Masaaki Shirakawa: Japan's economy in 2009 – review of the year and challenges ahead

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, to the Board of Councillors of Nippon Keidanren (Japan Business Federation), Tokyo, 24 December 2009.

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Introduction

I am honored to have this opportunity to address the representatives of Japan's economy that are gathered here today.

This year is just over a week remaining to its end. Looking back, when I addressed this forum exactly one year ago, the economies of Japan and the world were in the midst of a panicked contraction of economic activity associated with the occurrence of a global financial crisis. Since then governments and central banks around the world have launched various policy measures, firms have made significant production adjustment and other painstaking efforts, and Japan's economy and overseas economies have been picking up since around spring. However, amid the after-effects of the bursting of the global credit bubble, uncertainties surrounding the future remain high and many issues must be resolved in order that the global economy can return to a new, sustainable growth path, and shift to the so-called "new normal". Today, I will first review economic and financial developments in 2009, then describe the Bank's thinking on the conduct of monetary policy and conclude with an outline of the challenges Japan's economy needs to tackle from next year onward.

I. Developments in the global economy

I would like to start by discussing global economic developments. In my end-of-year speech last year, I said that the reason for the recent economic downturn was the bursting of a global-scale credit bubble. The process of the economic downturn may be summarized in the following two factors. The first factor is the unwinding of excess accumulated globally until the mid-2000s, mainly in the United States and Europe. We can call this a process in which problems of households' excess debts, firms' excess production capacity, and financial institutions' impaired assets are being addressed, or in other words, a process of making repairs and adjustments to the balance sheet. During this process, economic agents restrain spending activity, and chronic downward pressure is exerted on the economy. The second factor is the panicked contraction of economic and financial activity due to the financial crisis caused by the failure of Lehman Brothers in the autumn of 2008. While balance-sheet adjustments exert chronic downward pressures as I just explained, the panicked contraction had acute effects on the economy.

The main reason that the global economy started to pick up from early spring this year is that the second factor, the contraction of financial and economic activity, started to calm. In fact, due to the provision of liquidity by central banks around the world and government measures to restore the financial system, global financial markets have, regained a considerable degree of stability, a major difference from the situation one year ago.

At the same time, however, it is becoming clear that considerable pressure from balance-sheet adjustment, which I mentioned as the first factor, remains in the U.S. and European economies. Therefore, there is an increasingly stark contrast between the slow recovery of advanced economies, and the faster recovery of emerging and commodity-exporting economies. Specifically, in advanced economies, particularly in the United States and Europe, balance-sheet adjustments are still being made and as a result domestic demand is struggling to gather momentum, while emerging and commodity-exporting economies have been recovering at a faster pace than was expected in the spring of 2009. Against a backdrop of the need to improve standards of living and social infrastructure, many emerging and commodity-exporting countries are generally exhibiting a trend of strong domestic demand. On top of that, in these economies increased fiscal expenditure has been more effective in creating domestic demand through a strong multiplier effect, as, unlike the advanced economies, they face relatively minor pressure from balance-sheet adjustment. And, an inflow of funds from advanced economies, where interest rates are low, has helped growth by increasing lending and boosting asset prices.

Moving on to the outlook for the global economy, on the whole, the recovery trend is likely to continue due partly to advanced economies picking up, and also to the high growth of emerging economies, but uncertainties regarding the outlook are judged to remain high. There are both upside and downside risk factors. Major downside risk factors include possible consequences of balance-sheet adjustment in the United States and Europe as well as the gradual waning of policy effects. Meanwhile, although the strength of emerging economies is an upside risk factor, it is worth mentioning that, if capital inflows from advanced to emerging economies continue, this could lead to a rapid overheating and subsequent plunge in emerging economies. Moreover, the recent so-called "Dubai shock," which is fortunately calming, has served to reinforce the perception that attention should be paid to risk factors on the global financial front.

II. Developments in Japan's economy

Next, I would like to discuss the current state of and outlook for Japan's economy.

Amid the global economic downturn that I have just described, Japan's economy deteriorated significantly, due mainly to an unprecedented decline in exports and production. Thereafter, as overseas economies improved and progress was made in inventory adjustment both at home and abroad, exports and production started to recover. Furthermore, as demand for automobiles and electrical appliances, which were subject to tax reductions and subsidies, started to increase, Japan's economy bottomed out from around this spring, and can now be judged to be picking up. However, the level of economic activity remains low, signs of improvement have mostly been supported by the government's stimulus measures, and it is judged that there is not yet sufficient momentum for a self-sustaining recovery.

Turning to corporate financing, you may vividly remember that, around this time last year, issuance in the CP and corporate bond markets was difficult due to the effects of the failure of Lehman Brothers in 2008, those markets are now showing considerable improvement. In the CP market, issuance rates for CP have declined noticeably and issuance rates for some high-rated CP are even below yields on government bills. The corporate bond market has also been active. In addition to a decline in issuance rates, we have seen a rush in issuance since the summer, while firms have shifted the emphasis of their fund-raising from short-term funds to long-term funds. Large firms' financial positions have been improving, supported in part by a pick up in their sales and profits and also by a considerable improvement in the issuing conditions for CP and corporate bonds. However, the management at many large companies seem to have not completely loosened the reins about their future financial position despite high levels of liquidity on hand, given their vivid memory of the difficulties experienced since the autumn of 2008 and persistent uncertainties regarding the economic outlook. Moreover, the Bank is fully aware of the fact that, although policy effects from the government's emergency guarantee program have appeared, the financial position of small firms remains weak, as improvements in their sales and profits are lagging. As such, although Japan's corporate financing has been showing signs of improvement, the situation as a whole remains severe.

Regarding Japan's economic outlook, we expect that the pace of improvement will remain moderate up to around the middle of fiscal 2010 as pressure to adjust production capacity and employment is likely to remain. Indeed, the pace of economic recovery may slow temporarily, particularly around early next spring, when the effects of various economic stimulus policies are expected to subside. This tendency will be stronger in regional economies that depend heavily on public investment. However, in my view, it is unlikely that the recovery of the economy will stall at that time. This is because, advanced economies, including Japan, have made clear that they intend to continue with economic stimulus measures until economic recovery is assured. Also, the strength of domestic private demand in emerging economies is likely to remain self-sustaining. Nevertheless, we recognize that the recovery path will not be a smooth one, and the Bank will examine the economic situation without any predetermined view.

Next, looking at prices during this period, the year-on-year rate of change in the consumer price index (CPI) fluctuated widely due to the effects of petroleum product prices. After registering a sharp increase of 2.4 percent in the summer of 2008, it turned negative in the spring of 2009, and in August 2009, posted the largest decline on record of minus 2.4 percent. As the effect of last year's surge in oil prices fades, the rate of decline in the CPI is expected to shrink to around minus 1 percent. Developments thereafter will be key to the outlook for prices. Based on the economic outlook I outlined earlier, as economic slack dissipates the pace of decline in the CPI will tend to gradually moderate. However, if the pace of recovery in the economy is gradual, we should expect that downward pressure on prices would remain for a considerable period.

The root cause of a continuous decline in prices, that is, the phenomenon referred to as deflation, is weaker aggregate demand compared to the supply capacity of the economy as a whole. Therefore, to emerge from such a situation, it is vital to strive to continuously improve the supply-demand balance of the overall economy. In relation to this, two approaches will be necessary, namely efforts to generate short-term demand and improving medium- to long-term expectations for income growth that reflect increases in productivity. As these are closely related to the Bank's conduct of monetary policy and to challenges Japan should tackle, I would like to discuss them again later.

III. The Bank of Japan's conduct of monetary policy

Next, I would like to discuss the Bank of Japan's conduct of monetary policy.

I explained earlier that we can summarize the causes of the global economic downturn since the autumn of 2008 based on two factors. Similarly, the measures implemented by the central banks of major economies, including the Bank of Japan, may be categorized into two factors, namely measures to address the acute problems brought about by the financial crisis, and measures to address the chronic effects of balance-sheet adjustment.

As for the acute problems arising from the financial crisis, many central banks have conducted various measures to restore the necessary market functioning, which had seriously deteriorated, by providing ample liquidity to the financial markets and by, for example, purchasing certain financial assets, focusing on markets whose functioning was impaired. The Bank of Japan has also introduced various temporary measures, including extraordinary measures for a central bank, such as outright purchases of CP and corporate bonds. It might be safe to say that these measures by central banks have been effective in restoring stability in financial markets and facilitating corporate financing. Therefore, the majority of central banks in advanced economies, such as the Federal Reserve (FRB) of the United States and the European Central Bank, have already announced their intention to unwind these emergency measures. To align with those moves, the Bank of Japan has also recently announced that it will cease outright purchases of CP and corporate bonds at the end of 2009 as scheduled. Moreover, in order to be extra careful, the Bank of Japan will let special funds-supplying operations to facilitate corporate financing remain in effect until the end of March 2010, to cover the fiscal year-end, before being replaced by ordinary funds-supplying operations.

Our revision of these temporary measures is predicated on our thinking of selecting the most effective method for fund provision, in accordance with changes in financial market conditions. For example, as I explained earlier, one consequence of the Bank's measures was that issuance rates on some high-rated CP fell below yields on government bills. Therefore, investors exited the CP market and a side effect of the measures, shrinkage in market size, became more pronounced. If the temporary measures are maintained, the functioning of the CP market, which is important for firms' short-term fund raising, might in fact be damaged. Given that an improvement of the issuance conditions for CP has been achieved, special measures such as outright purchases by the central bank should be withdrawn. Instead, it would be more effective for improving the flow of funds if the regular funds-supplying operations, which accept a wide range of collateral, are actively used. While the Bank reviewed the temporary measures from this perspective, it goes without saying that one of the Bank's most important purposes is ensuring stability in financial markets. I would like to reiterate that the Bank will be prepared to act swiftly and decisively if concerns arise that financial market stability might be compromised.

While the central banks of major economies, including the Bank of Japan, have generally addressed the acute problems brought about by the financial crisis, as regards the chronic effects of balance-sheet adjustment they have expressed the intention of maintaining an accommodative financial environment. For example, from autumn to the end of 2008 the Bank of Japan reduced the policy rate to 0.1 percent, a level of interest rates of effectively zero. As for the future conduct of monetary policy, the Bank has announced that it will maintain the extremely accommodative financial environment and provide consistent support to Japan's economy to overcome deflation and return to a sustainable growth path with price stability.

At the beginning of December, since there was concern over a risk that international financial developments and instability in the foreign exchange market might adversely affect economic activity through worsened business sentiment, the Bank promptly held an unscheduled Monetary Policy Meeting and introduced a new funds-supplying operation in order to further enhance monetary easing. This operation employs the conventional framework of funds-supplying operations against pooled collateral, introduces a fixed interest rate set equal to the extremely low policy interest rate of 0.1 percent, and provides to the money market ample longer-term funds with a term of three months. The Bank plans to provide approximately 10 trillion yen through this operation. We expect that the longer-term money market rates, known as interest rates on term instruments, will decline further, and such effects have already started to appear and the financial markets appear to have regained some stability.

Moreover, at the Monetary Policy Meeting held in mid-December, the Bank clarified again its thinking on price stability. In 2006, the Bank introduced what is called an "understanding of medium- to long-term price stability" (hereafter "understanding"), which outlines the Bank's understanding of price stability that should be taken into account when discussing monetary policy, and released a numerical expression, a year-on-year rate of change in the CPI that "falls in the range approximately between 0 and 2 percent." This time, in order to prevent the expression "approximately" from inviting misunderstanding, we decided to employ clearer words to express the Policy Board's intention to not tolerate a year-on-year rate of change in the CPI equal to or below 0 percent and that the midpoints of most Policy Board members' understanding are around 1 percent. The agreed new expression was that each Policy Board member's understanding "falls in a positive range of 2 percent or lower, and the midpoints of most Policy Board members' 'understanding' are around 1 percent." I believe that dissemination of the Bank's outlook for economic activity and prices as well as its stance for the conduct of monetary policy, which I explained earlier, and its thinking on price stability will accordingly have a certain impact on the formation of interest rates in the financial markets.

While keeping in mind its understanding of medium- to long-term price stability, the Bank will continue to make wide-ranging assessments of various risk factors and strive to achieve the proper conduct of monetary policy. In doing so, based on lessons learnt from the bursting of the recent global credit bubble, I believe it is crucial to also pay attention to the possible accumulation of financial imbalances observed, for example, in asset prices and credit aggregates.

IV. Global financial crisis and Japan's economy

Next, I would like express my views on what kind of challenges Japan's economy will face in 2010 onward.

In conducting economic policy, or, in the management of firms formulating future strategy, it is critical to consider the lessons Japan should draw from the experience of the recent global financial crisis. In order to consider this, in my view, it is necessary to recognize the following two facts.

The first fact is that, as has often been pointed out during the recent economic downturn, the plunge in economic activity in Japan was the largest among the advanced economies. Comparing internationally the trough levels of real GDP by taking as the benchmark the April–June quarter of 2008, which is before the global financial crisis broke out, real GDP in the United States, where the global financial crisis originated, declined by less than 4 percentage points, while that in Japan decreased by more than 6 percentage points, which was the largest fall among the advanced economies.

The second fact is that Japan's financial system remained relatively robust, compared with those of the United States and Europe. For example, although various credit spreads in financial markets, such as the yield premium of corporate bonds against that of government bonds, did widen in Japan as well, but compared to other countries the degree of widening was small. Another example is bank lending. In the United States and Europe, following the outbreak of the global financial crisis the year-on-year growth rates of bank lending declined sharply by more than 10 percentage points over a period of one year and few months. Meanwhile in Japan, there was not such a sharp decline in the year-on-year growth rate of bank lending. Such marked difference is also observed in terms of the size of central bank balance sheets. In the United States, as credit markets had almost ceased to function, the central bank had no choice but to step in to take the place of the credit market, which resulted in a significant expansion of the FRB's balance sheet. Meanwhile, in Japan, the situation did not become so extreme. Japan's financial markets were also affected significantly, but not in as extreme a fashion as the U.S. markets. As a result, the Bank of Japan's balance sheet was not expanded as much as that of the FRB.

Then, why was the decline in Japan's economic activity particularly pronounced even though its financial system remained relatively robust? I believe that the answer to this question is key for discussing the future of Japan's economy.

In terms of the components of demand, the substantial fall in economic activity was particularly evident in exports. While some interpret this as a weakness due to dependency on external demand and hold the view that Japan's economy needs to make a full-fledged shift from being an external demand-dependent economy to being a domestic demand-driven one, I do not go along with such a view. I say this because Japan's percentage dependency on exports is in the mid-teens range, which is slightly higher than the United States, but clearly lower than in advanced economies in Europe. For example, export trade accounts for approximately 40 percent of GDP in Germany and over 25 percent in the United Kingdom and France, and in this context, Japan's economy is hardly external-demand dependent. Rather than taking this view, we should pay attention to the rapid changes in the environment surrounding Japan's manufacturing industry before and after the global financial crisis. Specifically, in my view, there are three key points.

First, the global financial crisis had a pronounced impact on areas of industry in which Japan has a competitive advantage. The global financial crisis paralyzed the financial intermediation function around the globe and uncertainties regarding the outlook increased. This directly hit expenditure, mainly for business fixed investment and consumer durables, that is susceptible to the fund-raising environment such as bank lending or the degree of uncertainty about the future, and dealt a major blow to production in the Japanese manufacturing industry, which supplies such goods globally.

Second, the impact of the adjustment of excesses and balance-sheet adjustment also tended to become significant. Up to the mid-2000s when the global economy enjoyed high growth supported by the credit bubble, there was a worldwide boom in spending on consumer durables. The Japanese manufacturing industry, which had established a comparative advantage in these areas, greatly benefited from this boom. However, in retrospect, and setting emerging economies aside, the boom in the United States and Europe was based on overly optimistic expectations and was unsustainable. And the balance-sheet adjustments in the United States and Europe, which ensued with the unwinding of the boom, directly hit Japanese manufacturing industry.

And third, there was a reaction to the considerable depreciation of the yen from the mid-2000s. To determine the effects of changes in exchange rates on export competitiveness, it is necessary to take into account differences in price fluctuations at home and abroad as well as the weights of trade. Looking at the real effective exchange rate of the yen, adjusted for these factors, we see that from around 2005 to mid-2007 it depreciated by more than 20 percent, and remained at its lowest level in the past 20 years, which supported a considerable increase in Japan’s exports. However, since the outbreak of the global financial crisis in the autumn of 2008, the yen appreciated rapidly and has recently been trading around its level in the early 2000s. This suggests that the portion of exports supported by the depreciation of the yen since the second half of the 2000s has been eliminated.

Based on these observations, the lesson that can be learned from the experience of the global financial crisis is not that Japan’s economy needs to make a full-fledged shift from being external demand-dependent to being domestic demand-driven, but that it is important that the global economy aims to achieve sustainable growth. Given that globalization is irreversible, it is not appropriate to see external demand and domestic demand as opposing concepts. I would emphasize that, for Japan’s economy, it is both important to reap the fruits of global economic growth and to lay the groundwork for expanding domestic demand.

V. Five challenges

Based on the lessons learned from the recent crisis and looking at the prospects for Japan’s economy from next year onward, various challenges lie ahead. Here, I would like to raise five challenges Japan should tackle.

First, the shift to what has been called the “new normal.” The growth pattern we experienced up to the mid-2000s that was supported by the global credit bubble is not expected to recur, nor should we expect it to recur. Nobody knows what specifically the “new normal” will be, and we are in the process of exploring a sustainable new growth mechanism. However, the size of the decline from the prior economic boom and the fact that this process requires a certain amount of time may provoke calls for protectionism and excessive regulation. Japan and others must seek to prevent such a situation.

The second challenge is to review various systems reflecting the ever-evolving global economic environment. In each country where firms are exposed to global competition, they are constantly seeking to make use of their comparative advantages. Amid factors such as population decline that could contract the domestic market in the medium to long term, in order to reap fruits of the global economic growth Japan must constantly review systems that stipulate conditions for competition so that Japanese firms can maximize their management efforts. At the same time, firms are required to strive to take a diverse range of innovative approaches.

The third challenge is to actively participate in the creation of global rules. Currently, various moves are taking place to establish new international rules to address global environmental issues and others. Moreover, there are active developments to take the initiative in rule-setting at the corporate level. To reap the fruits of global economic growth, it is essential for public authorities and private firms to strive to actively participate and take the initiative in such moves. In the financial field also, discussions are underway toward revising global financial regulations to reflect the lessons learned from the recent crisis. The Bank of Japan is also actively taking part in this process, through the G20 meetings and various venues for international discussion.

The fourth challenge is to develop various safety nets. In order for the economy to grow in a sustainable manner, it is essential to have sustainable expansion of private consumption. In order to lay the foundations for this, and to allow individuals to take the initiative in various fields, it is essential to enhance households' sense of security about their future lives by providing various safety nets.

The fifth challenge is to emerge from a mood that can be called "irrational pessimism." In the same way that "irrational optimism" creates a bubble, "irrational pessimism" will certainly not have positive effects on economic activity either. Of course, the economy will not improve just by sentiment, and what is most important is to formulate a solid growth strategy and strive actively to establish a new growth mechanism. In order to do so, however, sentiment matters. In the context of its role in realizing economic and financial stability a central bank can be compared to "an anchor," and I believe that a central bank is expected to serve as a well-balanced anchor in terms of economic analysis and information dissemination.

Closing remarks

I have pointed out five challenges for Japan's economy. As such challenges are met, productivity rises, and the public starts to expect a future increase in income we will then have reached a point at which demand can start a strong, full-fledged expansion. And that is the time when we will truly feel that Japan's economy has emerged from a situation called deflation. For Japan's economy to emerge from deflation and return to a sustainable growth path with price stability will ultimately require consistent endeavor between policymakers such as the Bank of Japan and private sector entities in their own fields. By listening to opinions and criticisms from you in the coming year, I will reaffirm that the Bank of Japan will continue to make consistent efforts to meet our challenges.

Thank you.