Kiyohiko G Nishimura: A tale of two programs in the early resolution of the deflation problem

Speech by Mr Kiyohiko G Nishimura, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Niigata, 5 December 2012.

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Introduction

I am privileged and honored to be here today to exchange views with administrative and business leaders in Niigata Prefecture. I deeply appreciate your support and cooperation in taking part in interviews and surveys conducted by our Niigata branch. The information from these interviews and surveys is invaluable for the Bank of Japan in grasping Japan's financial and economic developments and conducting monetary policy. What is more, we are delighted to share with you information – not only on what is happening in Japan but also around the globe – on various occasions, including events at branches like the opportunity we are enjoying today. I would like to express my sincere gratitude and also ask for your continued cooperation.

Today I will be talking about the early resolution of the deflation problem and the Bank's two programs. In the first half of my talk, let me outline financial and economic developments since the summer. In the latter half, I will explain the Bank's basic thinking on monetary policy conduct, focusing on its two programs: the Asset Purchase Program, the total amount of which the Bank at the end of October decided to increase for the second month in a row; and the Loan Support Program, which it decided to newly establish.

I. Developments in overseas economies

Deceleration in overseas economies becoming more severe

Looking at developments in overseas economies since the second half of 2011, the negative impact of the European debt problem has spread globally through the effects on trade and business sentiment. As a result, economic activity in many countries and regions, especially in the manufacturing sector, has remained in a deceleration phase. Every April and October, the Bank releases the *Outlook for Economic Activity and Prices* (hereafter, the Outlook Report), which presents Policy Board members' assessment of economic activity and prices based on their forecasts. In addition to the semiannual Outlook Report, the Bank also releases interim assessments in January and July that present the Bank's revised forecasts. The interim assessment in July 2012 listed uncertainty regarding overseas economies as one of the risk factors for Japan's economy, and frankly speaking, my impression is that these risks actually materialized within a short period of time since this summer.

Specifically, risks related to the European debt problem materialized and their effects spread. The negative impact of this problem has grown, not only in peripheral European countries but also in the core countries, through a decline in trade within the euro area and weakening business sentiment. Economic activity in Europe has receded slowly, with real GDP for the euro area now having registered negative growth for four consecutive quarters. This weakness in the European economy is affecting not only exports within the euro area but also those bound for outside the area, and has started to affect global trade and economic growth through global supply chain networks.

In addition, emerging economies, which had been hoped to drive global economic growth, are lacking momentum. As for the Chinese economy, exports to Europe – which make up a large share in China's total exports – have declined, the effects of excess investment in the wake of the Lehman shock are starting to be felt, and inventory adjustments in a wide range of areas, including materials industries, have been more prolonged than expected, though some economic indicators have shown signs of improvement very recently. Partly against the background of weakness in final demand in Europe and China, the pick-up in the NIEs and the ASEAN economies has moderated, particularly in exports and business fixed investment in manufacturing in the corporate sector.

Outlook for overseas economies

With regard to the outlook for overseas economies, the current deceleration phase is likely to continue for the time being, but we expect that against the background of a sustainable recovery in the U.S. economy and a pick-up in the Chinese economy the global economy will gradually emerge from that phase and enter a moderate recovery thereafter. Uncertainty about the outlook for overseas economies, however, is not insubstantial, including the timing of economic recovery. Attention should continue to be paid to the possibility that the European debt problem may become more serious. While the U.S. economy continues to be on a moderate recovery trend, the momentum toward recovery warrants careful monitoring given that uncertainty about the fiscal policy outlook, in particular with regard to the "fiscal cliff", remains significant. As for the Chinese economy, improvement in the supply and demand balance may require considerable time, especially in materials industries, where there is excess production capacity. Moreover, Japan-China relations have already started to affect a number of areas and there is concern that they may have wider implications for Japan's economy.

Although global financial markets were unstable until this summer, since then, investors' risk aversion triggered by the European debt problem has abated somewhat, partly owing to the fact that European authorities have carried out a range of policy measures. Nevertheless, particular attention needs to be paid to developments in financial markets, as fiscal and economic structural reforms in Spain and Greece are still underway.

II. Recent developments in Japan's economy

Weakening economic activity

I will now explain recent developments in Japan's economy. In the first half of 2012, Japan's economy registered high growth: real GDP in January–March grew at an annual rate of 5.2 percent as domestic demand remained firm, mainly supported by both public and private reconstruction-related demand. However, in July–September, GDP growth turned negative for the first time since October–December 2011, showing an annual decline of 3.5 percent.

Reflecting the deceleration in overseas economies, exports and industrial production have decreased. This weakness in exports and industrial production has started to affect domestic demand, which has remained firm thus far. For instance, business fixed investment in the manufacturing sector has shown some weakness, mainly due to the deceleration in overseas economies. Going forward, we need to remain vigilant as to whether there are any signs of firms delaying business fixed investment. In the manufacturing sector, the year-on-year rate of change in the number of new job offers has been negative since June 2012; moreover, overtime hours worked in the economy overall have also been decreasing somewhat, led by a decline in the manufacturing sector. Private consumption has lost some momentum, partly due to the decline following the expiry of subsidies for the purchase of environmentally friendly cars.

On the whole, domestic demand is expected to remain resilient, mainly supported by reconstruction-related demand in a broad sense, including investment related to disaster prevention and energy. It is, however, unlikely to increase at a pace that will offset the weakness in exports. Owing to these developments, the Bank judges that Japan's economy as a whole has been weakening somewhat.

As for prices, the year-on-year decline in the consumer price index (CPI, all items less fresh food) peaked at a rate of 2.4 percent in August 2009 after the Lehman shock. Since then, the aggregate supply and demand balance – which shows the rate of utilization of labor and fixed capital – has been improving moderately and the year-on-year rate of decline in the CPI has been shrinking steadily since end-2009 and recently has been around 0 percent.

Outlook for Japan's economy

Based on the aforementioned developments in overseas demand, exports and industrial production are expected to continue decreasing and Japan's economy as a whole to remain relatively weak for the time being. With the economy weakening somewhat, the Bank judged it appropriate to undertake additional monetary easing and at the Monetary Policy Meeting on October 30 decided to further enhance its monetary easing for the second month in a row, which I will elaborate on shortly with regard to the policy decisions. The Bank believes that together with the cumulative effects of earlier policy measures and the effects of the government's efforts to strengthen Japan's growth potential, the latest decision to implement monetary easing will prevent the economy from deviating from its course of returning to a sustainable growth path with price stability. As overseas economies gradually emerge from the deceleration phase, exports and industrial production are expected to start increasing and the economy as a whole to strengthen as spending activity gains momentum. In the October 2012 issue of the Outlook Report, the Bank's median projection for Japan's annual real GDP growth rate is 1.5 percent for fiscal 2012, 1.6 percent for fiscal 2013, and 0.6 percent for fiscal 2014. This projection takes into account the front-loaded increase in demand prior to the consumption tax hike and the subsequent decline. Excluding these effects, the projected growth rates for fiscal 2013 and 2014 would be around 1–1.5 percent.

This outlook entails a number of uncertainties and there are both upside and downside risks.

Under the current circumstances, however, we should be particularly mindful of the downside risks. Specifically, close attention needs to be paid to the possibility that a further prolonged deceleration in overseas economies may delay the recovery in exports and industrial production, thus exacerbating the negative effects on domestic demand.

Next, I would like to discuss the outlook for the CPI. Excluding the direct effects of the consumption tax hike on prices, the year-on-year rate of change in the CPI is expected to hover around 0 percent for the time being and start rising gradually thereafter reflecting the improvement in overall economic activity, such as increases in corporate profits and employment as well as a pickup in wages. The median projection of the year-on-year rate of change in the CPI in the October issue of the Outlook Report is –0.1 percent for fiscal 2012, 0.4 percent for fiscal 2013, and 0.8 percent for fiscal 2014, excluding the direct effects of the tax hike. It thus appears likely that the year-on-year rate of change in the CPI will move steadily closer toward the Bank's "price stability goal in the medium to long term" for the time being of 1 percent.

Compared with the projections in the July interim assessment, these projections represent a downward revision. The reason for the downward revision is that the improvement in the aggregate supply and demand balance – reflecting the downward revision of the economic outlook – is expected to be delayed and that crude oil prices were corrected downward. Nevertheless, despite the downward revision, the Bank's CPI projections are still higher than those of economists in the private sector.

In my view, the difference between the Bank's projections and private sector economists' projections is due to differences in the extent to which prices are seen to respond to changes in the aggregate supply and demand balance. The projections by private sector economists tend to strongly reflect developments in the mid-2000s, when prices failed to respond commensurately with the improvements in the aggregate balance. In fact, even though the economy registered moderate growth during this period, the inflation rate hardly picked up. This was a period when the excesses in production capacity remained unresolved, price competition among firms was even severer against the backdrop of subdued growth in the domestic market reflecting the aging of and decline in the population, and there was a substantial increase in cheap imports – from emerging economies such as China – that competed with domestic products. Increases in goods prices were also constrained by efforts by firms to restrain wages against the backdrop of an increase in global competition. Furthermore, property prices continued to decline at a rapid pace, and rents – which make up about 20 percent of the CPI components (all items less fresh food) – started to decline, keeping a lid on any upward pressure on overall CPI inflation.

In contrast with that period, cheap imports from China today are not so conspicuous as to exert sizable downward price pressure and the resolution of excess production capacity, even if only at a gradual pace, is also making progress. Moreover, it is increasingly possible to see cases where firms have succeeded in differentiating their goods and services in response to the aging of and decline in the population and customers are showing interest in high value-added goods with relatively high prices; thus, there are forces that make it relatively easier for firms to raise prices. In addition, the declining trend in property prices has finally come to a halt and rents are expected to do the same, albeit with some lag.

Taking recent changes into account, the year-on-year rate of change in the CPI in the baseline scenario in the Outlook Report is expected to start rising gradually as the aggregate supply and demand balance improves. However, it is also important to note that the changes that I mentioned are not that strong yet and remain vulnerable to external shocks. We therefore continue to remain vigilant to the downside risks.

III. First program: asset purchase program

The two stages of the transmission mechanism of monetary easing

Let me now move on to the Bank of Japan’s conduct of monetary policy.

The Bank recognizes that Japan’s economy faces the critical challenge of overcoming deflation as early as possible and returning to a sustainable growth path with price stability. Based on this recognition, the Bank has been pursuing aggressive monetary easing. The transmission of monetary easing 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 in which firms and households can raise sufficient funds at low interest rates.

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 actually take advantage of the accommodative financial conditions to actively increase their investment and spending. In the following, I will discuss the role of the Bank’s two programs in terms of these two stages.

Accommodative financial conditions

In its Monetary Policy Meeting on October 30, the Bank decided to increase the size of the Asset Purchase Program substantially. This increase is a step that targets the first stage of the transmission mechanism. The Program was introduced in October 2010, starting off with a size of about 35 trillion yen, and the increased purchases were scheduled to be completed at the end of 2011. Since then, the size of the Program has been increased repeatedly and the timeframe has also been extended. In September and October 2012, the Bank took bold steps to further increase the size of the Program – each time by about 10 trillion yen respectively. Consequently, the Program has reached the substantial amount of about 91 trillion yen, and the timeframe has been extended to the end of 2013. The aim of the Program was to generate accommodative financial conditions in a situation where the Bank's target rate was already at virtually zero percent, by encouraging a decline in longer-term market interest rates and a reduction in risk premiums through the purchase of not only Japanese government bonds (JGBs) and treasury discount bills (T-Bills) but also of various types of risk assets, including CP, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs).

Since the introduction of the Asset Purchase Program, financial conditions in Japan have become extremely accommodative both in historical and international comparison. In this sense, we believe that the Program has already achieved its intended effects. To be specific, in terms of firms' funding costs, both short-term and long-term average interest rates on new loan contracts have hit 1 percent – an unprecedented level. In terms of households' borrowing costs, 35-year fixed mortgage rates have fallen below 2 percent. Moreover, financial institutions' lending attitude remains accommodative, issuing conditions for CP and corporate bonds are also generally favorable, and, overall, an environment has been maintained in which households and firms can feel secure that they can gain access to funds. Moreover, the Bank's aggressive easing has mitigated the negative effects stemming from the appreciation of the yen and has fended off an even greater appreciation. Against the strong headwinds generated by the Great East Japan Earthquake and the European debt problem, extremely accommodative financial conditions have been firmly maintained.

As part of the Asset Purchase Program, the Bank has stated its commitment to maintaining powerful monetary easing to achieve so-called policy duration effects. Specifically, the Bank has clarified that for the time being it aims to achieve the goal of 1 percent inflation in terms of the year-on-year rate of increase in the CPI through the pursuit of powerful monetary easing, conducting its virtually zero interest rate policy and implementing the Program mainly through the purchase of financial assets. The Bank is determined to continue with this powerful monetary easing until it judges the 1 percent goal to be in sight. As I mentioned, the October issue of the Outlook Report notes that in fiscal 2014 it appears likely that the year-on-year rate of increase in the CPI will move steadily closer toward the Bank's "price stability goal in the medium to long term" for the time being of 1 percent. So far, however, we have not come to the conclusion that the 1 percent goal is in sight. While the Program's intended timescale for completing the increase is currently set for the end of 2013, given the commitment it has made, the Bank will continue to operate the Program beyond that date.

IV. Second program: loan support program

Making use of accommodative financial conditions

While the creation of accommodative financial conditions represents the first stage of the transmission of monetary easing, the second stage consists of the extent to which a wide range of economic entities actually make use of such accommodative financial conditions.

At present, the average interest rate paid by firms has fallen to nearly 1.5 percent. This is extremely low compared with firms' return on assets (ROA), which has been around 3 percent. Firms are in a position to raise ample funds at interest rates substantially below their rates of return. Thus, at first glance, it seems as though firms only need to borrow some funds and invest them in order to make a profit; yet, this is not necessarily the case.

Rather, they are faced with a situation where they have little confidence that if they do borrow funds they will actually be able to sell their products or services and make sufficient profits. Put differently, stagnant growth expectations have been preventing firms from being more aggressive in their business activities, and under these circumstances the accommodative financial conditions are not fully made use of.

In order to overcome this sense of stagnation, we need to make efforts to strengthen the growth potential of Japan's economy. As such efforts proceed and growth expectations pick up, firms' profit prospects will improve, the expected rates of return on new investments will increase, and firms will become more proactive in their spending such as on investment. Once such a virtuous circle has taken hold, the accommodative financial conditions will have even stronger effects, and the virtuous circle will become more sustainable. This is what we aim to achieve at the second stage of the transmission mechanism of monetary easing.

In terms of creating a favorable business environment, the government also plays an important role. On October 30, 2012, the government and the Bank of Japan released a joint statement with the title "Measures Aimed at Overcoming Deflation" in order to state clearly the shared understanding of their respective roles to overcome deflation. This statement reconfirms the importance of the government's role in creating a favorable business environment. The Bank strongly expects the government to generate new demand by vigorously promoting measures – including decisive regulatory reform – for strengthening Japan's growth potential, based on the government's recognition that reforming the economic structure predisposed to deflation is essential in order to overcome deflation.

Establishment of the framework for the "stimulating bank lending facility"

From the perspective of boosting the second stage of the transmission mechanism of monetary easing, the Bank in 2010 introduced the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth (I called it the Growth Foundation Strengthening Facility or GFSF in my previous speeches) in order to make its utmost contribution as the central bank. This facility enables the Bank to provide long-term funds at a low interest rate to financial institutions carrying out lending and investment that contribute to Japan's economic growth. Moreover, for a central bank, this is an extraordinary measure in the sense that it directly influences the lending activity of financial institutions. However, because the intention of the policy has been widely understood, I believe that the facility has been able to generate some successful outcomes. It is also heartening that this facility has served as a trigger for a wide recognition of the importance of strengthening the economy's growth potential.

Further to the introduction of this facility, the Bank on October 30, 2012 decided to establish the framework for the Fund-Provisioning Measure to Stimulate Bank Lending (I will call it the Stimulating Bank Lending Facility or SBLF hereafter) with a view to promoting aggressive action by financial institutions and helping to stimulate proactive credit demand by firms and households. Under this facility, the Bank will provide long-term yen-denominated funds at a low cost to financial institutions, at their request, up to an amount equivalent to the net increase in their lending. The total amount of funds provided by the Bank will be "unlimited" – that is, there shall be no upper limit. Financial institutions' lending eligible under the SBLF can be either yen-denominated or foreign currency-denominated. With economic globalization continuing, the growth potential of financial institutions and firms is closely linked to their overseas activities. The Bank therefore judged that encouraging lending by financial institutions – irrespective of the currency involved – would be an effective means to boost the growth of Japan's economy, and that strengthening financial institutions' overseas activities would help to support Japanese firms with growth potential from the financial side. Moreover, increasing lending will enhance the profit base of financial institutions themselves in the medium to long term and thus is consistent with what they should be aiming for. In fact, partly because they have shown steady achievements in their business matching activities, the outstanding amount of financial institutions' loans has recently been increasing at a moderate pace.

Both the newly-introduced SBLF and the existing GFSF aim to encourage further use of accommodative financial conditions in Japan by supporting financial institutions' efforts. In that sense, the two facilities are complementary to each other. Specifically, the SBLF intends to support the economy overall from the financial side by encouraging financial institutions to increase their lending and firms and households to increase their borrowing to engage in proactive economic activities. On the other hand, the GFSF mainly aims at playing a catalytic role in encouraging firms and financial institutions to proceed with efforts to strengthen the economy's growth potential.

The Bank decided to call the combination of the SBLF and the GFSF the "Loan Support Program". Under the Loan Support Program, it aims at strengthening the second stage of the transmission mechanism of monetary easing by letting the two facilities achieve their intended consequences. Furthermore, it expects that coupled with the stimulative effects of the Asset Purchase Program the effects of monetary easing as a whole will be amplified.

Looking at the last 12 months, the amount of lending by those banks and *shinkin* banks holding current accounts at the Bank that saw a rise in their lending increased by a total of approximately 15 trillion yen. This implies that under the new facility, the SBLF, those banks are entitled to receive funds of up to approximately 15 trillion yen from the Bank. Together with the 5.5 trillion yen from the GFSF, the total size of the Loan Support Program will be approximately 20 trillion yen. If financial institutions manage to increase their lending more aggressively, the total size of the Program will exceed 20 trillion yen. Furthermore, adding the Asset Purchase Program and the Loan Support Program together, the total size of these programs will easily exceed 110 trillion yen. Given that Japan's nominal GDP in 2011 was 468 trillion yen, the size of these programs is equivalent to almost a quarter of GDP. This shows that the monetary easing undertaken by the Bank at present has reached a level unprecedented in the past.

We strongly expect that financial institutions' efforts to increase their lending will lead to an expansion of the total amount of fresh funds supplied to the economy. To this end, the Bank is currently in the process of working out the details of the new facility, the SBLF, to make it easy for financial institutions to use. We expect to release the details before the end of the year and start operation of the facility as soon as possible.

Because of time constraints, I discussed the Bank's monetary policy focusing on these two programs. The message that I wish to emphasize once again is that the Bank has been and will always be ready to take appropriate and decisive action when the economy strays too far from the baseline scenario of the outlook for economic activity and prices or when risks to that scenario materialize. Going forward, in order to achieve its price stability goal for the time being, the Bank is determined to pursue its aggressive monetary easing, making full use of the new policy measures.

Concluding remarks

Let me conclude my speech today by touching on the economy of Niigata Prefecture.

In my speech, I stressed repeatedly the importance of making efforts to strengthen the economy's growth potential in order to overcome deflation. Looking at firms based in Niigata, there are many locations where skills to make top products have been nurtured and accumulated over the years. Even in the midst of fierce competition with overseas firms, many firms have succeeded in maintaining leading market shares either at home or abroad on the back of these skills and using know-how on how to expand sales channels. This shows that firms have been making incessant efforts toward strengthening growth potential in the face of adversity such as the global financial crisis. I have full respect for these efforts.

In addition, while Niigata is one of the most natural resource abundant regions in Japan – for example in terms of oil and natural gas deposits – it has long been involved in promoting renewable sources of energy. Initiatives aimed at commercializing solar power generation on a large scale at solar parks in the "snow country", where daylight hours in winter are short, have started to bear fruit and power generation has commenced. Reflecting the experience after the Great East Japan Earthquake last year, the utilization of renewable energy and the use of environmentally friendly cars and home appliances have been accelerating on a national basis. Given that other countries in the world are likely to face energy constraints in the future, Niigata's experience and accumulated know-how in this field should stand it in good stead to benefit from the first mover advantage.

Looking back at the past year, a major piece of national news was that for the first time in 36 years, crested ibis chicks hatched in the wild on Sado Island in Niigata Prefecture. The crested ibis is registered as a special natural treasure in Japan and the hatching of the chicks is happy news. It is hoped that such happy news can also soon be heard on the economic front. The Bank will continue to make every effort as a central bank and do its utmost to help your initiatives.

Thank you.