Tadao Noda: My answers to the frequently asked questions regarding monetary policy

Speech by Mr Tadao Noda, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Shiga, 4 March 2010.

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Introduction

I was appointed as a member of the Policy Board of the Bank of Japan in June 2006 after having worked mostly at a bank and also at firms in the private sector, for a total of 37 years. Thus, my background does not make me a central banker in the strictest sense. However, since my appointment as a full-time Bank officer, I am able to draw on my experience in the private sector in day-to-day deliberations and discussions on monetary policy and the Bank's operations.

Today, in this speech, I will present my views by means of answering frequently asked questions (FAQs) about economic and financial developments and the conduct of monetary policy. Broadly speaking, I will discuss the following three FAQs.

I. Where is Japan's economy heading?

II. How is the Bank's monetary policy conducted?

III. What is the cause of, and remedy for, the issue of deflation?

I. The outlook for Japan's economy: where is it heading?

I will first discuss where Japan's economy is heading.

A. The current situation: the economy has been picking up, but the momentum to support self-sustained recovery is still weak

Japan's real GDP growth rate was in the range of 2–3 percent from fiscal 2003 to fiscal 2006, but dropped to 1.8 percent in fiscal 2007. In fiscal 2008, economic conditions deteriorated substantially and the economy registered negative growth of 3.7 percent. After the failure of Lehman Brothers, extreme cautiousness spread in many financial markets and the flow of funds necessary for economic activity contracted, rapidly reducing global demand. Demand in Japan fell sharply, mainly in leading industries – notably automobiles, electronic machinery, and general machinery – and the economy was affected more heavily by the global financial crisis than that of the United States, where the crisis started.

Since the beginning of fiscal 2009, Japan's economy has been picking up, as shown by the relatively large growth in the real GDP growth rate on a quarter-on-quarter basis for two quarters – the April–June and October–December quarters – although it registered 0 percent growth for the July–September quarter. Exports have been increasing due to the improvement in overseas economies. Private consumption has also been picking up, mainly due to the strong sales of some durable goods, namely automobiles and electrical appliances, which have been supported by the government's economic stimulus measures that favor energy-efficient products.

Regarding the outlook for Japan's economy, it is expected to follow a sustainable recovery path reflecting improvement in overseas economies, although the recovery may not be smooth.

The world economy decelerated significantly following the failure of Lehman Brothers in September 2008. Currently, however, economic conditions around the world have generally continued to recover moderately due to the effects of economic stimulus measures by governments and inventory restocking. The U.S. and European economies remain in the early stages of recovery, but the pace continues to be moderate due to prolonged balance-sheet adjustments.[1] However, economies in Asia, including China, have continued to grow at a relatively rapid pace, in line with the improvement in domestic demand. The world economy as a whole is expected to continue recovering moderately.[2] Japan's exports are likely to continue increasing, reflecting these economic conditions overseas.[3]

It should be remembered, however, that the situation provides little grounds for optimism because the level of economic activity remains low. Although exports and production have continued to increase, their levels in the January–March quarter of 2010, the most recent quarter, were 16 percent below their peak levels reached in the January–March quarter of 2008, and the real GDP growth rate in the October–December quarter of 2009 was also 6 percent below its peak.[4] The low level of economic activity indicates that the levels of firms' profits and production are low and that firms consider their capital stock and employment to be excessive. Unfortunately, under these circumstances, firms need to be cautious with respect to increasing their business fixed investment and employment. Private consumption, excluding durable goods consumption that has been supported by the effects of policy measures, is also likely to remain sluggish amid the severe employment and income situation. In other words, the momentum for self-sustaining recovery in domestic private demand is still weak.

Let me explain the view of the Bank's Policy Board regarding the economic outlook as of January 2010. The median of the seven Policy Board members' forecasts for real GDP growth was minus 2.5 percent for fiscal 2009, 1.3 percent for fiscal 2010, and 2.1 percent for fiscal 2011. In other words, the Bank's baseline scenario projects that after two consecutive years of negative growth in fiscal 2008 and 2009, the economy will return to positive growth from fiscal 2010 to fiscal 2011.[5] If we regard the level of GDP at its most recent peak marked in fiscal 2007 as 100, then the level of GDP is likely to be 94 in fiscal 2009, 95 in fiscal 2010, and still only 97 in fiscal 2011.

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[1] Global structural adjustments, rather than a passing phase of a regular business cycle, lie behind the current global economic downturn. During the worldwide boom after 2002, various imbalances or excesses were accumulated on a global scale, and the difficulties in adjusting these imbalances are currently stifling the global economic recovery. For more details, see the speech "Recent Economic and Financial Developments and the Conduct of Monetary Policy" I delivered at a meeting with business leaders in Nagano in July 2009, a summary of which is available on the Bank's web site.

[2] According to the *World Economic Outlook* released by the International Monetary Fund (IMF) in January 2010, the year-on-year growth rate of the world economy decelerated to 3.0 percent in 2008, from much higher rates of around 5 percent a year between 2002 and 2007. Although the growth rate plunged to minus 0.8 percent in 2009, the largest negative growth since World War II, it is projected to recover to a positive rate of 3.9 percent in 2010 and 4.3 in 2011.

[3] Japan's exports depend on the situation in overseas economies. As mentioned later, it is highly uncertain as to whether they will continue recovering. However, the Organisation for Economic Co-operation and Development (OECD) composite leading indicator and the New Orders Index within the Manufacturing ISM *Report On Business* released by the Institute for Supply Management in the United States, both of which are regarded as leading indicators of Japan's exports, continue to show improvements. I believe that exports are likely to continue increasing, at least for the time being.

[4] Comparing the recent levels of production, the real GDP growth rate, and exports with those before the January–March quarter of 2008, they are at the levels reached in the first half of the 2002, 2005, and 2006 calendar years, respectively.

[5] Every April and October, the Bank releases its *Outlook for Economic Activity and Prices* (the Outlook Report), and in the intervening January and July makes interim assessments of the outlook laid out in the Outlook Report. In the interim assessment made in January 2010, the Policy Board members took the view that growth prospects remain broadly unchanged compared with the Bank's projections presented in the October 2009 Outlook Report.

B. *Risk factors for Japan's economy: downside risks have been moderating*

I have explained the baseline scenario of the outlook for Japan's economy. I will now describe the risk factors or uncertainties involved in the scenario that warrant attention. Compared with the risk assessment presented in the October 2009 Outlook Report, upside and downside risks have started to become more balanced as a whole due to the faster-than-expected growth in emerging economies.

1. Developments in overseas economies

Exports continue to be the driving force behind Japan's economic recovery, and if the improvement in overseas economies is hampered, then the baseline scenario that Japan's economy has picked up and will follow a sustainable recovery path might not be achieved. This suggests that the largest risk factor for Japan's economy may well be developments in overseas economies.

Growth in the U.S. and European economies, the main engine of overseas economies, has been dragged down by the situation in the household and banking sectors: households are reviewing their balance sheets and enduring firms' severe employment adjustments, which are fundamental factors working to restrain household spending, while banks are reducing their lending as they hold impaired assets, which are still expanding, on their balance sheets. Situations such as these might exert downward pressures on economic activity for an extended period. In addition, there remains the risk that financial activity once again might be adversely affected by the sluggish economic activity.

In China and other emerging economies, where infrastructure investment had been considerable even before the financial crisis, governments' expansionary macroeconomic policies introduced after the financial crisis have stimulated economic activity further. In addition, the inflow of capital has become aggressive against the background of global investors' increased appetite for risk-taking in the expectation that the low interest rate policy in industrialized countries will continue. The increase in capital inflow has pushed up growth in emerging economies through, for example, a rise in asset prices. These factors combined have contributed to a faster-than-expected recovery in emerging economies. This is reassuring in terms of supporting economic recovery in industrialized countries through improvement in exports, but there are growing concerns about upside risks such as the rise in overall prices and asset prices in some emerging economies. Moreover, the uptrend in commodity prices is continuing, as evidenced by the fact that West Texas Intermediate (WTI), the benchmark for crude oil prices, rose to a level more than double the recent low of 34 U.S. dollars per barrel, marked at the end of 2008, partly due to the expectation of increased demand in emerging economies. This suggests that an acceleration of capital inflow to emerging economies is a warning sign of the upside risk. Also demanding attention is the possibility that a rapid unwinding of international capital flows might occur in a situation where global investors' expectations change significantly due to certain shocks, and this in turn could cause disruptions in financial markets and financial systems. It is therefore important, in view of the situation in international capital flows, to carefully examine whether there has been growing pressure in the markets for future adjustments that could potentially lead to a crisis.

2. Effects of policy measures taken worldwide

The second risk factor for Japan's economy is the uncertainty regarding the effects of various policy measures taken by countries around the globe. Economic stimulus measures by governments have been one of the key driving forces behind the global economic recovery achieved so far, but if such policy effects wane before private demand starts a full-fledged self-sustaining recovery, it is possible that economic activity will deviate downward from the projected growth path. Japan and many industrialized countries are facing the difficult issue of how to strike a balance between improving fiscal discipline and avoiding economic slowdown, as they suffer from deteriorating fiscal balances and have only limited capacity for further government spending.[6]

The market has started to direct its attention to the risk that deterioration in fiscal balances might push up long-term interest rates and thereby reduce the effects of monetary policy. The so-called sovereign risk is considered to be an extension of that risk. In fact, Greece, which is suffering the most serious fiscal deficit problem among the European Union member states, has experienced a sharp rise in long-term interest rates. This is an illuminating example of how loss of confidence in fiscal sustainability might trigger a significant negative market response. Therefore, it is important that governments clearly show the future course of fiscal consolidation, or improvement of fiscal discipline, and steadily proceed with it at an appropriate time.

3. Possible changes in firms' medium- to long-term growth expectations

The third risk factor for Japan's economy is the possible changes in firms' medium- to long-term expectations of future economic growth. In the baseline scenario that Japan's economy has picked up and will follow a sustainable recovery path, it is projected that firms again will increase spending on fixed investment and employment. If emerging economies are expected to maintain sustainable high growth while Japan's economic growth is increasingly expected to remain slow, there is a risk that investment in and lending to emerging economies might escalate but domestic spending might continue to be suppressed. It is said that many firms are considering increasing the share of their overseas production. How such a shift to overseas production might affect not only domestic fixed investment and employment, but also the structure of imports and exports, warrants careful monitoring.[7]

II. The Bank's monetary policy: how is it conducted?

So far, I have talked about the current situation and the outlook for Japan's economy. Next, I will explain how the Bank has conducted monetary policy.

A. Measures taken by the Bank: treading an unprecedented path

Since September 2008, when the turmoil in global financial markets and the financial systems in the United States and Europe increased in severity, the Bank has undertaken various measures. These measures can be broadly divided into the following: (1) reductions in the policy interest rate; (2) provision of ample funds; and (3) restoring the proper functioning of financial markets.

1. Reductions in the policy interest rate

Let me begin with interest rate policy. The Bank lowered its target for the uncollateralized overnight call rate – that is, the policy rate – in October and again in December 2008, to

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6 In his State of the Union address on January 27, 2010, U.S. President Barack Obama proposed a three-year freeze on government spending – excluding that related to national security, Medicare, Medicaid, and Social Security – and emphasized the need to improve fiscal discipline, saying that "if we don't take meaningful steps to rein in our debt, it could damage our markets, increase the cost of borrowing, and jeopardize our recovery". At the same time, he gave due consideration to avoiding an economic slowdown by making this freeze take effect next year, not this year.

7 In cases where Japanese firms establish their production bases abroad, there would be an increase in Japan's exports of capital goods and intermediate goods, which are needed for overseas production, and in its imports of consumer goods produced by Japanese firms abroad. In Japan, although the ratio of overseas production has been rising, exports of intermediate goods, mainly transport equipment, have expanded. Recently, however, re-imports of information and communication electronics equipment produced abroad have started to increase.

0.1 percent, or virtually zero percent. The policy interest rate has remained at that level since then.

2. *Provision of ample funds*

The second measure involves the provision of ample funds. Financial market stability is a prerequisite for sustainable economic growth. It is therefore vital that a central bank provide ample funds to financial markets when they face a situation of extremely tight liquidity.

Based on such thinking, the Bank has provided ample funds while guiding the policy interest rate in an appropriate manner to achieve the targeted level, through various money market operations that I will talk about later. Let us look at, for example, the amount outstanding of funds provided as at the calendar year-ends of 2007, 2008, and 2009. In 2007, during which we saw no particular market disruptions, the provision of funds as at year-end amounted to 33 trillion yen. In contrast, the amount at the 2008 year-end reached nearly 40 trillion yen, reflecting the significant instability in financial markets following the failure of Lehman Brothers, or the "Lehman shock". The Bank has continued to provide ample funds to maintain the extremely accommodative financial environment, even after financial markets started to regain stability in the middle of 2009. The amount outstanding of funds provided as at the 2009 year-end amounted to 42 trillion yen.

3. *Restoration of the proper functioning of individual financial markets*

The third measure is aimed at restoring the proper functioning of individual financial markets. To this end, the Bank started outright purchases of CP and corporate bonds, both of which are unprecedented and exceptional measures for a central bank, from January and March 2009, respectively. These measures were effective in restoring the functioning of the CP and corporate bond markets while markedly improving their issuing conditions.[8] Given that the purpose to restore market functioning had been achieved, these measures were completed at the end of 2009. Issuing conditions for CP and corporate bonds have remained favorable.

B. Selection of policy measures: examining the positive and negative effects

So far, I have outlined the measures taken by the Bank. Next, I will try to explain an issue about which I am often questioned, namely, what are the determinants the Bank deems important when making monetary policy decisions, or more specifically, when choosing which measures to take?

The Bank has been aggressive in its decision to take exceptional measures in response to the sharp economic downturn and malfunctioning of some financial markets after the Lehman shock. At the same time, however, it has been cautious in deciding on measures that potentially could hurt Japan's economy. In the deliberation process, I take great care, just as in corporate management, to carefully examine from a long-term perspective both the positive and negative effects of various policies, and select the optimum measures for Japan's economy.

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8 Outright purchases of corporate financing instruments such as CP and corporate bonds to facilitate corporate financing should be regarded as exceptional measures for a central bank, for the following reasons. First, they involve directly shouldering a greater degree of individual private firms' credit risk and, consequently, a relatively high probability of incurring losses that will ultimately be borne by the taxpayer. And second, they carry the risk of damaging the financial health of the Bank and ultimately undermining confidence in the currency and monetary policy. The Bank nevertheless decided to introduce such exceptional measures, with the conditions that the measures be temporary until the market functions again, and that upper limits to total purchases be set.

C. *Reduction of interest rates on term instruments: the most effective way to support the economy*

The Bank's policy rate is the uncollateralized overnight call rate. Since the Lehman shock, however, I have attached importance to the reduction of longer-term interest rates – that is, interest rates on term instruments. This is because corporate and household loans in many cases are based on these rates and, thus, I believe the most effective way to support the economy is to lower them. The Bank introduced a new means of providing the money markets with ample longer-term funds with three-month maturity at a fixed rate of 0.1 percent, which is equivalent to the policy rate – namely, a special funds-supplying operation to facilitate corporate financing, and a fixed-rate funds-supplying operation against pooled collateral.[9] Interest rates on term instruments by nature are not suitable as target policy rates with specific figures[10]; however, stabilizing such rates at low levels has been effective in pushing down the interest rate burden for the country's economic activity.

D. *Outright purchases of Japanese Government Bonds (JGBs): the risk of a rise in long-term interest rates warrants attention*

As an example of the policy measure to which possible negative side effects require careful attention, I would like to put forward the case of outright purchases of JGBs. The Bank conducts its monetary policy through market operations – providing funds to, and/or absorbing them from, financial markets on a daily basis. At the same time, as part of its objective of supplying ample funds, the Bank purchases 21.6 trillion yen worth of JGBs a year so as to reduce the burden of day-to-day short-term operations by steadily supplying long-term funds.

Will the Bank further increase outright purchases of JGBs as a means of monetary easing? This is another question that I am often asked. It is necessary to consider the risk that outright purchases might be misinterpreted as a means of facilitating government financing by monetizing public debt. This could cause adverse side effects, such as a rise in long-term interest rates that diverge from the outlook for economic activity. The benchmark long-term rate in Japan has been stable in the range of 1.0–1.5 percent, although the country's ratio of public debt to GDP is the highest among industrialized countries.[11] However, there is no guarantee that Japan will be able to continue to increase public debt over the long run while

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[9] The Bank introduced the special funds-supplying operation to facilitate corporate financing and the fixed-rate funds-supplying operation against pooled collateral in January and December 2009, respectively. Both operations provide longer-term funds with three-month maturity at a fixed rate of 0.1 percent, which is equivalent to the policy rate. These operations differ over the range of eligible collateral: that eligible for the former operation is limited to corporate debt, as it aims to facilitate corporate financing, while in the latter case, the Bank accepts collateral that includes Japanese government securities. The former operation will be completed at the end of March 2010, in view of the improvement in firms' funding conditions and of the Bank's intention to expand operation schemes by accepting a wider range of collateral.

[10] LIBOR and TIBOR are reference rates offered by reporting banks and are not the actual rates applied to transactions; therefore, they sometimes fall short of being adequate market indicators. For details, see "BOX 4: London Interbank Offered Rate (LIBOR)" in the January 2010 issue of the *Financial Markets Report*, which is available on the Bank's web site.

[11] According to the *OECD Economic Outlook* published in November 2009 (No. 86), the ratio of government debt to GDP projected for 2009 was 189.3 percent in Japan, far exceeding that of the United States (83.9 percent), the United Kingdom (71.0 percent), and Greece (114.9 percent), with the average of the OECD countries at 90.0 percent. Meanwhile, the rating agency Standard & Poor's downgraded its outlook for Japan's sovereign AA ratings from "stable" to "negative". The IMF, in its *Global Financial Stability Report Market Update* released in January 2010, cited Japan and the United Kingdom as countries under growing market pressure for an increase in their government debt issuance, as evidenced by the widening of sovereign credit default swap (CDS) spreads.

maintaining long-term rates at the current low levels.[12] As I have mentioned when explaining the second risk factor for Japan's economy, a rise in long-term interest rates is a major risk faced by many industrialized countries. It is important to bear in mind that, when the Federal Reserve and the Bank of England started outright purchases of government securities in 2009, long-term interest rates in both economies soared after a temporary initial fall.[13] The Bank will continue purchasing JGBs in order to ensure provision of long-term funds, while making clear that the purchases are in no way intended for government financing.[14]

E. The positive and negative effects of providing ample funds: alleviating market anxiety while maintaining market functioning

Regarding the provision of liquidity to financial markets, it is also necessary to consider both the positive and negative effects. As I mentioned earlier, the Bank has continued to supply ample funds. However, even in such a situation, the Bank frequently has been asked whether it will resume the quantitative easing policy[15] it adopted in the past, and whether it will expand the size of its balance sheet.

I evaluate the positive effects of quantitative easing as follows: it is effective in alleviating market anxiety and stabilizing financial markets when the financial system is under great strain, as was the case when the policy was adopted in Japan in 2001. But its effects are significantly limited in terms of stimulating the spending activities of economic entities and raising the level of prices. Regarding the size of a central bank's balance sheet, I consider the expansion of reserves held at the central bank to be the by-product of various funds-supplying operations, and believe the total amount of reserves does not directly indicate the degree of monetary easing.[16] The more important point is how far the massive amount of

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[12] Long-term interest rates in Japan are stable at low levels in spite of the extremely large government debt outstanding compared with other industrialized countries. This has been attributed to factors unique to Japan's bond market, namely, that there are ample domestic surplus funds backed by high private-sector savings, and JGBs are mostly purchased and held by residents in Japan. However, in view of the fiscal burden that will be required to support the aging society, it is uncertain whether domestic sources of funds alone might continue to assume such a burden. The surplus in household funds is on a downward trend and firms might cease to hold surplus funds due to the changes in corporate investment behavior.

[13] For more information concerning empirical studies on, and overseas examples of, the effects of outright central bank purchases of government securities on long-term interest rates, see the speech "Recent Economic and Financial Developments and the Conduct of Monetary Policy" I delivered at a meeting with business leaders in Nagano in July 2009, a summary of which is available on the Bank's web site. Federal Reserve Chairman Ben S. Bernanke has repeatedly commented that purchases of Treasury securities were not conducted with the aim of targeting a particular interest rate, nor monetizing federal debt.

[14] The Federal Reserve and the Bank of England completed their purchases of long-term government securities in October 2009 and January 2010, respectively.

[15] From March 2001 to March 2006, the main operating target for the Bank's money market operations was changed from a specific interest rate – the uncollateralized overnight call rate – to the amount of funds – the total outstanding balance of current accounts held by financial institutions with the Bank which include reserve balances. Specifically, the guideline for market operations was set as "The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around XX trillion yen". This type of money market operations was called a "quantitative easing policy" because it was conducted by achieving the target aimed at the financial quantitative indicator. At present, the Bank provides ample funds by conducting various operations, setting the operating target not at a quantitative indicator but at the policy interest rate.

[16] On this point, the research paper from the Federal Reserve Bank of New York, entitled "Why Are Banks Holding So Many Excess Reserves?", written by Todd Keister and James J. McAndrews, and released in December 2009, concludes that "the liquidity facilities and other credit programs introduced by the Federal Reserve in response to the crisis have created, as a by-product, a large quantity of reserves in the banking system"; and "The total quantity of reserves in the banking system reflects the scale of the Fed's policy initiatives, but conveys no information of the initiatives' effects on the bank lending or on the economy more broadly".

funds provided by the Bank to financial institutions is passed on to firms and households – in other words, to what extent the policy has effects on the increase in bank lending. This depends on firms' and households' demand for funds and banks' lending attitude. Currently, the year-on-year rate of change in bank lending is negative as a result of the sluggish demand for funds. Against this background, the abundant funds supplied by the Bank to financial institutions have been accumulating as excess reserves at the Bank, underlining a growing sense of an abundance of liquidity. At present, the Bank does not supply funds by setting its operating target at the outstanding balance of current accounts, as was the case with the past "quantitative easing policy". The Bank, however, is providing a sufficient amount of liquidity to meet market demand, creating a sense of confidence regarding the availability of liquidity. Considering this, I believe that the current operations have effects similar to those of the "quantitative easing policy" conducted in the past.

With regard to negative effects, it is important to avoid impairing the proper functioning of markets. If a central bank's intervention is excessive and the markets become excessively dependent on funds provided through the Bank's market operations, the intervention itself may impair the proper functioning of markets, thereby defeating its intended purpose.[17] In this sense, the past "quantitative easing policy" may have had a negative impact on market functioning, because the amount of funds provided by the Bank was set as the operating target. In comparison, the Bank provides the sufficient amount of liquidity that markets require, while maintaining their proper functioning.

III. The issue of deflation: what is the cause and remedy?

Having discussed the Bank's conduct of monetary policy, I now turn to the third topic for today: the issue of deflation. I will touch upon the current state of prices in Japan, before moving on to the cause of and remedy for deflation.

A. Price movements in Japan: deterioration in the supply and demand balance exerts downward pressure

The year-on-year pace of decline in the consumer price index (CPI) excluding fresh food, or the core CPI, has been moderating due to the prices of petroleum products, which are lower than their high levels of a year ago. However, the year-on-year rate of decline in the CPI excluding food and energy – the core-core CPI, which is said to indicate the underlying trend in prices – continues to accelerate.[18] Households are curtailing spending due to the continued decrease in household income, and firms are responding to this situation by lowering the retail prices of their goods/services.[19] Deterioration in the supply and demand balance in the economy as a whole, as well as the fundamental weakness in consumption – except in the case of a small number of certain durable goods – are adding downward pressure on the price formation process.

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[17] In Japan, the quantitative easing policy and zero interest rate policy resulted in a sharp decline in the volume of market transactions that did not involve the Bank. This caused a weakening in the infrastructure of money markets. More specifically, credit lines were cut or terminated, the number of fund managers was reduced, and trade expertise suffered a decline in proficiency. Considering the time and money it took to rebuild the market infrastructure and increase market activity, it is very important that proper market functioning be maintained.

[18] The CPI in the Tokyo metropolitan area for February 2010 showed a slight decrease in the number of items for which prices declined. However, data on a nationwide basis show a continued increase in the number of items for which prices declined.

[19] There has been a gradual increase in the number of firms adopting a strategy to avoid excessive price-cutting competition.

As of January 2010, the median outlook for the core CPI by the seven Policy Board members was minus 1.5 percent in fiscal 2009, minus 0.5 percent in fiscal 2010, and minus 0.2 percent in fiscal 2011. The members had expected that the downward pressure on prices would gradually diminish as the supply and demand balance improved with the recovery in the economy, but prices would continue to decline – deflation would continue – even in fiscal 2011, or the final fiscal year of the projection period.

One of the problems with deflation is that nominal debt, wages, and interest rates do not change in proportion to the decline in the price level, and therefore remain high in real terms. As a result, spending comes under pressure from several angles, adversely affecting economic activity. Given that the pace of improvement in the aggregate supply and demand balance is expected to be moderate, it is important to pay close attention to future developments in the economy and prices.

B. The fundamental cause of deflation: lack of demand

I will now talk about the cause of deflation. Since the 1990s, inflation rates have been falling worldwide, reflecting the substantial decline in costs as planned economies joined the world of the market economies. During this worldwide trend, Japan's inflation rate has been lower than that of other industrialized countries since the bubble period in the late 1980s. Until the mid-1990s, the high prices in Japan were pushed down by rationalization of the distribution system and deregulation. Since then, prices have continued to decline due to various additional factors, including: (1) the continuous decline in wages as a result of managers and workers in Japan placing priority on maintaining employment during the adjustment phase following the bursting of the economic bubble; and (2) restrained demand reflecting the decline in expectations for future economic growth resulting from the aging and shrinking of Japan's population. Ultimately, these factors point to the fundamental cause of deflation – lack of demand.

C. Remedy for deflation: unlocking and capturing potential demand

It is necessary that we confront and find a way to tackle this fundamental cause of deflation: the lack of demand.

Deflation cannot be solved just by generating sustainable demand that is large enough to close the output gap, as the problem does not lie solely on the demand side. What is important is where to unlock demand and how to capture it on the supply side. Given that the output gap has been historically large following the bursting of the global bubble, it would be unrealistic to expect that demand will recover to meet the existing supply capacity for goods and services, as that would mean a reemergence of a bubble economy. Looking back on Japan's history, the economy has grown by unlocking and capturing potential demand through various efforts and innovations undertaken by firms.[20] Besides the rapidly expanding demand in neighboring East Asian countries[21], potential demand in Japan is not inconsiderable in areas such as medical and nursing care, environmental conservation, and tourism.[22]

[20] Recently, for example, production of certain high-tech products – liquid crystal display (LCD) televisions, light emitting diode (LED) products, and solar cell modules – is exceeding levels seen before the Lehman shock.

[21] The number of visitors from China has hit a record high, helped in part by the July 2009 lifting of a ban on private tours to Japan, although the total number of foreign tourists is declining.

[22] For example, whereas the average ratio of job offers to applicants in Japan has been substantially below 1, that for health and medical care, social welfare, and nursing care has been above 1. Actively working to correct this mismatch will improve the situation in the labor market while at the same time unlocking potential demand.

Taking policy actions to support firms' efforts to unlock and capture new demand is also important, and in this regard, I believe the top priority is to eliminate uncertainty about the future. For example, households are said to be restraining their spending in an effort to increase savings because of anxiety about the future of social security and medical systems. I am particularly concerned about the weak consumption by the younger generation, which is a sure reflection of their strong sense of insecurity.[23] The success of the child allowance program included in the government's budget for fiscal 2010, as well as its economic impact in terms of the marginal propensity to consume, hinge on the extent to which such uncertainty is alleviated.

For Japan, more than any other country, it is of paramount importance to boost productivity given that the population has started to decline. Growth in productivity in the manufacturing sector has been increasing since 2000, but that in the nonmanufacturing sector, which accounts for a large share of the economy, has been lackluster. There is no quick solution to improving productivity, but a key move is to create actual demand by reallocating existing managerial resources – personnel, production capacity, and money – in such a way as to meet potential demand.[24] In order to support such efforts, it is necessary to flexibly revise the existing systems and frameworks in response to changes in the economic environment at home and abroad, while securing a social safety net.

If demand achieves a sustained recovery throughout the economy, this will lead to an improvement in supply and demand conditions in the labor market. I mentioned earlier that a continuous decline in wages is one of the causes of deflation. A sustained recovery in the labor market would lead to a rise in nominal wages, thus having a positive effect on prices. Moreover, were economic recovery accompanied by a rise in productivity to continue, real wages would increase, leading to higher living standards.

D. Boosting demand and easing monetary conditions: monetary easing is one of the necessary conditions to overcome deflation

The Bank's statement released on December 18, 2009 shows its strong commitment: "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. To this end, the Bank will continue to consistently make contributions as central bank. In the conduct of monetary policy, the Bank will aim to maintain the extremely accommodative financial environment". Furthermore, in the same statement, regarding the "understanding of medium- to long-term price stability" (the level of inflation that each Policy Board member understands, when conducting monetary policy, as being consistent with price stability over the medium to long term; hereafter "understanding"[25]), which is expressed in terms of the year-on-year rate of change in the

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[23] According to the Family Income and Expenditure Survey, a breakdown of expenditure by householder age group shows that, in 2009, people aged 60 years and over increased their spending from the previous year, while spending by those younger than 60 decreased. The younger the age group, the larger the rate of decline. Furthermore, the results of the Survey of Household Economy show that purchases of durable goods, which have been increasing due to the effects of economic stimulus measures, are growing notably among people aged 50 and over.

[24] Some economic stimulus measures taken since the 1990s might have blocked economic metabolism and hindered productivity improvement by keeping managerial resources in inefficient sectors. For example, as a result of public works projects, managerial resources stayed in the construction industry, known for its low productivity.

[25] Taking into account the "understanding", the Bank assesses the economic and price situation from "two perspectives" and then outlines its thinking on the future conduct of monetary policy. The "first perspective" involves assessing the most likely outlook for economic activity and prices through fiscal 2011. The "second perspective" assesses the risks considered most relevant to the conduct of monetary policy, including risks that have a longer time horizon than the "first perspective".

CPI, the Bank made clear 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.[26]

The Bank's commitment to maintain the extremely accommodative financial environment, as well as its clarification of the "understanding", have had an adequate effect on stabilizing the price expectations and shaping the interest rate expectations of market participants, thereby helping to reduce interest rates on term instruments, which, as I mentioned earlier, is the Bank's most effective way to support the economy.

In summary, maintaining the extremely accommodative financial environment is one of the necessary conditions for overcoming deflation. Another is confronting the fundamental cause of deflation – that is, the lack of demand – and making steady efforts to unlock and capture potential demand, as well as to improve productivity.

The Bank of Japan will maintain the extremely accommodative financial environment to underpin demand from the financial side. In my view, action should be taken swiftly and decisively when deemed necessary, based on an assessment of economic and financial activity and prices from the "two perspectives".

In the same December 18 statement, the Bank made clear that "in order to realize sustainable economic growth with price stability, it is necessary to make wide-ranging assessments of risk factors, including accumulation of financial imbalances observed in, for example, asset prices and credit aggregates". This recognition is based on the experience of the recent global financial crisis that too much emphasis on price developments could result in overlooking other serious risks. This is a reconfirmation of the Bank's view on the importance of assessing risks from the "second perspective".

[26] The "understanding", reviewed in April 2009, was expressed in terms of the year-on-year rate of change in the CPI and fell in the range approximately between 0 and 2 percent, with most Policy Board members' median figures at around 1 percent.