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, 31 August 2009.

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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 take this opportunity to express my deep gratitude for your cooperation with the Bank of Japan's branches in Osaka, Kobe, and Kyoto. Before we exchange views, I will first speak about the background to the recent economic recovery and the economic outlook, as well as the Bank's thinking behind the conduct of monetary policy.

At the gathering held at the end of August last year in Osaka, I mentioned two things about Japan's economic outlook. One thing was that growth would likely remain sluggish for the time being. And the other was that, even so, there was a remote possibility that Japan's economy would experience a crucial adjustment phase. I presented a cautious outlook that growth would likely remain sluggish for the time being because I judged that the accelerated rise in energy and materials prices at the time as well as the effects of the bursting of a global credit bubble triggered by the subprime mortgage problem would continue to weigh on the economy at home and abroad in the form of balance sheet adjustments. While I believe that the judgment itself was a valid one, as for the part that there was a remote possibility that Japan's economy would experience a crucial adjustment phase, it turned out that the possibility became a reality and the economy followed a bumpier road than envisaged at the time. Needless to say, the direct cause was the collapse of Lehman Brothers in September last year. Because of that, a liquidity crisis emerged on a global basis, and we faced a serious situation that confidence, which could be said as a prerequisite for the normal functioning of financial markets, collapsed. As a result, the economic conditions deteriorated simultaneously and sharply worldwide, the situation no policy authorities around the globe ever imagined. In fact, looking back on the changes in the International Monetary Fund's forecast for world economic growth for 2009, it was plus 3.9 percent in July last year, but was subsequently revised downward for several times to become minus 1.4 percent in July this year. The sheer fact that the forecast for the growth rate was revised downward by more than 5 percentage points in a period of only one year illustrates how rapidly the world economic conditions deteriorated during that period.

There is finally a glimmer of recovery in the economy at home and abroad. Nevertheless, as many people might feel, there is still considerable uncertainty about future developments.

I. Developments in the global economy

I will start with the current global economy.

As I have just mentioned, the factors behind the global economic slowdown since last autumn, which correlate with each other, can be broadly divided into two factors. One is the global accumulation of excesses during the mid-2000s and the adjustments of the balance sheets of firms, households, and financial institutions emanated in the process of the unwinding of excesses. The other is the liquidity crisis triggered by the collapse of Lehman Brothers, and the resulting panicky contraction of financial and economic activity.

Let me explain the first factor little more in detail. Up to the mid-2000s, the world economy had marked high levels of growth at around 5 percent for four consecutive years. With hindsight, centering on the United States and Europe, a large credit bubble was formed and excesses in financial and economic activity in various aspects emerged during that period. In the area of financial activity, credit and leverage increased substantially as exemplified by the subprime mortgage problem. The economic activity also overheated. The examples are a substantial increase in housing investment in the United States and a surge in demand for durable goods around the world. In the meantime, a bullish economic outlook prevailed among firms, and they substantially augmented their production capacity. However, high growth supported by the credit bubble cannot continue for long.

The world growth started to slow around the beginning of 2008. The essence of what is happening now is an adjustment to bring excessive capital stock and debt back to normal levels, and business fixed investment and private consumption are contained. Financial institutions have also been striving to reduce their impaired assets and to resolve excessive leverage. In such a process, financial institutions' proactive lending capacity will necessarily decline. Therefore, during the period of balance sheet adjustments, it is inevitable that the global economy remains under downward pressure.

If such balance sheet adjustments are to impose "chronic illness" on the economy over a long period, the liquidity crisis, which was the second factor behind the global economic downturn, would bring a powerful "acute pain" that contracted economic activity at a stroke. As I have mentioned, triggered by the collapse of Lehman Brothers, providers of funds, such as financial institutions and institutional investors, became extremely cautious about counterparties' creditworthiness. That led to a sharp decline in transactions, not only in the interbank market where banks exchange funds but also in the CP and corporate bond markets where firms raise funds. As a result, the functioning of financial markets declined at a stroke, and the funds necessary for economic activity did not prevail. That, together with firms and households' intensified anxiety, shrank the global financial and economic activity in a panicky manner.

The global economic conditions seem to have stopped worsening this spring. That is because the "acute pain" has started to dissipate for the following three reasons. First, ample fund supply by central banks and an aggressive injection of public funds into U.S. and European financial institutions have proved effective, and global financial markets have been regaining stability. Second, inventory adjustments have progressed as a result of a substantial production cutback. And third, once plunged demand is now showing signs of gradual recovery, thanks to the effects of a large-scale economic stimulus around the globe. Those developments are likely to continue for some time. If that is the case, what becomes more important from now is how to assess the effects of balance sheet adjustments centering on the United States and Europe, which was the first factor behind the current economic downturn. However, that point is associated with high uncertainty. It takes a considerable period of time to complete the balance sheet adjustments following the experience of a large bubble. A possibility cannot be denied that the factors including the continued decline in the U.S. commercial real estate prices will make the adjustments more significant than envisaged in terms of duration and magnitude. Meanwhile, emerging economies including China have recently been showing growth slightly stronger than expected. A large-scale economic stimulus in China has exerted favorable effects on the neighboring East Asian countries, seemingly playing a role of raising economic growth of the regions as a whole. The Bank will also pay attention to how the bold monetary easing in advanced countries affects emerging economies where the problem of balance sheet adjustments is relatively small.

II. The current state of and outlook for Japan's economy

Based on the picture of the global economy, I will now move on to the current state of and outlook for Japan's economy. From the autumn of last year, Japan's economic conditions worsened far more sharply than those in the United States and Europe where the current crisis had started. Japan's real GDP growth recorded a more than 10 percent decline on an annualized basis for two consecutive quarters in the October-December quarter of last year and the January-March quarter of this year. The reason why economic conditions deteriorated in Japan more seriously than those in other countries was that the high-tech manufacturing industries including automobiles, electrical machinery, and general machinery, which benefited from the recent high growth of the global economy, had a high share in Japan's economy. A fall in global demand especially for durable goods and capital goods owing to the rapid contraction of global economic activity directly hit those industries, resulting in a substantial decline in exports and production.

Since this spring, as the "acute pain" of the global economy has started to dissipate, there has been a reversal of the mechanism which I have just mentioned. That was illustrated by the April-June real GDP growth rate of 3.7 percent, on an annualized basis, which was the highest growth in the G-7 countries. With progress having already been made in inventory adjustments both at home and abroad, the recovery in exports and production has increasingly become obvious, centering on automobiles and electronic parts. In particular, against a backdrop of China's strong demand for electrical appliances, exports to East Asia first rebounded early this spring. Signs of improvement remain observed not only in the real economy, but also in corporate financing. The issuing rates of CP and corporate bonds, which surged from last autumn, have declined to the levels seen before the collapse of Lehman Brothers. While only a handful of firms with high ratings could issue corporate bonds up to the end of last year, the situation improved significantly such that the issuance was a record high this June. Firms' financial positions have continued to improve particularly at large firms. While some yelps were once heard from firms' managers and treasurers on their financial positions, they seem to have materially regained their composure recently, albeit still not being able to dispel uncertainty about the future outlook.

Looking ahead, Japan's exports are expected to continue to increase as the overseas economies start recovering. The resultant recovery in corporate profits and the effects of various policy measures will likely bring about a gradual recovery in business fixed investment and private consumption. Therefore, the Bank's baseline scenario is that "Japan's economy will start recovering from the latter half of fiscal 2009."

However, I will hasten to add that the Bank judges that the pace of recovery is highly likely to be only moderate. Given that the global adjustments of balance sheets will continue, it is hard to assume a marked and rapid recovery in exports. In addition, against a backdrop of excessive capital stock and the severe employment and income situation, business fixed investment and private consumption are likely to remain relatively weak for the time being. As I have mentioned earlier, it is still not clear how the balance sheet adjustments centering on the United States and Europe will proceed. The Bank will continue to carefully examine financial and economic developments at home and abroad, while paying due attention to various risks surrounding Japan's economy.

III. The Bank's thinking on prices

I will now move on to the developments in prices in Japan. Since recording an increase of 2.4 percent in the summer 2008, the year-on-year rate of change in the consumer price index (CPI) for all items excluding fresh food has been on a declining trend and has been negative since March this year. The rate of change for July, released at the end of last week, marked a decrease of 2.2 percent on a year-on-year basis, the largest decrease ever recorded. The same can be said about other countries. Looking at the rates of change in consumer prices for all items in July, they were negative in all G-7 countries but for the United Kingdom – for example, minus 2.2 percent in Japan, minus 2.1 percent in the United States, and minus 0.7 percent in Germany. In addition, the average rate of change for G-7 countries declined year on year by 4.6 percentage points during the past year.

The major reason for the recent acceleration in the price decline in Japan was the prices of imports such as resources and energy being lower than the high levels observed up until around the summer last year. From the autumn this year, the effects of higher prices of last year are expected to diminish gradually. Going forward, price developments will, in principle, be affected by the supply-demand balance of the economy as a whole. In that regard, if economic conditions recover in line with the projection that I have mentioned earlier, the supply-demand balance of the economy will improve gradually, and the year-on-year rate of decline in the CPI will likely moderate. However, the supply-demand balance has been deteriorating greatly, reflecting the sharp deterioration in economic conditions from the autumn of last year, and the pace of improvement in the supply-demand balance is expected to be slow, reflecting the aforementioned economic outlook. Therefore, the downward pressure on prices is likely to persist for a long period. The situation is the same in the United States and Europe, and the view is prevailing in many countries that it will take a considerable period of time for the growth rate of prices to return to a desirable level, while the level itself differs between countries.

What is critical in the conduct of economic policy is whether there is a possibility of the price declines leading to a vicious circle that a decline in prices will induce a deterioration in economic conditions, which will in turn lead to a further decline in prices – the so-called deflationary spiral. To that end, there are two key factors for judgment. The first is whether the stability of the financial system is being maintained. Looking back in history the cases in which price declines caused a contraction in economic activity, most cases coincided with the period of significant financial system instability, as typified during the U.S. Great Depression in the 1930s. Japan's financial system has so far been generally stable, and in that regard the Bank does not judge that the risk of the economy falling into a deflationary spiral has increased. And the second is whether firms and households' inflation expectations in the medium to long term decline. Various survey results and market developments suggest that firms and households' expectations for inflation in the medium to long term have so far been stable.

By also taking into account those points, the Bank has been closely monitoring price developments.

IV. The Bank's thinking behind monetary policy conduct

After having explained economic and price developments, I will lastly briefly refer to the Bank's conduct of monetary policy and the thinking behind it.

I have explained the significant changes in the global economy since last year by summarizing the causes into two factors: the liquidity crisis and the balance sheet adjustments. When a great stress is imposed on financial markets, what a central bank should do as a top priority is to provide ample liquidity and ensure the stability of the financial markets and the financial system. To avoid the risk of the economy falling into a deflationary spiral, a central bank should properly and promptly act as "the guardian of liquidity."

Meanwhile, it varies from country to country the extent to which the balance sheet adjustments by the private economic entities are needed. In any event, those adjustments are an inevitable process for the global economy to return to a sustainable growth path. The problem is that, if the pace of adjustments is too fast, economic activity will deteriorate further. In those circumstances, the role required of the policy authority of each country is to strike a delicate balance between encouraging necessary balance sheet adjustments to proceed smoothly, and preventing them from moving too rapidly so as to induce a further deterioration in economic conditions.

Since last autumn the Bank has reduced the policy interest rate to 0.1 percent, and has taken various measures to ensure the stability of financial markets and facilitate corporate financing, including the U.S. dollar funds-supplying operations against pooled collateral, the outright purchases of CP and corporate bonds, and the special funds-supplying operations to facilitate corporate financing. In addition, by being particularly focused on maintaining the stability of the financial system, the Bank has also taken measures such as the purchase of stocks held by banks and the provision of subordinated loans to banks. While not a few of those measures have been extraordinary ones as policy instruments of a central bank, the Bank has judged it appropriate to carry them out as temporary measures in light of the difficult economic and financial situation.

At present, Japan's economic conditions are showing some signs of recovery. At the same time, the Bank fully recognizes that the outlook is associated with great uncertainty. While there might be many possibilities, the Bank will pay attention for the time being to the downside risks to economic activity and prices, and continue to do its utmost as the central bank to bring Japan's economy back to a sustainable growth path with price stability. In the meantime, as for the treatment of temporary measures, the Bank will properly make decisions without a predetermined view upon thoroughly examining the state of corporate financing and financial markets.

In closing, leaving the issues of monetary policy, I will emphasize the importance of the efforts to raise the productivity level of the economy as a whole. Needless to say, what determines the long-term growth path of a country's economy is an increase in the level of productivity. While Japan's ratio of business fixed investment relative to GDP is now at a high level among the advanced countries, when considered together with Japan's recent low growth rates, it suggests the low returns of domestic investment. The rise in the investment efficiency and the productivity level of the economy as a whole will be brought about by advancing the development of high value-added products as well as pursuing optimal resource allocation at various levels, including within firms, between firms, between industries, and between regions. The main characters that address the issue of raising productivity are of course people of the private firms. For such efforts, the Bank is and will be of service through creating a stable economic and financial environment.

Thank you.