Koji Ishida: Recent economic and financial developments

Speech by Mr Koji Ishida, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Tochigi, 11 March 2013.

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I. Economic activity and prices

A. Recent financial and economic developments

1. Overview

I would like to start by looking at recent developments in the global economy.

The global economy plunged following the Lehman shock in 2008, but moved subsequently toward recovery. Since mid-2011 however, it has decelerated following the outbreak of the European sovereign debt crisis triggered by the fiscal problem in Greece.

Thereafter, as the debt problems in major economies such as Spain and Italy also worsened, the euro area economy entered a severe recession and the real GDP growth rate for the area turned negative in 2012. In addition, the growth rate declined for the Chinese economy, which exports a great deal to Europe, and emerging and commodity-exporting economies in general were seriously affected. In these circumstances, Japan's economy has inevitably undergone significant adjustments since summer 2012, such as in the form of a decrease in production and curbs on business fixed investment due to a drop in exports.

The problems in the euro area have shown signs of stabilizing, reflecting progress made since the latter half of 2012 in establishing frameworks to avert a crisis. Examples include the introduction of a program called Outright Monetary Transactions (OMTs), through which the European Central Bank (ECB) purchases government bonds issued by euro area countries facing financial difficulties, and the start of the operation of the European Stability Mechanism (ESM). In this situation, markets outside the euro area have begun to factor in the bottoming out of respective economies. The International Monetary Fund (IMF) has projected that the global economy will recover in 2013 and 2014, having bottomed out in 2012.

2. European economy

The euro area economy, which is considered to have triggered the global economic slowdown in 2012, remains in a moderate recessionary phase. Private consumption in the euro area has been on a downtrend since 2011 against the backdrop of the debt problems. Car sales have been particularly weak. Looking at exports and production, exports to outside the area had been solid, primarily in Germany with its competitive edge, owing in part to the depreciation of the euro to date. However, these exports have more recently shown sluggish growth due to the deceleration in the global economy. As a result, production, which had already been stagnant due to weak consumption in the euro area, has declined further. However, with the pick-up in the global economy, there are indications of a halt in the deterioration of business sentiment – a leading economic indicator – and some positive developments in other economic indicators. Even so, given that some peripheral European countries need to continue to implement fiscal austerity measures, the European economy as a whole is highly likely to remain sluggish for the time being.

The fundamental cause of the European sovereign debt crisis and the current economic stagnation presumably lies in the imbalance between individual economies in the euro area. National currencies were unified into the single currency of the euro despite disparities in the economic strength of the countries involved, but sovereignties over fiscal and other national affairs have not been unified. In these circumstances, peripheral European countries experienced an economic boom, as their previously high interest rates converged toward the low level of Germany's interest rates following the currency union and their funding from global capital markets became easier at low cost. Subsequently, peripheral European countries ran current account deficits, and their deficits were covered by investment and borrowing from the private sector mainly in the core euro area countries. Moreover, peripheral countries allowed labor costs to rise, causing a widening gap in competitiveness with euro area countries that enjoyed high productivity, such as Germany.

The funding conditions have deteriorated for financial institutions in the peripheral European countries burdened with the debt problems, since the problems have worsened amid a global increase in awareness of credit risk arising from interbank funds transactions in the wake of the Lehman shock. This implies that it has become difficult for peripheral European countries' current account deficits to continue to be financed with funds from other countries' private sectors. From 2011 through the first half of 2012, the debt problems in the euro area not only raised tensions in global financial markets but also exerted significant downward pressure on the global economy as a whole. Since the latter half of 2012, however, the situation has shown signs of stabilizing reflecting the implementation of a number of measures to avert a crisis, as I mentioned earlier.

Nevertheless, since the economic imbalance in the euro area that lies at the root of the crisis has not yet been resolved, due attention should continue to be paid to the possibility that some events might cause a crisis to recur. I see the risks to the outlook for the European economy as still tilted sharply to the downside.

3. U.S. economy

Next, I will discuss the U.S. economy. Although the Lehman shock originated in the United States, the U.S. economy has regained momentum since the plunge and has been growing at an average annual rate of around 2 percent. In the October–December quarter of 2012, the real GDP growth rate slowed due to negative contributions from inventory investment and government spending, but domestic final private demand items, such as private consumption and housing investment, maintained their uptrend.

With regard to business sentiment, the business sentiment index for the nonmanufacturing sector has stayed firm. Meanwhile, the index for the manufacturing sector fell temporarily to around the breakeven point of 50 reflecting the deceleration of the euro area and Chinese economies together with the "fiscal cliff" problem in the United States, but it has recently been recovering. As for the outlook, assuming that uncertainties arising from fiscal and other problems are gradually dispelled, I expect that business sentiment in the manufacturing sector will gradually pick up, and that, as a result, production and business fixed investment will gain momentum.

As for the employment situation, the unemployment rate, which had remained between approximately 4 to 6 percent, jumped to around 10 percent after the Lehman shock occurred. In the four years thereafter, the unemployment rate fell back only to slightly below 8 percent. Compared with the loss of about 9 million jobs, new jobs created totaled only about 6 million despite an increase in the working population. However, as the number of employees has been steadily rising, the employment situation is improving as a trend.

With regard to developments in the household sector, car sales have recovered considerably and housing prices, which had bottomed out, are starting to rise, albeit moderately. The number of housing starts is still around half of the level seen before the bursting of the housing bubble but is increasing moderately. Viewed from another angle, the current low level means that there is still ample room for growth.

The Lehman shock was caused by the formation and bursting of the U.S. housing bubble, so it is expected to take a long time before the excess debt in the household sector that was created during the bubble's formation is resolved. This balance-sheet problem in the household sector, coupled with downward pressure arising from the fiscal side, has probably held down U.S. economic growth to around 2 percent, although the growth rate without these negative factors would have been essentially somewhat higher. The ratio of household debt to disposable income has been declining after rising sharply during the bubble period. Although the ratio remains at a high level, it is converging toward the trend line. If the recent rise in housing prices continues, the balance-sheet problem is expected to ease, leading to more vigorous household spending activity due to the wealth effects.

The U.S. economy has been confronted with a very serious problem of the fiscal cliff. The fiscal cliff refers to a state in which the expiration of various tax cuts – namely, those introduced by the administration of former President George W. Bush and those carried out after the Lehman shock – and the implementation of automatic spending reductions threatened to occur simultaneously at the start of 2013. Given the extremely large scale of the tax cuts and spending reductions, there were concerns that the fiscal cliff could exert strong downward pressure on the economy, depending on how it was dealt with. Concerning the expiration of the tax cuts, a compromise was recently reached to extend some of them. However, a resolution was not achieved before the new deadline of March 1, 2013 for automatic spending reductions, and spending reductions have begun. As a series of problems lie ahead – such as the expiration of the provisional budget on March 27, 2013 and of the suspension of the federal debt ceiling by mid-May – the fiscal issues could still turn out to be a major destabilizing factor for the U.S. economy.

It is expected that a compromise will eventually be reached over these problems. In any case, it is inevitable that U.S. economic growth will be restrained in the first half of 2013 given the negative factors on the fiscal front, such as tax increases and spending cuts. However, economic growth should accelerate gradually in and beyond the middle of 2013, when the effects of the problems are likely to subside. In this case, U.S. long-term interest rates may rise gradually, which may in turn affect long-term interest rates in Japan and the U.S. dollar-yen exchange rate. Accordingly, close monitoring of future developments is required.

4. China's economy, and the NIEs and the ASEAN economies

With regard to the Chinese economy, the Chinese authorities implemented tightening measures, such as those to restrain the increase in real estate transactions and curb public investment, due to concerns that the massive economic stimulus measures that had followed the Lehman shock could cause an acceleration in inflation and a surge in asset prices. Because the decline in China's exports to Europe was combined with the effects of the tightening measures, downward pressure on the Chinese economy grew as a whole. However, since summer 2012 the authorities have partly revised their policy stance, and the conduct of monetary policy has become rather accommodative. In these circumstances, the Chinese economy has recently been picking up, supported also by expectations of a recovery in the global economy.

Private consumption has been firm on the back of a favorable employment and income situation. As for fixed asset investment, the pace of increase has slowed, reflecting excessive production capacity of materials and slower growth in exports in the manufacturing sector, but this slowdown in investment has recently been coming to a halt due to recoveries in public investment and real estate investment. Business sentiment in the services sector has been firm, and that in the manufacturing sector has started improving as business conditions have recently turned for the better.

China's exports have started to recover after bottoming out in the July–September quarter of 2012. A drop in exports to Europe, which account for a large share of China's overall exports, has been counterbalanced by increases in exports to other destinations. In 2012, the share of exports to the United States surpassed that of exports to Europe. As for the outlook, although some uncertain factors remain, I expect that the growth rate of the Chinese economy will gradually rise and succeed in reaching somewhere between 8 and 8.5 percent for the year.

The pace of pick-up in the NIEs and the ASEAN economies remains moderate as business fixed investment, particularly in the NIEs, has been sluggish. As for the outlook, however, if the prospects for the global economy brighten – led by the U.S. and Chinese economies – the pace of recovery in the NIEs and the ASEAN economies is likely to increase, supported by a gradual pick-up in exports and firm domestic demand.

5. Current state of Japan's economy

Thus far, I have talked about developments in overseas economies. Let me turn now to Japan's economy.

Japan's economy, which had been recovering steadily from the plunge following the Lehman shock in 2008, was significantly affected by the Great East Japan Earthquake of March 11, 2011. Thereafter, flooding in Thailand temporarily acted to brake Japan's economic growth, but relatively high growth was achieved during the first half of 2012 due partly to a rebound from the plunge, inventory restocking, and heightened demand for rebuilding.

Nevertheless, as the second half of 2012 began exports and production decreased sharply, reflecting the deceleration in the global economy due to the worsening of the European debt problem and the slowdown in the Chinese economy. The real GDP growth rate for the July–September quarter of 2012 was minus 0.9 percent on a quarter-on-quarter basis and minus 3.7 percent on an annualized basis. However, that for the October–December quarter was 0 percent on a quarter-on-quarter basis and 0.2 percent on an annualized basis, and Japan's economy seems to have stopped weakening recently, in a situation where overseas economies have shown signs of picking up, as I mentioned earlier.

However, the pace of improvement in Japan's exports seems somewhat slow compared with developments in overseas economies. This is attributable to a degree to the drop in exports to China, reflecting in part the recent developments in the relations between Japan and China, but it is largely attributable to the sluggish exports of capital goods and parts, which are a major category of Japan's exports along with automobiles. In this regard, the sluggishness in exports of capital goods and parts is strongly affected by the fact that sentiment in the manufacturing sector has deteriorated worldwide amid the current phase of global economic deceleration, causing firms to take a cautious stance toward business fixed investment. If a recovery trend in overseas economies becomes clear and production starts increasing, firms will regain their appetite for business fixed investment, raising the level of Japan's exports.

I have discussed overseas demand. Now, looking at domestic demand, public investment, in terms of the amount of public construction completed, has continued to increase since around the end of 2011, primarily in that related to reconstruction following the earthquake disaster. Public investment is expected to continue trending upward, supported by the effects of various economic measures. Business fixed investment has shown some weakness on the whole, as that in the manufacturing sector has declined due to the drop in exports and production, although resilience has been observed in investment in the nonmanufacturing sector. On the other hand, private consumption remains resilient and the effects of the decline in car sales due to the ending of measures to stimulate demand for automobiles have fallen off. Private consumption is expected to remain resilient as a trend. Attention, however, needs to be paid to the fact that the income situation cannot necessarily be regarded as firm, given that summer and winter bonus payments in 2012 were below the previous year's levels and non-scheduled cash earnings have also declined. Meanwhile, housing investment has generally been picking up, supported in part by reconstruction of disaster-stricken homes. It is expected to continue to do so, as a front-loaded increase in demand prior to the consumption tax hike is likely to occur.

Recently, stock prices have been rising and the yen has been depreciating. A number of factors have been pointed out as the background to these developments, including (1) abating tensions in the global financial markets due to a settling down of the European sovereign debt crisis for the time being and the reduced threat of the fiscal cliff; (2) expectations for the outlook for the U.S. and Chinese economies; and (3) the widening of Japan's trade balance deficit and a sharp fall in the current account surplus. Rising expectations in regard to the policy conduct of the government and the Bank of Japan are also a large factor. In these circumstances, business and household sentiment has improved significantly.

As overseas economies recover, Japan's economy is expected to return to a solid recovery path as well. In this situation, it is particularly important that the improved business and household sentiment be maintained to ensure strong momentum for recovery.

B. Outlook for Japan's economic activity and prices

Next, I will talk about the outlook for Japan's economic activity and prices. Semiannually, in April and October, the Bank releases the *Outlook for Economic Activity and Prices,* known as the Outlook Report, in which it presents its outlook for economic activity and prices for the next two years, carefully assesses upside and downside risks, and summarizes its thinking on the conduct of monetary policy. Then, in January and July, the Bank makes interim assessments of the outlook laid out in the Outlook Report. According to the interim assessment made in January 2013, the Policy Board members' baseline scenario for Japan's economy is that it is expected to level off more or less for the time being, and thereafter it will return to a moderate recovery path as domestic demand remains resilient, partly due to the effects of various economic measures, and as overseas economies gradually emerge from the deceleration phase. As for prices, the year-on-year rate of change in the consumer price index (CPI) is expected to turn negative for the time being, due to the reversal of the previous year's movements in energy-related and durable consumer goods, and thereafter it is likely to be around 0 percent again. The year-on-year rate of change in the CPI is expected to then start rising moderately as the aggregate supply and demand balance improves.

Specifically, the median of the Policy Board members' forecasts for Japan's real GDP growth rate is 2.3 percent for fiscal 2013 and 0.8 percent for fiscal 2014. The median of their forecasts for the year-on-year rate of change in the CPI is 0.4 percent for fiscal 2013 and 2.9 percent for fiscal 2014 – or 0.9 percent excluding the direct effects of the consumption tax hike. While this outlook entails various risks, the Bank also presents the Risk Balance Charts, which show the probability distribution of the forecasts taking into account such upside and downside risks. According to this distribution, the upside and downside risks to the outlook are broadly balanced.

Thus far, developments in Japan's economic activity and prices have been in line with this outlook.

II. Monetary policy

Now, I will outline the Bank's current conduct of monetary policy, based on the current state of Japan's economy and the future outlook just described. At the Monetary Policy Meeting (MPM) held on January 21 and 22, 2013, the Bank took additional steps to provide monetary accommodation decisively to overcome deflation early and achieve sustainable economic growth with price stability. It also introduced the "price stability target" of 2 percent in terms of the year-on-year rate of change in the CPI.

A. Introduction of the "Price Stability Target"

In this regard, I would first like to talk about the "price stability target" of 2 percent.

In February 2012, the Bank judged that the inflation rate consistent with price stability sustainable over the medium to long term was in a positive range of 2 percent or lower in terms of the year-on-year rate of change in the CPI, and set the "price stability goal" at 1 percent for the time being. With the aim of achieving this goal, the Bank has been pursuing monetary easing.

In January 2013, however, as a replacement for this 1 percent goal, the Bank set the "price stability target" of 2 percent.

As mentioned earlier, the median of the Policy Board members' forecasts for the year-on-year rate of change in the CPI excluding the direct effects of the consumption tax hike is 0.9 percent for fiscal 2014. This figure is the average for fiscal 2014, and under this forecast it is projected that the rate of change will reach 1 percent on a monthly basis at around the end of fiscal 2014. Given this situation, with the aim of better ensuring the overcoming of deflation, the Bank decided to work to achieve the target of 2 percent thereafter.

Since the 1980s, except for the period immediately after the bursting of the bubble, the year-on-year rate of change in the CPI in Japan remained consistent, at a level below 2 percent. There has been a delay in adjusting Japan's economy in response to structural change such as rapid population aging and increasing globalization, and as a result the potential growth rate as well as firms' and households' medium- to long-term expectations for growth have been declining. In these circumstances, a chronic shortage of demand has been observed and therefore the negative output gap has had less of a tendency to narrow. In this situation, firms have committed to cutting costs to survive competition while maintaining employment, and this has also exerted continued downward pressure on wages. These overall developments have led to the persistent downward pressure on prices.

To overcome deflation, it is necessary to reverse this vicious cycle by responding appropriately to structural change, and raising firms' and households' medium- to long-term expectations for growth. The price stability target of 2 percent is significantly high considering the long-term developments in Japan's price situation, but if the general public's expectations for growth of the economy heighten – causing the actual inflation rate to rise – the public's expectations for inflation can also be expected to increase. I believe that the achievement of the price stability target of 2 percent can be highly expected, if – in parallel with the pursuit of aggressive monetary easing by the Bank – efforts by a wide range of entities toward strengthening the competitiveness and growth potential of Japan's economy make progress.

B. Introduction of the "Open-Ended Asset Purchasing Method"

As I have explained, the Bank will pursue aggressive monetary easing, aiming to achieve the "price stability target". Specifically, the Bank decided at the MPM held on January 21 and 22, 2013 to (1) continue with a virtually zero interest rate policy and purchases of financial assets for as long as the Bank judges it appropriate to continue with each respective policy measure and (2) introduce the open-ended asset purchasing method for purchases of financial assets from January 2014.

The Bank purchases various financial assets – such as government securities, corporate bonds, CP, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs) – from the markets through the Asset Purchase Program, and aims to encourage a decline in longer-term interest rates and a narrowing of risk premiums.

The Bank set the size and term of the Asset Purchase Program as about 101 trillion yen by the end of 2013. After completing the term for the current purchasing method, from January 2014, the Bank will for some time purchase financial assets totaling about 13 trillion yen every month without setting any termination date. This new method was introduced because the Bank judged that it could clearly show its intention to continue purchasing financial assets toward achieving the newly introduced "price stability target".

C. Fund-provisioning measure to stimulate bank lending

The Bank has been continuing with the virtually zero interest rate policy and providing ample funds to the money market, and the effects of its monetary policy will become stronger if firms and households make greater use of the current extremely accommodative financial conditions.

From this viewpoint, the Bank formally launched the fund-provisioning measure to stimulate bank lending (the Stimulating Bank Lending Facility) in December 2012 with the aim of promoting financial institutions' aggressive action and helping stimulate the proactive credit demand of firms and households. With this facility, the Bank will provide long-term funds at a low interest rate to financial institutions that have increased their lending, at their request, up to an amount equivalent to the net increase in their lending, with no upper limit to the total amount of funds to be provided by the Bank under this facility. In June 2010, prior to the establishment of this facility, the Bank introduced the fund-provisioning measure to support strengthening the foundations for economic growth (the Growth-Supporting Funding Facility). The Bank has prepared a framework consisting of 5.5 trillion yen in total – including loans in U.S. dollars – and nearly 4 trillion yen has already been used.

D. Strengthening policy coordination between the government and the bank

On January 22, 2013, in line with the further pursuit of aggressive monetary easing I have just described, the government and the Bank released "Joint Statement of the Government and the Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth". In the statement, the Bank announced that it would pursue monetary easing and aim to achieve the "price stability target" of 2 percent at the earliest possible time. Concurrently, the government announced that it would not only flexibly manage macroeconomic policy but also strongly promote measures for strengthening the competitiveness and growth potential of Japan's economy as well as steadily promote measures aimed at establishing a sustainable fiscal structure.

As mentioned earlier, the growth strategy – which aims at restoring the flexibility and adaptability of Japan's economy and raising its potential – is extremely important for Japan. Furthermore, Japan's fiscal situation is very severe compared with other countries. Although yields on Japanese government bonds (JGBs) are stable at a historically low level, this is simply because the credibility of Japan's fiscal management in financial markets has been ensured. If such credibility were to falter, interest rates would rise substantially, undermining the effectiveness of monetary policy as well as increasing the loan burden on individuals and firms, and inflicting damage on the business conditions of financial institutions with JGB holdings. The economy would naturally be affected adversely. These developments would also increase interest payments on JGBs and subsequently lead to a worsening fiscal situation. Such a case must be avoided. This necessity is made apparent by the recent situation in the euro area. The Bank has been purchasing a large amount of government securities and will continue to do so. In order for the Bank to proceed with massive monetary easing, it is extremely important to steadily promote measures aimed at establishing a sustainable fiscal structure.

As I have described, the Bank will work together with the government and do its utmost to overcome deflation early and achieve sustainable economic growth with price stability.