its perception regarding prices – has been formulated on the basis of such conditions, and this is the reality of the abstract notion of "inflation expectations" in economic theory. Consumers, with the perception that prices should not rise, are unlikely to accept price hikes by firms, who in return reduce costs including wages; hence, it will take longer for the economy to overcome deflation. After all, it is more important to generate material changes in the economy, including strengthening the economy's growth potential and achieving higher wages. I will come back to this point shortly.

Meaning of the output gap

The third issue regarding overcoming deflation concerns the meaning of the output gap. According to the Cabinet Office's estimation, the output gap amounts to about 2 percent of GDP or approximately 10 trillion yen on an annual basis, in line with the Bank of Japan's estimation. Given that it was about 40 trillion yen right after the Lehman shock, the output gap has narrowed substantially, though it still exists. Because the output gap is generally recognized as a shortage of demand, one can argue that, if a fiscal measure equivalent to the amount of the gap is taken, the gap will be wiped out and this will put an end to deflation. Surely, if such a shortage is temporary in nature, this argument may hold. Nevertheless, one has to bear in mind that the output gap assumes only the present supply-side structure and merely captures the shortage of demand corresponding to that structure. Society and the economy keep changing all the time, and in Japan new demand is being created constantly on the back of the aging population, women's entry into the labor market, and increasingly diverse preferences. In the medical and nursing business, one often hears that services sufficient to meet demand are not being provided, mainly due to various regulations and labor shortages at worksites, even though there is rapidly expanding potential demand resulting from the aging population. Moreover, with regard to the elderly's spending – which has received considerable attention lately – there is a big difference among the elderly in terms of income, health conditions, and taste. Therefore, unlike the consumption by younger members of the population, the elderly's spending pattern is increasingly granular, and depending on the creativity of the supply side, there is considerable room left to expand the elderly's spending. The cause of this inability to meet potential demand – namely, the shortage of supply in growing business areas – is not measured in the output gap. Put differently, in a rapidly changing economy, the output gap only captures the shortage of demand in terms of the current supply of goods and services, and does not capture the shortage of supply against new potential demand. In this sense, the notion of the output gap is asymmetric. Put differently, what should essentially be recognized as the mismatch between supply and demand is instead perceived in the form of the shortage of demand.

In order to improve the output gap in a sustainable manner, it is necessary to restructure the supply side according to economic changes, which enables potential demand to materialize. The newly created demand is based on what people willingly want; hence, this is likely to create a virtuous circle of increasing expenditure, revenue, and income. As such, not only short-term macroeconomic policies but also initiatives to change the economic structure in which new businesses are more likely to emerge, such as enhancing the metabolism of the economy, play an important role in achieving improvement in the output gap.

Importance of invigorating the growth potential

Last, but not least, is the importance of invigorating the growth potential. This is the issue that provides an overall summary of what I have been talking about.

The Bank has been emphasizing repeatedly that Japan's economy faces the critical challenge of overcoming deflation and returning to a sustainable growth path with price stability, and that this challenge can only be met if efforts by a wide range of economic agents to strengthen growth potential and support from the financial side proceed hand in hand. Growth potential is ultimately the ability to differentiate from the existing goods and services and to cultivate new demand swiftly at home and abroad. If one succeeds in providing attractive goods and services that consumers can acknowledge as having worth, one can maintain the ability to control prices while preserving value-added. Such value-added will initially generate an increase in corporate profits. If this is eventually distributed in a balanced manner to the household sector in the form of a rise in employment and higher wages, it will result in a broad-based increase in purchasing power. Furthermore, this will lay out the foundation for the economy where cultivating new demand is likely to be successful. Once the virtuous circle in which rising wages leads to an increase in expenditure and income starts to work through, the general public will begin to willingly accept the idea of moderately rising prices. This is the avenue that the change in price perception – that is, a rise in inflation expectations – will take in line with the economic reality, and this is the fundamental mechanism for overcoming deflation. After the Lehman shock, wages have been relatively firm compared with the immediately preceding recovery phase, and we will monitor carefully how they feed into prices in the future (Chart 17).

The ability to cultivate new demand derives from firms' spirit of challenge. At the same time, however, financial institutions need to support the funding of firms that exhibit risk-taking behavior arising from this spirit, and the government should lay out foundations such as expanding, through decisive deregulation, business areas for firms; such efforts play pivotal roles in helping firms take on challenges. This recognition is shared by the government. At the Monetary Policy Meeting held on October 30, in addition to the aggressive monetary easing, the Bank decided to release the "Measures Aimed at Overcoming Deflation" jointly with the government in order to state clearly their shared understanding. In this "shared understanding," the government showed a clear recognition that, in order to overcome deflation, it is essential to reform an economic structure that is predisposed to deflation, as well as conduct appropriate macroeconomic policy management. The Bank strongly expects the government to vigorously promote measures for strengthening Japan's growth potential. Of course, the Bank will make its utmost efforts from the financial side. Once various efforts by a wide range of economic entities come into play, I am confident that sustainable growth with price stability can be achieved.

V. Issues concerning the Bank of Japan's conduct of monetary policy

In the following, I will introduce issues concerning the conduct of the Bank's monetary policy, bearing in mind questions that are often raised.

Is monetary easing enough or not?

We have heard the opinion that, with a view to overcoming deflation as early as possible, the Bank's policy stance is not enough. By contrast, there is another opinion arguing that financial conditions are already accommodative enough and asking if there is anything meaningful to be gained by further enhancement of monetary easing. At the press conference held after the Monetary Policy Meeting at the end of October, I received questions based on both arguments.[2]

As I have argued so far, in order to create a situation in which prices would rise, it is imperative to pursue powerful aggressive easing – that is, the first stage of the monetary transmission mechanism – and make efforts to strengthen the growth potential – i.e., the main feature of the second stage of the mechanism. It will take some time before the efforts to strengthen the growth potential bear fruit. For our part, the effect of monetary easing will

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[2] For details, please refer to the minutes of the Governor's regular press conference (available only in Japanese) on October 30, 2012. http://www.boj.or.jp/announcements/press/kaiken_2012/kk1210b.pdf.

be maximized by pursuing further aggressive measures at a pace most consistent with these efforts.

It is certainly true, as pointed out at the press conference, that financial conditions have already become quite accommodative, but there is no question that the Bank should exert every effort to enhance its easing effects as much as possible, in an effort to achieve its goal by imaginatively using its policy instruments. In view of this, the Bank decided to further enhance monetary easing at this juncture, when the economy has started to weaken somewhat, after carefully examining economic activity and prices.

Should the bank announce "unlimited" purchases of financial assets?

With respect to the second issue for discussion regarding monetary policy, we have heard a view that the effect of monetary easing will be reinforced if we announce unlimited purchases of financial assets. In support of this view, the Federal Reserve's policy is sometimes pointed to as an example. Specifically, the Federal Reserve decided at the Federal Open Market Committee in September to continue purchasing agency mortgage-backed securities until improvement in the labor market is achieved in the context of price stability. The Bank of Japan has also stated clearly that it will continue to pursue aggressive monetary easing until it judges the rate of change in the CPI of 1 percent to be in sight. In other words, the Federal Reserve and the Bank of Japan share things in common in their conduct of monetary policy, in the sense that both central banks are determined to continue with necessary policy measures to achieve appropriate economic conditions and prices to which they are committed.

Indeed, looking back at the track record of the Bank of Japan's monetary policy conduct, the Program started off at a size of about 35 trillion yen, with purchases of financial assets expected to be completed by end-2011. At present, its size has become about 91 trillion yen and its timeframe has been extended until end-2013. The Program has become far more aggressive than the one envisaged at the time of its introduction. Furthermore, the Bank has embarked upon a number of policy measures – including the enhancement of the growth-supporting funding facility and the introduction of the stimulating bank lending facility – in response to changes in economic developments.

I stress once again that the Bank of Japan has been conducting further aggressive monetary easing until it judges the 1 percent goal – in terms of the rate of change in the CPI – to be in sight, and that the Bank has been making full use of new policy measures while not setting any timeframe *a priori*. I should also note that, in terms of purchasing financial assets without any timeframe, the Bank regularly purchases JGBs in line with the increasing trend in banknote demand, which grows with the economy, and continues to purchase at the rate of 21.6 trillion yen per year.

Does increasing "money" solve the problem?

As for the third issue, there is a view that the Bank should increase "money" more aggressively in order to overcome deflation as early as possible. There are a number of indicators of "money." Looking at the monetary base – which is the central bank's liabilities and consists of banknotes in circulation and current account balances held at the Bank of Japan – its ratio relative to nominal GDP in Japan has been higher than those in the United States and Europe (Chart 18). In the case of the United States and Europe, it was only after the Lehman shock that this ratio started to rise. On the contrary, in the case of Japan it has been rising for longer periods of time, which gives the impression that the increase in Japan following the Lehman shock has not been very noticeable. However, even when focusing specifically on the period after the Lehman shock, the amount of increase in the monetary base as a ratio relative to nominal GDP is about the same for Japan as it is for the United States and the euro area. Similarly, looking at the money stock – which is equivalent to the amount of cash held by non-financial private sectors – its ratio relative to nominal GDP in

Japan has again been outperforming those in the other two economies, and it is currently on a clear uptrend (Chart 19).

The quantity theory of money – under which one argues that increasing the amount of money will lead to a pick-up in prices – is easy to understand but cannot explain the reality of the current circumstances of zero interest rates that persist in Japan and the United States (Chart 20).

For the sake of clarity, starting from fiscal 2000, if one assumes that an increase in money will feed into prices in accordance with the quantity theory of money, the average rate of inflation in terms of the year-on-year rate of change in the CPI would become 4.8 percent when one uses the monetary base and 1.6 percent when one uses the money stock. These two figures are considerably different from –0.2 percent, which is what we actually see in the real world. The same argument can be made in the case of the United States and Europe. The point that I have been making so far – that is, in order to overcome deflation, it is necessary not only to achieve accommodative financial conditions but also to have the ability to make use of them – can also be understood from the perspective of the actual money-price relationship.

Apart from the discussion based on quantitative indicators of money, we often hear the view that the Bank should print money more aggressively, which is a somewhat loose term. Everyone would welcome a situation in which money was distributed freely. But such a story sounds too good to be true, of course.

When one talks about "money," this means either cash or deposits; in other words, liquidity at hand. Normally, however, this means either income or wealth. "A man with a lot of money" ("Okanemochi" in Japanese) refers to a person with abundant income or wealth. But the money the Bank supplies is different from this. The fact that fund provisioning by the Bank is often referred to as "printing money" likely generates such a misunderstanding. The Bank's fund provisioning is usually done in the following way: first, the Bank purchases government bonds from financial institutions; and second, those institutions in return receive money in the form of increasing the amount outstanding of the current deposits held at the Bank. In other words, monetary easing is not simply printing money and distributing it for free. It is distributed in exchange for equivalent purchases of financial assets, such as sovereign bonds, as well as loans with sovereign bonds as collateral. Neither income nor wealth will increase at this stage.

What increases is "money" in the form of the current deposits at the Bank. Such an action by the central bank generates a decline in interest rates, stimulates the credit demand of firms, and invigorates a variety of economic activities such as investment. Ultimately, it will increase "money," which represents income and wealth.

A possible counter-argument is that dropping money from a helicopter – or money from heaven – will stimulate the economy and raise prices.[3] This is also a loose expression. Recently, whether or not to cancel the holding of government bonds by the central bank was discussed in the United Kingdom, and this is essentially equivalent to what one means by dropping money from a helicopter. Were this to be done, the central bank would record losses, resulting in either a reduction of the bank's profit disbursements or a request to the government for injection of capital. Whatever the outcome, the resulting action by the government would have to be backed up by tax receipts. This action falls into the domain of fiscal policy, which must be determined by the government and the parliament.

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3 In his speech on October 23, 2012, Governor King of the Bank of England (BOE) referred to the thinking behind money creation as well as the problem of combining monetary and fiscal policies. http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech613.pdf.

Under the current circumstance of zero interest rates, holding money does not incur any cost; no matter how much money the Bank supplies, money is absorbed just as water is by a sponge. I acknowledge that the total amount of money is important and that the monetary base is expected to continue expanding substantially on the back of the Bank's current purchases of financial assets. At this juncture, however, it is more important to ensure that money is actually deployed, by invigorating the growth potential of the economy.

Should the bank purchase foreign bonds?

Lastly, there is a view that the Bank should purchase foreign bonds in order to correct the strong yen.

However, the Bank of Japan Act stipulates that the Bank shall buy and sell foreign exchange as an "agent handling national government affairs" – that is, an agent of the Finance Minister – when the purpose of the buying and selling, like that of foreign exchange intervention, is to stabilize the exchange rate of the Japanese currency. The Finance Minister is responsible for foreign exchange intervention. This reflects, as I understand, the debates in the Diet on the bill that became the current Bank of Japan Act, when the view was presented that it was desirable to centralize this currency diplomacy under the auspices of the government because there was always a counterparty when it comes to the issue of foreign exchange policy. Under the current legal framework, the government intervenes when it judges that it is necessary to do so, and the amount of intervention since 2010 has in fact exceeded 15 trillion yen (Chart 21). In addition, the government can issue financing bills (FBs) to raise ample funds for intervention at virtually a zero interest rate.

Meanwhile, the Bank monitors with great interest any development in the foreign exchange market and its effect on economic activity and prices. In particular, under the present circumstances where there is a high degree of uncertainty with regard to future developments for overseas economies, we should be mindful of the negative effects on Japan's economy as a result of the yen's appreciation leading to a decline in corporate profits and deterioration in business sentiment. The Bank has been conducting monetary policy by taking due account of such effects, and it will continue to do so.

While factors determining foreign exchange rates are complex, there are several forces behind the appreciation of the yen after the Lehman shock, including the following: first, as the interest rates in the United States and Europe have declined markedly and the interest rate differentials with Japan have narrowed, there was a reversal of yen carry trades; second, the yen has come to be perceived as a relatively safe currency on the back of the European debt problem. As for determinants of the foreign exchange rate, one sometimes hears a view that the aforementioned developments in the monetary base have influenced the formation of the exchange rate. Based on historical experience, there seems to be no clear relationship between the monetary base and the exchange rate on the whole (Chart 22). In any event, the fact that the Bank has been pursuing powerful monetary easing by depressing the already low interest rates to an even lower level should have mitigated upward pressure on the yen to some extent.

Concluding remarks

Today, I have covered a wide range of topics, including issues concerning the Bank's conduct of monetary policy and the importance of invigorating the economy's growth potential. Let me conclude by raising two key subjects that I believe are important in order for the economy to overcome deflation and return to a sustainable growth path – namely, "perception" and "mood." Such topics may be viewed as the last things to be on the mind of a central bank's governor. They do, however, raise the same awareness as did Keynes' reference to "animal spirits."

In handling these topics, let me introduce a fact that I often times refer to these days, that is, an international comparison related to changes in the real GDP between the year 2007 –

prior to the financial crisis – and today (Chart 23). Japan's current real GDP, like that of European countries, remains below the level seen in 2007. Looking at per capita GDP figures, this trend holds true for major countries including the United States. It is worth noting, however, that the drop for Japan is the lowest among these countries. Furthermore, Japan's real GDP per working-age population has exceeded its pre-crisis level, while those for the United States and Europe remain below their levels at that time. Put differently, while Japan as a whole tends to register low growth because of the decline in the working-age population, each individual Japanese worker contributes to an increase in value-added at a pace exceeding that in the United States and Europe. This suggests that we should not become excessively pessimistic. At the same time, however, this implies that merely maintaining the status quo and abandoning efforts to invigorate the economy's growth potential could quite easily send Japan's economy into a severe condition. The average growth rate for the next decade or two is defined by the potential growth rate. The potential growth rate can be broken down into the rate of growth in the number of workers and that of real GDP per worker – in other words, the labor productivity growth rate. Future developments in the number of workers can be determined quite accurately on the assumption of the most recent labor participation rate by gender and age. According to such estimates, the number of workers will grow at a rate of –0.6 percent in the 2010s and –0.8 percent in the 2020s. The labor productivity growth rate for the years 2000 through 2008 – a period characterized by relatively favorable economic conditions – was 1.5 percent (Chart 24). Efforts to raise the labor productivity growth rate are necessary, of course. However, we cannot expect advanced economies – having already completed their "catching up" process – to maintain a growth rate as high as 2 or 3 percent. In objectively acknowledging this reality, it is important to continue making efforts to raise the labor productivity growth rate and to increase the number of workers through a rise in the labor participation rate.

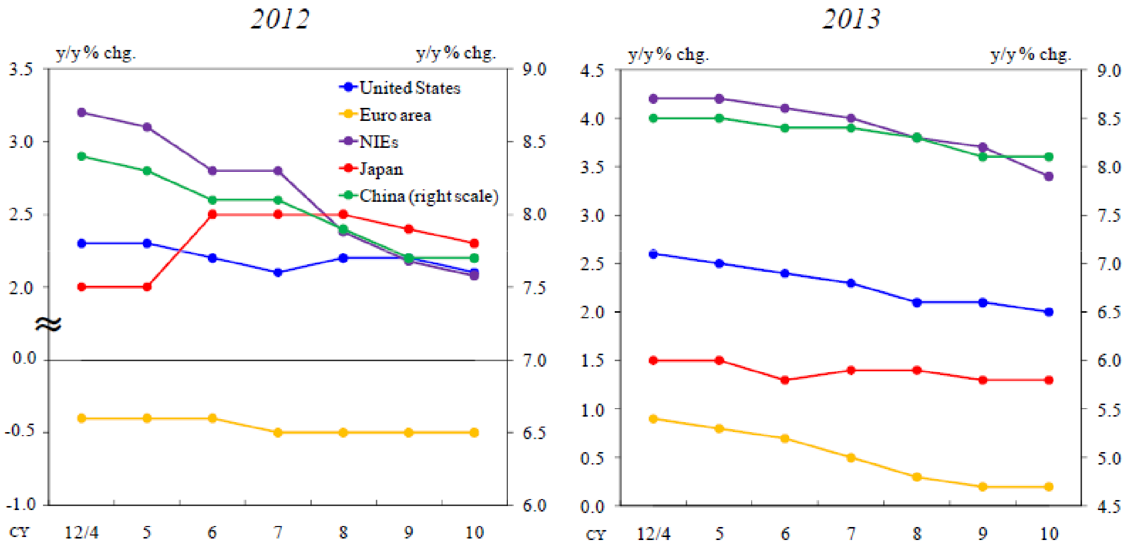
The starting point of such efforts is the combination of the dispassionate appreciation of the facts that I have just mentioned, and a positive mood generated from awareness of the strengths of Japan's economy. While the economy faces an unprecedented headwind – namely, the rapid aging of and decline in the population – it seems to be that its strengths in such a situation are not objectively understood. For example, today, many Japanese firms maintain sound balance sheets and the business conditions of financial institutions have been stable, since Japan did not encounter any large-scale credit bubbles in the mid-2000s. This situation is in stark contrast to the 1990s, when the country was faced with the task of resolving the "three excesses," as evident at least in the fact that a financial base for supporting efforts to invigorate the economy's growth potential is readily available. What is more, the fact that Japan leads the world in addressing the global issues of population aging and energy constraints can be interpreted as an opportunity to heighten its presence by continuing to be the world's driving force when dealing with these issues in the future. The so-called soft power is another of Japan's strengths that must not be overlooked. At the annual meetings of the IMF and the World Bank held in Tokyo last month, for the first time in 48 years, Japan successfully reinforced a strong impression on the world of its high operational skills for event management, and of its warm hospitality. I have found this to be a reflection of Japan's soft power.

As such, it is important for Japan to unite its strengths and make determined efforts toward invigorating its economy's growth potential. In doing so, we must recognize the various positive qualities that I have just mentioned while holding onto a sense of urgency, although without falling into pessimism. The Bank is determined to continue making its utmost efforts as the central bank toward overcoming deflation as early as possible and realizing sustainable growth with price stability.

Thank you.

Chart 1

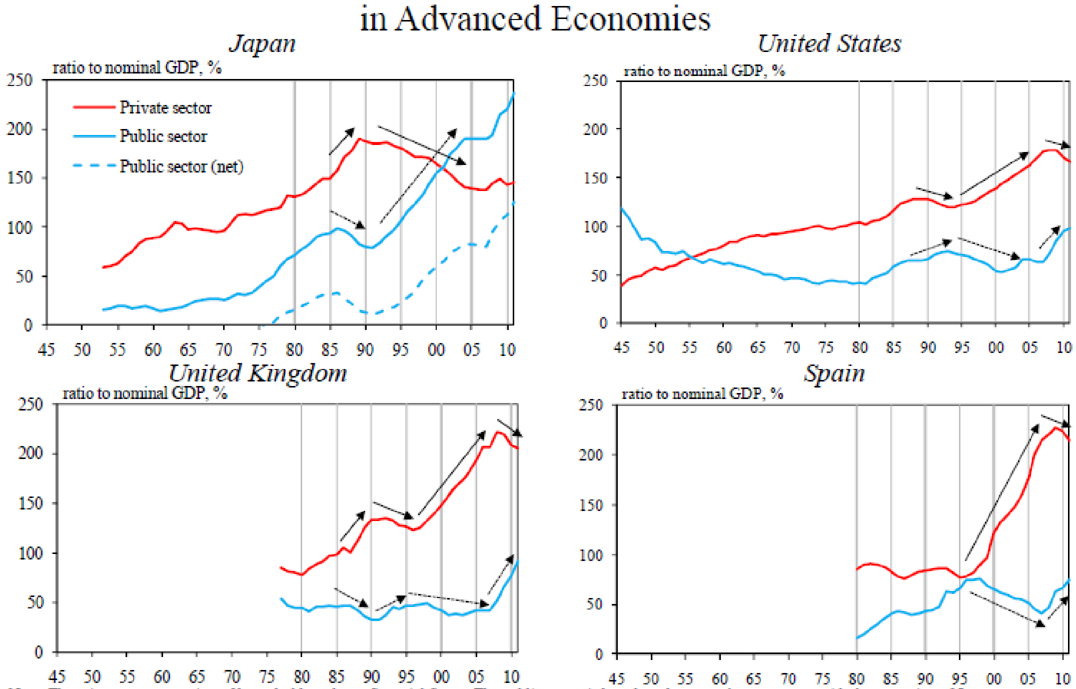
Real GDP Forecasts by Private Sector-Economists



Note: NIEs consist of South Korea, Taiwan, Hong Kong, and Singapore. Figures are calculated using GDP weight based on the purchasing power parity (calculated by IMF).
Source: Consensus Economics Inc., "Consensus Forecasts."

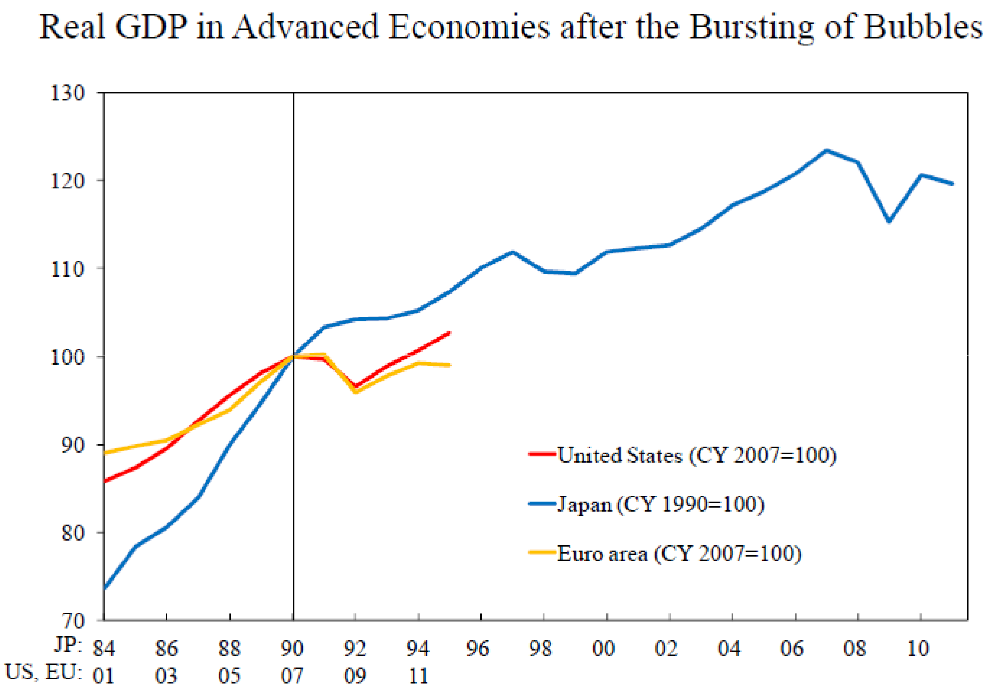
Chart 2

Private Sector Debt and Public Sector Debt in Advanced Economies



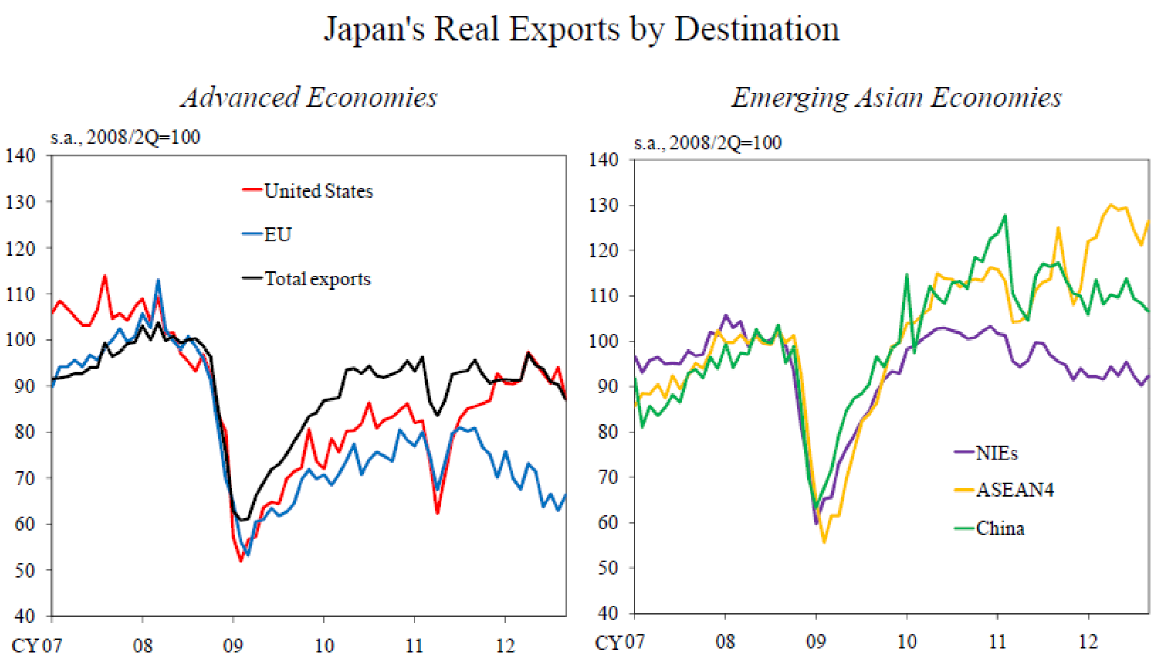
Note: The private sector consists of households and non-financial firms. The public sector is based on the general government, with the exception of Japan, for which the public sector includes public non-financial firms.
Sources: BEA; FRB; ONS; Eurostat; Bank of Japan, etc.

Chart 3



Sources: BEA; Eurostat; Cabinet Office, etc.

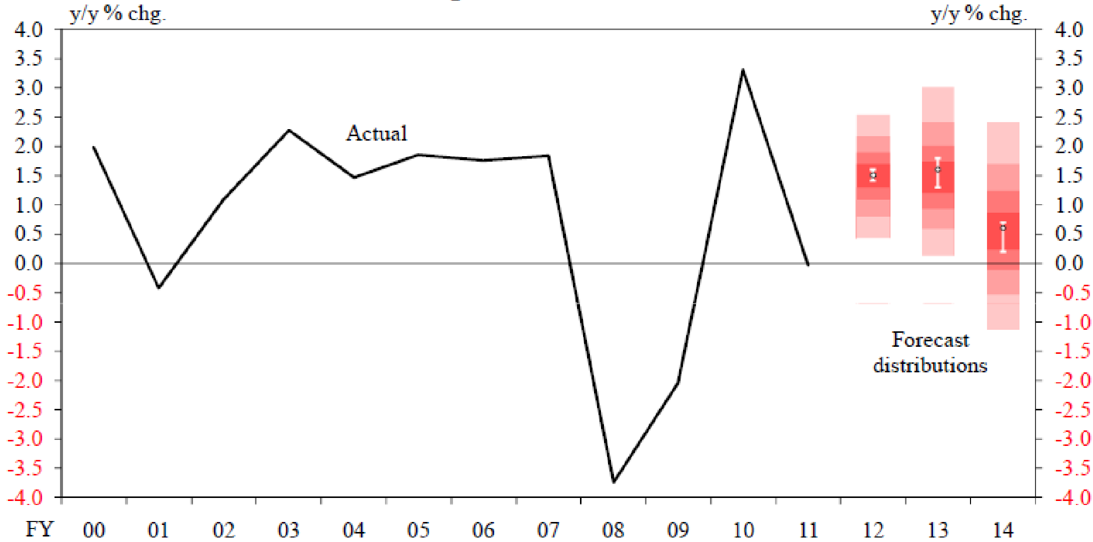
Chart 4



Note: NIEs consist of South Korea, Taiwan, Hong Kong, and Singapore. ASEAN4 refers to Thailand, Indonesia, Malaysia, and the Philippines.
Sources: Ministry of Finance; Bank of Japan.

Chart 5

Japan's Real GDP



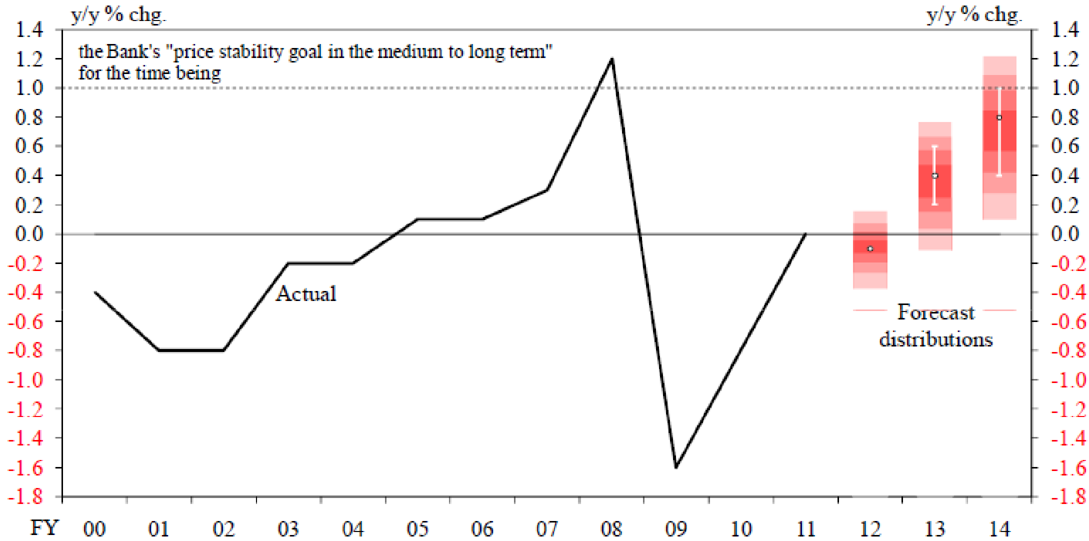
Notes: 1. Based on the aggregated probability distributions (i.e., the Risk Balance Charts) compiled from the distributions of individual Policy Board members, the Forecast Distribution Charts are compiled as follows. First, upper and lower 10 percentiles of the aggregated distributions are trimmed and second, colors indicated below are used to show the respective percentiles of those distributions. For the process of compilation of the Risk Balance Charts, see the box on page 9 of the April 2008 *Outlook for Economic Activity and Prices*.

Upper 40% to lower 40%	Upper 30 to 40% & lower 30 to 40%	Upper 20 to 30% & lower 20 to 30%	Upper 10 to 20% & lower 10 to 20%

2. The circles in the bar charts indicate the median of the Policy Board members' forecasts (point estimates). The vertical lines in the bar charts indicate the range of the forecasts of the majority of Policy Board members.

Chart 6

Japan's CPI (All Items Less Fresh Food)



Notes: 1. Based on the aggregated probability distributions (i.e., the Risk Balance Charts) compiled from the distributions of individual Policy Board members, the Forecast Distribution Charts are compiled as follows. First, upper and lower 10 percentiles of the aggregated distributions are trimmed and second, colors indicated below are used to show the respective percentiles of those distributions. For the process of compilation of the Risk Balance Charts, see the box on page 9 of the April 2008 *Outlook for Economic Activity and Prices*.

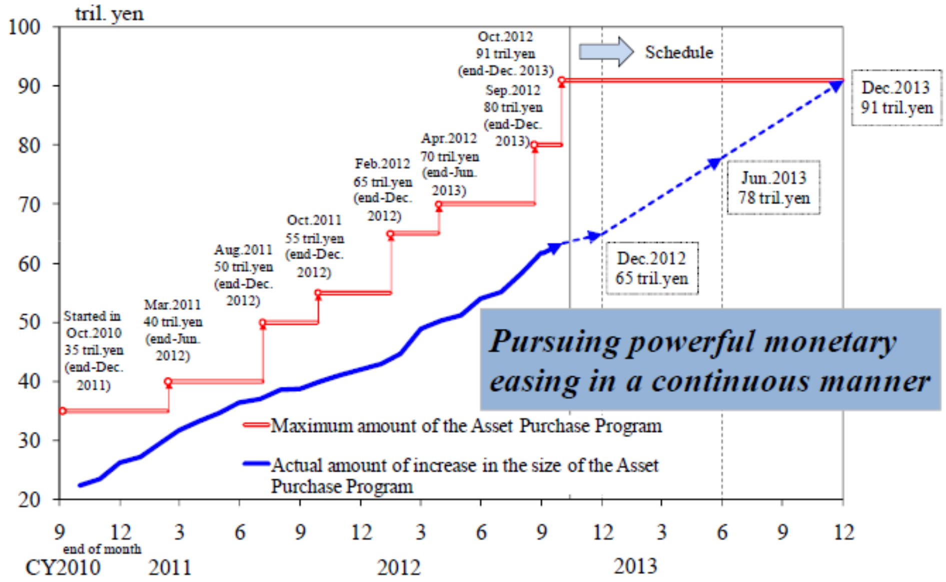
Upper 40% to lower 40%	Upper 30 to 40% & lower 30 to 40%	Upper 20 to 30% & lower 20 to 30%	Upper 10 to 20% & lower 10 to 20%

2. The circles in the bar charts indicate the median of the Policy Board members' forecasts (point estimates). The vertical lines in the bar charts indicate the range of the forecasts of the majority of Policy Board members.
3. The forecast for the CPI excludes the direct effects of the scheduled consumption tax hikes.

Chart 7

Asset Purchase Program

Maximum Amount and Actual Amount of Increase in the Size of the Program



Note: Dates in parentheses indicate the intended timescale for completing the increase.

Chart 8

Breakdown of the Asset Purchase Program

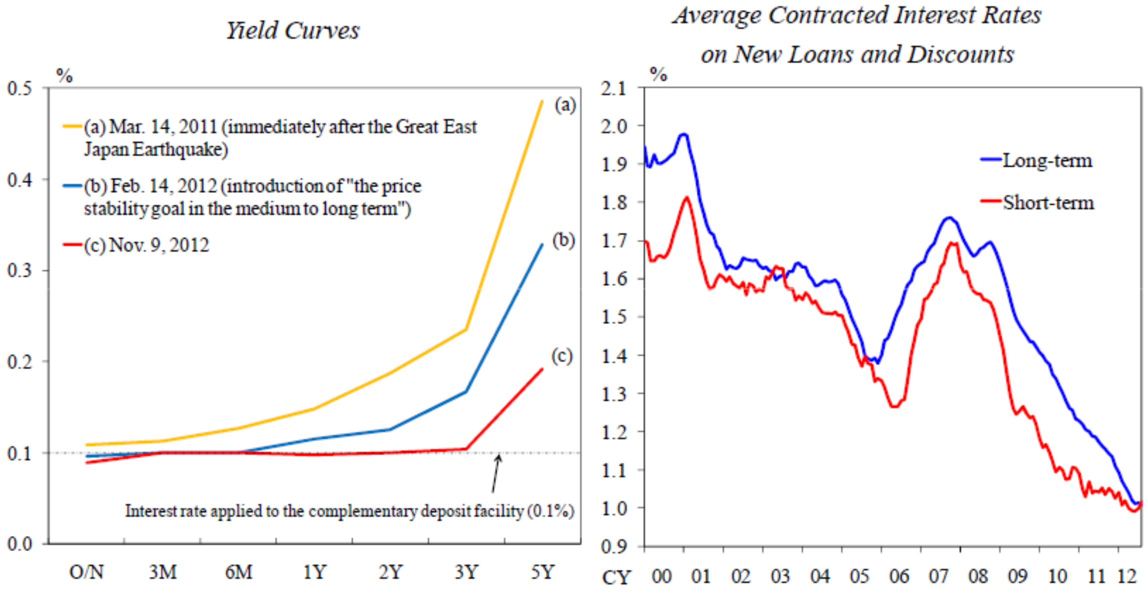
(tril. yen)

	Started in Oct. 2010	Program size before recent decision	Program size after recent decision	Change in amount	Amount outstanding (as of end-Oct. 2012)
(Intended timescale for completing the purchases)	(End-Dec. 2011)	(End-Dec. 2013)	(End-Dec. 2013)		
		(A)	(B)	(B) - (A)	
Total size	About 35	About 80	About 91	About +11	63.4
Asset purchases	5.0	55.0	66.0	+11.0	34.4
JGBs	1.5	34.0	39.0	+5.0	20.9
T-Bills	2.0	14.5	19.5	+5.0	7.5
CP	0.5	2.1	2.2	+0.1	1.5
Corporate bonds	0.5	2.9	3.2	+0.3	2.9
ETFs	0.45	1.6	2.1	+0.5	1.4
J-REITs	0.05	0.12	0.13	+0.01	0.1
Fixed-rate operation	30.0	25.0	25.0	—	29.0

Note: In addition to purchases under the Program, the Bank of Japan regularly purchases JGBs at the pace of 21.6 trillion yen per year.

Chart 9

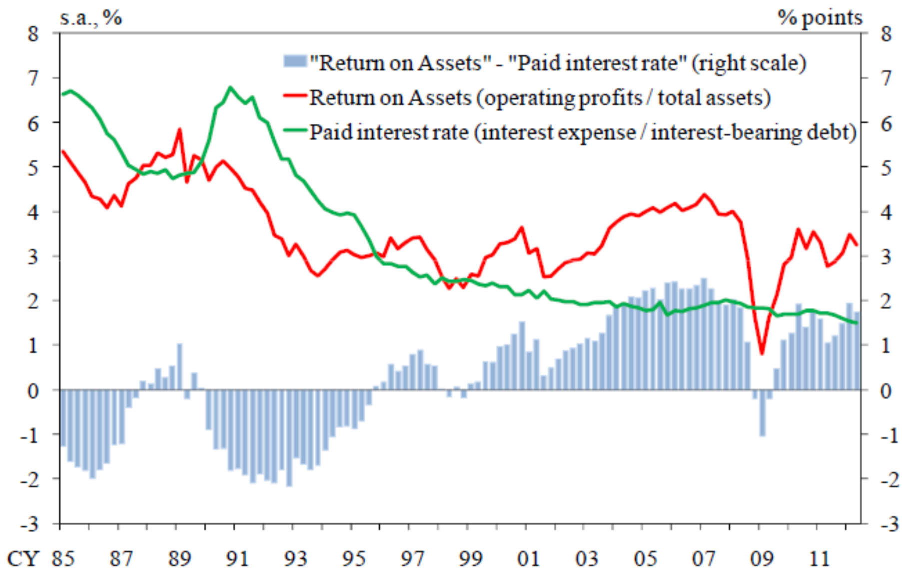
Interest Rates



Note: Average contracted interest rates are the six-month backward moving averages on new loans and discounts.
Sources: Bank of Japan; Bloomberg.

Chart 10

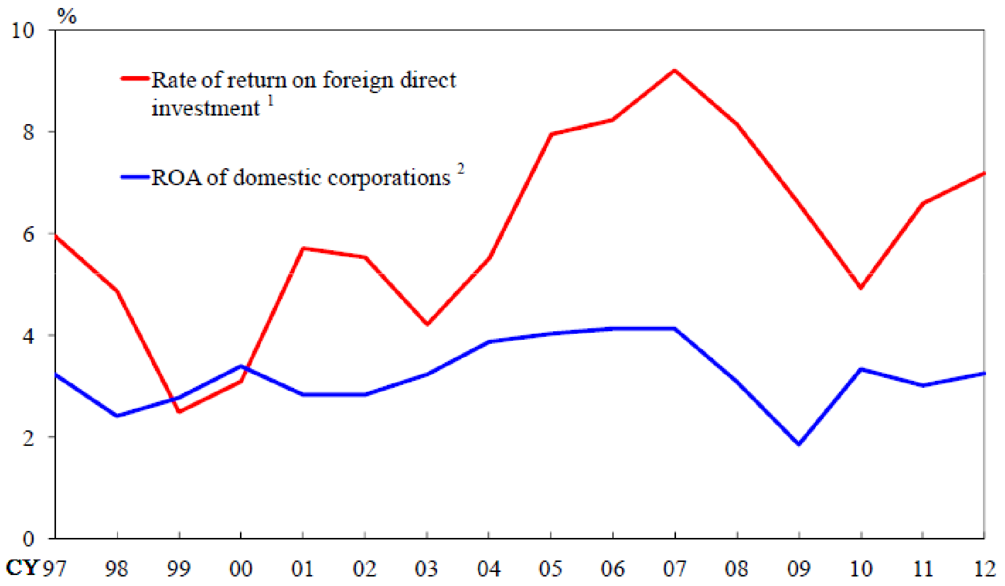
ROA and Paid Interest Rate



Sources: Ministry of Finance; Bank of Japan.

Chart 11

Rates of Return on Investment by Domestic Corporations at Home and Abroad



Notes: 1. Figures are calculated as direct investment income (credit, based on the "Balance of Payments") divided by direct investment assets.
2. Figures are calculated as operating profits divided by total assets, based on all-size enterprises and all industries, and exclude finance and insurance.

Sources: Ministry of Finance; Bank of Japan.

Chart 12

Establishment of the "Stimulating Bank Lending Facility"

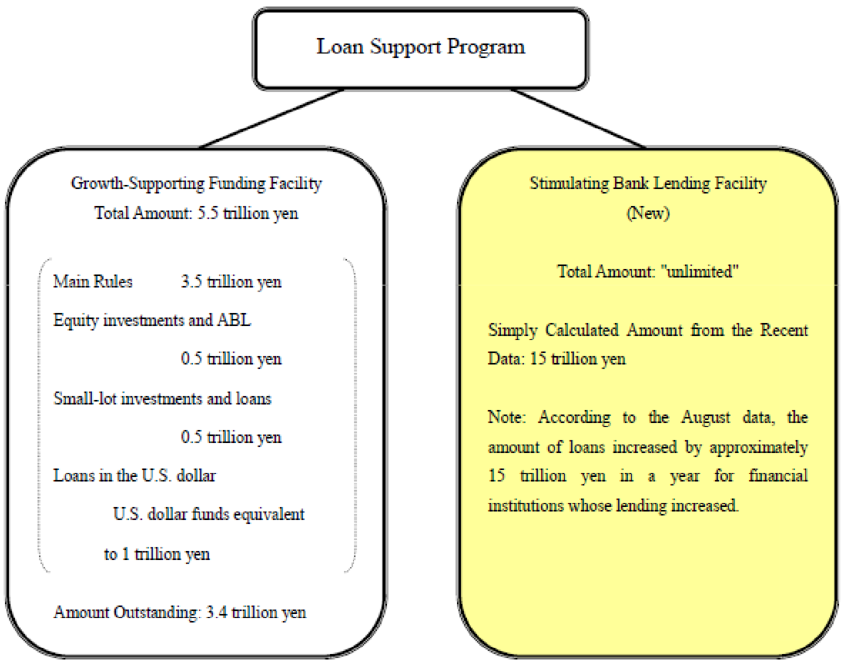
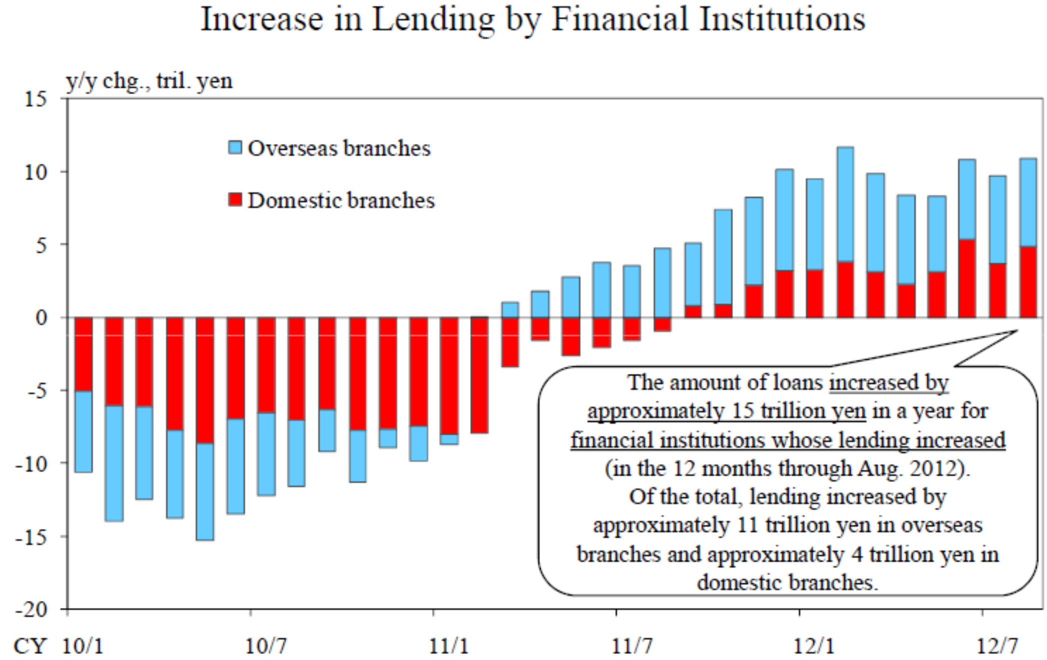
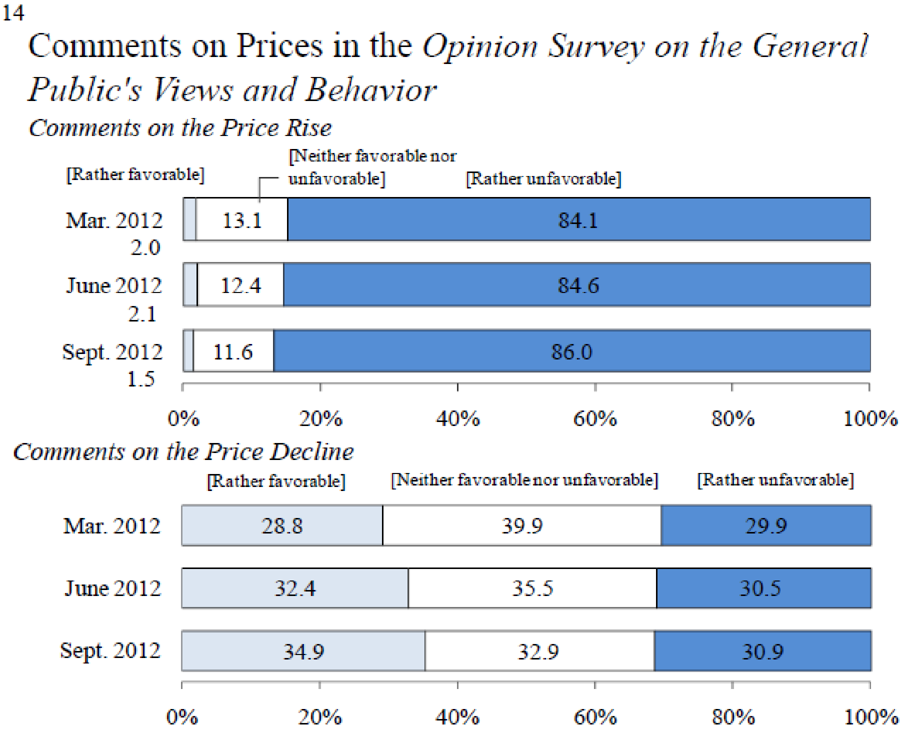


Chart 13



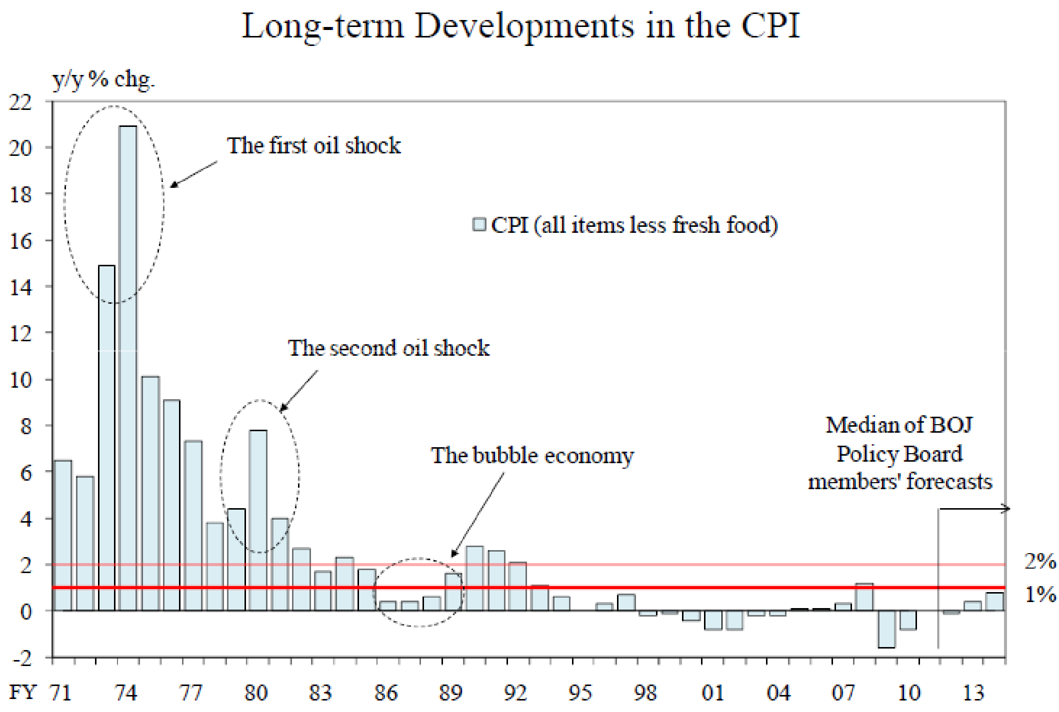
Note: Financial institutions refer to domestic banks and *shinkin* banks that are counterparties of the Bank.
Source: Bank of Japan.

Chart 14



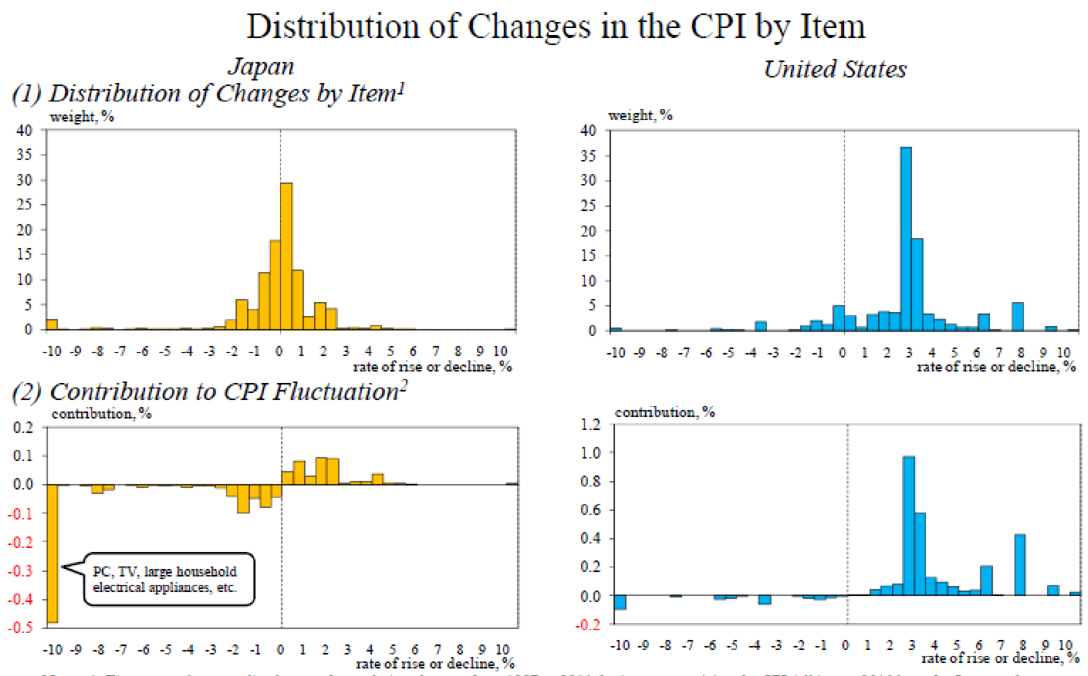
Note: The Bank conducts its quarterly *Opinion Survey on the General Public's Views and Behavior* in order to grasp how the public's current impression of household circumstances and changes in financial and economic conditions affect their perceptions and actions.
Source: Bank of Japan.

Chart 15



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

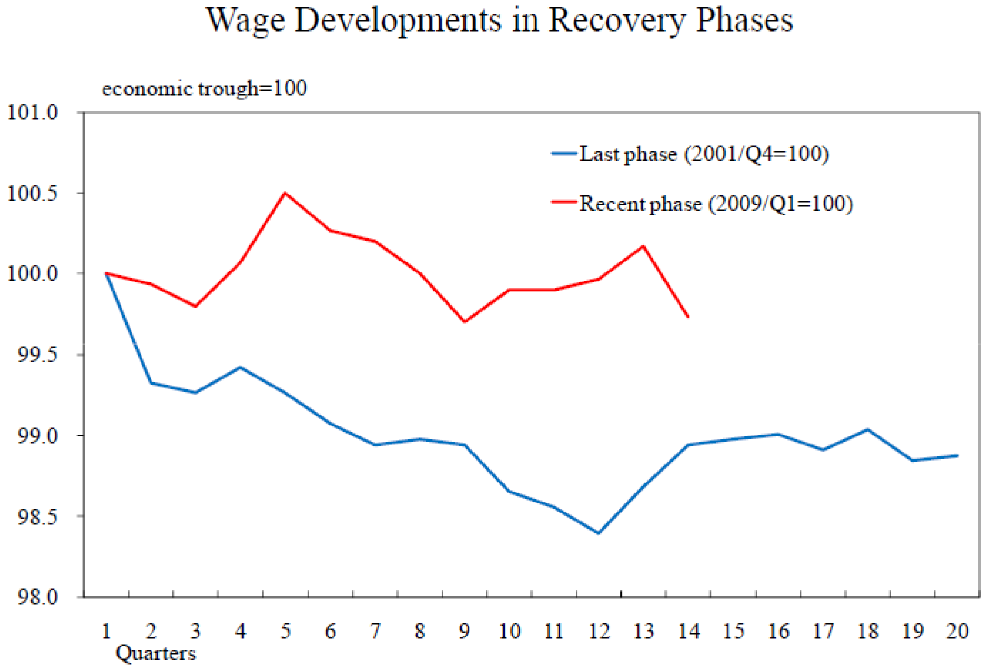
Chart 16



Notes: 1. Figures are the annualized rates of cumulative changes from 1997 to 2011 for items comprising the CPI (all items, 2010 base for Japan and as of 2011 for the United States). The weights used in the calculation are 2010 base for Japan and as of December 2011 for the United States.
2. Figures for Japan are calculated by "changes in (1)" x "weights (the 2010 base)" and those for the United States by "changes in (1)" x "weights (as of December 2011)."

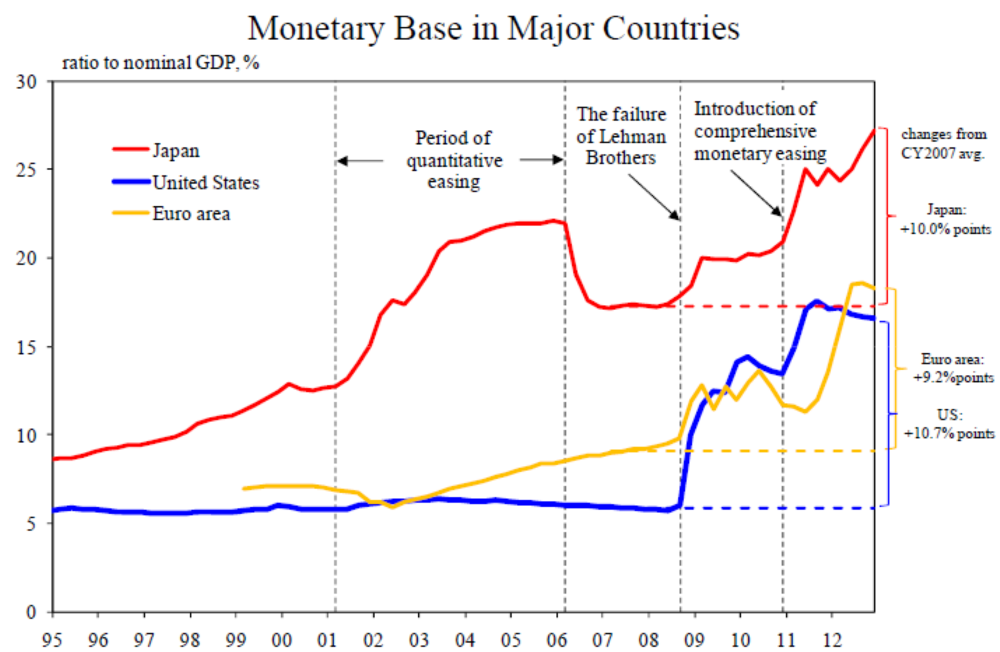
Source: Ministry of Internal Affairs and Communications.

Chart 17



Note: Figures are total cash earnings for establishments with at least five employees.
Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
Source: Ministry of Health, Labour and Welfare.

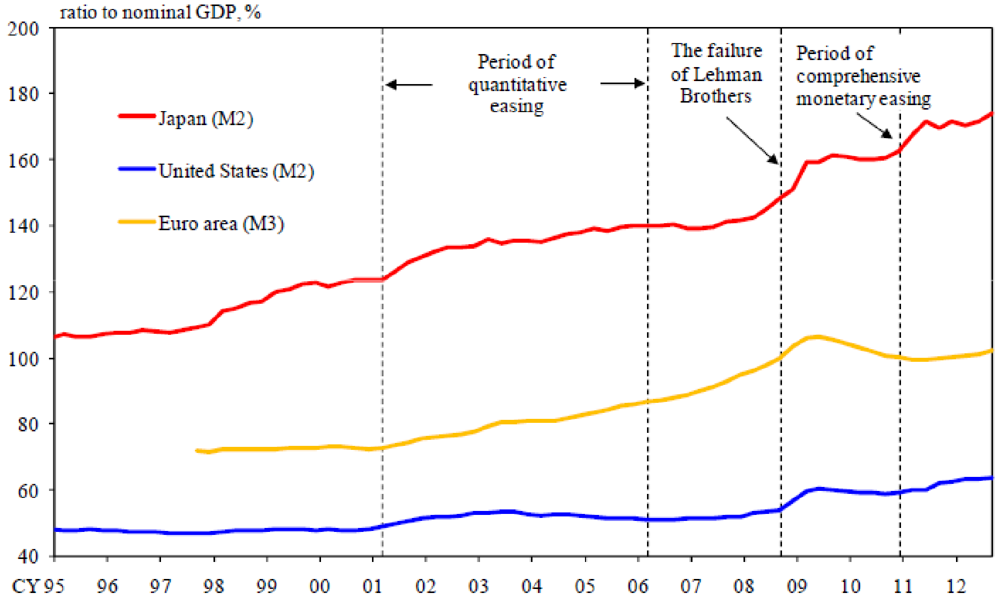
Chart 18



Note: 1. Monetary base is the sum of banknotes in circulation, coins in circulation, and current account deposits at a central bank.
2. Figures for the euro area for 2012/Q3 and Q4 are calculated using its nominal GDP figures for 2012/Q2. Figures for Japan and the United States for 2012/Q4 are calculated using their nominal GDP figure for 2012/Q3.
Sources: Cabinet Office; Bank of Japan; FRB; ECB; Eurostat.

Chart 19

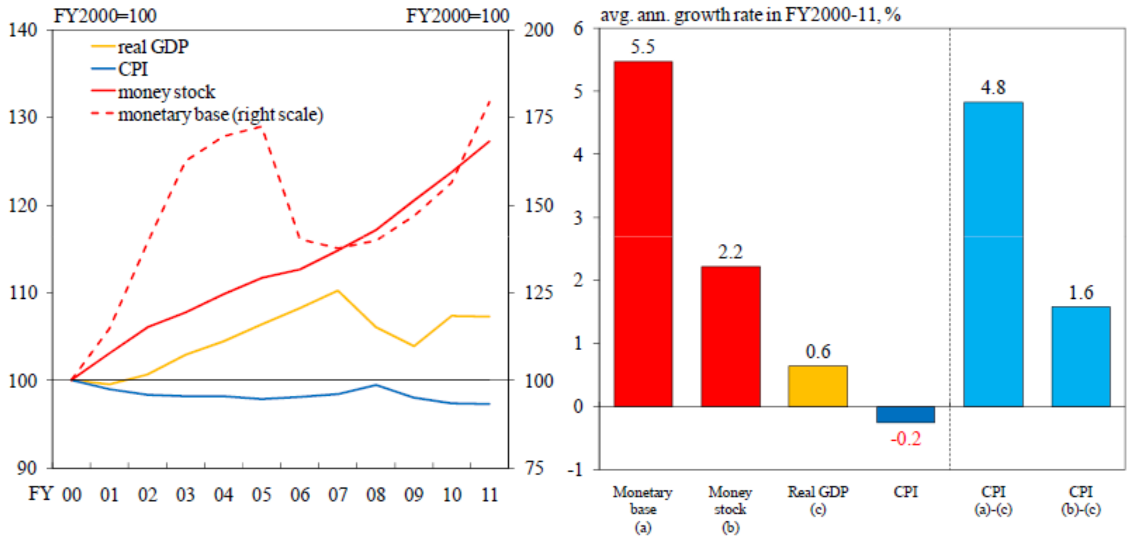
Monetary Stock in Major Countries



Note: Figures for the euro area for 2012/Q3 and Q4 are calculated using its nominal GDP figures for 2012/Q2. Figures for Japan and the United States for 2012/Q4 are calculated using their nominal GDP figure for 2012/Q3.
Sources: Cabinet Office; Bank of Japan; FRB; ECB; Eurostat.

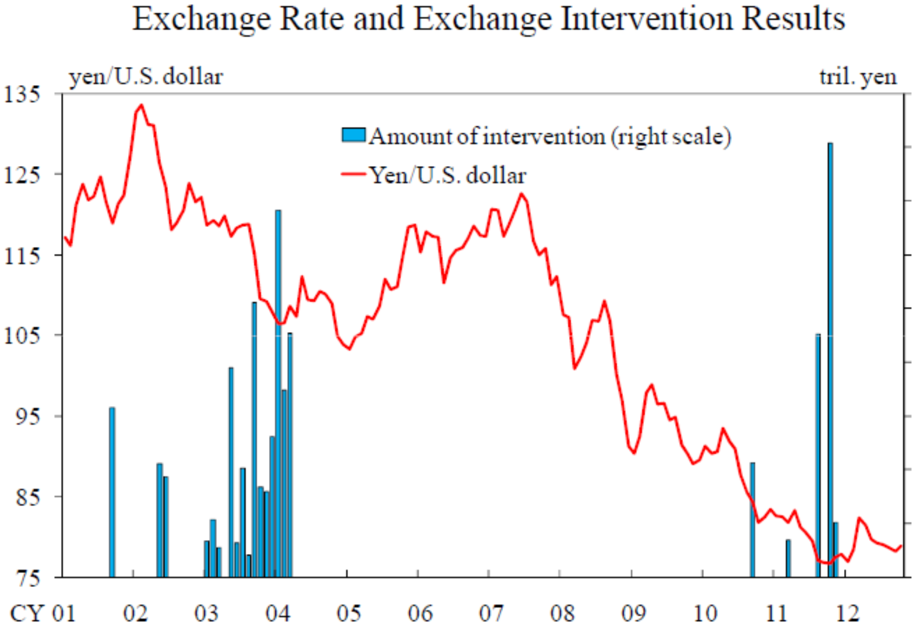
Chart 20

Money, and Economic Activity and Prices



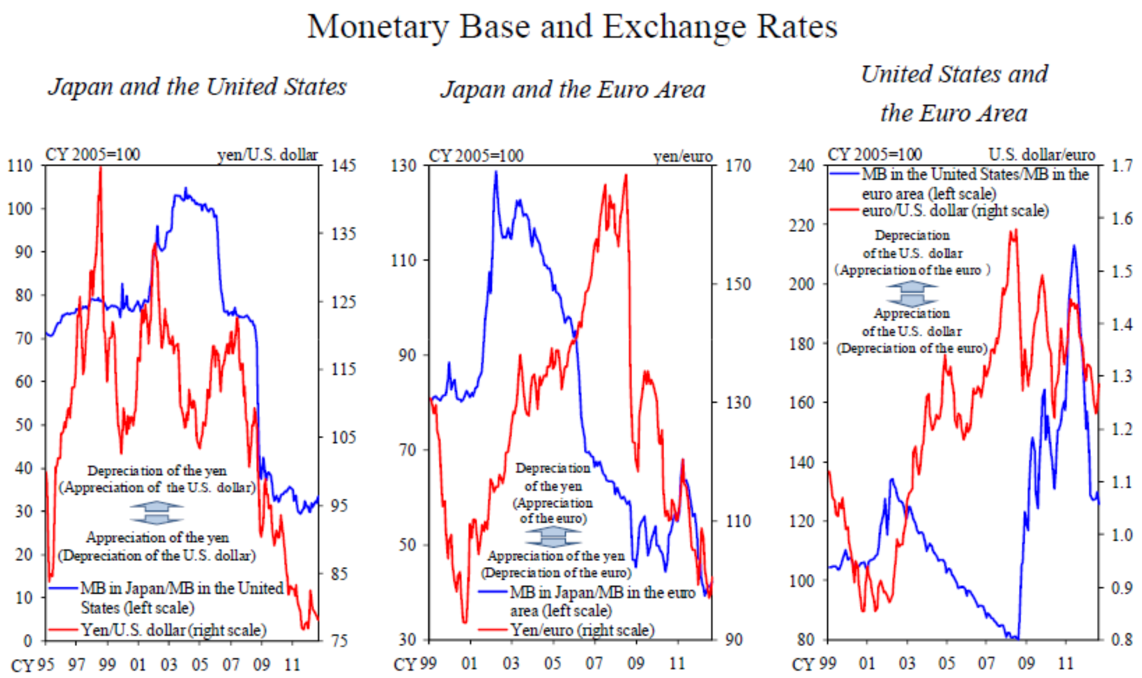
Note: Figures for the CPI ((a)-(c), (b)-(c)) represent the rates of change in the CPI on the assumption that changes in the monetary base and money stock are reflected in prices in accordance with the "quantity theory of money."
Sources: Cabinet Office; Ministry of Internal Affairs and Communications; Bank of Japan.

Chart 21



Note: Yen/U.S. dollar rates are monthly averages, while the amount of foreign exchange intervention is the monthly total.
Sources: Ministry of Finance; Bank of Japan.

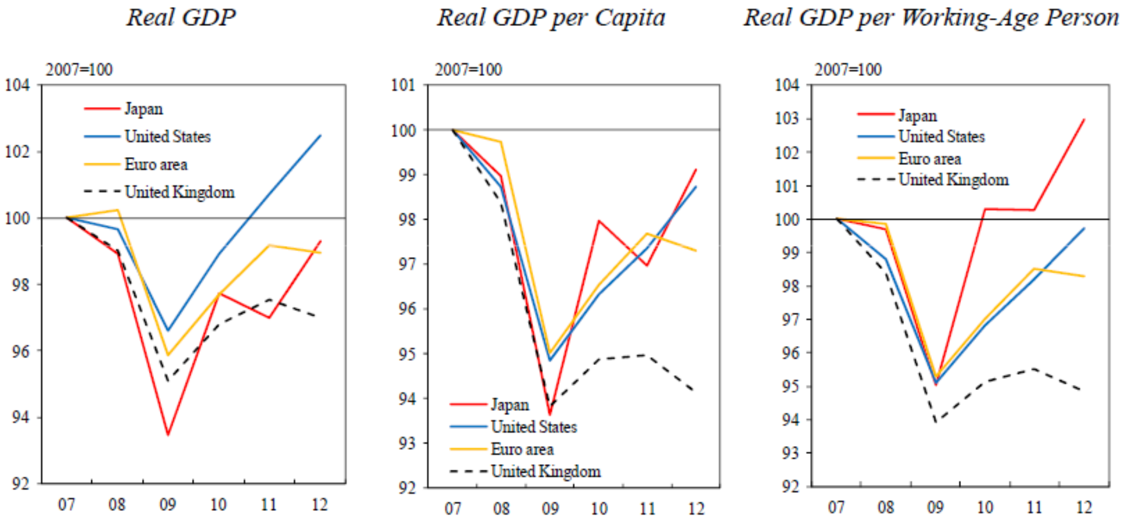
Chart 22



Sources: Bank of Japan; Federal Reserve Board; European Central Bank; Bloomberg.

Chart 23

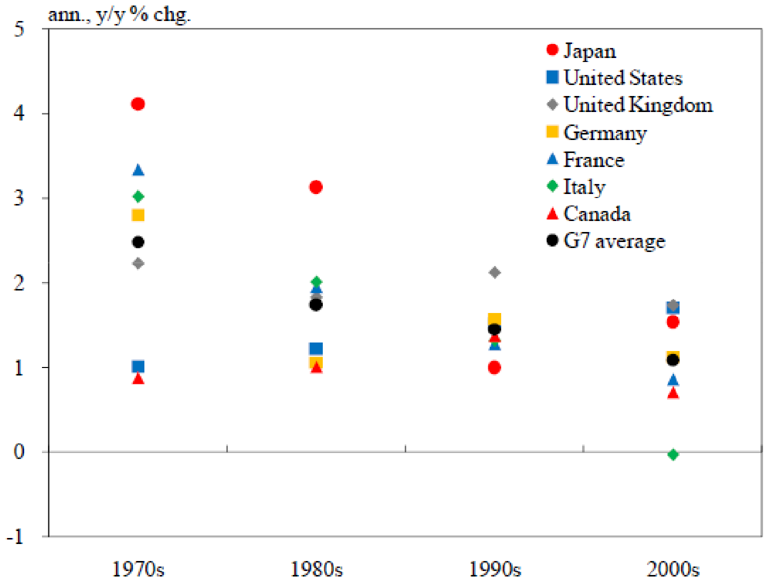
GDP of Advanced Economies



Notes: 1. A working-age person refers to those between 15 and 64 years old.
2. Figures for 2012 are January-June averages. Figures for the population for 2012 are calculated using the growth rate for 2011.
Sources: Cabinet Office, "National Accounts"; World Bank; BEA; Eurostat; ONS.

Chart 24

Developments in Labor Productivity Growth Rate (Real GDP per Worker)



Note: To eliminate the effects of the financial crisis after the failure of Lehman Brothers, figures for the 2000s are the averages for 2000 through 2008.
Figures for the 1970s are the averages for 1971 through 1979.
Sources: OECD; Cabinet Office; Ministry of Internal Affairs and Communications.