Hirohide Yamaguchi: Path to overcoming deflation and decisive additional steps in monetary accommodation

Speech by Mr Hirohide Yamaguchi, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Nagasaki, 31 January 2013.

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Introduction

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

At the Monetary Policy Meeting held last week, the Bank of Japan took additional steps to provide monetary accommodation decisively toward overcoming deflation as early as possible and achieving sustainable economic growth with price stability, and decided on three things. First, the Bank decided to introduce a 2 percent "price stability target." Second, the Bank decided to introduce an "open-ended asset purchasing method" under the Asset Purchase Program. Third, the Bank decided on the joint release of a statement with the Government titled "Joint Statement of the Government and the Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth."

Today, before exchanging views with you, I will first talk about the current state and the outlook for economies at home and abroad, followed by the thinking behind the recent monetary policy decision by the Bank.

I. Overseas economic developments: brightening overseas economies

Let me first state briefly the view on Japan's economy. Japan's economy remains relatively weak. While such situation will likely continue for the time being, thereafter, Japan's economy is expected to return to the moderate recovery path toward the middle of the year as domestic demand remains resilient and overseas economies emerge from the deceleration phase and increase their brightness. Let me explain the background.

Let me start with the developments in overseas economies. Looking back at the developments over the past year, the European debt problem was aggravated up to the summer. Its adverse effects spread over globally through a decline in trade and a deterioration in business sentiment, and, since the summer, many countries have moved deeper into a deceleration phase. While overseas economies have been remaining in a deceleration phase, recently, a silver lining has started to be seen mainly in the United States and China.

Developments in the European economy

By region, the European economy continues to be in a moderate recession phase with continued fiscal austerity and tight financial conditions on the back of a debt problem. Deterioration in business and household sentiment has spread not only to southern European countries that have been burdened with the debt problem but also to core European countries, including Germany and France. As a result, firms' business fixed investment has decreased and weakness in private consumption, particularly of durable goods like automobiles, has become pronounced.

Meanwhile, the policy authorities' responses to the debt problem have made some progress since last summer. Broadly speaking, there were four moves. First, the European Central Bank established a new scheme that allowed for purchases of an unlimited amount of government bonds within the euro area under certain conditions. Second, the framework for supporting Greece was maintained tentatively and support to Spain's banking sector was implemented. Third, the European Stability Mechanism, a permanent support fund for the countries in the euro area, started to operate. And fourth, the establishment of a single banking supervisory mechanism in the euro area was agreed on. As a result of those policy responses, the risk of a panic dispatched from Europe spreading to the global economy mainly through turmoil in global financial markets seems to have subsided considerably.

As for the outlook for the European economy, as belt-tightening fiscal management will continue, a moderate recession might continue for the time being, but eventually the European economy will emerge from the recession phase starting from a pick-up in exports, mainly in core countries like Germany.

Developments in the U.S. economy

The U.S. economy has been recovering moderately. Up to the end of last year, business sentiment became cautious and business fixed investment slowed on the back of uncertainties associated with the so-called “fiscal cliff,” which refers to the concurrent expiration of past tax cut measures and a reduction in fiscal spending at the beginning of this year. Nevertheless, even against such a backdrop, supported by an improvement in labor and income conditions and the low interest rate environment, housing investment has been picking up and private consumption, particularly car sales, has continued to recover.

Hereafter, with the “fiscal cliff” being barely averted, business sentiment is expected to improve and business fixed investment is also expected to recover. It is also likely that private consumption and housing investment will continue improving, supported mainly by the accommodative financial environment. As a result, the U.S. economy will continue to follow a moderate recovery path and is expected to become a driving force of the global economy.

Developments in the Chinese economy

A silver lining has also been seen in the Chinese economy. While inventory adjustment pressure, particularly in the material industry, has been persisting and an increase in production has not yet restored a clear increasing trend, private consumption has remained firm on the back of favorable labor and income conditions. Exports have been showing signs of recovering, albeit with fluctuations. Infrastructure investment has recently been increasing partly due to the policy authorities’ prop-up measures, and a slowdown in an increasing trend in fixed asset investment as a whole has come to a halt. Business sentiment, particularly in the manufacturing sector, has been improving. From a longer- term perspective, the Chinese economy is in a transition phase from high growth to stable growth, and there remains uncertainty whether a smooth transition could be made. Having said that, as for the immediate future, in addition to policy effects both from the fiscal and monetary fronts, inventory adjustment is likely to progress, supported by firm domestic demand, and exports are also expected to pick up, and thus the recovery trend in the Chinese economy will gradually become pronounced.

Developments in the NIEs and ASEAN economies

At present, partly due to stagnant exports to Europe and other countries, the pick-up in the NIEs and the ASEAN economies has moderated. However, as for the outlook, if the global economy increases its brightness led by the United States and China, exports will gradually pick up and the pace of recovery will likely accelerate.

Developments in global financial markets

Meanwhile, the global financial markets have considerably restored stability. Global investors have gradually become ready to take risks. Behind that are (a) in the United States, amid a continuing moderate recovery, the “fiscal cliff” has been barely averted, (b) in Europe, progress has been seen in policy responses with regard to the debt problem, and (c) in the

Chinese economy, a silver lining has gradually started to be seen. Against such a backdrop, stock prices in the United States and Europe bottomed out last summer and have been rising. As investors have turned ready to take risks, yields on southern European countries' government bonds have declined substantially. In the foreign exchange market, the euro has been bought back and the yen has been depreciating.

Outlook for overseas economies

To summarize the above, overseas economies will gradually emerge from the deceleration phase and turn to a moderate recovery, with the United Stated and China being driving forces. Of course, we cannot keep our eyes off the developments in the European debt problem. Whether the recovery in the U.S. economy will continue while overcoming the fiscal problem requires caution. As the Chinese economy is burdened with various problems, I will not say there is no uncertainty whether the economy will make a smooth transition to a recovery path. Those uncertainties continue to warrant thorough attention.

II. The current state and outlook for Japan's economy: path to moderate recovery

Current state of Japan's economy

Let me turn to the developments in Japan's economy. At present, Japan's economy remains relatively weak. While the economy registered somewhat a high annual growth rate of about 3 percent in the first half of 2012 mainly supported by increases in reconstruction-related demand, exports and industrial production declined substantially in the second half due to a deceleration in overseas economies. As capital goods and parts account for a large part of exports and industrial production in Japan, if demand for those goods decline due to weakening activity in the manufacturing industry worldwide, the resultant effects will tend to be large. A substantial decline in exports to China, particularly automobile exports, due to the effect of Japan-China relations, also added to the decline, mainly in exports. As for other effects of Japan-China relations, there has been a large decline in the number of incoming foreign tourists. I have heard that this region has also been affected. Against such a backdrop, there has been an increasing downward revision in the prospects for corporate profits and business sentiment has become cautious. While business fixed investment in the non-manufacturing sector has been firm, there have been increasing moves, particularly in the manufacturing sector, to defer business fixed investment, and thus the overall investment has become somewhat weak. In terms of employment and income, particularly in the manufacturing sector, the number of new job offers declined substantially and overtime work has also been decreasing. In such a way, the deceleration in overseas economies has spread over not only to exports and production but also to domestic demand and employment.

While there have remained effects of the decline following the expiry of subsidies for the purchase of energy-efficient cars, private consumption as a whole, particularly service consumption, has remained resilient. One reason why private consumption maintains resilience might be the underlying support by demand of the elderly. Households headed by 60 years or older account for more than 40 percent in private consumption. In the meantime, public investment, particularly reconstruction-related investment, has been increasing and housing investment has been picking up partly due to the rebuilding of disaster-stricken houses. While such resilience in domestic demand has not offset all the effects of deceleration in overseas economies, it has nevertheless been an element steadily underpinning Japan's economy.

Outlook for Japan's Economy

With regard to the outlook, as I mentioned at the outset, Japan's economy is expected to remain relatively weak for the time being, and thereafter, it is expected to return to the moderate recovery path toward the middle of the year as domestic demand remains resilient and overseas economies gradually increase their brightness. As a recovery is the one following some periods of relatively weak developments and the pace will be moderate, firms might have difficulty realizing an economic recovery. However, there is a good possibility that "with hindsight the first half of 2013 was the turning point." As mentioned earlier, there is a silver lining in overseas economies and, in particular, it is encouraging that the U.S. economy is on a recovery trend. In addition, the recent developments in the yen exchange rate will gradually underpin exports. In domestic demand, public investment is likely to continue to be on an increasing trend and housing investment likely to also continue to pick up. In the not distant future, business fixed investment will likely return to the moderate uptrend partly due to investment related to disaster prevention and energy. Private consumption is likely to remain resilient as a trend, with the effects of the decline following the expiry of subsidies for the purchase of energy-efficient cars subsiding.

Prices

On the price front, the year-on-year rate of change in the consumer price index (CPI) excluding volatile food is around 0 percent. For the time being, it is expected to turn negative due to the reversal of the previous year's movements in energy-related and durable consumer goods, and thereafter, is likely to be around 0 percent again for some time and then gradually increase its rate of change with economic recovery.

Taking into account such developments in economic activity and prices, the Monetary Policy Meeting last week examined the outlook for economic activity and prices for the next two years. Looking at the median of the Policy Board members' forecasts, the real GDP growth rate, following +1.0 percent in fiscal 2012, is somewhat high at +2.3 percent for fiscal 2013, partly due to a surge in consumer spending prior to the consumption tax hike. In fiscal 2014, while there will be some reversal developments, the growth will be +0.8 percent exceeding the potential growth rate. The year-on-year rate of change in CPI excluding volatile food, following –0.2 percent in fiscal 2012, is forecasted to gradually increase the rate of change, with +0.4 percent in fiscal 2013, and, on the basis of excluding the effects of the consumption tax hike, +0.9 percent in fiscal 2014. The reason the Bank set 2 percent as the "price stability target" is, that the achievement of 1 percent – a goal for the time being set by the Bank – has come into sight in fiscal 2014, and that it has judged necessary to clarify its next target. I will later explain again such line of thinking.

III. Thinking behind the recent policy decisions: decisive additional steps in monetary accommodation

Let me explain the Bank's monetary policy conduct.

As I mentioned at the outset, at the Monetary Policy Meeting last week, the Bank took additional steps to provide monetary accommodation decisively toward overcoming deflation as early as possible and achieving sustainable economic growth with price stability. Specifically, first, the Bank has set the "price stability target" at 2 percent in terms of the year-on-year rate of change in the CPI, and second, aiming to achieve the target at the earliest possible time, introduced the "open-ended asset purchasing method" under the Asset Purchase Program. And third, the Bank clarified its posture that it will strengthen policy coordination with the Government and work together.

Introduction of "Price Stability Target"

To begin with, let me talk about the Bank's decision to set 2 percent in terms of the year-on-year rate of change in the CPI as the "price stability target."

Japan's economy has been in deflation for a long period. Behind that not only cyclical factors but structural factors have been at play. Amid substantial changes of the environment for Japan's economy, such as rapid ageing and globalization, Japan has fallen behind in adapting to those changes, and, as a result, the growth rate has been on a downtrend and firms' and households' medium- to long-term growth expectations have also declined. Amid low growth expectations, firms have sought to survive with cost cutting and price competition. In doing so, adjustment has been made mainly in wages and working hours, which exerted successive downward pressure on prices in Japan's economy. To put it another way, if such structure can be converted, it becomes possible to overcome deflation. The bottom line is, it is necessary to restore the flexibility and adaptability of Japan's economy and unlock its potential, and thereby raise firms' and households' growth expectations.

In my view, now is the "window of opportunity" toward overcoming deflation. There is a prospect that the U.S. and the Chinese economies, which have substantial effects on Japan's economy, will return to the recovery path. Against such a backdrop, as I mentioned earlier, the possibility of Japan's economy, which has been stagnant since last year, to return to the moderate recovery path toward the middle of the year has been increasing. Also, in our outlook for economic activity and prices, the possibility for the year-on-year rate of change in the CPI excluding volatile food to reach 1 percent in 2014 has gradually come in sight. Under such changes, if the inflation rate actually rises, people's inflation expectations are also likely to increase. We should not miss this "window of opportunity."

Based on such line of thinking, the Bank has further enhanced its past line of policy of "setting a goal at 1 percent for the time being" and set 2 percent as the "price stability target." Under the target, the Bank will pursue monetary easing aggressively and aim to achieve the target at the earliest possible time.

With regard to such monetary policy conduct of the Bank, we have sometimes been asked whether the Bank has adopted the so-called "inflation targeting." In that regard, looking at the monetary policy conduct of other countries which have actually adopted "inflation targeting," for example, the United Kingdom, the Bank of England conducts flexible monetary policy which takes into account not only developments in prices but also those in other areas, including the real economy and asset prices. The Bank's decision this time of "price stability target" is the same as the one many central banks are currently adopting, and it is generally called "flexible inflation targeting." Within such monetary policy framework the Bank intends to make as decisive policy responses as ever while steadily examining the situation of economic activity and prices.

Introduction of "Open-Ended Asset Purchasing Method"

Next, how to pursue aggressive monetary easing. In particular, let me explain the newly introduced "open-ended asset purchasing program."

The Bank will pursue aggressive monetary easing, aiming to achieve the "price stability target," through a virtually zero interest rate policy and purchases of financial assets, as long as the Bank judges it appropriate to continue with each policy measure. Purchases of financial assets mean to purchase a wide range of financial assets, including government bonds, corporate bonds, CP, exchange-trade funds (ETFs), and real estate investment trusts (REITs), from the market through a program called "Asset Purchase Program." Through the purchases, the Bank aims at encouraging a decline in longer term interest rates and narrowing the risk premiums, thereby facilitating firms' and households' funding at a low cost.

In actually purchasing financial assets, the Bank used to set the goal of an outstanding purchased amount at a particular point of time in the future, like "about 101 trillion yen by the end of 2013." This time, the Bank has decided to purchase a certain amount of financial assets every month without setting any termination date because the Bank judged that it could clearly show its intention to continue purchasing financial assets toward achieving the newly introduced "price stability target." Specifically, after completing the current purchasing method, from January 2014, the Bank will, for some time, purchase every month about 13 trillion yen, 2 trillion of which is Japanese government bonds, of financial assets. As a result, the total size of the Asset Purchase Program will be increased by about 10 trillion yen to about 111 trillion yen in 2014 and is expected to be at least maintained thereafter.

About the new asset purchasing method, we have sometime been asked "As you have introduced a new method, why don't you start purchases immediately rather than waiting until the beginning of next year?" A clear answer would be that the Bank already decided on a massive fund provision of more than 50 trillion yen this year. To elaborate on that, the amount outstanding of the "Asset Purchase Program" now stands at about 65 trillion yen and, by pursuing the already decided purchases, it will increase by about little less than 40 trillion yen by the end of the year. In addition, the Bank introduced last October a framework called "Stimulating Bank Lending Facility," within which the Bank provides funds to financial institutions for the entire amount of a net increase in lending. I will talk about the thrust of the facility later. The fund-provisioning under the facility is expected to reach more than 15 trillion yen in about a year, based on the recent lending data. Putting those together, the Bank will make a new massive fund-provision of more than 50 trillion yen in about a year. On top of those purchases and fund-provisioning, from the beginning of next year, the Bank will purchase about 13 trillion yen of financial assets every month. As just described, the Bank intends to aggressively pursue monetary easing in a continuous manner, and judged that, by being committed to continuing such massive fund-provisioning next year onward at this stage, it would like to make the already accommodative financial conditions further accommodative.

There has also been the opinion that, for the "decisive additional steps in monetary accommodation," a net increase in the Program's total size of about 10 trillion yen might be insufficient. On that point, we would like to be assessed in relation to the Bank's strong posture to pursue monetary easing in a continuous manner from this year to next year onward, as I have just mentioned. Toward achieving the "price stability target" as early as possible, from the beginning of next year onward, the Bank will purchase financial assets without setting any termination date. The total size of the Asset Purchase Program will be increased by about 10 trillion yen in 2014 and is expected to be at least maintained at that high level thereafter. Such commitment by the Bank will be a substantially stepped-up policy posture. Of course, with regard to the future management of the Program, it could be the case that further accommodation will be pursued, while examining the situation of economic activity and prices, if necessary.

Strengthening policy coordination between the Government and the Bank

This time, the Government and the Bank decided and released the "Joint Statement of the Government and the Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth." In the statement, the Bank stated that it set the "price stability target" at 2 percent and, under the target, would pursue monetary easing to achieve the target at the earliest possible time. The Government expressed that it would formulate measures for strengthening the competitiveness and growth potential of Japan's economy, and promote them strongly, as well as steadily promote measures aimed at establishing a sustainable fiscal structure.

As the possibility of Japan's economy returning to the recovery path in the not distant future and the year-on-year rate of change in the CPI excluding volatile food reaching 1 percent in fiscal 2014 has come into sight, the Bank has considered that it would be highly significant to seize the "window of opportunity" and that it would be highly significant if the Government and the Bank work together and make concerted efforts to overcome deflation and achieve sustainable economic growth.

As mentioned earlier, the Bank will pursue monetary easing aggressively with the aim of achieving the "price stability target." In doing so, it is important to steadily ensure the market credibility of fiscal management. The Bank currently holds a large amount of government bonds and will still pursue large-scale government bond purchases. While Japan's fiscal conditions are in a severe state, compared with other countries, yields on government bonds have been at historic low levels. In our view, such situation suggests that market credibility of fiscal management has been ensured. Nevertheless, taking into account the experience of Europe and others, we need to be aware that the market's view could change rapidly. Once credibility of fiscal management wavers, the effects of monetary policy may even be eroded by a rise in interest rates. In addition, there is a risk that, through adverse effects on business performance of financial institutions, which hold government bonds, and eventually on the financial system, financial and economic stability might be impaired. In the joint statement, the government referred to fiscal management and clearly stated that "in strengthening coordination between the Government and the Bank of Japan, the Government will steadily promote measures aimed at establishing a sustainable fiscal structure with a view to ensuring the credibility of fiscal management." That is an important point in the Bank's pursuit of aggressive monetary easing.

IV. Initiatives to utilizing accommodative financial conditions

In concluding the explanation of monetary policy, let me talk about the relationship between monetary easing and firms. Thanks to the Bank's monetary easing, at present, banks' lending rates have declined to a historic low level of around 1 percent both for a short-term and a long-term. Financial institutions have been maintaining their active lending stance and firms and households can quite easily borrow money from financial institutions.

If firms and households make better use of such accommodative financial conditions, the Bank's monetary policy effects will become larger and overcoming deflation as well as sustainable growth with price stability will be achieved earlier and more surely.

For firms and households to thoroughly utilize accommodative financial conditions, what kind of situation does it refers to? Presumably, it is to create a situation in which, for firms, they can foresee profits by borrowing funds and investing the funds, and for households, they can take out housing loans without concern about future income conditions.

I might have to repeat this several times, but, at present, as positive developments have been generated, including developments in economic activity at home and abroad, the Government's policy measures, and ensuing developments in foreign exchange and stock markets, which offers a "window of opportunity" to build up economic entities' momentum to utilize the current situation. Financial conditions are quite accommodative and the Bank will continue to promote monetary easing aggressively. We are looking forward to positive actions by firms.

For financial institutions that have contact with firms, while thoroughly knowing that they have been aggressively making efforts, we would like to ask the institutions to further make efforts to encourage firms' positive actions and to tap new fund demand. In that regard, the Bank itself will provide support as a central bank as much as possible. At present, with a view to being a catalyst for firms and financial institutions to promote efforts toward strengthening growth potential, the Bank has a framework of "the fund-provisioning measure to support strengthening the foundations for economic growth." It is the framework in which the Bank provides low interest rate and long-term funds to financial institutions providing loans to or investing in wide-ranging areas that contribute to the growth of Japan's economy, such as medical and nursing care, environment and energy, agriculture, forestry and fisheries, and tourism. The Bank has prepared 5.5 trillion in a total amount of the framework and already about 4 trillion yen has been used. In addition, as I briefly mentioned earlier, last October, with the view to promoting financial institutions' aggressive action and helping increase proactive credit demand of firms and households, the Bank introduced a new framework of "Stimulating Bank Lending Facility." Under the facility, in 15 months through end-March 2014, if financial institutions increase net lending, the Bank will provide an unlimited amount of long-term funds at a low interest rate for the net increase. In thoroughly utilizing the accommodative financial conditions, the Bank will continue to use its ingenuity, seeing whether there is anything that can be done further as a central bank.

Concluding remarks

As time is running out, let me conclude my speech by touching on the economy of Nagasaki Prefecture.

Nagasaki Prefecture, as a region that has been open to the world since ancient times, has played a major role in formulating Japan's culture and modernization as well as nurturing a unique regional culture. It is blessed with nature like beautiful coast lines as well as ample tourism resources such as hot springs and agricultural and marine products, receiving many tourists from home and abroad. As a move to further enhance the attractiveness of Nagasaki, last August, the construction of the railway between Isahaya Station and Nagasaki Station of the Nagasaki route of the Kyushu Shinkansen line began with an aim of completion in 2022. I have heard good news that, last October, Nagasaki City was chosen as one of the world's top three nightscapes along with Monaco and Hong Kong at "Nightscape Summit 2012 in Nagasaki."

Meanwhile, the population, particularly in remote islands, has been declining, and, above all, the prefecture is faced with a great challenge of the continuing exodus of young people to other prefectures. Needless to say, that is the epitome of a challenge Japan as a whole is faced with. In response, the prefectural administration has been making aggressive efforts to utilize a location advantage, including a diversity of remote islands and a friendly relationship with overseas, as well as to incorporate the vitality of Asian countries like South Korea and China. In promoting such projects, I have heard that "Nagasaki Summit," which is a venue for industry-academia-government collaboration, has also been playing a critical role.

Turning to the financial front, local financial institutions, through collaborating with the administration and universities, have been supporting the establishment and nurturing of local firms' new business and business revitalization of troubled firms. Several of these institutions have been participating in the Bank's "fund-provisioning measure to support strengthening the foundations for economic growth." As "Stimulating Bank Lending Facility" will start, I strongly hope that local institutions could make the most of the facility.

As I have just mentioned, in Nagasaki Prefecture, the fruits of the efforts toward incorporating external demand and tapping domestic demand have been steadily accumulated, and that will not only be the foundations for Nagasaki Prefecture's future development, but also be a precious asset for Japan as a whole and, further, for Asian countries which are bound to be faced with similar challenges in the not-so-distant future.

The Bank expects your various efforts and will continue to provide support as much as possible as a central bank.