# Seiji Nakamura: Japan's monetary policy and developments in economic activity and prices

Speech by Mr Seiji Nakamura, Member of the Policy Board of the Bank of Japan, at a meeting with Business Leaders, Fukuoka, 4 February 2010.

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## I. The current economic situation

### *A. Overseas economies*

The world economy has been on a moderate recovery path, supported by fiscal stimulus measures such as the promotion of car sales and accommodative monetary policies implemented around the world. Increased production, reflecting progress in inventory adjustment and a recovery in trade, also contributed to the recovery. The International Monetary Fund (IMF) saw the economic recovery as sustained, and on January 26, 2010 revised upward its outlook for world economic growth in 2010 to 3.9 percent, up 0.8 percentage points from its forecast released in October 2009. The high growth in emerging economies such as China has been upholding the economic activity of industrialized countries, including Japan, through increased trade.

Emerging economies have marked higher-than-expected growth as the balance sheet problems of financial institutions and individuals were small relative to those of industrialized countries. As a result, the stimulus measures within these economies were particularly effective. The strong domestic demand boosted by a virtuous cycle of production, income, and spending, inflow of overseas capital, and recovery in exports to industrialized countries also contributed to the high growth. For example, in China, the real GDP growth rate for the October-December quarter of 2009 increased 10.7 percent from a year earlier, and growth remains particularly strong in areas such as personal consumption and fixed asset investment. Furthermore, exports, which had been sluggish, saw double-digit month-on-month growth in December, spurred by high-value-added products such as high-tech goods and electrical machinery, and turned positive on a year-on-year basis for the first time in 14 months.

In order to maintain robust growth, the Chinese government appears to have started to implement preemptive measures to cool down the overheating seen in part of the real estate market, as well as the surge in bank lending. Emerging economies, including China, are expected to maintain high growth for the time being. Given that these economies are now the main engines of the world economy, it is necessary to watch out for any signs of a possible economic bubble and monitor the sustainability of their economic growth.

In industrialized countries, economic conditions are improving, although the pace of recovery has been moderate as it has had to cope with the need to alleviate various structural imbalances, such as excessive consumption and the heavy debts accumulated ahead of the financial crisis. Such imbalances have been apparent in that the net assets of U.S. households had decreased by almost 20 percent from their peak, while consumer loan delinquency rates have been increasing. Also, banks have been maintaining their tight lending attitudes and the amount outstanding of lending has been decreasing.

In the United States, real GDP for the October-December quarter of 2009 registered 5.7 percent growth and the economy as a whole has been recovering, although the level of economic activity is still low and a full-fledged recovery is likely to require more time. Personal consumption seems to be leveling off as Christmas sales in 2009 recovered slightly from the previous year, when sales had fallen sharply due to the effects of the collapse of Lehman Brothers, the so-called Lehman shock, and new car sales on an annualized basis exceeded 10 million units for four consecutive months. The housing market has also been recovering, although uncertainty remains, and commercial real estate prices continue to fall. The unemployment rate remains high, at 10 percent, without any prospect of an early recovery in the job market.

The economy in Europe has been recovering, with exports acting as the main driving force, although domestic demand has been weak as evidenced by the decline in retail sales (excluding cars) in December from a year earlier, when sales had fallen sharply due to the effects of the Lehman shock. Looking ahead, however, economic activity could be hindered by balance sheet adjustments in the financial sectors of European nations as well as in some governments including that of Greece. Therefore, the pace of economic recovery in Europe is likely to be more moderate than that in the United States.

### *B. The Japanese economy*

The downturn in the Japanese economy following the Lehman shock, with the accompanying steep decline in exports and production, was more severe than that in the United States and Europe. This reflected Japan's industrial structure, which is susceptible to the effects of world economic deterioration. The Japanese economy had been underpinned by buoyant exports of transport equipment, electrical machinery, and general machinery directed mainly to the United States and Europe, supported by the weak yen. Since these sectors had come to account for an increasingly large share of Japan's production, the sudden nearly 40 percent decline in exports forced substantial curtailment of production and inventory. The impact was particularly large in the automobile sector, which is linked to a wide range of related industries.

Although the Japanese economy deteriorated significantly, exports and production have started to pick up since hitting bottom in February 2009, due to recovery in overseas economic conditions, mainly in emerging economies such as China, and progress in inventory adjustments at home and abroad. However, it is important to add that December 2009 levels of exports and production were 78 percent and 87 percent, respectively, of those in September 2008, just before the Lehman shock. In the area of domestic demand, private consumption is picking up as a whole, with increased sales of cars and household electrical appliances resulting from economic stimulus measures. There are some signs that housing investment has stopped decreasing, since the number of housing starts, a leading indicator, increased for four consecutive months until December 2009. The ratio of job offers to applicants also improved for four consecutive months, but the unemployment rate has remained high, at 5.1 percent, and the perception of an excessive workforce remains prevalent among employers. Nominal wages per employee are declining and consumers' spending appetite has not improved. Although the decline in business fixed investment has finally started to come to a halt, a number of firms are cautious about making new investments in Japan given that the outlook for a recovery in demand is unclear and there is a strong sense of excessive capital stock. In sum, although economic activity is picking up, momentum to support a self-sustaining recovery is weak because production and exports remain at low levels, and any improvements so far have been largely supported by various stimulus measures at home and abroad.

## II. The bank's policy responses since autumn 2008

I will now talk about various policy measures the Bank has taken in response to the unprecedented turmoil in economic and financial conditions since autumn 2008. Prior to the failure of Lehman Brothers in 2008, many firms in Japan sought to reduce on-hand liquidity in order to increase capital efficiency under extremely accommodative financial conditions. After the Lehman shock, however, firms faced a rapid financial contraction, making their procurement of funds through CP and corporate bonds extremely difficult. This critical situation caused firms, small and large, to worry about the availability of funds, thereby raising tensions in financial markets.

In response to the turmoil in economic and financial conditions, the Bank took various steps to ensure market stability; for example, lowering the policy rate in two stages from 0.5 percent to 0.1 percent in October and December 2008, and providing ample liquidity to the markets, including unlimited U.S. dollar funding. Furthermore, the Bank adopted exceptional measures such as outright purchases of CP and corporate bonds to support a recovery in market function. Also, through its special funds-supplying operations to facilitate corporate financing, the Bank provided an unlimited amount of funds to counterparties at a fixed rate of 0.1 percent against corporate debt submitted as collateral. Through these efforts, the Bank helped firms deal with difficulties in funding through markets and also encouraged interest rates to decrease.

Having achieved the intended purpose of restoring the proper functioning of these markets, the Bank decided to terminate outright purchases of CP and corporate bonds at the end of December 2009. Meanwhile, it decided to extend special funds-supplying operations to facilitate corporate financing until the end of March 2010, and thereafter to continue providing ample liquidity through conventional policy measures.

At the unscheduled Monetary Policy Meeting held on December 1, 2009, the Bank decided to introduce a new operation to provide funds amounting to approximately 10 trillion yen, with a term of three months at a fixed interest rate of 0.1 percent. This decision was prompted by the need to support economic recovery from the financial side against the background of increased risk that international financial developments and foreign exchange market instability since the latter half of November 2009, such as the occurrence of Dubai's debt crisis, might adversely affect economic activity by impacting business and household sentiment.

The Bank's basic stance on monetary policy at present is to provide support to the Japanese economy in order to overcome deflation and return to a sustainable growth path with price stability. To this end, the Bank aims to maintain the extremely accommodative financial environment by providing ample liquidity to meet the demand in financial markets.

I believe it is important for the Bank to maintain this basic stance on monetary policy. At the same time, the Bank should not have any predetermined view regarding the future path of monetary policy, but should take measures that would be most appropriate on each occasion in response to changing economic and financial conditions.

## III. Domestic price developments

### *A. Price developments*

Inflationary concerns heightened around the world in July 2008, when crude oil prices hit 140 dollars per barrel and, in Japan, the consumer price index excluding fresh food (core CPI) rose 2.4 percent from the previous year. However, in August 2009, the core CPI fell 2.4 percent year on year, while inflationary concerns abated significantly, reflecting the drop in prices of natural resources triggered by the slowdown in the world economy and the outflow of speculative funds from commodity markets prompted by the financial crisis. In December 2009, the rate of decline in the core CPI marked a 1.3 percent fall as the effects of the setback in crude oil prices receded, and is expected to continue to diminish in line with a moderate economic recovery.

In the interim assessment of the October 2009 Outlook for Economic Activity and Prices released on January 26, 2010, the median forecast for the core CPI was minus 1.5 percent for fiscal 2009, minus 0.5 percent for fiscal 2010, and minus 0.2 percent for fiscal 2011. Although the CPI is forecast to remain in negative territory until the end of fiscal 2011, the rate of decline is expected to moderate. The government's plan to make high school tuition effectively free, due to be implemented during fiscal 2010, might cause the rate of decline to accelerate. However, it is necessary to accurately grasp the basic price trend by adjusting for the effect of temporary factors caused by institutional changes.

### *B. Deflation*

The term "deflation" is mostly used to describe a continued fall in general prices, or otherwise to indicate a drop in asset prices or economic stagnation. Nowadays, however, the term seems to be used quite carelessly in various situations. The current heated price competition among Japanese retailers and other service providers is considered to be causing a deflationary phenomenon, and is viewed by some as a problem. Consumers are growing wiser and more price conscious, spending frugally and purchasing only essential items in needed quantities. An increasing number of firms have been adapting to such changes in consumer behavior and taking action to entice consumers by providing new products and services that meet the shift in demand, or lowering sales prices by eliminating unnecessary functions. The price revisions resulting from such efforts by firms should be considered separately from the problem of deflation.

The sustained decline in prices in Japan is due to a combination of factors. For example, Japanese firms have placed a higher priority on the continuity of employment and business than on maintaining the wage level, and also on maintaining long-term business relationships and gross sales volume than on profitability. These and other factors have allowed the price level in Japan to remain low for a longer period than in the United States and Europe. The ongoing fall in prices has also been triggered by recent market movements, namely, the decline in oil prices in reaction to their surge to more than 140 dollars per barrel in 2008, as well as the sharp decline in global demand resulting from the financial crisis. Therefore, in view of the current economic outlook that the recovery will be sluggish, demand – which is well short of supply at present – is unlikely to recover quickly, and the downward pressure on prices will not ease in the short term.

The Bank's current policy measures have been helping to underpin demand, by encouraging money market rates to decline and by providing ample liquidity to financial institutions. Fiscal measures have also been taken to stimulate demand for consumer durables. Further restructuring efforts in the private sector are necessary to achieve sustained growth in demand. In other words, it is vital that the Bank, the government, and the private sector each play their part and jointly work to boost demand. The frequently voiced opinion that, to end deflation, the Bank should provide massive amounts of liquidity to private financial institutions as a quick fix to overcome the situation, ignores longer-term issues that have major implications for the future.

Looking back at the Bank's quantitative easing policy implemented from 2001 to 2006, the Bank provided ample liquidity to financial institutions via their current accounts held at the Bank, but private banks' lending to other private sector entities did not rise relative to the increase in the outstanding balance of current account deposits, indicating that the policy's direct impact on ending deflation was small. Recently, the Bank's accommodative stance on money market operations has enhanced the sense of an abundance of liquidity, causing market rates, including those on longer-term instruments, to decline further toward 0.1 percent, which is the rate applied to the complementary deposit facility. Nevertheless, due to weak corporate demand for funds, the Bank's ample supply of funds once more has failed to lead to an increase in bank lending, although financial institutions have not been averse to lending. In sum, the ordinary operation of the transmission mechanism of monetary easing has not been working.

Based on this observation, I believe that Japan will not be able to end deflation via policy measures such as simply increasing the supply of liquidity. In addition to the Bank's contribution to price stability, it is essential that all economic entities work together to create demand at home and abroad through innovation and steady day-to-day efforts, to ensure, and attain the prospect of, higher income over the medium- to long-term through increased productivity.

### *C. Announcement of the "Understanding of Medium- to Long-Term Price Stability"*

After the Monetary Policy Meeting on December 18, 2009, the Bank reiterated its "Understanding of Medium- to Long-Term Price Stability" in order to gain an accurate understanding of its thinking on price stability in the conduct of monetary policy. The announcement was made in an attempt to clearly show the Bank's commitment to fight deflation by eradicating any impression that the public and market participants may have held that the Bank was an "inflation fighter, but not a deflation fighter," and was not making serious enough efforts to end deflation. In its statement, the Bank specified that the Policy Board does 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.

## IV. The outlook and risk factors for the future conduct of monetary policy

### *A. The outlook*

The Bank discusses economic activity and prices at the Monetary Policy Meetings held each month. Semiannually, in April and October, it releases the *Outlook for Economic Activity and Prices*, known as the Outlook Report, in which the Bank makes public its forecasts for economic activity and prices for the next two to three years, and three months after their release conducts interim assessments of the reports.

In the latest interim assessment released after the Monetary Policy Meeting held on January 25 and 26, 2010, the median of the Policy Board members' forecasts for year-on-year real GDP growth was minus 2.5 percent for fiscal 2009, 1.3 percent for fiscal 2010, and 2.1 percent for fiscal 2011, indicating that the economy was developing basically in line with the Bank's outlook released in October 2009. The Japanese economy is likely to improve gradually, reflecting recovery in overseas economies. Although there remains the risk of a temporary leveling-off by around the middle of fiscal 2010, as the effects of various policy measures taken at home and abroad wane, the general upward trend is unlikely to be broken, with the growth rate rising to well above the potential growth rate in fiscal 2011, underpinned by a self-sustaining recovery in overseas economies, particularly emerging economies.

The recovery in overseas economies, however, is likely to be moderate because considerable time may be required to overcome the various distortions accumulated in the global economy, mainly in industrialized countries. Therefore, it will take some time for the Japanese economy to achieve a full-fledged recovery.

Given the sluggishness in the economies of industrialized countries, it is necessary for Japanese firms to reach out to consumers in emerging economies, which have a rapidly expanding middle class. Developments in the share of Japan's exports during the 2000-2009 period show that the U.S. share decreased by almost half, from 29.7 percent to 16.1 percent, while that of China trebled from 6.3 percent to 18.9 percent, making China Japan's largest trading partner in terms of both exports and imports. The share of exports to Asian economies as a whole increased from 41.1 percent to 54.2 percent, while that of the United States and the EU member states combined dropped from 46.0 percent to 28.6 percent, underlining an accelerating expansion in the share of emerging markets. Japanese firms had held an advantage in producing and selling high-value-added products and services, mainly to industrialized countries, but are not yet adept enough to satisfy the demand in emerging economies centered on inexpensive, low-specification products and services. Moreover, many Japanese firms have long considered emerging economies mainly as efficient production bases for exports to European and U.S. markets; therefore, much work needs to be done to retarget them as potential markets, by developing and producing new market-oriented products in a low price range, establishing sales networks, and providing staff training. Japanese firms are said to be slow to localize business lines in emerging economies. When I visited rapidly developing inland China last year, I saw some U.S. and European firms successfully advancing quickly into the cities of Chongqing and Chengdu and localizing their business models, whereas there were only a few Japanese firms that were aggressive in localizing their operations. The local deputy mayor had mentioned this situation. Given the geographical proximity to emerging economies with markets of high growth potential, Japanese firms, including those in nonmanufacturing sectors, have a good chance of expanding their shares in these growing markets.

### *B. Risk factors*

There are both upside and downside risk factors to take into account in considering the outlook for the Japanese economy. The former include a possible upswing in the economic growth of emerging economies and commodity-exporting countries resulting from accommodative financial environments and economic stimulus measures in various countries. The latter relate to the possible consequences of balance-sheet adjustments in the United States and European countries, as well as Japanese firms' medium- to long-term expectations of future economic growth. Regarding prices, primary commodity prices could rise in reflection of increasing demand among emerging economies and commodity-exporting countries enjoying rapid growth; meanwhile, a prolonged sluggishness in the Japanese economy could add downward pressure on medium- to long-term inflation expectations, accelerating the decline in prices. The balance of risks remains somewhat tilted to the downside because of the extremely large negative impact of the financial crisis, yet not to the degree seen a year earlier.

In order to lower break-even points or reach out to consumers in the markets of emerging economies, many corporate managers are in a restructuring process of withdrawing from unprofitable areas of business, selling loss-making sections or merging them with other companies, exploring new business areas, and reviewing supply and production as well as research and development capabilities. For this reason, firms might close down existing domestic production facilities and transfer them overseas. Even if overseas economies fully recover, domestic business fixed investment would be restrained and a recovery in the employment situation would be limited. For example, production of information and communications equipment for the Japanese market, such as flat-panel televisions and cellular phones, is being transferred overseas, increasing the share of imported equipment. Research and product development is also being transferred and localized as a result of improved business infrastructure. Transfers of research and production overseas, to emerging economies in particular, are likely to increase steadily. Whether this trend will accelerate and lead to a hollowing-out of the Japanese manufacturing sector is a matter of concern.

As a result of the aggressive fiscal policies designed to underpin the economy after the Lehman shock, fiscal deficits and government debt have increased to a very high level in many countries. Now that the panic-like phenomena in the economy and financial markets have subsided, concerns are growing around the world about the sustainability of government debt. For example, in Greece, the new government elected in October 2009 made public that the fiscal deficit was larger than previously announced. This disclosure prompted a downgrade of the sovereign debt rating for Greece, leading to a sharp rise in interest rates. In the euro area, Portugal, Italy, Ireland, and Spain are also thought to be having serious fiscal-deficit problems, and interest rates are rising in these countries. There was evident concern in the European Central Bank's comments in a statement issued after a meeting of the Governing Council on January 14: "The very large government borrowing requirements carry the risk of triggering rapid changes in market sentiment, leading to less favourable medium and long-term market interest rates. This, in turn, would dampen private investment and thereby weaken the foundations for sustained growth. Moreover, high levels of public deficit and debt would place an additional burden on monetary policy and undermine the credibility of the provisions of both the Treaty on European Union and the Stability and Growth Pact as a key pillar of Economic and Monetary Union. The Governing Council therefore calls upon governments to decide and implement in a timely fashion ambitious fiscal exit and consolidation strategies based on realistic growth assumptions, with a strong focus on expenditure reforms." The predicament in the euro area should have given enough warning to the United States, the United Kingdom, and Japan in consideration of their own severe fiscal conditions.

It is extremely difficult to generate balanced measures for short- and longer-term issues, namely, for continued short-term fiscal support and medium- to long-term fiscal consolidation, when the level of economic activity remains low and the pace of recovery in private demand is sluggish. However, we must bear in mind that depending too heavily on temporary emergency measures could trigger larger problems in the future. Therefore, it is necessary to review such measures in a timely manner and thoroughly discuss fiscal restructuring over a medium- to long-term period in order to achieve balanced and sustainable growth.