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 a Meeting with Business Leaders, Hyogo, 21 October 2009.

*   *   *

Introduction

I am pleased to be here today to speak before, and exchange views with, distinguished business leaders of the economy of Hyogo Prefecture. Occasions like this are particularly valuable because they allow us to hear directly and in detail from businesspeople about the situation of the regional economy – including business conditions of many firms ranging from small to large – as well as provide our explanations, and hear your opinions, on the Bank of Japan's current outlook for the Japanese economy and its thinking behind the conduct of monetary policy.

I understand that members of our staff, including the General Manager of the Kobe Branch, visit you frequently to collect information on economic and financial conditions of the region. The information you provide us is very important as a means of accurately understanding the economic and financial situation, and of formulating the conduct of monetary policy. I would like to take this opportunity to thank you for your cooperation.

Today, before exchanging views with you, I would first like to explain the Bank's view on Japan's economic and financial situation, as well as its thinking behind the conduct of monetary policy. I will start with developments in the world economy and then move on to economic activity, financial conditions, and price developments in Japan. In view of these issues, I will briefly explain the Bank's thinking behind the conduct of monetary policy, and lastly express some of my views on medium- to long-term issues that the Japanese economy now faces.

I. Developments in the world economy

I would like to start with developments in the world economy.

Until around the mid-2000s, the world economy enjoyed high levels of growth, at around 5 percent, with the innovation in information and communications technology and further globalization as the two main engines of growth. However, in hindsight, the rapid growth in the world economy, particularly in the United States and Europe, relied heavily on another factor: the optimistic expectations that prices of assets such as homes and stocks would continue to rise. Based on such expectations, households and firms aggressively increased their debt in favor of consumption and investment, while financial institutions increased provision of loans and consequently their leverage – the ratio of total assets to capital bases. The development of securitized products spurred this buoyant mood.[1] Securitized products are designed to transfer the credit risk associated with the loans extended by financial institutions to investors who have a higher capability than financial institutions to take on the risk. This allowed lower-income households that previously had been unable to afford to buy homes to become capable of making such purchases. At the same time, massive funds from investors, who sought higher returns without sufficient risk management, flowed into the securitized markets, thereby creating an overheating of the housing market. However, after

[1] For details on the role of securitized products, see "Financial System Stability and Market Confidence," a summary of a speech given by Kiyohiko G. Nishimura at the Japan Society of Monetary Economics' Spring Annual Meeting on May 16, 2009 (available on the Bank's web site at http://www.boj.or.jp/en/index.htm).

home prices began to fall, the risks that investors had previously ignored came to the fore; this triggered the worsening of the U.S. subprime mortgage problem in summer 2007 and the subsequent asset bubble burst, which in turn led the world economy into severe recession from 2008. As a result, households and firms, as well as financial institutions, particularly in advanced economies, came to face the problem of balance-sheet adjustments: households and firms had to repay their excessive debt by curtailing their consumption and investment, while financial institutions had to dispose of their impaired loans and reduce their excessive leverage.

The bursting of the asset bubble and ensuing increase in impaired assets at banks evolved into a financial crisis when Lehman Brothers collapsed last autumn. Providers of funds became extremely cautious about counterparties' creditworthiness. This led to a sharp decline in transactions in the interbank market, where banks lend and borrow funds, as well as in the corporate bond and CP markets, where firms raise funds, and financial markets ultimately stopped functioning. The sharp deterioration in market functioning, together with firms' and households' excessively heightened anxiety, shrank global financial and economic activity, creating acute pain for the world economy.

Such pain began to wear off from around this spring, and global economic conditions have recently been improving for the following three reasons. First, the supply of ample liquidity by central banks, together with governments' measures to restore financial system stability, has proved effective, and global financial markets have been regaining stability. Second, inventory adjustments have progressed markedly as a result of a substantial production cutback worldwide. And third, the effects of macroeconomic policies implemented aggressively around the globe have begun to appear.

In this situation, divergence and even polarization between sectors, as well as regions, have become evident all over the world. This trend can be observed widely in terms of both economic and financial activity. Let me give you four examples. First, production has recovered relatively quickly because of the progress in inventory adjustments, whereas recovery in employment conditions has been only very moderate. Second, developments in production and consumption differ greatly between sectors that are more influenced by the effects of fiscal policies and those that are less influenced. Third, a significant difference in the pace of recovery has been observed between advanced economies – which face the problems of balance-sheet adjustments following the collapse of the asset bubble and of an aging population – and emerging economies – which face neither of these problems. And fourth, in financial markets, the recovery in money markets has become clear, whereas in the longer-term markets, market liquidity still cannot be judged to have fully recovered, as seen in large differences in interest rates between borrower banks.

The outlook for the world economy greatly depends on how the divergence and polarization will diminish, or, conversely, will intensify. The Bank's current baseline scenario for the world economy is as follows: emerging economies will first pick up, partly due to the policy effects; this upturn will exert positive effects on advanced economies, where private demand will start to improve gradually by the time the policy effects dissipate; and the world economy as a whole will eventually return to a moderate growth path.

However, since the world economy may unfold a different scenario depending on how divergence and polarization evolve, the outlook is still attended by a high level of uncertainty. For instance, if the balance-sheet adjustments lead to a protraction of the serious employment situation in advanced economies, thereby restraining growth in demand, world economic growth could turn out to be weaker than projected. Should growth in emerging economies exceed expectations, world economic growth could also beat assumptions. If this is the case, demand for resources might increase and the terms of trade for advanced economies could deteriorate as commodity prices surge. Ultimately, advanced economies may fall into stagflation. I therefore believe attention should continue to be paid to how the various types of divergence and polarization evolve.

II. Japan's economic developments

I would now like to turn to Japan's economic developments.

In recent years, the Japanese economy greatly depended on growth in overseas economies. Specifically, the driving force behind Japan's longest period of post-war economic expansion, which continued until the recent financial crisis emerged, was the growth in exports. Meanwhile, private consumption remained weak due to the change in the consumption structure associated with the further aging of the population, the low growth in domestic employment reflecting the transfer of production bases overseas, and the ensuing sluggish growth in household income. Such weakness in private consumption led to sluggish growth in business fixed investment of the industries dependant on growth in consumption, and domestic private demand consequently continued to be relatively weak. Furthermore, the sharp deterioration in global economic conditions – the situation that can be expressed as the acute pain caused by the recent financial crisis – led to a sharp contraction in the volume of world trade; this significantly reduced Japan's exports, and the country's economy underwent a sharp downturn at an unprecedentedly fast pace.

However, positive momentum has been observed in Japan since this spring as overseas economic conditions have stopped worsening, and the Bank's current assessment is that "Japan's economy has started to pick up." Specifically, public investment, exports, and production have been increasing. On the other hand, against the backdrop of the severe income situation and weak corporate profits, private consumption and business fixed investment have remained relatively weak.

For the time being, the future course of the Japanese economy will depend greatly on overseas economic conditions, and, as I mentioned earlier, these are expected to continue to recover, albeit at a moderate pace. Exports and production are expected to continue increasing. Public investment is also expected to keep rising for the time being, owing to progress in the implementation of the policy package. A recovery in corporate profits reflecting improvement on both the supply and demand fronts, as well as the implementation of various economic stimulus measures, is projected to gradually boost business fixed investment and private consumption, both of which have been relatively weak recently. In sum, the Bank's baseline scenario is that Japan's economic conditions are likely to improve gradually.

However, the outlook is still attended by a high level of uncertainty. Needless to say, the most considerable risk factor behind the outlook is future developments in overseas economies; as I mentioned earlier, these pose upside as well as downside risks to the Japanese economy. In addition, domestic risk factors include a potential decline in firms' medium- to long-term growth expectations against the backdrop of domestic and overseas economic growth declining to a level lower than that realized before the current recession. As you can see, there are various risks to the outlook for the Japanese economy both on the upside and downside. On balance, the Bank's present assessment is that risks to the economy still remain greatly on the downside. In either case, the Bank will continue to carefully examine economic developments, while paying due attention to various risks surrounding the economy.

III. Developments in the financial environment

In parallel with the pickup in the Japanese economy that I have just explained, the financial environment, with some lingering severity, has increasingly been showing signs of improvement. I would now like to explain in some detail developments in Japan's financial environment since last autumn.

In Japan, the acute pain caused by the financial crisis emerged markedly last autumn in securities markets such as the corporate bond and CP markets, in which large firms, banks, and institutional investors are major participants. After the collapse of Lehman Brothers, Japan's stock prices fell sharply and defaults of corporate bonds started to be observed. In these circumstances, the excessive anxiety of market participants prevailed in the corporate bond and CP markets, and this made investors excessively cautious about taking on issuers' credit risk. In addition, market functioning deteriorated significantly: transactions decreased sharply, and the average market rates did not reflect the market fundamentals but rather were influenced strongly by specific circumstances of individual transactions. As a result, conditions for corporate bonds and CP issuance deteriorated significantly. In the corporate bond market, the credit spread (the yield differential between corporate bonds and government bonds) on BBB-rated corporate bonds was at around 1 percent in summer 2008 but expanded rapidly thereafter, and exceeded 4 percent around the end of fiscal 2008. In fact, almost no issuance of BBB-rated bonds was observed at the time. Even the spread on A-rated corporate bonds, which have been recognized as medium-rated bonds, expanded and exceeded 1.5 percent around the end of fiscal 2008, although it was at about 0.7-0.8 percent in summer 2008. There was almost no issuance of such bonds from October through November 2008. Issuance rates on CP also rose substantially. In November, CP issuance rates (3-month) exceeded banks' lending rates (in terms of the average contracted interest rates on new short-term loans) for the first time, although this entirely unprecedented phenomenon was observed only in this month.

Accordingly, large firms, which faced difficulty in raising funds by issuing corporate bonds or CP, began to shift to bank loans to satisfy their funding needs. Large firms' shift to bank loans reduced the flow of funds into small firms, raising concerns about small firms' cash availability.

In this situation, large and small firms came to see their financial positions as having deteriorated substantially, and around the end of fiscal 2008 the judgment index worsened to the level observed at the time of Japan's financial crisis in 1998. Tensions intensified not only in securities markets but also in bank loan markets, and this caused concerns about a potential adverse feedback loop between financial and economic activity, whereby deterioration in financial activity worsens economic activity, and financial and economic activity amplify the adverse effects on each other.

Thus, Japan's financial environment worsened significantly, particularly in the area of corporate financing, creating a situation that I expressed as acute pain caused by the financial crisis. Recently, however, as excessive anxiety in financial markets has subsided and economic activity has started to pick up, the financial environment has increasingly been showing signs of improvement, although there remains some lingering severity for small firms in particular.

Let me discuss recent developments in securities markets, focusing on the changes from the conditions that I mentioned earlier. Conditions for corporate bonds and CP issuance, which had been worsening and consequently exerting pressure on large firms' funding, have recently become favorable, except for corporate bonds that are rated BBB or lower.[2] The credit spread on A-rated corporate bonds has declined since around this spring, and the value of corporate bonds issued publicly has increased markedly. The number of firms issuing bonds has also increased. There are even some market participants who have recently pointed out some overheating of the markets. In contrast, while public issuance of BBB-rated corporate bonds has been observed, the number of firms issuing such bonds is limited as the credit spread remains at a high level. However, the unfavorable conditions for issuance of low-rated bonds seem to be due to structural factors, rather than the market

[2] According to the September *Tankan* (Short-Term Economic Survey of Enterprises in Japan), CP issuance conditions as perceived by firms of all industries have improved only marginally. This seems to represent a bias in the results since some firms that do not issue any CP responded to the question based on, for example, media reports. In fact, looking at the figures by industry, CP issuance conditions as perceived by firms of industries that include many CP issuing firms have improved greatly.

dysfunction; in fact, investors have attributed the continued sluggishness in the issuance of low-rated bonds to the rekindling of concerns about possible downgrading of issuing firms, while issuing firms have attributed it to the fact that the terms for bank loans are more appealing than those for funding in the corporate bond and CP markets. Regarding the CP market, the issuance rates have declined significantly regardless of credit ratings, and those of high-rated CP have even fallen below yields on government bills.

As for changes in bank loan markets, firms' demands for loans to fund working capital and fixed investment have declined recently. In fact, the diffusion index for financial institutions' perception of demand for loans in the *Senior Loan Officer Opinion Survey on Bank Lending Practices at Large Japanese Banks* recorded the highest figure at the end of last year, then peaked out, and became negative in the July survey regardless of the firm size. Against such a backdrop, the pace of increase in bank lending, after showing high growth on the back of the sharp economic downturn until around the end of 2008, has been slowing.

Since the economy has started to pick up and the functioning of securities markets has been improving, large firms have come to see their financial positions as having improved markedly. Small firms also have reported that there are signs of improvement, partly because the effects of the emergency guarantee scheme, introduced by the government at the end of last year, have begun to appear and partly because the economy has started to pick up. However, there remains some lingering severity, as shown by the fact that the level of the judgment index is still around that observed at the time of the bottom of the economic cycle in early 2002, and that the extent of improvement is marginal compared with large firms.

IV. Developments in prices

I would now like to discuss developments in prices.

Consumer prices have shown large swings since last year, reflecting changes in the prices of petroleum products. More specifically, on the back of the surge in the prices of petroleum products, the year-on-year rate of change in the consumer price index (CPI; excluding fresh food) rose sharply in the first half of 2008 and posted an increase of 2.4 percent in the summer of that year. It was the highest rate in about 16 years, since 1992, excluding the year when the CPI was impacted by a rise in the consumption tax rate. However, after the rapid increase, it started to decline significantly from the second half of 2008. The latest data released at the end of September showed that the CPI declined by a year-on-year rate of 2.4 percent in August, marking the largest drop since the data began to be compiled. The level of the CPI in August is equivalent to the level in June 2007, just before the period when the prices of petroleum products began to surge.

As for the outlook, the year-on-year decline in the CPI is likely to moderate as the effects of the prices of petroleum products abate and the supply-demand balance improves as a result of the pickup in the economy. Nevertheless, the year-on-year decline in the CPI is likely to continue for a relatively long time, because substantial slack seems to have emerged in the economy due to the significant economic downturn from autumn 2008 and because the pace of improvement in the supply-demand balance is expected to be slow.

I would like to note that not only Japan but also many other major economies, including the United States, are seeing a downward trend in consumer prices. In many of these economies, while economic conditions are likely to improve, it is expected that it will take a long time for inflation rates to return to desirable levels given the significant impact of the negative demand shock to these economies.

Against this background, the media seem to be citing the word "deflation" more frequently than before. "Deflation" is a common word but its meaning varies depending on the speaker. For instance, some use this word to mean a decline in consumer prices, whereas others use it to mean a decline in asset prices and in economic activity. Moreover, the price indicator they refer to varies and there is no consensus view about the degree and duration of a price fall to determine "deflation."

Regardless of the definition of "deflation," a matter of great importance is whether there are prospects for the economy to return to a sustainable growth path with price stability. In this regard, it is important to prevent a situation where a decline in prices induces deterioration in economic conditions. To this end, it seems vital that the following two preconditions are met. First, financial system stability must be maintained. In a situation where the financial system is working properly, financial institutions can, to the extent depending on their financial soundness, provide liquidity to firms that faced a temporary, sharp fall in demand. If bank lending can act as a buffer to absorb a negative demand shock, firms are less likely to engage in fire sales to obtain funds to repay debt or engage in the sort of drastic reduction in prices that may lead to further deterioration in the economy. And second, it is essential that expectations for inflation rates over the medium to long term remain stable, uninfluenced by short-term developments in inflation rates. In such a situation, firms' price-setting behavior will probably be based on expectations that in the long run prices in general will turn upward. This is likely to prevent prices from declining continuously and reduce the possibility of further economic deterioration.

I would now like to assess the environment surrounding prices in Japan on the basis of the two preconditions I just described. Regarding financial system stability, the Japanese financial system has not suffered from internal factors, such as impaired assets at Japanese banks, compared to the U.S. and European counterparts. As for expectations for inflation rates over the medium to long term, survey results and various market data suggest that there has been no notable change. Nevertheless, as balance-sheet adjustments are still continuing on a global basis, resultant risks to financial system stability are unlikely to disappear in the near future. Moreover, given that prices are expected to continue falling for a relatively long time, there remains a risk that expectations for inflation rates over the medium to long term could possibly decrease significantly in line with developments in actual inflation rates. Therefore, the Bank intends to continue to monitor developments in prices closely, while paying careful attention to the preconditions I have mentioned.

V. Conduct of monetary policy by the Bank

I have explained economic and price developments at home and abroad, and now would like to briefly talk about the Bank's thinking behind its current and future conduct of monetary policy based on these developments.

Since last autumn, the Bank has conducted various measures to support the Japanese economy from the financial side.

With regard to the interest rate policy, the Bank, after reducing its policy interest rate to 0.1 percent, maintained its extremely low policy interest rate level and thus provided an accommodative financial environment, contributing to underpinning economic activity.

In addition, with a view to ensuring the stability of financial markets and facilitating corporate financing, the Bank, while providing ample liquidity to the markets, introduced measures such as outright purchases of CP and corporate bonds as well as special funds-supplying operations to facilitate corporate financing. Although it is extraordinary for a central bank to use many of these policy tools, the Bank judged it appropriate to introduce them as temporary measures in response to various phenomena such as the spread of excessive anxiety among market participants and the rapid deterioration in market functioning in the corporate bond and CP markets – acute pain in the financial environment caused by the recent financial crisis. Regarding the impact of these temporary measures, I believe that the outright purchases of CP and corporate bonds have proved effective to a certain degree in reducing excessive anxiety among market participants, and that special funds-supplying operations to facilitate corporate financing have supported the recovery in market functioning, which previously declined sharply. Also, I believe that the expansion in the range of collateral that the Bank accepts has boosted supply of credit by banks to firms.

With regard to the policy measures taken in the recent financial crisis around the world, including those taken by the Bank, the term "exit strategies" has been frequently mentioned, as global economic conditions have started to improve. Exit strategies are variously defined but are often discussed at international conferences to indicate strategies to exit from expansionary monetary and fiscal policies as well as measures to stabilize financial systems.

On this point, it was confirmed at the meeting of the Group of Twenty (G-20) Finance Ministers and Central Bank Governors held last month that, although "the . . . timing and sequencing of actions will vary across countries and across the types of policy measures," they "will continue to implement . . . necessary financial support measures and expansionary monetary and fiscal policies . . . until recovery is secured." This view was shared again at the meeting of the Group of Seven (G-7) Finance Ministers and Central Bank Governors held on October 3, 2009.

In fact, it will take a long time for various adjustments to progress in the United States and Europe, and during the adjustment process expansionary policies will continue to be required in order to underpin economic activity. The Japanese economy has just started to pick up, and on the monetary policy front it is vital that the Bank secure the accommodative financial environment for an extended period to facilitate the return of the economy to a sustainable growth path.

As for the emergency measures that have been introduced in response to the acute pain triggered by the collapse of Lehman Brothers, and in particular to the spread of excessive anxiety among market participants and the rapid deterioration in market functioning, the review of these measures should be separated from exit strategies regarding the macroeconomic policies that I have just mentioned. It is considered appropriate that the emergency measures be reviewed in accordance with the degree of decrease in excessive anxiety and of recovery in market functioning. In the United States, the Federal Reserve has already set out a plan to suspend or scale back some of its facilities such as purchases of long-term government bonds and the Term Auction Facility (TAF), which is a tool to supply longer-term liquidity.

Regarding when the Bank's temporary measures should be withdrawn, the Bank will examine the impact and necessity of each measure as comprehensively as possible, and will make a decision at an appropriate time at a future Monetary Policy Meeting based on the comprehensive review.

The Bank will continue to exert its utmost efforts as the central bank to facilitate the return of the Japanese economy to a sustainable growth path with price stability.

Closing remarks: medium- to long-term issues that the Japanese economy faces

In closing my speech, I would like to touch upon medium- to long-term issues that the Japanese economy faces.

For the Japanese economy to attain growth that raises people's standard of living amid drastic changes in the world economy, Japanese firms need to address medium- to long-term changes in the world economic environment. I would like to point out three key changes.

The first change, potentially, is a decline in the sustainable growth rate of the world economy. As mentioned earlier, given that the asset bubble lasted for a long time and spread globally, we may have to wait for some time longer than a typical short-term business cycle until the necessary adjustments are completed. Firms need to respond to this possibility from a long-term perspective.

The second change is the aging of the population, which is developing in every advanced economy including Japan. In an economy where the population is decreasing due to aging, growth in consumption will inevitably slow and the structure of consumption will also change, with the relative importance of consumption by the elderly rising. China, which is enjoying high growth, is also likely to become subject to the effects of an aging population before long, although this issue is seldom discussed.

The third change is tighter constraints from limited irreproducible resources and the ecological environment. Global warming is not an issue for a single country but literally for the entire globe.

I believe the wisdom of corporate managers – today's main audience – can produce the best solution to deal with these changes. Therefore, I would like to raise only two general points.

The first relates to how to address balance-sheet adjustments on a global scale. The importance of expanding domestic demand is undeniable, but I think it is also important to attract demand from emerging economies. They are Japan's competitors in world trade but at the same time potential customers for Japanese products. Historically, Japanese manufacturers have responded swiftly to structural changes in the world economy and cultivated new customers. I believe that they should further develop such competency to address the medium- to long-term issues, and this would be one of the pillars supporting a smooth adjustment process for the Japanese economy.

The second point relates to how to minimize the negative effects of an aging population and the constraints from limited irreproducible resources and the ecological environment. My opinion is that innovations that create eco-friendly products will pave the road to success. Let me adduce an example of the issue of an aging population. Today's development of technologies, typically of digital appliances, seems to be one that primarily targets the younger generation and generates profits through mass production. However, such development would produce less value-added than before as the proportion of the population comprised by the younger generation decreases. It will become increasingly important for firms to employ new elderly-oriented technology ahead of their competitors. In fact, in the area of finance, product innovations are necessary to find the way to finance socially-required investments by making use of financial assets held by the elderly in particular. It is crucial that different industries – for example, financial and manufacturing sectors – cooperate with each other to address such issues.

Looking at the economy of Hyogo Prefecture based on the argument just presented, responses to the medium- to long-term changes in the economic environment seem to be making steady progress. As for responses to the constraints from limited irreproducible resources and the ecological environment, for example, there are many factories producing solar, lithium-ion, or nickel-hydrogen batteries in the region. A number of firms related to wind power generation are also clustered in Hyogo Prefecture, and I understand it is viewed as one of the regions with high potential in ecological business.

The changes we are facing in the economic environment are a global phenomenon and eventually will affect all of society. In such a situation, exerting originality and ingenuity is the only way to survive as individual firms and a nation as a whole. I sincerely hope that various efforts currently being made will bear fruit and bring prosperity to the economy of Hyogo Prefecture.