Masaaki Shirakawa: Recent economic and financial developments and the conduct of monetary policy

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at a meeting with business leaders, Osaka, 25 August 2008.

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Introduction

I am honored to be here today to speak and to exchange views with business leaders from the Kansai region. I have especially fond memories of the region because I taught as a professor at the Kyoto University School of Government for about two years before being appointed as the Governor of the Bank of Japan this spring. I would like to take this opportunity to express my deep gratitude for your cooperation with the Bank's branches in Osaka, Kobe, and Kyoto.

Today, I will speak about issues facing Japan's economy and the Bank's thinking regarding the conduct of monetary policy.

I. The current situation of Japan's economy

First, I would like to discuss the current situation of Japan's economy. Since the beginning of 2002, the economy has enjoyed a moderate but prolonged period of economic expansion. Since the end of last year, however, the pace of economic growth has gradually slowed. Business fixed investment has been leveling off because the rise in energy and materials prices, which has accelerated since this spring, has depressed corporate profits. Private consumption has also been relatively weak due to the ongoing price rise, while growth in wages has remained sluggish. The pace of increase in exports has slowed, because of the effects of a slowdown in overseas economies. Given this situation, the Bank's assessment at the Monetary Policy Meeting held on August 18 and 19 was that Japan's economic growth has been sluggish.

Prices, on the other hand, have been on the rise. The year-on-year rate of increase in the domestic corporate goods price index (CGPI) exceeded 7 percent in July due mainly to the rises in prices of steel and petroleum products. This was the highest rate of increase in 27 years, since 1981. The year-on-year rate of increase in the consumer price index (CPI) also rose in June to 1.9 percent. This was the highest rate in 15 years excluding fiscal 1997, when CPI inflation increased reflecting the rise in the rate of consumption tax.

Japan currently faces a difficult situation given the sluggishness in the economy and the rise in prices. This situation has been caused by two factors: the surge in energy and materials prices; and the disruptions in global financial markets stemming from the U.S. subprime mortgage problem, and the slowdown in the global economy.

II. The surge in energy and materials prices and Japan's economy

First, I will address a topic related to the surge in energy and materials prices. A rise in such prices exerts downward pressure on Japan's economy, which depends heavily on imports of resources, through a decrease in purchasing power – an outflow of income. At the same time, it exerts upward pressure on prices.

Let us look back on the two oil crises Japan previously faced. During the first oil crisis, crude oil prices surged from 3 U.S. dollars to 12 dollars per barrel – a fourfold rise – in a brief period between 1973 and 1974. During the second oil crisis, they surged from 15 dollars to 40 dollars between 1979 and 1980. Unlike these two cases, the current surge has been continuing over an extended period, which makes a comparison of the rise in oil prices difficult, since the extent of the increase differs depending on where one starts the calculation. If we start from 2002, when the level of oil prices was 21 dollars, the current level of 110-120 dollars – somewhat below the recent peak – is more than five times the level recorded in 2002. This means that the rise during the current phase has been the largest, even compared with the two oil crises. As a result, the size of the income outflow resulting from the surge in oil prices has also been the largest during the current phase: about 5 percent of real GDP, compared with about 3 percent during the two oil crises.

Rises in crude oil prices, as well as the resultant outflows of income and decreases in production capacity, should be accepted as given conditions for Japan's economy. In other words, they cannot be avoided. However, economic and price developments differed markedly between the periods immediately after the two oil crises emerged.

During the first oil crisis, Japan's economy suffered from a combination of runaway inflation and economic stagnation – in other words, stagflation. Economic indicators show that the economy, which continued enjoying rapid annual growth of 8-9 percent until 1973, suddenly contracted by 1 percent in 1974 and CPI inflation peaked at an annual rate of 25 percent in 1974. Contrarily, during the second oil crisis, the economy continued to grow at a rate of 3-5 percent and the CPI posted only a single-digit increase. At that time, CPI inflation exceeded 10 percent in the United States and 20 percent in the United Kingdom, and it can therefore be said that during the second oil crisis Japan's economy, together with the German economy, performed extremely well relative to other countries.

What then made the difference in Japan's economic and price performances between the two oil crises? Of the various factors, two seem to be most important.

The first factor was the difference in the economic and price situation immediately before the crises as well as the policy response. Just before the first oil crisis, there was an economic boom stemming partly from the government's plan for "remodeling the Japanese archipelago." The economy was overheated and the financial environment was overly accommodative, having increased the inflation expectations of households and firms. In fact, the rate of annual wage increases exceeded 20 percent in 1973. Against this background, a surge in crude oil prices increased inflation expectations further, making matters even worse. On the other hand, when the second oil crisis occurred, the economy was not overheated, the financial environment was not overly accommodative, and inflation expectations were restrained. In this situation, monetary tightening was initiated in a timely manner, and this kept inflation expectations low and thus succeeded in avoiding the so-called second-round effects – a rise in prices of non-petroleum goods and services triggered by a rise in crude oil prices. It was widely acknowledged that Japan's economy had successfully contained "home-made" inflation.

The second factor was that Japan succeeded in transforming its economic structure while accepting the change in the relative-price structure due to the surge in crude oil prices. After the first oil crisis, Japanese firms pursued resource-saving production, and as a result, crude oil consumption per unit of output – the amount of crude oil used to produce a unit of value added – decreased in 1980 by 22 percent compared with the period of the first oil crisis. Meanwhile, Japanese firms made use of the change in the operating environment, seeking to develop energy-saving products such as small passenger cars, and this strengthened their international competitiveness. To put it another way, Japanese firms – which succeeded in transforming their production structure into one that was compatible with high crude oil prices, or with the new structure of relative prices – reacted positively to the change in the operating environment and created areas of comparative advantage. This contributed to overcoming the second oil crisis and to Japan's economic growth thereafter.

The two factors I have just mentioned caused the large difference in economic developments between the two oil crises. The experience seems to clearly suggest policies necessary to cope with the current rise in crude oil prices. First, the second-round effects should be avoided so that inflation is contained within the rise in import costs and passing of the rise in import costs on to output prices. And second, it is crucial to promote a change in economic and industrial structures to make them compatible with the new structure of relative prices. It should, however, be noted that the current rise in crude oil prices has characteristics different from the past crises. In the current phase, global demand for crude oil has continued expanding over an extended period, and growth in demand from emerging economies has contributed in particular. On the other hand, in the past oil crises, supply constraints were the main cause of the rise in crude oil prices, rather than increases in demand. I will touch on such issues related to the difference in the background of price rises later when I discuss risks related to price developments.

III. The U.S. subprime mortgage problem

I will move on to the second factor causing sluggish growth in Japan's economy: the disruptions in global financial markets and the slowdown in the global economy.

Roughly one year has passed since the U.S. subprime mortgage problem emerged, and the nature of this problem seems to have evolved over time.

The first stage was the time of "liquidity constraints." Conduits and aggregators of securitized products including those backed by subprime mortgages faced difficulties in raising funds from the market, as a result of large declines in the prices of such products. Financial institutions' liquidity demand grew considerably to provide the conduits and aggregators with liquidity, and this exerted strong upward pressure on interest rates in U.S. and European money markets, where financial institutions borrow and lend funds. In reaction to the liquidity constraints and the surge in money market rates, central banks have strived to ensure market stability by devising various measures, for example, extending the term of liquidity provisions and widening the range of counterparties and collaterals.

As the money markets gradually moved closer toward stability, the second stage emerged: the time of "credit contraction," which began in early 2008. The declines in the prices of securitized products increased financial institutions' losses and reduced their capital bases; consequently, financial institutions have tightened their credit standards and their lending attitudes. This has exerted strong downward pressure on the economy.

Most recently, a third stage has emerged. In this stage, delinquency rates of not only subprime-related products but also commercial real estate loans and consumer loans have been rising reflecting the sluggishness in the U.S. economy. As a result, a situation in which the sluggishness in the economy causes financial institutions' asset quality to deteriorate further – with further adverse impact on the economy – is becoming a cause for concern. To put it another way, at the third stage there are concerns about a negative feedback loop between financial markets, asset prices, and economic activity.

Many discussions have taken place on what kinds of lessons can be drawn from the U.S. subprime mortgage problem. Since the nature and background of the problem are complex, I hesitate to draw lessons prematurely. It might be argued that the cause of the problem was investors' and financial institutions' lax risk management. This observation seems to me accurate, but it would not be true to say there were no warning signs about the accumulation of risks. We must therefore pursue the reason why many market participants made the mistakes that eventually led to the problem despite the warning signs. Although solutions at this point have yet to fully emerge, several major issues – although not completely new – seem again to have come to the fore.

Looking back at previous bubbles in financial activities and asset prices, including Japan's asset price bubble, we can see that many have occurred following a period of price stability and continued low interest rates. In the current phase too, investors and financial institutions eased their credit standards and increased dependence on loans or leverage, accelerating their "search for yield" through investment in, for example, securitized products. Underlying this situation were excessively accommodative financial conditions and credit expansion on a global scale – amid a prolonged period of economic growth and low inflation. On the other hand, when bubbles burst, capital bases of financial institutions are impaired and the period of credit contraction begins, depressing economic activity and constraining the transmission of monetary policy. Similar to cases when bubbles emerge, the current U.S. subprime mortgage problem keenly illustrates that it is difficult to recognize the bursting of a bubble as it happens. Central banks should therefore pay due attention, in their conduct of monetary policy, to the negative effects that may arise from prolonged accommodative financial conditions.

Let me bring the topic back to the future course of the global economy. As described earlier, with regard to the U.S. economy, it is unforeseeable when and how the negative feedback loop between financial markets, asset prices, and economic activity will diminish. In Europe, economic growth is slowing further. In Asia, although the Chinese and Indian economies continue to post high growth, some of the NIEs and ASEAN economies are showing deceleration in exports and signs of slowing domestic demand. Developments in the global economy as a whole are therefore likely to remain highly uncertain for the time being.

IV. The outlook for Japan's economy and the conduct of monetary policy

In view of the two problems I have discussed, I would now like to talk about the outlook for Japan's economy and the Bank's conduct of monetary policy.

The Bank's main scenario is as follows: growth will likely remain sluggish for the time being against the backdrop of high energy and materials prices and weaker growth in exports due to a slowdown in overseas economies; however, Japan's economy is unlikely to experience a deep adjustment phase.

Let me explain the thinking behind this projection. First, as a result of firms' restructuring efforts, which continued in the 1990s up until recently, the "three excesses" – namely, in production capacity, employment, and debt – have been eliminated, and Japan's economy has become more resilient to shocks that weaken economic growth. Second, losses incurred by Japanese financial institutions due to the subprime mortgage problem are limited compared to those of U.S. and European financial institutions and Japanese financial markets continue to be stable, which suggests that the functioning of the financial system remains intact. And third, Japan's financial conditions have been accommodative. Although it is a cause for concern that financing conditions of firms in construction and real estate industries and small firms in general are becoming increasingly severe, financial conditions taken as a whole have been accommodative. The short-term real interest rate calculated by subtracting the CPI inflation rate from the call rate has been negative, as the policy interest rate – the uncollateralized overnight call rate – has been at a low level of 0.5 percent. Firms' financing costs have also remained low. This accommodative environment for corporate finance is expected to continue to support business activity.

Because of this, it is reasonable to expect, as the main scenario, that Japan's economy will return gradually to a moderate growth path as commodity prices level out and overseas economies move out of their deceleration phase.

Regarding the outlook for prices, it is unlikely that the second-round effects will intensify in the near term, judging from the current level of the domestic output gap, the inflation expectations of households, and firms' price-setting behavior. Developments in wages are one of the important indicators pointing to the emergence of second-round effects, and so far wage growth has been relatively weak. The rate of increase in consumer prices will likely rise slightly over the coming months, since the pass-through of earlier increases in import prices is expected to continue for a while. Thereafter, however, the rate of increase is expected to decline gradually in line with the expected moderation in the rises in international commodity prices and the resultant subsiding of firms' raising of sales prices.

Economic forecasts often differ. Economic forecasters, including central banks, do their utmost to provide accurate projections of economic activity and prices, but projection errors are often sizable. In view of that, it is very important for the Bank to carefully consider the most likely outlook, the main scenario, as well as various factors causing uncertainty in making economic projections, which are the basis for the conduct of monetary policy. It is also important for the Bank to not take any predetermined view, but to maintain an open-minded stance when it examines incoming data and to revise its projections as necessary.

Let me move now to a discussion of risk factors. Global financial markets, which I mentioned earlier, are likely to remain unstable for the time being, and there are downside risks to the world economy. Regarding the outlook for Japan's economy, there is a risk that domestic demand may weaken as a result of the outflow of income due to the high energy and materials prices. The Bank is therefore attentive to the downside risks to economic growth, although the economy does not face the need to adjust production capacity and employment.

As for prices, the Bank is focusing on the upside risks to inflation. Energy and materials prices have been rising for a long time due to the aforementioned worldwide growth in demand, especially demand from emerging economies, in addition to factors pertaining to supply constraints. Therefore, this rise should not be regarded as temporary. Given the trend increases in energy and materials prices and the fact that Japan's economy has not faced such a high level of inflation in recent years, the Bank should pay attention to the risk that possible changes in the inflation expectations of households and firms' price-setting behavior may generate second-round effects.

As I have explained, the current situation requires the Bank to carefully monitor both downside risks to economic growth and upside risks to inflation. Furthermore, if the downside risks to the economy turn out to decrease, there is a risk that prolonging the period of accommodative financial conditions will lead to swings in economic activity and prices. The Bank continues to carefully assess the future outlook for economic activity and prices, closely considering the likelihood of its projections as well as factors posing upside or downside risks, and will implement its policies in a flexible manner. Moreover, since global financial markets are expected to remain unstable and there are various uncertainties in the outlook for economic activity and prices, it is essential for the Bank to ensure the stability of the Japanese financial markets.

Closing remarks

As I have so far explained, the current state of Japan's economy and the world economy pose an extremely difficult situation for the conduct of monetary policy. While monetary policy is expected to contribute to sustainable economic growth by creating a stable financial and economic environment, it cannot by itself increase the potential growth rate of the economy. A prerequisite for the economy to boost its growth potential is a rise in productivity, facilitated by innovation and a continual review of resource allocation.

The Kansai region is famous for its long history of pioneering entrepreneurship, as demonstrated by the fact that the world's first futures trading was carried out at the Dojima rice exchange in Osaka during the Edo Period (1603-1867). In the current environment, I look forward to seeing the region's originality and inventiveness add to the vigor of Japan's economy. For our part, we will continue to support your efforts through our conduct of monetary policy.

I would like to close my speech by mentioning an early episode in the relationship between the business community of the Kansai region and the Bank of Japan. The Bank was established in 1882 with capital of 10 million yen – equivalent to approximately 30 billion yen today. Of the contribution to the Bank's capital from the private sector, which accounted for half of the total, about 60 percent of the shareholders and 48 percent of the amount came from the Kansai region. In other words, the business community of the Kansai region contributed significantly to the establishment of Japan's central banking system, which underpins the market economy.

Thank you very much for your kind attention.