Kiyohiko G Nishimura: Recent economic and financial developments and the conduct of monetary policy

Speech by Mr Kiyohiko G Nishimura, Deputy Governor of the Bank of Japan, at the Foreign Correspondents' Club of Japan, Tokyo, 29 September 2008.

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It is a great pleasure to be addressing this community of distinguished journalists at the Foreign Correspondents' Club of Japan. Today, I first wish to share with you how I see the current state of the Japanese economy and the outlook. And then I will touch on the implications of both for the future course of monetary policy.

Diverse engines of growth and canceling-out of small shocks during economic recovery since 2002

To assess current economic activities in Japan, it is worthwhile to look back on the developments since 2002 as a starting point.[1]

The Japanese economy has recovered continuously since hitting the bottom in early 2002. Although an average of around 2 percent real GDP growth during this period does not seem particularly high, it is above the economy's potential, and shows remarkable stability. Thestability comes not from a uniform decline of demand fluctuations across sectors, but from a canceling-out of small fluctuations of demand in different sectors. In fact, one salient characteristic of this period is that the timing of peak production varied among industries.

In past business cycles, we commonly observed concurrent increases and decreases in production in various industries. A typical example is the so-called IT bubble and its collapse: production of not only IT-related goods but also other goods increased and decreased in tandem. In contrast, since 2002, various industries have taken the lead in production and have been successively replaced. For example, when the production of IT-related goods decreased, production in materials industries increased.

I can point out two contributing factors, closely related to globalization. First, on the demand side, the engine of world growth has been diversified. High economic growth continued in countries such as China, India, Russia, and some in the Middle East, and Japan's exports to these countries increased considerably. As a result, the variety of goods exported, previously confined mainly to IT-related and durable consumer goods, broadened to include goods such as construction machinery and materials. Second, on the supply side, linkages between various industries in Japan became weaker as international diversification of production sites continued. When materials necessary to produce a particular good were imported rather than secured domestically, a decrease in domestic demand for this good did not have large direct negative effects on other domestic industries through the input-output relationship, although it reduced imports of materials.

The diversification of demand and supply sources just described led to asynchronicity in production activity and resulted in canceling-out of small shocks in sectoral demand and supply, leading to a stable growth pattern. However, this also meant that we did not have a strong engine of growth affecting all sectors, and thus the speed of economic expansion was moderate. In fact, the recovery since 2002 has been led mostly by the corporate sector,

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[1] For details of this assessment, see Kiyohiko G. Nishimura, "Increased Diversity and Deepened Uncertainty: Policy Challenges in a Zero-Inflation Economy," *International Finance* 10:3 (2007), 281-300, which is based on my speech at the Brookings Institution in July 2007 (http://www.boj.or.jp/en/type/press/koen07/ko0707a.htm).

especially exporting firms. Corporate profits exceeded their previous peak and corporate fixed investment increased steadily. However, since growth was at best moderate, firms remained cautious in increasing their labor force and production capacity, and maintained their restrictive stance on wage increases. Although this cautiousness apparently has prevented firms from accumulating excess production capacity and excess labor so far, it has resulted in sluggish wage increases and ultimately, in a lackluster state of consumption.

The current state of the Japanese economy

In this way, the Japanese economy enjoyed not so strong, but stable and resilient, economic growth until the end of last year. Since then, however, the growth rate has slowed.

First, there was the shock caused by a stringent revision of the Building Standard Law, resulting in a fall in housing and construction investment. Then came a sharp increase in energy and materials prices, which has caused a substantial transfer of income from Japan to oil and materials exporting countries. This decrease in real income had an adverse effect on both private consumption and corporate fixed investment. The decrease in corporate fixed investment has been noticeable especially among small and medium-sized enterprises that rely mostly on domestic demand and therefore do not benefit from strong increases in exports.

Recently, exports have lost their momentum, reflecting the gradual slowdown of the world economy. The turmoil in the U.S. financial markets, which stemmed from the U.S. subprime mortgage problem, has affected economic activities in the U.S. as well as those worldwide. Currently, the Japanese economy is sluggish against the backdrop of high energy and materials prices and weaker growth in exports. Thus, it is particularly important to assess, first, developments in energy and materials prices and second, financial market conditions and their effects on economic activities, especially in the United States.

Factors contributing to the surge in commodity prices

Let me first examine the surge in commodity prices. There are three possible factors behind the recent surge. The first factor is the increase in demand especially in emerging economies, whose resource usage is not so efficient. The high growth rate of these economies has led to a rapidly increasing demand for energy and materials. The second factor is the difficulty of increasing the supply of these products in a timely manner. A large investment is required with a considerable lag between exploration and production. Moreover, projects are often impeded by environmental and geopolitical problems. The third is a financial factor. Global investors, confronted with the turmoil in global financial markets, are said to have shifted their investments from complex financial products to simple commodities. This so-called "flight to simplicity" may have contributed to the surge in commodity prices.

Since the rise of commodity prices started well before the current financial turmoil, it is likely that it was the demand factor that set the long-run trend. However, it is hard to deny outright that supply constraints and especially financial factors contributed to recent acceleration until July. Although commodity prices have slipped back since around mid-July, they are likely to remain elevated if the demand-side factor in emerging economies does not change.

The subprime mortgage problem and global financial turmoil

I now turn to the subprime mortgage problem, and the resulting global financial turmoil, which is still under way.

In financial markets, there are many investors with different preferences in terms of liquidity, return, and risk profile of financial products. Financial institutions effectively intermediate between these investors by providing various financial products. Securitization was an innovation that enabled financial institutions to provide a wider range of financial products with a view to meeting investors' various needs. In order to enhance confidence in newly introduced securitized products, various "supporting devices," such as liquidity-enhancement guarantees from banks, insurances by monolines, and credit ratings, were employed and used widely. Moreover, to facilitate transactions as well as to obtain profits, financial institutions themselves became active players in the securitized products market.

Investors' confidence in financial products was first shaken in the spring of 2007 when prices of some tranches of subprime RMBS fell in a way unthinkable previously. This raised suspicion that information provided by rating agencies and utilized by financial institutions in their sales pitch was, after all, wrong. Erosion of confidence in the values of securitized products became increasingly evident as time went by. As confidence eroded, investors became extremely cautious and reduced transactions.[2] This led to a further price decline of securitized products and contributed to further erosion of confidence. Moreover, an old and more familiar vicious circle of financial stresses and economic slowdown was coming into play in recent months.

The turmoil in global financial markets in the last several weeks has been extraordinary. Stock markets have been volatile and credit spreads spiked. Demand for liquidity has increased and there has been a conspicuous "flight to quality." In order to address the elevated pressures in U.S. dollar short-term funding markets, six central banks announced coordinated measures to supply dollar liquidity to money markets on September 18. The U.S. government announced a plan to buy impaired assets possessed by U.S. financial institutions. The purchase of impaired assets is particularly important in several ways. First, it will create liquidity and promote price discovery in the markets for these assets. Second, this measure will make the balance sheets of these financial institutions more transparent so a reasonable assessment of their financial condition can be made by investors, reducing uncertainty considerably. Although there remains considerable uncertainty about the outlook for global financial markets, I hope that a series of measures taken by governments and central banks will contribute to stabilization of the markets, leading to recovery in global economic growth.

The outlook for economic activity and the risk factors

I would now like to turn to the outlook for the Japanese economy.

Our main scenario is that economic activity 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. The question is whether or not the Japanese economy will experience a deep adjustment phase. We believe that the possibility of this occurring is rather small.

First, as a result of firms' restructuring efforts, which started in the 1990s and continued up until recently, the "three excesses" – namely, in production capacity, employment, and debt – have been largely eliminated. This suggests that the Japanese economy has become more resilient to shocks affecting economic growth. Second, the subprime-related losses of Japanese financial institutions are limited compared to those of U.S. and European counterparts. As a result, Japanese financial markets continue to function well, though there

[2] This seemingly overcautious behavior is not irrational. Rational investors, who are, say, 95% confident that these financial institutions' advice is true, but think that there is a 5 % chance that the institutions might be utterly incompetent and their advice might be wrong, always consider the worst outcome and try to improve it, rather than to maximize their profits taking the institutions' advice for granted. This decision situation is called ε-contamination of confidence. See Kiyohiko G. Nishimura and Hiroyuki Ozaki, "An Axiomatic Approach to Epsilon Contamination," *Economic Theory*, 27:2 (2006), 333-340.

are occasional disturbances reflecting the stress in global financial markets. And third, Japanese financial conditions have been generally accommodative with a very low inter-bank call rate, although financing conditions in the construction and real estate industries, and small and medium-sized enterprises in general, are becoming increasingly tight. 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. This accommodative environment for corporate finance is expected to continue to support business activity.

Thus, the main outlook scenario is that the Japanese economy will return gradually from its current sluggish condition onto a moderate growth path, as commodity prices stabilize and overseas economies move out of their deceleration phase.

The outlook for economic activity, however, is accompanied by considerable uncertainty, and various risk factors could influence the outlook. Global financial markets, which I mentioned earlier, are likely to remain strained for some time, and there are downside risks to the world economy. There is also a risk that domestic demand may weaken further as a result of the outflow of income due to the elevated energy and materials prices prevailing until recently. The Bank is therefore attentive to the downside risks to economic growth, although the economy does not face urgent need to adjust production capacity and employment.

As I have mentioned earlier, one salient characteristic of the economic recovery since 2002 was the diversification of growth engines and canceling-out of small shocks. In contrast, we are now facing two large shocks that may spread to many economies – the surge in energy and materials prices and the financial turmoil stemming from the subprime mortgage problem. We cannot totally rule out the possibility that, if these two shocks simultaneously impact heavily on the global economy, business conditions in various industries and firms in various regions might become synchronized, and thus trigger a negative feedback or amplification of adverse effects through interdependency. Thus, with respect to future developments in the real economy, we should be attentive to the downside risks.

Low inflation in the recovery since 2002 and a spike in energy and material prices

Let me turn to inflation. First I will explain why inflation was almost non-existent from 2002 up until the midyear of 2007. Then I will assess the current threat of a possible rekindling of inflation posed by the sharp increase in energy and material prices.

As I have explained earlier, real GDP growth had been on average around 2 percent since 2002 until recently, somewhat above Japan's potential growth rate. The output gap, which was substantially negative before the economic recovery started, recovered gradually to its past average. However, the CPI inflation rate remained near zero until around the middle of last year. There are two factors contributing to this lack of response of prices to a change in output gap.

First, competition has intensified against the backdrop of globalization and deregulation. Emerging economies, in the process of being incorporated in the global economy, have established themselves as global production sites with abundant and inexpensive labor. Imports from these emerging economies have increased dramatically and the competitive threat from these imports prevented domestic producers from increasing their product prices when demand recovered. Deregulation is another factor increasing competition, which is exemplified in the deregulation of large-scale retail stores. Competition has intensified among retailers, large or small, and they have tried to avoid charging higher prices even if demand picked up, fearing that they might lose their customers to their competitors.

Second, wage increases have remained subdued throughout this period. Competitive pressures from emerging economies of inexpensive labor have become a major factor restricting increases in wages. Moreover, there are other factors specific to Japan. An increase in the number of non-regular employees with low wages is one. Another factor is the mass retirement of baby-boomers who were paid higher wages than young workers, and the resulting replacement of high-wage old workers by low-wage young ones. Furthermore, severe fiscal conditions forced central as well as local governments to restrain wages of government and related agencies' employees, which had a spill-over effect on other service industries. This subdued wage behavior might also be the product of the very low inflation expectations of private economic entities, reflecting the past low inflation record.

The benign situation of low inflation has changed since the end of last year. The Corporate Goods Price Index has increased rapidly against the background of the surge in commodity prices to record annual increase of 7.2 percent in August. CPI inflation is also rising noticeably. Specifically, prices of petroleum products, such as gasoline and kerosene, and processed food have been increasing. Moreover, there are some spill-over effects on related service products, such as eating out and electricity. The rate of CPI inflation excluding fresh food increased from 0.5 percent in the fourth quarter of last year to 2.4 percent in August. However, if we exclude energy and food from the CPI, then the inflation rate has been still around zero, although it has crept up a little in recent months.

Thus, the recent rise in the CPI inflation rate is mostly due to the rise in commodity prices and some pass-through to other goods and services.

The outlook for prices and the risk factors

The Bank first published its "understanding of medium- to long-term price stability" in 2006 and it has been reviewed annually. This document clarifies the level of inflation that each Policy Board member understands as being consistent with price stability over the medium to long term, in conducting monetary policy. The "understanding" is expressed in terms of the rate of change in the CPI, and currently falls approximately between 0 and 2 percent with most members' median figures at around 1 percent.

The recent CPI inflation rate exceeds the upper limit of the range. However, the assessment of price stability should be based on its sustainability in the medium to long term. Thus, the real question is whether the current momentum of inflation is sustained in the medium to long run, or to put it another way, whether we see second-round effects of inflation. This depends on people's confidence in price stability, which ultimately is determined by the stance of monetary policy. At this moment, we are not seeing second-round effects, and it seems unlikely that they will emerge in the near term, given the current weakness of demand, households' negative reaction to price increases, and firms' price-setting behavior. Wage-setting is one important indicator of whether we have second-round effects, and so far wage growth has been relatively weak.

Taking account of these recent developments, it is reasonable to expect that, although CPI inflation is likely to remain elevated over the coming months due to lagged pass-through of earlier increases in import prices, it will decline gradually in line with the expected moderation of worldwide commodity price inflation and tapering-off of import-price pass-through.

However, we see risks in this main scenario, which are on the upside. As I mentioned earlier, increases in energy and materials prices are long-run phenomena, rather than temporary, reflecting the growing importance of emerging economies. Moreover, since this is the first outbreak of noticeable inflation in a decade, it may eventually change inflation expectations of households and firms' price-setting behavior. Taking these possibilities in mind, the Bank should pay close attention to the possible upside risk of a rekindling of inflation.

The conduct of monetary policy

Finally, I now turn to monetary policy. The Bank introduced the new monetary policy framework in March 2006 and has been explaining its monetary policy stance based on this framework. In this framework, the Bank first examines the prospects for economic activity and prices for one to two years ahead and assesses whether the economy will follow a path of sustained growth with price stability in the most likely scenario. This is policy assessment under the "first perspective." Then, the Bank assesses the risks considered most relevant to the conduct of monetary policy. This is policy assessment under the "second perspective." I would now like to outline the Bank's current assessment based on this framework which forms the basis for the conduct of monetary policy.

In the "first perspective," the most likely outlook is that economic activity will remain sluggish for the time being, while the CPI inflation rate is expected to remain above 2.0 percent over the coming months. Thereafter, the economy is expected to return gradually onto a moderate growth path as commodity prices stabilize and overseas economies move out of their deceleration phase. CPI inflation is expected to moderate gradually as energy and materials prices level out and the pass-through of earlier increases in import prices is completed. Thus, after its current sluggishness, the economy is likely to return eventually onto a sustainable growth path with price stability.

In the "second perspective," which assesses risks of the most likely outlook, we concluded that the Bank should monitor carefully both downside risks to economic growth and upside risks to inflation. Furthermore, if downside risks to the economy turn out to decrease, we should pay close attention to the risk of prolonging the period of accommodative financial conditions, which may lead to swings in economic activity and prices in the future, as the recent experience of the world economy suggests.

In conducting monetary policy, the Bank will continue 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 an accordingly flexible manner. Moreover, since global financial markets are expected to remain strained for some time and there are various uncertainties in the outlook for economic activity and prices, it is essential for the Bank to maintain market stability.

The world's economies now face serious challenges. The Japanese economy is no exception. Uncertainties remain elevated both in financial markets, real economic activity, and inflation. To deal with these challenges, we believe it is important to explain carefully how we assess economic conditions and how we conduct monetary policy. To this end, we, the policy makers, must be good communicators. Providing necessary information appropriately will enhance the credibility of our policy-making. Also, as globalization proceeds, it has become increasingly important to communicate internationally. I think these thoughts can be shared with people like you who are professionals in the field of communication.

In closing, before I leave you I would like to express our strong commitment to make appropriate economic assessments and policy decisions, and to explain them to the public appropriately in a timely manner. Thank you very much for your kind attention.