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

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at a special meeting hosted by the Kyushu Association of Corporate Executives, Fukuoka, 1 December 2008.

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Introduction

I am honored to be invited to speak at the special meeting hosted by the Kyushu Association of Corporate Executives. I have a close relationship with the Kyushu region because I lived in Kokura, my home town, until I graduated from high school, and also worked as the General Manager at the Oita Branch of the Bank of Japan for one and a half years, from 1994 through 1995. Currently, 7 of the 32 branches are in the Kyushu region. I would like to express my deep gratitude for your cooperation with these branches. Today happens to be the 67th anniversary of the establishment of the Fukuoka Branch, and I am doubly delighted to have the opportunity to speak today before business leaders in the region on such a memorable day.

At present, the world economy, including Japan's economy, faces a very difficult situation as the effects of the financial turmoil stemming from market developments in the United States and Europe have been spreading worldwide. I would first like to talk about the current situation of both of the domestic economy and overseas economies, and also the ongoing global financial crisis, and then explain the Bank's thinking regarding the conduct of monetary policy.

I. The current situation of and outlook for Japan's economy

Today I will speak about developments in Japan's economy mainly from a macroeconomic perspective. Anticipating that some of you may be concerned that the Bank does not fully understand the circumstances specific to each region and each firm, I will stress that the Bank is fully aware of different circumstances by region, industry, and firm size that cannot be perceived only from a macroeconomic perspective. Such differences are reported regularly by General Managers of the Bank's branches. In addition, I have had far more opportunities to discuss with business leaders in various regions since being appointed as the Governor of the Bank of Japan, and on these occasions I have been reminded of the differences.

In today's speech, I will focus on the major trends in the world economy and Japan's economy, but I would like to stress again that, when assessing economic developments, the Bank always takes into account microeconomic information such as economic developments in each region and business performance of firms.

Let me first discuss the current situation of Japan's economy. Looking back, since the beginning of 2002 Japan's economy has enjoyed a moderate but prolonged economic expansion. Since the middle of 2007, however, the economy has experienced a series of negative shocks, and now faces a difficult situation. The first shock came from a sharp decline in housing investment since the middle of 2007, due to the coming into force of the revised Building Standard Law. Growth in corporate profits and wages has been subdued, due to the deterioration in the terms of trade reflecting increases in energy and materials prices, and as a result growth in business fixed investment and private consumption has been slowing since around the end of 2007. The slowdown in overseas economies has become pronounced as strains in global financial markets and in the U.S. and European financial systems have intensified since this summer, and reflecting this, growth in Japan's exports turned negative. Given these developments, economic activity in Japan has become increasingly sluggish recently. Economic data, including the index of industrial production, released at the end of last week showed severe economic circumstances.

The pace of the recent increase in the sluggishness of Japan's economy has been rapid, and overseas economies are also undergoing a similar drastic change. The U.S. economy has deteriorated reflecting the emergence of a negative feedback loop operating between financial and economic activities as the financial crisis stemming from the subprime mortgage problem increased in severity. European economies are also deteriorating, with increased downward pressure on economic activity from the financial side. Moreover, the effects of the weakness in the U.S. and European economies have been spreading to Asian economies. China has continued to show relatively high growth, but the country's growth in exports has recently slowed somewhat and investment related to real estate has been relatively weak against the backdrop of a fall in real estate prices. In the NIEs and the ASEAN economies, domestic demand has been weak while export growth has been decelerating, and these economies have been slowing. A slowdown in the world economy taken as a whole has become evident as the effects of the financial crises in the United States and Europe spread steadily to Asian economies.

According to the *World Economic Outlook* released at the beginning of last month by the International Monetary Fund (IMF), output of advanced economies is expected to contract for the first time in the post-war period; growth in emerging economies is also expected to decline from the past several years' high growth of around 8 percent to 5-6 percent; and the growth of world output is projected to fall substantially to 2.2 percent. This is significantly lower than the world growth of around 5 percent registered for four years in the mid-2000s.

The timing of the recovery in overseas economies depends on several prerequisites for recovery, and with regard to the U.S. economy the key questions are how adjustments in the housing market will progress and when the financial system will regain stability. I must admit that the timing of the recovery in the growth rate of overseas economies as a whole is highly uncertain, but given the current severe situation it seems appropriate to assume that the growth rate of overseas economies taken as a whole is likely to show a clear recovery only after the middle of 2009.

As overseas economies are expected to continue to face a difficult situation, Japan's economy, which recorded negative growth in the second and the third quarter of this year, is likely to continue to show increased sluggishness over the next several quarters. The primary reason why the Bank takes this view is that the effects of developments in overseas economies and of the turmoil in global financial markets, which I mentioned earlier, have been steadily spreading to Japan's economy. I will elaborate on this later.

The price situation has also changed significantly. Looking back to about a year ago, the year-on-year rate of change in the consumer price index (CPI) for all items excluding fresh food was around 0 percent, but then rose at a rapid pace, especially in petroleum products and food, due to the pass-through of higher commodity prices, and reached 2.4 percent this summer. However, most recently it began to decline due to the drop in commodity prices. Given recent developments in commodity prices, it is projected to fall at a rapid pace going forward. The major factor behind the drastic change in the trend of the CPI is changes in import costs. In addition, changes in aggregate supply and demand conditions and in the expected inflation rate also affect prices. Aggregate supply and demand conditions will likely ease, as growth in real GDP is expected to continue to fall short of the potential growth rate for the next several quarters. Although it depends on developments in prices of petroleum products and materials, the rate of change in the CPI may, for a brief period, turn negative in fiscal 2009.

Bearing in mind these developments in Japan's economy, I will now move on to the factor that I regard as most important when discussing future developments in Japan's economy and overseas economies – the impact of the ongoing financial crises in the United States and Europe on overseas economies and on Japanese financial conditions.

II. The financial crises in the United States and Europe and their impact

As you all know, the current financial crises stemmed from the emergence of the U.S. subprime mortgage problem. Since then, the severity of the situation has intensified with pessimisms rising and falling in a repetitive pattern. In particular, the situation changed drastically just after the bankruptcy filing of Lehman Brothers, which led to a continuation of the intensified strains in global financial markets. Looking back, the problem surfaced as "liquidity constraints" when conduits and aggregators of securitized products and financial institutions faced difficulties in raising funds, which were triggered by declines in prices of securitized products backed by subprime mortgages. The next stage was a development of the "credit crunch"; losses incurred by financial institutions that possessed a large amount of securitized products expanded, and their capital bases were impaired. As a result, financial institutions tightened their credit standards and their lending attitudes, and this started to exert strong downward pressure on the economy.

And now we face the current situation, where the negative feedback loop operating between financial and economic activities has intensified. Delinquency rates of not only mortgage loans but commercial real estate loan and consumer loans have risen reflecting the weaker U.S. economy. Consequently, capital bases of financial institutions have been further impaired, and their lending attitudes have become even tighter. In addition, firms' fund-raising conditions in the markets have deteriorated, as seen in the difficulty faced by firms in issuing CP and corporate bonds and the extreme rise in issuance rates. They have ultimately had an adverse impact on economic activity – the emergence of a negative feedback loop operating between financial and economic activities. Meanwhile, the Federal Reserve has lowered its target for the federal funds rate from 5.25 percent to 1.0 percent since last September. In spite of this monetary easing, the issuance rates of corporate bonds have risen compared with the level observed in the summer of 2007.

In addition, we can point out the worldwide propagation as one of the features of the current financial crises. There were some failures of major financial institutions in the United States following the bankruptcy filing of Lehman Brothers, and failures started to be seen also in Europe. Furthermore, the financial crises in the United States and Europe are starting to affect emerging economies, and the inflow of funds to these economies has decreased substantially. There are various transmission channels. For example, in recent years emerging economies in Central and Eastern Europe experienced active credit expansion by foreign financial institutions based in Western Europe but now see a decline in loans outstanding. Moreover, some emerging economies became incapable of raising funds from global financial markets and finally needed financial assistance from the IMF. Thus, unlike the past currency and financial crises in Latin America and East Asia, the ongoing financial crises in the United States and Europe propagated rapidly around the globe. The progress in the globalization of financial and economic activities since the 1990s has strengthened the financial and economic interaction between countries. And the current economic deceleration or deterioration in each country is the first global economic slowdown to take place in a period of such drastic changes in the environment. In addition, the economic growth rate has deteriorated with unusual speed. With these characteristics of worldwide propagation and unusually rapid deterioration, pessimistic views tend to propagate easily and themselves promote further deterioration in the economy.

Under these circumstances, it is necessary to understand the nature of the ongoing problem in order to consider policies necessary to address the situation. Let me first explain the swift and successive policy responses of governments and central banks. First is the provision of liquidity by central banks. Central banks have been making efforts to stabilize money markets by implementing U.S. dollar funds-supplying operations under a coordinated framework in addition to providing sufficient liquidity in their own currency. Second is placing troubled financial institutions under government control and injecting public funds. Third is the substantial expansion of the coverage of deposit insurance and the guaranteeing of financial institutions' debts.

As a result of these measures, the situation in money markets in the United States and Europe has improved compared with the situation at the height of the tensions in those markets. However, the conditions in the money markets are far from normal, as seen in the fact that the 3-month dollar funding rate in the interbank market is around 2 percent higher than the yield on government bonds with the same maturity. Global financial markets remain under significant stress as seen in continued high credit spreads such as those on corporate bonds. Stock prices have plunged worldwide, and foreign exchange rates have continued to fluctuate widely.

Why haven't conditions improved in spite of the swift actions taken by each country? As one of the reasons, we can point out that, given the various large excesses and imbalances accumulated in the several years up to the current global economic deceleration and deterioration, and financial crises, the process of adjustments will inevitably be deep. As I mentioned earlier, a prolonged period of worldwide high growth never witnessed before continued for several years in the mid-2000s. In addition, inflation rates declined due to an expansion of production capacity resulting from the participation of emerging economies in the global market economy, and low interest rates continued in the environment of high growth and low inflation. In the process, various excessive activities, both economic and financial, were undertaken and "excesses" were accumulated. Behind the rise of the U.S. subprime mortgage problem and the surge in crude oil and materials prices observed until this summer, there were global high growth and expansion in financial leverage. Of course, there were some voices warning about the situation. However, given that the economy was in a favorable condition, it was difficult to accept such warnings as is often the case given the nature of human beings and society.

The world economy is now undergoing a process of adjustment of various excesses that had been accumulated, to achieve more sustainable growth. Under these circumstances, it is necessary to implement appropriate macroeconomic policies while maintaining financial system stability by injecting public funds into financial institutions in order to prevent the economy from falling into a deep adjustment phase or turmoil. Although such policies have been implemented, losses incurred by financial institutions and their capital shortages tend to expand when a negative feedback loop between financial and economic activities is operating. Hence, uncertainty remains as to the final amount of losses that need to be covered and of public funds injection required. The large losses that arise from adjusting accumulated excesses can only be covered by flows of income generated by daily economic activities, and this will inevitably take time.

III. Financial conditions in Japan

Let me explain financial conditions in Japan as an extension to what I have said about the global financial system. Financial markets in Japan, which had remained stable relative to these in the United States and Europe, have also drastically changed since the bankruptcy filing of Lehman Brothers. Measured by the spreads between interbank funding rates and government bond yields, the situation in the Japanese money markets remains comparatively favorable to date, but it seems that careful analysis of the possibility that pressures acting to depress economic activity from the financial side may increase in Japan is becoming necessary.

In the conduct of monetary policy, it is extremely important but nonetheless difficult to judge how accommodative or how tight financial conditions are in a country. To make an accurate judgment of financial conditions, the Bank examines them from various angles, which may include evaluation of the level of interest rates and asset prices, quantitative monetary analysis making use of monetary aggregates and bank loans, interviews with financial institutions and non-financial firms, and various surveys. From the perspective of corporate financing, the Bank, in a manner similar to corporate management, examines the situation based on two criteria: first, at what interest rates funds can be raised; and second, how easily these funds can be raised, in other words, the availability of funds. Let me discuss the current financial conditions facing firms from those two perspectives.

First, with respect to funding rates, interest rates on bank loans remain at a low level. On the other hand, interest rates applied to funding in the market, such as issuing CP and corporate bonds, are rising reflecting growing risk aversion among investors such as investment trust companies and life insurance companies, under the influence of the turmoil in global financial markets. The issuing rates on corporate bonds have been rising especially for those with low credit ratings, and issuing rates on CP, which had been creeping up since the summer, have risen rapidly since September. Although the level of these interest rates is somewhat lower than in 1998 and 1999 when corporate financing experienced a period of increased pressures, the so-called credit crunch, the pace at which these rates are rising is comparable to that in 1998 and 1999.

In addition, when evaluating the level of funding rates, comparing them with corporate profitability becomes important. In Japan, the ratio of funding in the market to bank borrowings is approximately one to four, giving bank borrowings the dominant share. Because of this, even with the current sharp rise in issuing rates on CP, funding rates as a whole remain broadly unchanged and remain very low relative to firms' profitability. On the other hand, in 1998 and 1999, funding rates were nearly at the same level as profitability due to the sharp decline in the latter. From these points, it is clear that the current level of funding rates itself is still accommodative. Nevertheless, corporate profits are under strong pressure due to the effects of earlier increases in energy and materials prices and the increased sluggishness in economic activity, which have led to a decline in profitability. This seems to indicate that the level of funding rates relative to profitability is becoming less accommodative.

Second, with respect to the quantitative side, the availability of funds is showing marked changes. With regard to funding in the market, the rate of increase in the amount outstanding of CP issued, which had been around 10 percent year on year since 2007 until the failure of Lehman Brothers, declined sharply thereafter owing to growing risk aversion among investors, and has recently fallen below the previous year's level. Furthermore, the postponement of corporate bonds issuance, which had been limited to firms with low credit ratings, is spreading to firms with high credit ratings, which in the past had been able to issue bonds without difficulty.

Under these circumstances, it seems that firms' attitudes are becoming increasingly defensive against the backdrop of the deceleration in global economic growth and the turmoil in financial markets as well as increased future uncertainty, and this is leading to a growing number of firms hoarding liquidity. Meanwhile, the rate of increase in the amount outstanding of bank loans is rising on the whole, particularly loans to large firms. However, the number of firms reporting tight lending attitudes of banks have been increasing, particularly among firms in the construction and real estate industries and small firms.

To sum up, financial conditions in Japan seem to have become less accommodative at an accelerating pace, particularly in terms of availability of funds, reflecting the turmoil in global financial markets.

Although future conditions for funding depend on various factors, among them the level of bank capital and conditions in global financial markets are important. Currently, the capital ratios of banks, in general, are considerably above the level required by regulation. However, banks, when actually making loans, consider not only their capital ratios at the time but also various other factors such as expected future credit costs. Recently, given the declines in stock prices, the market risk of stock holdings is having an impact on bank capital, in addition to increased credit costs incurred by banks due to the increase in bankruptcies. Although at present the rate of increase in the amount outstanding of bank loans is rising, banks' lending attitudes will tend to become more cautious if they are not confident about the level of their capital bases. Furthermore, if the turmoil in global financial markets should intensify, there is a risk that funding in the market might become more difficult as a result of increased risk aversion among investors. Although the decrease in issuance of CP and corporate bonds, as a whole, is covered by the increase in bank loans as shown in the data up to the most recent figure for October, the Bank will monitor future developments carefully.

IV. The conduct of monetary policy

So far I have explained the present situation of and the outlook for the world economy and Japan's economy. With regard to Japan's economy, the increased sluggishness in economic activity is likely to persist for the next several quarters and, going forward, attention needs to be paid to the downside risks to economic activity arising from developments in the financial crises in the United States and Europe and their influence as well as financial conditions in Japan. Turning to prices, upside risks have decreased compared with the past, and there is a possibility that the inflation rate will decline further if downside risks to economic activity materialize or commodity prices fall further.

Based on these assessments, the Bank, at the Monetary Policy Meeting held on October 31, reduced the policy interest rate by 20 basis points to 0.3 percent. With regard to the conduct of monetary policy, the Bank, given the increased uncertainty, will 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 monetary policy appropriately. For the time being, it is particularly important to pay attention to the downside risks to economic activity that may arise from developments in the U.S. and European financial systems and in global financial markets as well as their influence.

To produce maximal monetary easing effects, it is a necessary precondition that markets function in a stable and smooth manner. When this condition is not met, as the recent situation in the United States shows, the actual funding rates may rise notwithstanding the substantial reduction in policy interest rates. From this standpoint, the Bank has undertaken various measures. The first aim of these measures is to ensure stability in money markets through provision of liquidity. The Bank has not only been providing sufficient funds in yen, but also been providing dollar funds, based on the internationally coordinated framework, with no limitation on the amount as long as they are within the value of collateral submitted.

The second aim is to facilitate corporate financing. As I mentioned earlier, financial conditions are currently becoming less accommodative mainly in terms of funds availability, and the risk that the effects of the current low interest rates may not permeate through the economy is increasing. The Bank has already been conducting purchases of CP under repurchase agreements, and to facilitate corporate financing, the Bank has started to increase such purchases since October, and further increased them since November. Furthermore, the Bank is currently working on practical ways to contribute as a central bank to facilitate corporate financing during the run-up to the calendar and fiscal year-ends. The Bank will decide what measures to employ and put into action as soon as this work is completed.

Various efforts by parties concerned are essential to address the current severe economic conditions, and the Bank will continue to do its utmost to facilitate the return of Japan's economy to a sustainable growth path with price stability. Although what actual policies are desirable depends ultimately on the situation in terms of economic activity, prices, and financial conditions at the time, the Bank will take appropriate measures in light of its purpose stated in the Bank of Japan Act, that is, to ensure stability in prices and the financial system.

Closing remarks

In closing, I would like to touch upon economic developments in the Kyushu region and discuss Asian economies that have close relations with this region.

There have been dynamic changes in the structure of the economy in the Kyushu region, making the most of its geographical advantage of being the closest to Asian economies. Japan's exports to Asian economies, for example, have increased around twofold during the last 10 years, whereas exports from the Kyushu region increased around threefold. Growth in exports of Japan's major products, such as electrical machinery and automobiles, is substantially higher in the Kyushu region relative to Japan as a whole. As a result, the share of secondary industries, such as those producing electrical machinery and automobiles, in the Kyushu region is increasing – the region is sometimes referred to as "Car Island" or "Silicon Island" – and the region is becoming a hub for Asian trade.

The Kyushu region is now making the most of being the closest to Asia, which has the fastest growing economies in the world. Assessing the growth potential of Asian economies, therefore, is important, but there are differing views on this and, ever since the 1990s, there have been various arguments. For example, the World Bank, in a book titled "The Asian Miracle: Economic Growth and Public Policy" published in 1993, stated that Asian economies had entered an autonomous growth cycle induced by direct investment. On the other hand, Paul Krugman, this year's Nobel laureate, stated in a 1994 article titled "The Myth of Asia's Miracle" that Asian growth was merely driven by extraordinary growth in inputs of resources like labor and capital, and Asian "tigers" were more like "paper tigers" because their growth was not accompanied by gains in productivity. More recently, there has been discussion as to whether the so-called "decoupling," whereby emerging economies will continue their high growth despite the slowdown in advanced economies, or "coupling," where emerging economies will be influenced by the slowdown in advanced economies, applies to the current state of the world economy.

Recent developments indicate that Asian economies are decelerating due to the deterioration in the U.S. and European economies, as I mentioned earlier, and so any "decoupling" or "coupling" is clearly not perfect. In Asia, various countries and regions, one after another, have accomplished economic take-off starting with the NIEs, followed by the ASEAN economies and China, and then by India. And Asia taken as a whole has attained high growth through countries and areas at different stages of development influencing on each other. Developments in Asian economies have a strong bearing on the future of the economy in the Kyushu region together with developments in Japan's economy and in the world economy as a whole. In discussing the future of Asian economies, although it may well depend on how long the economic weakening in the United States and Europe continues, the Bank will pay close attention to whether strong intraregional demand in Asia can be maintained through making the most of economic dynamism in Asian economies with the assistance of economic policy actions in countries such as China.

As I mentioned in the beginning, the Bank collects information on the regional economies through research conducted at its branches. As I have already said, I worked in the Oita branch of the Bank for a year and a half during the early 1990s, and one of the advantages that I enjoyed as General Manager was being able to hear candid views from the management of various firms in the region regardless of firm size. I had an experience of visiting a small convenience store at the time and hearing views on the business of convenience stores from a couple managing the store in their family room upstairs. The name, the Bank of Japan, may give you the impression that we are making policy judgments only from macroeconomic data or information collected in the metropolis, but this is not so. Since the interest rate policy affects areas throughout the country, we make efforts to collect a wide array of information to make our judgment. To this end, I would like to ask for your continued support.

I am looking forward to hearing your views on the current situation of and issues facing the Kyushu economy as well as your requests to the Bank.

Thank you very much for your kind attention.