Masaaki Shirakawa: Japan's economy and monetary policy

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at a meeting held by the Naigai Josei Chousa Kai (Research Institute of Japan), Tokyo, 29 January 2010.

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Introduction

I am privileged to have the opportunity to speak before such a large audience today.

Thinking back, this time last year, the global economy and financial markets were in the midst of a rapid and large decline, and I think many business managers were seized by the fear that no bottom was in sight. Policy makers at home and abroad also tackled the situation with a sense of nervousness that one wrong policy step might result in a 1930s-style Great Depression. Fortunately, one year on, today, as a result of the intense efforts of private firms and the prompt implementation of various unconventional policy measures by governments and central banks around the globe, the downturn of the global and Japanese economies has been brought to a halt and activity has started to pick up. While economic conditions are improving, this improvement to a great extent owes to the support provided by the various policy measures, and the level of economic activity in advanced economies still remains below that prior to the Lehman shock. I imagine that, from the perspective of business managers, the "fear of no bottom in sight" may have gone, but the "anxiety of no future in sight" may remain significant. Today, I would like to talk about recent financial and economic developments at home and abroad, the thinking behind the Bank's conduct of monetary policy, and medium- to long-term challenges for Japan's economy.

I. Developments in the global economy

The mechanisms underlying the downturn and the recovery

While the main topic of today's speech is Japan's economy, in the short-term, economic conditions in Japan will greatly depend on developments in the global economy, as has been the case in the past year.

As you are well aware, the global economy, sparked by the failure of Lehman Brothers in the autumn of 2008, faced a panicked contraction of financial and economic activity stemming from a liquidity crisis. As we all know, the most basic premise for economic transactions to take place is the confidence that counterparties will honor their obligations. However, following the failure of Lehman Brothers, confidence among financial market participants in counterparties collapsed and fund providers such as financial institutions and institutional investors became extremely cautious regarding the creditworthiness of their counterparties. Nagging suspicions spread in many financial markets, and the funds necessary for economic activity did not circulate easily. The effect, as it were, was like an unintended sudden financial tightening on a global scale. Firms and consumers were not able to raise funds and thus were forced to cut back on their spending. Moreover, due to heightened anxiety, many started to restrain their spending. As a result, the global economy experienced the acute symptoms of what could be described as an instantaneous evaporation of demand. Reflecting the characteristics of this crisis, what was affected the most were capital goods and durable consumer goods. Since Japan's strength lies in exactly these kinds of goods, that is, automobiles, electrical machinery, general machinery, etc., Japan's economy was severely affected. And for the same reason, despite the fact that they were not the epicenter of the financial crisis, not only Japan but also many other East Asian economies, including South Korea, Taiwan, and Singapore, were among those that experienced the most severe downturn in economic activity immediately after the crisis.

The global economy bottomed out around the spring of last year and is now in a stage of recovery. The growth forecast for the global economy for 2010 by the International Monetary Fund has been edging up over time, from 1.9 percent in April 2009, to 3.1 percent in October, and to 3.9 percent in the forecast released this week. Underlying these revisions are the progress made in inventory adjustments and the effects of various policy measures by governments and central banks. Let us take a look at the recovery process in more detail.

The major driving force of the current recovery are emerging and developing economies, and the share of these economies in global growth is forecasted to reach 70 percent in 2010. In contrast, although the United States, Europe, and other advanced economies have emerged from the sharp recession, there has not yet been sufficient momentum for a self-sustaining recovery. At the root of the panic sparked by the failure of Lehman Brothers was the structural problem of balance-sheet adjustments. Toward the mid-2000s, households and firms especially in the U.S. and several European economies borrowed excessively from financial institutions based on the optimistic assumption that asset prices, such as home prices, would keep on rising, boosting consumption and investment. Financial institutions provided funds to support such behavior of households and firms and continued to increase lending. However, once asset prices started to decline, such developments reversed almost instantaneously. In order to reduce debts that had increased excessively during the asset price bubble, firms and households were forced to cut back on consumption and investment. Efforts to reduce debts led to a decrease in aggregate demand and a fall in asset prices. Financial institutions also had to restore balance between bloated assets and excessive risks on the one hand and capital bases on the other. In this process, it inevitably became difficult for financial institutions to engage in active risk-taking such as the extension of new loans. While the repair of balance sheets is an unavoidable process to return economies to a sustainable growth path, it should be noted that the process in the meantime exerts continuous downward pressure on economies. If the plunge in economic activity following the Lehman shock can be described as the "acute symptoms" of the financial crisis, then the balance sheet adjustments are a "chronic illness" that will continue to affect economies.

In contrast, emerging and commodity-exporting economies have recently been recovering at a more rapid pace than expected. The rapid recovery of emerging and commodity-exporting economies is mainly attributable to three factors.

First, with their populations growing, potential domestic demand in these countries is strong to start with, driven by buoyant consumption associated with rising living standards and the need for expanding social infrastructures. A typical example is China, where demand for durable consumer goods such as televisions and automobiles is extremely strong. Moreover, in emerging and commodity-exporting economies, social infrastructure, such as roads and electric power plants, is still underdeveloped relative to the population. If such infrastructure improves, there is the potential for further increases in demand for automobiles and home electronics.

Second, the emerging and commodity-exporting countries themselves have also implemented aggressive economic stimulus measures in response to the recent crisis. Unlike the advanced countries, the emerging and commodity-exporting economies were not facing a problem of balance sheet adjustments, and potential demand was strong to start with, so that the multiplier effects of fiscal stimulus measures are likely to have been significant.

And third, there have been massive flows to emerging and commodity-exporting economies of funds for risk-taking that could not find sufficient investment opportunities within advanced economies. Therefore, in the emerging and commodity-exporting economies, economic recovery has been underpinned by an increase in domestic bank lending and a rise in real estate prices. This trend has also been accelerated by the fact that many emerging and commodity-exporting economies have adopted inflexible exchange rate regimes tying their currencies to the U.S. dollar. However, if accommodative monetary conditions continue too long, this could lead to an overheating of emerging and commodity-exporting economies or turmoil in financial markets, or, in the future, to an economic downturn due to a reversal of capital flows. Therefore, some countries have already started taking policy measures on the monetary policy front such as raising policy interest rates.

The outlook

This was a quick review of the mechanisms underlying the plunge and recovery of the global economy following the failure of Lehman Brothers. One of the important issues in forecasting future developments is how to assess the monetary and fiscal policies that have played such a major role in the current recovery process.

During the current economic recovery, the various policy measures taken by central banks have exerted substantial effects. Although policy rates in the major economies had reached virtually zero at the end of 2008 and there remained no room for further rate reductions, credit spreads, which had jumped during the crisis, nevertheless narrowed significantly and credit availability recovered as a result of various unconventional measures. In other words, even though the policy rates at which central banks provide funds to financial markets had reached the lower bound, monetary easing was substantially enhanced through measures to promote financial market stability.

Another thing I would like to add with regard to monetary easing is that, in contrast with the past, the effects of monetary easing in the advanced economies have been greater in other economies, especially emerging economies, than in the advanced economies themselves. With respect to the transmission mechanisms of the effects of monetary easing, textbook examples include increased bank lending and capital investment due to a decline in interest rates and rising exports owing to exchange rate depreciation. However, the transmission mechanisms of the effects of monetary easing are also changing in tandem with the globalization of financial markets. In the current situation, in part because advanced economies face the problem of balance sheet adjustments, one mechanism that might become important is the stimulus provided to advanced economies' exports and domestic capital investment through the recovery in emerging markets.

In terms of macroeconomic policy, the role of fiscal policy has also been important. Since the failure of Lehman Brothers, governments have, in response to the rapid economic and financial contraction, injected public capital into financial institutions and have implemented large-scale fiscal stimulus measures. Such large-scale policy interventions were indispensable to maintain financial system stability and stem the plunge in economic activity. Yet, while these measures have been achieving their intended purposes, at the same time, fiscal deficits have increased and government debt has risen markedly. It can be said metaphorically that, in the recent crisis, the governments assumed the risks and debt that the private sector could not shoulder. However, as economic and financial market stability has returned, participants in global financial markets have started to pay greater attention to the risks the governments shouldered and the associated problems, namely the issues of fiscal deficits and fiscal discipline. What is interesting in relation to this is the Fed's purchases of Treasury securities during March to October last year. In conducting such purchases, the Fed repeatedly emphasized that the purchases were neither public financing by the central bank nor aimed at guiding long-term interest rates to specific levels. The emphasis, despite the fact that the Fed's purchases of Treasury securities were much smaller than the Bank's purchases of government bonds relative to the size of the economy, could be seen as part of its determination to maintain confidence in its monetary policy.

Under these difficult circumstances, what kind of monetary and fiscal policies are desirable is something that ultimately each country needs to decide for itself based on its own economic and financial conditions. In terms of the basic stance of policy conduct, advanced economies at present are placing priority on economic recovery, while emerging economies are beginning to pay greater attention to the potential overheating of their economies. What is important in the end is that the global economy as a whole is brought back to a sustainable growth path. With this goal in mind, it is necessary for policy authorities to carry out the appropriate policies while firmly maintaining confidence in their policies.

II. Economic and price developments in Japan

Based on the developments in the global economy just described, I would now like to discuss economic and price developments in Japan.

Let us first consider the situation Japan's economy finds itself in at the moment. The fluctuations in the economy are shown most vividly in the index of industrial production. Taking as the period immediately before the Lehman shock the July–September quarter of 2008 and setting the index of industrial production to 100, the level of activity dropped to 66 in February 2009. The drop was particularly pronounced in the automobile and electronic parts industries. Thereafter, production started to increase from March and recovered to a level of 86 in December. Since the index of industrial production essentially covers manufacturing industry, which accounts for only 20 percent of Japan's economy overall, to gauge overall economic activity, it is necessary to look at developments in real GDP. After falling sharply in the October–December quarter of 2008 and the January–March quarter of 2009 at annualized quarter-on-quarter rates of 10 percent, average real GDP growth in the next two quarters was about 2 percent. For the October–December quarter of 2009, private-sector forecasts put growth at a similar rate. The level of real GDP in the October–December 2009 quarter is expected to be about 95 when taking the level immediately before the Lehman shock as 100.

Looking at the pick-up of the economy in terms of final demand items shows that exports, on a quarter-on-quarter basis, expanded by over 10 percent both in the April–June and the July–September quarters of 2009 and continued to expand by about 9 percent in the October–December quarter, with exports to East Asian economies accounting for more than half of that increase. Private consumption has been picking up, particularly of durable consumer goods such as automobiles and electronic appliances, due to the effects of various policy measures, although the employment and income situation remains severe, as illustrated by decreasing bonus payments. Business fixed investment, too, following a continuous slide from the April–June quarter of 2008, is bottoming out. Not a few firms have been considering shifting investment to emerging markets, where expansion in demand is expected. However, since the level of business fixed investment has already declined considerably, if exports and production continue to increase, the capacity utilization rate will increase and business fixed investment will bottom out and start to increase. Housing investment has recently been showing signs of bottoming out. In contrast, public investment has started to level off. Based on this assessment, the Bank judges that Japan's economy is picking up. However, this pick-up reflects various policy measures taken at home and abroad, and there is not yet sufficient momentum for a self-sustaining recovery in domestic private demand. Moreover, given that the recent pick-up of the economy centers on the manufacturing sector, there are disparities in the degree of improvement between regions where manufacturing firms are concentrated and other regions. Furthermore, there are also disparities among firms, with the situation differing between large firms, small firms, and micro businesses.

The question is how the economy will develop. The baseline scenario is that the economy is likely to continue picking up on the back of improvements in overseas economies and the effects of economic policy measures. However, the pace of improvement in Japan's economy is likely to be moderate until around the middle of fiscal 2010, since the pace of recovery in the global economy is likely to remain moderate and, in Japan, pressure for adjusting employment and wages is likely to remain. Going forward, as balance-sheet adjustments in the United States and Europe make fair progress, in Japan the improvements in the corporate sector originating from exports are likely to spill over to the household sector. Therefore, in fiscal 2011, Japan's economic growth is likely to clearly accelerate. In terms of figures, the economic growth rate is projected to be around 1 percent for fiscal 2010 and around 2 percent for fiscal 2011. However, the Bank is fully aware that the baseline scenario is accompanied by various uncertainties, and thus will continue to examine economic developments without having any prejudgment.

I will now turn to price developments in Japan. Since I will discuss the so-called “deflation issue” in a moment, let me, for the time being, simply look at the figures. Since 2008, consumer prices have been swinging widely due mainly to the fluctuations of prices of petroleum products and other commodities. The year-on-year rate of change in the consumer price index (CPI) excluding fresh food peaked at 2.4 percent in the summer of 2008, followed a downward trend thereafter, and posted the largest decline on record, minus 2.4 percent, in August 2009, mainly because of the base effect of the previous year’s surge in oil prices. Subsequently, with the fading of the effects of the decline in the price of petroleum products, the rate of decline in the CPI in December moderated to a year-on-year rate of change of minus 1.3 percent.

Looking ahead, the pace of the year-on-year decline in the CPI is expected to continue moderating due mainly to the gradual improvement of the supply and demand balance associated with the pick-up of the economy. However, given that the recovery started from a level of unprecedented weakness in demand and the pace of economic recovery going forward is expected to be moderate, downward pressure on prices is likely to remain for a considerable period. The Policy Board members’ forecasts of the year-on-year change in the CPI released early this week is around minus 0.5 percent for fiscal 2010 and around minus 0.2 percent for fiscal 2011.

III. The thinking behind monetary policy

Let me now explain the thinking behind the Bank’s conduct of monetary policy.

Earlier, I pointed out the two causes of the global economic slump: the acute symptoms sparked directly by the financial crisis and chronic illness due to balance sheet adjustments. The policy responses of Japan and other countries were taken to address these two causes.

Regarding the acute symptoms, many central banks took measures such as the purchase of particular financial assets in markets that had ceased functioning to prevent a worsening of the financial crisis and to ensure the flow of funds necessary for private economic activity, working to restore the functioning of markets. The Bank also took policy steps that are unconventional for a central bank such as the outright purchase of CP and corporate bonds. In this regard, there has been some criticism that the Bank has not implemented sufficient monetary easing, which is based on the argument that the relative increase in the Fed’s balance sheet has been greater than that in the Bank’s. Such criticism shows a complete misunderstanding of the facts. The significant expansion of the Fed’s balance sheet simply reflects the unfortunate situation that the functioning of U.S. capital markets, which account for about 70 percent of firms’ fund raising, had seriously declined and there was no alternative but for the Fed, as the central bank, to completely take over the role of the markets. Although the functioning of corporate bond and CP markets in Japan declined, the financial system, when compared with those of the United States and Europe, nevertheless remained relatively stable. This is partly the result of the various efforts made based on the bitter experience since the latter half of the 1990s. It is for these reasons that the Bank’s balance sheet has not expanded as much as that of the Fed. Rather, the size of the Bank’s balance sheet already expanded significantly before the crisis. Global financial markets have been regaining stability thanks to the extraordinary measures implemented by central banks around the world. Therefore, reflecting the improvements in financial markets, central banks overseas have been winding up various crisis measures in a sequenced manner since last summer. In Japan, too, since the functioning of CP and corporate bond markets has recovered, the Bank wound up its outright purchases of CP and corporate bonds at the end of December 2009. Nevertheless, as I always stress, the Bank is prepared to act swiftly and decisively should concerns that financial market stability might be hampered re-emerge.

With the response phase to the financial crisis behind us, the key policy challenge now is to how to guide the economy onto a sustainable growth path. While the Bank lowered the interest rate level to virtually zero by reducing the policy interest rate to 0.1 percent at the end of 2008, given the outlook for economic activity and prices described earlier, the Bank considers it necessary to maintain the extremely accommodative financial environment. At the beginning of December 2009, the Bank introduced a new funds-supplying operation so as to further enhance easy monetary conditions. With this operation, the Bank provides ample longer-term funds to the money market at an extremely low interest rate of 0.1, which is equivalent to the policy rate, by employing the existing framework of funds-supplying operations against pooled collateral, which accept a wider range of collateral such as Japanese government securities and corporate bonds.

The Bank recognizes that it is a critical challenge for Japan's economy to overcome deflation and return to a sustainable growth path with price stability. As the central bank, we will continue to make every effort to contribute to achieving this goal.

IV. The "deflation issue" and achieving sustainable growth

Finally, I would like to refer to the so-called "deflation issue." Recently, in discussions of various economic phenomenon, they have increasingly been argued in association with deflation. Therefore, it is all the more important to correctly understand the cause of deflation.

Since the 1990s, inflation has been falling worldwide. Reasons for this include the success of central banks' monetary policies aimed at price stability and the substantial decline in costs as planned economies made the transition to the market. However, the arguments frequently heard today are not about this general decline in inflation but about why the inflation rate in Japan is lower than in other advanced economies. In fact, Japan's inflation rate as measured by the CPI has been about 2–3 percentage points lower than that of other advanced economies even in the bubble period in the late 1980s. There are three possible reasons why inflation in Japan has been low for a protracted period.

First, rationalization of the distribution system and deregulation. While one rarely hears it mentioned today, from the 1980s to the mid-1990s, high prices in Japan, that is, the need to address the difference between domestic and foreign prices, were frequently identified as a major issue with regard to Japan's economy. Rationalization of the distribution system and deregulation were implemented to address the issue. Rationalization of the distribution system, together with globalization, led to an increase in low-priced imports. Moreover, deregulation exerted downward pressure on prices by reducing margins in industries and of firms that were protected by regulation in the past. While this was an extremely challenging situation for firms that were subject to such competitive pressures, it also meant an increase in real purchasing power for consumers and a rise in productivity for Japan's economy as a whole.

The second potential reason is the continuous decline in wages since the latter half of the 1990s. Since the bursting of the bubble economy, Japan's economy has undergone a severe and unavoidable adjustment process. Looking at the labor market from a macroeconomic perspective, since the latter half of the 1990s, managers and workers in Japan have put priority on maintaining employment, and to do so, workers accepted reductions in wages. Comparing consumer prices in Japan with those in other advanced economies, what stands out is the decline in service prices, implying that while flexible wage adjustments have been effective in terms of preventing an increase in unemployment, in return, they have put consistent downward pressure on the prices of labor-intensive services.

The third potential reason, which I believe is the most important one, is that expectations for future economic growth have declined. This decline in growth expectations has been further spurred by the aging and shrinking of Japan's population. The decline in growth expectations appears to have dampened investment in the corporate sector and heightened anxiety over future income in the household sector and thereby restrained private consumption. This contraction in spending by firms and households seems to have induced a vicious cycle in that it led to a further deterioration in aggregate supply and demand conditions in the economy, which in turn further reduced growth expectations. Ultimately, at the root of the aforementioned decline in wages, there is a lack of demand due to the decline in growth expectations.

In any case, the root cause of deflation is a lack of demand. Then, what should be done to resolve this lack of demand? In this regard, some point out the need for demand-boosting measures large enough to close the output gap. However, the output gap after all compares the demand for goods and services based on existing needs and supply capacity for goods and services that meet such needs. With the unprecedented global bubble having burst, it is unlikely that there will be sufficient demand for the existing supply capacity for goods and services. On the other hand, potential needs such as with regard to nursing and caring are substantial. The challenge, therefore, is to make efforts to convert potential needs into actual demand, and turning this into reality requires entrepreneurs and innovators. Concerning policies to counter deflation, some argued that "if the central bank were to increase its balance sheet, then deflation would come to an end." However, both the Bank in the first half of the 2000s, in implementing quantitative easing, and the Fed since 2007 significantly expanded their balance sheets; yet, there have been no corresponding price rises. Based on such experience, the argument that "if the central bank were to increase its balance sheet, then deflation would come to an end" is rarely discussed in the United States and Europe. What is clear is that, when the stability of the financial system is in danger, expansion of the central bank's balance sheet, that is, the provision of liquidity, is extremely effective in preventing a downward price spiral by ensuring the stability of the financial system. And that is exactly what the Bank of Japan did. However, once financial system instability is overcome, an increase in liquidity alone cannot resolve deflation. We need to look squarely at the root causes underlying the deflation issue.

Prices are often considered as the temperature of the economy. It is not possible to artificially raise only the temperature for a prolonged period. Rather, in order for the temperature to follow an upward trend, it must be based on genuine health-promoting measures and, in some cases, an appropriate cure. The same applies with regard to the response to deflation. The important thing in order to apply the brakes to a moderate downward trend in prices is to raise trend growth expectations. Put differently, with the recognition that it is indispensable to make steady efforts to raise productivity, we need to tackle this challenge.

In this regard, there is no "magic wand." Here, I would like to point out two basic elements that are important in overcoming deflation and achieving sustainable economic growth.

The first is the importance of making the most of global demand, especially from emerging and developing economies, which are expected to enjoy high growth. At present, the penetration rate of automobiles in China is about 4 percent. This more or less matches the level in Japan in the first half of the 1960s when motorization started in earnest. In Japan, it took 30 years for the penetration rate of automobiles to reach 50 percent. While the road of growth for emerging economies may not be even, the potential opportunities provided by the growth of these markets are vast, as many people recognize. Given that globalization is steadily progressing, it would not be appropriate to see external demand and domestic demand as opposing concepts. I would like to emphasize that for Japan's economy it is important to both reap the fruits of global economic growth and to lay the groundwork for expanding domestic demand.

The second point that I think is important in overcoming deflation is the need to establish a supply system that corresponds to potential demand and thereby raise productivity. In order to make the most of the demand from expanding new markets in emerging and developing economies, we need to change the goods supplied and the supply system by taking into account the characteristics of individual markets. If we are able to provide goods and services that meet potential demand, sales will increase and consequently productivity will rise. While discussions of “productivity” typically refer to producing existing products efficiently, unlocking potential demand and establishing the necessary supply system also raises productivity. What is important, therefore, are efforts by firms to adapt existing human and management resources to new markets in order to link potential needs with actual demand. Moreover, in order to support such efforts at the firm level, it is critical to review systems and mechanisms so as to ensure the flexibility of Japan’s economic structure in response to changes in the economic environment at home and abroad. For example, both firm entry rates and firm exit rates in Japan are about 5 percent, which is roughly half of the corresponding rates in the United States, suggesting that Japan’s economic metabolism is low. While there is not enough time today to go into this in detail, to improve this situation and create a mechanism in which productive resources are smoothly transferred to areas where there is a strong need for them, the role of financial markets is also important. In addition, the necessary social safety net should be put in place to deal with adverse effects arising during the process.

These are two of the issues I think are important to raise the potential growth rate of Japan’s economy. Looking back at Japan’s economy in the past, we have a record of overcoming difficulties and achieving prosperity through people’s wisdom and efforts. To truly bring Japan’s economy back onto a sustainable growth path, proactive efforts such as the ones I just mentioned are essential. While the process of putting such efforts into practice will not be without pain, it is unavoidable given the drastic economic changes taking place on a global basis. In this regard, what somewhat worries me is the recent mood of pessimism that fails to recognize the strengths of Japan’s economy. For example, while Japan’s financial system has remained relatively stable during the recent crisis, this fact seems to be underappreciated. Similarly, regarding the growth of emerging economies only as a threat is not a very well-balanced view. For instance, it has been estimated that if motorization in China and India were to progress at the same pace as in Japan when it was about to enter the era of high-speed growth, more automobiles than those now existing in the world will be produced. If this does indeed occur, the burden on the global environment will be extremely large, but, by the same token, this suggests that demand for environmental technology, which Japan is good at, will also increase. Of course, Japan should not be complacent about its environmental technology, but I think it is important to remember to perceive the growth of emerging economies as a positive challenge.

Closing remarks

I have talked about the various challenges Japan’s economy faces, and the Bank will do its utmost as the central bank to support your efforts. While a central bank carries out many functions, if you ask me what its most fundamental role is, I would say it is to contribute to economic development by maintaining confidence in the currency. Such confidence, I would like to stress once again, provides a vitally important anchor. In order to fulfill this role, the Bank must be an organization that assesses the situation accurately, explains its assessment to the public, and acts decisively. I would like to conclude my speech today by emphasizing that the Bank is acutely aware of the important role it has to play.

Thank you.