

Kiyohiko G Nishimura: Japan's economy and monetary policy

Speech by Mr Kiyohiko G Nishimura, Deputy Governor of the Bank of Japan, at a Meeting with Business Leaders, Miyagi, 21 April 2010.

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Introduction

I am honored today to have this opportunity to speak and to exchange views with business leaders in Miyagi Prefecture. I will express my gratitude for your cooperation in interviews with the staffers from the Sendai Branch and for the Bank of Japan's surveys. Information obtained from those interviews and surveys is invaluable and utilized fully in assessing economic and financial developments and conducting monetary policy.

Before exchanging views with you, I will talk about economic and financial developments in Japan as well as the thinking of the conduct of monetary policy. I will also briefly touch on the challenges Japan's economy faces for its growth.

I. Economic conditions in Japan

Overseas economies

With progress in economic globalization, developments in Japan's economy are under significant influence of overseas economic developments. The plunge in Japan's economy after the failure of Lehman Brothers in the autumn of 2008 was attributable to the worldwide economic dive triggered by the financial crisis, the epicenters of which were the United States and Europe. Therefore, I will first talk about overseas economies.

In response to the rapid deterioration in international financial markets and in the global economy following the failure of Lehman Brothers, the governments and central banks around the globe took bold policy measures. Partly due to the effects of those measures, international financial markets have regained stability. For example, in money markets in which financial institutions mutually trade short-term funds, the transaction volume once plunged to the extent "liquidity evaporated." It is now in a state that money markets are awash with low cost funds, and extremely low interest rates have been continuing.

The real economy is the same as the international financial markets and Overseas Economies in terms of bottoming out from the substantial deterioration which continued until the beginning of 2009 and has been improving since then. The global economy has been recovering moderately led by robust growth in emerging economies.

There are several reasons emerging economies were among the first to recover and continue to grow strongly.

First, domestic demand, including business fixed investment and private consumption, was potentially strong. In emerging economies, the purchasing power of households has risen and is expected to rise in accordance with an expansion of the economy. Therefore, emerging economies, which attracted attention as production bases for advanced economies, have also become increasingly attractive as products markets. To capture such promising markets, firms in advanced economies have been increasing the number of production and sales bases for local products. In addition, local firms have also been increasing their production by introducing technologies and sales know-how from advanced economies. A virtuous cycle, in that such an increase in business activity stimulates consumption through a rise in the purchasing power of households, which in turn further increases business activity, is expected to continue. Expectations for the future are also pushing up demand at present.

Second, fiscal and monetary policies carried out as a financial crisis response in various countries significantly exploited the potential demand. For example, in China, purchase support measures for automobiles and television sets were taken and a large-scale fiscal expenditure was set partly for improving infrastructure. Accommodative monetary conditions in advanced economies resulted in providing low cost funds to the markets, and those funds are flowing into emerging economies in which high growth is expected. That brought about an improvement in funding conditions and a rise in stock prices, which contributed to increasing business activity and promoting consumption through an increase in income.

By contrast, while the U.S. and European advanced economies have been recovering, momentum has been lacking. In the United States, while the number of workers has started to increase and consumption has been holding up well, house sales and house prices have been stagnant and the unemployment rate has been close to 10 percent. In European countries, where economic ties with high growing East Asian regions are weak, the improvement has been further lagging. Moreover, financial institutions are shouldering large impaired assets and taking a cautious stance in extending loans and households are taking a cautious consumption behavior due to the heavy debt burden. Those are the problems common to the United States and Europe. They are the “balance-sheet problem,” namely, the problem of how to repair the impaired asset conditions. As you remember, it dragged the economy for a protracted period also in Japan after the burst of the bubble.

As for the outlook, it is projected that overseas economies will continue to improve while stability in international financial markets will be maintained. Emerging economies will continue to expand, and the U.S. and European economies will gradually increase their degree of recovery, even though balance-sheet problems need time to resolve. However, such outlook is associated with various uncertainties.

First, in international financial markets, the recovery in the depth of market transactions and in market liquidity has still been delayed for longer-term transactions. In addition, triggered by the problems concerning fiscal deficits in some European countries, fiscal soundness and fiscal sustainability have been drawing increasing attention in various countries.

Second, there are many uncertain factors concerning the outlook for overseas economies. If the aforementioned resolution of balance-sheet problems in the United States and Europe takes more time than expected, such delay will drag down the economies accordingly. In addition, there is nascent concern about overheating in emerging economies. In China, real estate prices, mainly in the city areas, have been rapidly increasing. Such increase is recently observed in the inland areas, in addition to the coastal areas. Moreover, the growth rate of wages and prices has been gradually increasing. Also, in many other emerging economies, concern over inflation has been emerging. In those economies, while policy interest rates have been raised and lending restraint measures have been taken, the authorities have been forced to perform difficult maneuvers on those policy measures. If the restraint measures are too strong, it would be a sudden brake on the main engine of those economies. On the other hand, if the restraint measures are insufficient, it will be an upside risk for economic activity in the short run. However, in the future, it will become necessary to substantially correct the excesses and that might end up in destabilizing those economies.

Particularly, the outlook for the Chinese economy warrants attention. Amid the trend of establishing the global division of labor that makes the most of development in information and telecommunications technology, China has been growing at a pace that can be called as “explosive” and has become in part the world’s factory. In the process of growth, advanced economies had overcome constraints in terms of human resources, technology, and finance, and evolved after passing several stages. However, by benefiting from globalization in technology and finance, China is achieving a development that overcomes those constraints at once and has several development stages co-existing simultaneously. It should be noted that, if such growth continues, it cannot be denied that, at one point, a bottleneck might emerge in terms of the labor force and resources, leading to a rapid increase in inflationary

pressure, or the economy might reach the growth ceiling. In such a case, Japan's economy will be affected significantly. In other emerging economies, with varying degrees, rapid changes might take place due to the effects of information and telecommunications technology advancement and globalization.

We need to continue to deliberately examine developments in overseas economies, including advanced and emerging economies, and the national authorities' conduct of macroeconomic policy.

The current state of the economy

Based on the developments in overseas economies, I will now turn to Japan's economy.

Japan's economy has been picking up due mainly to the improvement in overseas economies and the effects of various policy measures. Exports, mainly to high growing emerging and commodity-exporting economies, have been increasing since the spring of 2009. Correspondingly, the level of capacity utilization in domestic firms is gradually picking up. Although there is not yet sufficient momentum to support a self-sustaining recovery, consumption, backed mainly by demand for eco-friendly automobiles and electrical appliances that has been underpinned by policy measures, is picking up. Moreover, it has become evident that the decline in business fixed investment has been leveling out.

The economy is likely to continue picking up. On the back of favorable conditions in overseas economies, exports and production are likely to increase somewhat more than projected and, albeit with some swings, to perform firmly. Policy support will continue for the time being, as represented by an extension of the purchase support measures for electrical appliances that have been highly effective. In addition, the fact that housing starts have started to increase is a welcoming sign. When houses are built, there are spillover effects on electrical appliances and furniture. Markets have once been concerned about the so-called "double dip," but we judge that the possibility of the economy experiencing another plunge has fairly receded.

Then, how about the sustainability of the recovery going forward? The point is, when the effects of economic stimulus measures taken during the financial crisis dissipate, whether there is sufficient momentum for a self-sustaining recovery in private demand to offset the waning effects of stimulus measures. If private demand has not recovered sufficiently, the once concerned plunge in the economy will take place at a delayed timing. However, if the improvements in exports and production are sustained, capacity utilization will improve and profits will recover through an increase in sales. Then conditions will be in place for business fixed investment to recover, and the broad-based recovery will be in sight, and it will gradually extend to small firms that compose the bases of industries and to households through wages and dividends. If the uptrend continues, to the extent the runaway is long, the base for economic recovery will firm up.

The timing of the recovery spreading over to small firms and households needs to be considered with a certain margin. Firms that shoulder exports and production are exposed to severe pressure of international competition. There is a possibility that, from a viewpoint of maintaining competitiveness, overseas investments might be considered first and returns to employees might be restrained. In addition, parts procurement has spread to overseas and thus the extent of spillover to domestic affiliated firms appears to have reduced. As a result, we need to recognize a possibility that the spillover effects of the recovery on small firms and households might be delayed.

As for the economic outlook, there are other various uncertainties both upside and downside. Of those, uncertainty about developments overseas is what I have mentioned earlier. Moreover, as uncertainty originated at home, developments in firms' growth expectations are extremely important.

Since the outbreak of a financial crisis, firms rapidly intensified their cautious stance for the future. While the stance gradually improved thereafter, I persistently hear from firms'

management that they cannot have confidence about the future. If pessimism about the future strengthens, it will result in contracting business activity. In that regard, a survey by the Cabinet Office conducted on large firms showed that firms' medium- to long-term growth expectations have been maintained. However, the dominant majority in terms of the number of firms and the number of workers is small firms. According to the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) released at the beginning of this month, what stands out is the fact that, while small firms' business sentiment has improved, it has lagged behind, compared with the pickup in large firms and in the economy as a whole. It is important to promptly dispel uncertainties surrounding the economy and offer prospects for future growth. I will explain my views on the challenges for Japan's economic growth later.

Price developments in Japan

I will now talk about price developments.

The year-on-year rate of change in consumer prices has been declining, while the pace has been moderating since last August to around -1 percent recently.

We hear from firms that it is difficult to raise sales prices as consumers are sensitive to prices due to their tight purse strings, and as competition is harsh among firms. The *Tankan* showed that output prices have not risen, compared with the improvement in business sentiment and the rise in input prices.

Nevertheless, it can be said that some beams of light are starting to break through a thick cloud of deflation.

First, there is a subtle change in firms' price-setting behavior and consumers' purchase behavior. With your cooperation, the Bank conducted a survey on firms' price-setting behavior at the beginning of this year. The results, which were published in our January *Regional Economic Report*, showed that there were signs in some firms to avoid endless price competition and try to differentiate in aspects other than prices. The impression obtained through various surveys and interviews is that there are subtle and gradual signs on the consumers' front to purchase quality products by paying reasonable prices.

Second, the effects of exports and production bottoming out in the early spring of 2009, and the economy as a whole picking up since then, will gradually materialize from now on. A rule of thumb is that there is about one year lag until changes in the economy affect the inflation rate. In that sense, it could be said that from the middle of 2009 to the spring of 2010 was a period in which the effects of the economic plunge from the autumn of 2008 to the spring of 2009 put strong downward pressure on prices with a time lag. And the effects of the pickup in the economy since the spring of 2009 can be considered to spread over to prices only from now on.

Third, reflecting the aforementioned changes in firms' price-setting behavior and the lagged effects of the pickup in the economy, there are some changes in the trend of prices. Have you ever heard of expressions such as the consumer price index excluding fresh food or the consumer price index excluding food and energy? Those are the price indexes that, in order to gauge the trend changes, exclude the swings by temporary factors such as weather and commodity price fluctuations, and the year-on-year rate of decline in those price indexes has been moderating. There is also a way to automatically exclude a certain portion of items that register significant price fluctuations. The consumer price index compiled in that way is called the "trimmed-mean" consumer price index. The year-on-year rate of decline in consumer prices in terms of trimmed mean index accelerated toward the autumn of last year, but it has been moderating recently for three consecutive months.

Taking those into account, as the economy is likely to continue picking up and the aggregate supply and demand balance improves, the moderating trend in the decline in prices is expected to continue.

Of course, there are uncertainties about the outlook for prices. Because of that, it is necessary to surely confirm the steps toward overcoming deflation. In the following, I will raise two points that warrant attention in considering the outlook for prices.

First, the risk stemming from overseas economies. There are risks both in the direction of deflation and inflation. On one hand, buoyant business fixed investment is continuing in emerging economies. If that results in excess supply worldwide, it will increase deflationary pressure. On the other hand, while accommodative monetary conditions are maintained in major economies, if a view that such conditions will become protracted more than necessary takes hold, there is a risk that a new type of credit “bubble” might be generated, for example, in emerging economies, and also exert unexpected effects on Japan. Moreover, consumption of resources and energy in emerging economies has been increasing explosively, which, depending on the situation in supplying economies, could abruptly push up commodity prices in the future. If prices in emerging economies rise due partly to an increase in wages, it might spread over to the prices of Japan’s import products and others. In such a case, unlike energy that cannot be substituted by domestic products, it would affect prices in Japan through a path of gearing demand toward domestic products whose relative expensiveness will decline.

Second, people’s view on prices. If people increasingly foresee that deflation will continue, it will put downward pressure on prices. In that regard, as long as viewed from survey data, people’s medium- to long-term inflation expectations have been maintained at about 1 percent. However, such expectations are subjective in that it might change in the future. It has been said that people’s view on prices tends to be affected by past price changes. In that regard, what warrants attention is that the waiver of high school tuition has been in effect since April, which is estimated to push down consumer price inflation by around 0.5 percentage points. The effects of such one-off factors disappear in 12 months, and thus should be considered separately from the trend change in consumer prices. Nevertheless, since the effects will accelerate the pace of the price decline on surface for the time being, a possibility of that affecting people’s view on prices warrants vigilance.

Domestic financial conditions

Next, about domestic financial conditions.

In the money market, the effects of monetary easing by the Bank have been gradually spreading and the interest rates including those of a longer term have declined to extremely low levels. The effects of monetary easing have spread to firms’ funding costs, including the borrowing rates from banks. In addition, issuing conditions for CP have become favorable, more than those seen prior to the failure of Lehman Brothers. Issuing conditions for corporate bonds have also been favorable, with signs of improvement recently spreading to those for low-rated corporate bonds.

The *Tankan* showed that firms’ financial positions have been improving as a whole. However, many small firms, due partly to the lagged improvement in their businesses, still see their financial positions as tight. Nevertheless, the overall move toward easing has been continuing, including small firms. This point has also been confirmed by various surveys targeted at smaller firms than the *Tankan*.

Against such a backdrop, it can be judged that domestic financial conditions, with some lingering severity, have shown increasing signs of easing.

II. Monetary policy

Taking into account the developments in economic activity and prices, I will move on to the conduct of monetary policy.

The Bank wound up outright purchases of CP and corporate bonds at the end of December 2009, and special funds-supplying operation to facilitate corporate financing at the end of March 2010. The special funds-supplying operation to facilitate corporate financing is an operation, by which the Bank extends loans to its counterparts for an unlimited amount against the value of corporate debt, including loans on deeds and corporate bonds, submitted as collateral. These had been introduced temporarily as extraordinary measures during the financial crisis. Behind the introduction of these measures were an excessive sense of anxiety prevailing in part of financial markets and the considerable decline in the functioning of the markets, such as the plunge in transaction volume and the disappearance of appropriate pricing. Subsequently, as financial markets restored their functioning, the adverse effects stemming from those measures, such as the shrinkage of the market scale and distortion in price formation in the markets, were seen. Therefore, the Bank decided to wind up these temporary measures and to consistently maintain accommodative monetary conditions by taking the most appropriate funds-supplying measures according to the changes in the market situation.

It is not correct to gauge the winding up of those measures as the holding back of monetary easing. The Bank recognizes that Japan's economy is faced with a critical challenge of overcoming deflation and returning to a sustainable growth path with price stability. To this end, the Bank will continue to consistently make contributions as central bank. There is no change in such a stance.

Policy responses that should be taken when a great shock like a financial crisis occurs are, in a sense, clear. Timely, targeted, and temporary stopgap measures are required there. The temporary measure to cope with the rapid decline in market functioning in CP and corporate bond markets was a good example. By contrast, the stagnation of the economy as symbolized in deflation is a deep-rooted problem, and a response to it will be different in nature from that to a financial crisis. Like there is no quick fix for lifestyle diseases, we believe it important, while significant effects are not seen immediately, to consistently maintain accommodative monetary conditions.

The Bank reduced the policy rate to virtually zero percent. In addition, to further enhance accommodative monetary conditions, the Bank introduced a measure to encourage a decline in the longer-term interest rates in December 2009. It is a measure to provide three months' funds against a broad range of collateral in an amount of 10 trillion yen at a fixed low rate of 0.1 percent. Thanks partly to the measure, not only market interest rates but also firms' funding costs have declined further.

The amount to be provided through the measure was substantially increased to 20 trillion yen in March. That step was to expand the measure to encourage a decline in longer-term interest rates while coping with the fact that, from April onward, fund provision through special funds-supplying operations to facilitate corporate financing from the Bank will decline. The Bank's decision on further easing at a time when the economy has been somewhat improving more than projected was considered by some as an unexpected decision. However, since it continues to be the case that some time is needed for Japan's economy to return to a sustainable growth path with price stability, we judged it necessary to ensure the improvements in economic activity and prices through an additional easing measure.

I believe that this point will be understood easily if the following is taken into account. There is a risk that, when firms' activity has contracted, the effects of low interest rates might not be fully exerted. As long as firms do not have willingness, low interest rates do not necessarily lead to an increase in investment and employment. By using an old saying, we sometimes say "you can lead a horse to the water, but you can't make him drink." Put it the other way round, what would happen if you bring him to the water at a time when the exhausted horse has somewhat regained strength? We might be able to say that the horse is more likely to drink water and might start to run around vividly again. In such a way, we believe that the

additional accommodative measure taken by the Bank this time will contribute to ensuring the improvements in economic activity and prices.

Since interest rates are already at extremely low levels, room for a further decline by monetary easing is naturally limited. However, that does not suggest that monetary easing has reached its limit. Because, for firms, the level of funding rates matters in its relation to the rate of return. Even if a firm can raise funds at low costs, power to stimulate firm's business will be limited when there are few promising investment projects. By contrast, amid continued low interest rates, if the economy recovers and projects with high profitability increase, the usability of funds obtained at low costs will considerably improve. It is expected that the economy will continue picking up and firms' rate of return to further improve. In those circumstances, the Bank states clearly that it will maintain the extremely accommodative monetary conditions. This means that the effects of monetary easing will become further pronounced in the future.

III. Challenges for Japan's economic growth

In the rest of my speech, I will touch on the challenge toward the growth of Japan's economy. The challenge of how to raise the ability of Japan's economy to create value-added.

The environment has been changing significantly. Information and telecommunications technology has increasingly facilitated the adjustment of global positioning for production and sales bases. In addition, while the recovery in consumption in the United States and Europe has been sluggish, emerging economies have been increasing their presence. In Japan, the wave of the aging population, which is progressing at the fastest pace in the world, has been quietly approaching China and Asian economies.

Japanese firms have adhered to "high-quality manufacturing" and "finely-tuned services." The resulting "coordination-type" products, which are exhaustively coordinated from the stage of parts designing and firms make constant improvements in even after entering the stage of bulk production, have been accepted particularly by the U.S. and European markets. Typical are automobiles.

At the other end of those, there are "combination-type" products. Those are the products of total design, which separate the products into several modules, standardize interface between the modules, and combine or assemble those to make final products. A good example is a personal computer that consists of such modules as CPU, a mother board, and a liquid crystal display monitor.

The recent progress in information and telecommunications technology has made it possible to make products that will to some extent meet consumers' preferences by procuring high quality modules from the world and just assemble them. The combination-type products are spreading. Just for assembling, emerging economies, in which wages and land rents are low, have an advantage. To that extent, the advantage of coordination-type products, in which Japanese firms can exert their strength, has declined. Japanese firms still maintain high technological competitiveness in the production of core modules and processing equipment. However, technology transfer from Japan to emerging economies has been further progressing, and the gap between the two economies has been narrowing. I have often heard that Japan should be all right since it has "manufacturing DNA" that no other country has. The reality is that such DNA has gradually been transferring to emerging economies through the shift of Japanese firms' production bases overseas and associated transfer of product development sections.

Having said that, in general terms, it may not be an appropriate policy for Japanese firms to convert to a combination-type structure. That is because, that case might lead to abandoning the strength Japanese firms have accumulated, in addition, to be forced to compete in terms of costs with firms in emerging economies.

What is necessary now for Japanese firms is not to be complacent about technological advantages, but to develop coordination-type products that respond speedily to and are finely-tuned to consumers' needs, and generate a new market itself. Such high value-added markets might not necessarily be large. However, if firms cover broadly even such niche markets, those markets as a whole will provide a significant profit opportunity for firms.

In that regard, population aging that has been progressing in Japan could be a catalyst. Consumer needs of the elder generation are highly versatile than younger generations, to the extent that elderly people have wide dispersion in income and asset formation. If firms can make finely-tuned responses to those needs, it will lead to stimulating potential demand, namely, exploiting niche markets. In the near future, population aging will progress in China and many overseas economies. If Japanese firms can move ahead in product development and accumulation of business know-how in the aging population, it will lead to an increased chance for those firms to benefit from the first mover's advantage overseas in the future.

However, challenging various niche areas ahead of other firms entails risk. On this point, there are critics who argue that, by referring to the fact that the establishment rate of firms in Japan remains at about half that in United States and Europe, Japanese DNA is stability-oriented to start with and lack venture spirits. However, in the past, there were times when the establishment rate in Japan was comparable to that in countries around the world. Stability-oriented DNA is a mere perception. We expect firms to aggressively exert entrepreneurship. At the same time, it is also important for the public sector to prepare an environment in which challenges to new businesses can easily take place.

Concluding remarks

The economy in this region has been picking up, while there is lingering severity in private demand, including business fixed investment and private consumption.

Against such a backdrop, Miyagi Prefecture has set a goal of "achieving the wealth prefecture Miyagi, and striving to achieve gross production of 10 trillion yen," and has been making efforts to vitalize the industries from various perspectives. I have learned that many companies were already attracted to the region. Moreover, Sendai City has a broad-based ability to pull in customers as the largest commercial city in the Tohoku region, and large-scale facilities have recently been opened one after another.

Of course, the environment surrounding the regional economy, including intensified competition with overseas and the decline in public works, is by no means favorable. However, the region is full of attractions, with one of the nation's largest granaries, a wealth of fishery resources, many research institutions, and ample traditional craft industries. The region has high potential for growth.

Today, I am scheduled to visit various places such as the central shopping area in front of Sendai Station. I believe it is a valuable opportunity to gain firsthand knowledge about the reality of the regional economy that cannot be gauged through statistics and the media. Moreover, as called as "a city of trees," boulevard trees here are beautiful, and I can just imagine that it might be dazzlingly beautiful when green shoots burst out all together through early summer. Like those green shoots, I am also looking forward to closely seeing your efforts toward growth.