Hidetoshi Kamezaki: Recent economic and financial developments in Japan

Summary of a speech by Mr Hidetoshi Kamezaki, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Sapporo, 28 July 2010.

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I. The economy and prices

A. The current economic situation

Following the precipitous deterioration in the wake of the Lehman shock in the fall of 2008, Japan's economy, since bottoming out in spring 2009, has been showing signs of a moderate recovery. The main driving force of the recovery has been improvement in overseas economic conditions, as a result of which Japan's exports and production have been increasing, while business fixed investment is showing signs of picking up. Moreover, the government's economic stimulus measures favoring environment-friendly products have contributed significantly to the pick-up in private consumption.

Overseas economies have continued to recover moderately, underpinned by the effects of both stimulus measures adopted around the world and inventory restocking. Looking at developments by region, the Chinese economy has continued to manifest high growth, supported by the surge in fixed asset investment spurred by a large stimulus package of 4 trillion renminbi, although recently the pace of growth has slowed somewhat. The U.S. economy has been recovering at a moderate pace, supported by a massive stimulus package of 780 billion U.S. dollars. European economies overall are also picking up – although there are some differences across countries – led by increases in exports and production partly due to a decline in their currencies. Recovery in the euro area, however, has been weaker than in other regions because stimulus measures adopted in the region were relatively small in scale, economic structures lack flexibility, and credit uncertainty triggered by the fiscal problems in Greece remains. Against this background, Japan's exports to all regions continued to increase. This has brought about production growth, led business fixed investment to pick up and caused household income to stop declining.

The key elements of the government's economic stimulus measures favoring energy-efficient products are the eco-point system for electrical appliances, as well as tax reductions and subsidies for purchases of environment-friendly cars. These measures, together with the greatly improved cost performance of the products, the switchover from analogue to digital terrestrial broadcasting, and the extended lifespan of automobiles, have tapped potential replacement demand and had a significant positive effect on the sales of products covered by these measures. In addition, it seems that the measures have provided consumers with an incentive to visit retail stores and encouraged them to purchase products to which the stimulus measures do not apply, such as DVD recorders that are compatible with flat-panel TVs and the latest home cleaning robots. This increase in spending on durable consumer goods has had a positive effect on the economy by increasing production.

In sum, Japan's economy has been supported by two major engines of growth, namely, the improvement in overseas economic conditions and the government's economic stimulus measures favoring environment-friendly products. However, because the recovery remains weak in areas that have not directly benefited from these developments, many people have yet to feel that the economy overall is recovering. Moreover, although Japan's economy enjoyed relatively high growth of around 5 percent at an annualized rate from the end of 2009 through the beginning of 2010, the level of economic activity remains lower than before the Lehman shock. It is, thus, too early to say that a self-sustaining upturn in domestic private demand is fuelling a robust recovery.

B. The economic outlook

Next, I will talk about the outlook for Japan's economy. The effects of the two factors that have so far been the engines of economic growth are likely to weaken. Specifically, overseas economies, including those that currently are growing at a rapid pace, seem likely to slow to more steady and sustainable rates of growth as the effects of inventory restocking and stimulus measures abate. The uptrend in Japan's exports is expected to continue, but the pace of increase is likely to moderate gradually. Durable goods consumption is expected to fall temporarily in reaction to the termination of the government's economic stimulus measures favoring energy-efficient products: subsidies for purchases of environment-friendly cars expire at the end of September, while the eco-point system for electrical appliances expires at the end of December.

New factors should be taken into account, however. For example, the government's child allowances, which started in June, are expected to help support private consumption. Moreover, business fixed investment and household income are likely to pick up, reflecting an improvement in the capacity utilization rate and in corporate profits. Supported by these factors, Japan's economy should assume a moderate recovery trend.

The outlook I just presented, however, is subject to various upside and downside risks.

One upside risk is that growth in emerging and commodity-exporting economies might accelerate. Recently, a growing number of emerging and commodity-exporting economies have been shifting away from accommodative monetary policies, while in China, the government has implemented measures to curb the overheating of the real estate market. However, if capital from industrialized economies – which are persisting with accommodative monetary policies – continues to flow into these countries and thereby exacerbates overheating in asset markets, it could boost growth. These developments could then pose an upside risk to Japan's economy by means of an increase in exports. Such developments would not be wholly desirable since overheating in emerging and commodity-exporting economies would inevitably lead to a tightening of policies, which might then pose a downside risk to Japan's economy.

When considering downside risks, the growing instability in global financial markets warrants attention. The fiscal problems in Greece and some other European countries will not only lead to a deterioration in domestic demand in these countries as a result of fiscal austerity measures, but also exert downward pressure on European economies as a whole in a number of ways. These include fiscal consolidation in other countries, as they attempt to avoid a similar fate; the weakening of the financial intermediary function of financial institutions that own sovereign debt issued by countries stricken by the crisis; and a decline in the propensity to consume, as a result of uncertainties surrounding overall markets. The direct impact on Japan's economy is likely to be minimal, as its lending to countries in the region is inconsiderable, while exports to Europe account for only about 10 percent of the total. However, for China and the United States – the major destinations of Japanese exports – Europe accounts for about 20 percent of exports and Japan could, therefore, be indirectly affected. Furthermore, it is necessary to be aware of downside risks, stemming from the effects of the yen's appreciation against the euro, on Japan's export competitiveness, as well as the impact of financial market instability on firms' funds procurement.

C. Price developments

I will now move on to prices. Commodity prices, which have a major impact on price developments in Japan, have been on a rising trend, reflecting high growth in emerging economies. As a result, recent import prices have been about 10 percent above year-ago levels, after having plunged more than 30 percent year on year in summer 2009. In addition, the domestic corporate goods price index (CGPI), which measures fluctuations in prices of goods traded between firms in Japan, has risen somewhat above levels for the same period a year ago.

The consumer price index (CPI) excluding fresh food (the core CPI), which measures the price of goods and services purchased by households, has been declining on a year-on-year basis since March 2009, indicating deflation. However, following the largest year-on-year decline of 2.4 percent in August 2009, the pace of decline has been moderating as a trend. Meanwhile, the pace of decline in the CPI excluding food and energy, or the core-core CPI, which is not usually susceptible to commodity price fluctuations, has also been moderating recently, after marking the largest fall of 1.2 percent at the beginning of 2010. These developments, apart from the rise in commodity prices, probably occurred because the Japanese economy bottomed out and started recovering around spring 2009, and the effects of the narrowing of the negative output gap began to be reflected in prices with a lag of about one year.

The year-on-year rate of decline in the core CPI is likely to continue slowing, reflecting the rise in commodity prices and the narrowing of the negative output gap, and the rate of change in the CPI may even enter positive territory in fiscal 2011. There are, needless to say, both upside and downside risks associated with the outlook for prices, just as for economic activity. The upside risks include an upswing in commodity prices caused by stronger-than-expected growth in emerging economies. On the other hand, price developments could deviate downward from the outlook if pessimism among the public spreads due to a slower-than-expected recovery of the economy. A decline in the medium- to long-term inflation expectations of various economic entities could trigger a fall in the actual inflation rate. Thus, risks associated with price developments require careful monitoring.

II. Measures taken by the Bank

Next, I will elaborate on the Bank's policy measures since the start of the recent global financial crisis.

A. Measures to address the rapid financial contraction

In order to address the rapid financial contraction triggered by the failure of Lehman Brothers, the Bank successively conducted same-day funds-supplying operations and introduced U.S. dollar funds-supplying operations as emergency measures to provide liquidity for financial markets. Furthermore, the Bank decided to introduce outright purchases of CP and corporate bonds, based on the recognition that a significant decline in the functioning of markets, such as the serious shortage of liquidity in the CP and corporate bond markets, was causing a tightening of overall corporate financing conditions. In addition, the Bank introduced a series of temporary emergency measures to facilitate corporate financing, including the easing of the rating requirement for corporate debt to be accepted as eligible collateral and the special funds-supplying operation to facilitate corporate financing, through which the Bank provided 3-month funds for an unlimited amount against the value of corporate debt pledged as collateral at a fixed interest rate of 0.1 percent.

Furthermore, in order to ensure an accommodative financial environment, on both October 31 and December 19, 2008, the Bank reduced the target level of the policy interest rate (the uncollateralized overnight call rate), bringing it down from 0.5 percent to the current 0.1 percent. In order to provide ample liquidity through maintaining the policy interest rate at this low level, the Bank also introduced the complementary deposit facility, whereby interest is made payable on excess reserve balances held at the Bank by financial institutions.

At the same time, the Bank introduced temporary measures to secure the stability of the financial system, given that the strains in global financial markets and the subsequent fall in stock prices and rise in credit costs had greatly affected financial institutions' intermediary function and financial soundness. Such measures include the purchase of stocks held by financial institutions to help them reduce the market risk associated with stock holdings and the provision of subordinated loans to banks to help them maintain sufficient capital bases.

Since then, the Bank has been gradually bringing to an end some of its temporary measures as financial markets have regained stability. In May 2010, however, in order to address the increased strains in global financial markets triggered by the fiscal problems in Greece and some other European countries, the Bank re-established the U.S. dollar funds-supplying operations that had been wound up at the beginning of February 2010.

B. Measures to address deflation

Although financial markets have been gradually regaining stability and the economy is showing signs of a moderate recovery, the Bank recognizes that Japan's economy still faces the critical challenge of overcoming deflation and returning to a sustainable growth path with price stability. For this reason, the Bank reiterated its commitment to fight deflation. 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; hereinafter "understanding"), the Bank, at the Monetary Policy Meeting held in December 2009, made it 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. On this basis, the Bank continues to maintain the policy rate at the extremely low level of 0.1 percent. Moreover, in order to ease monetary conditions further by encouraging a decline in longer-term interest rates, the Bank in December 2009 introduced a new fixed-rate funds-supplying operation against pooled collateral (hereinafter fixed-rate operation), whereby funds with a maturity of three months are provided at an extremely low interest rate of 0.1 percent. The total amount of loans to be provided through the fixed-rate operation was first set at approximately 10 trillion yen in December 2009, but this was increased to approximately 20 trillion yen in March 2010.

C. Introduction of the fund-provisioning measure to support strengthening the foundations for economic growth

Through the measures I have mentioned so far, the Bank has been providing ample funds to financial markets and financial institutions. However, the funds have not been sufficient to feed into the economy and bring about strong growth. Therefore, as the central bank, the Bank examined ways in which it could support financial institutions, in their efforts in terms of lending and investment, in a way that would help strengthen the foundations for economic growth. As a result of deliberations, the Bank on June 15, 2010, decided to introduce a new fund-provisioning measure to strengthen the foundations for economic growth.

The measure provides funds for financial institutions, reflecting their efforts in terms of lending and investment to strengthen economic growth at a loan rate equivalent to the Bank's policy interest rate, which currently is only 0.1 percent. The duration of each loan provided by the Bank is one year in principle, and the maximum duration of the loans is four years, including rollovers. With this measure, the Bank hopes to offer the broadest support possible for the various efforts that financial institutions make on their own initiative. The Bank will start providing funds by around the end of August 2010 and new loans will be disbursed quarterly. The measure is temporary and the Bank set March 31, 2012, as the deadline for new loan applications, so that financial institutions would accelerate their implementation of lending and investment.

The Bank has already started making necessary preparations to provide funds through this measure. On June 25, the Bank announced it had selected 66 counterparty financial institutions for fund-provisioning through public application. Not only major banks, but also a wide range of other financial institutions, including regional banks, became counterparties. Each counterparty submitted its plan for strengthening the foundations for economic growth to the Bank, which is currently evaluating each counterparty's eligibility based on the amount of lending and investment carried out under the plan in the April-June quarter of 2010. Based on the evaluation, the Bank will determine how much it will lend in its first disbursement.

Let me next explain the background to the Bank's decision to introduce this fund-provisioning measure.

III. Strengthening the foundations for economic growth

A. Deflation

As I mentioned earlier, Japan is experiencing deflation. Price instability, including deflation, has various negative effects on the economy and society. For instance, it reduces the efficiency of resource allocation, restrains economic activity by making economic outlook uncertain, and distorts income distribution by changing the real value of contracts, assets and liabilities, which are typically in nominal terms. In addition, there are problems particular to deflation. For example, it has been pointed out that debtors with a high propensity to consume tend to restrain their spending when the real value of their debt rises, weighing down the economy. In addition, due to the zero bound on nominal interest rates, real interest rates do not fall to the level required by the level of economic activity.

Declining inflation rates are a trend shared by all major economies around the world. It is only in Japan, however, that prices in terms of the CPI excluding food and energy (the core-core CPI) have been falling. The main reason for this is the large output gap, which has remained consistently negative since the second half of the 1990s. What is more, the gap has been much larger than in other major economies. This is attributable to the excess supply capacity that has not been adequately adjusted relative to the level of domestic demand, which has stayed sluggish since the bursting of the economic bubble.

Weakness in domestic demand was prolonged by the delay in balance-sheet adjustments by various economic entities and the lack of forward-looking expenditure since the bursting of the economic bubble. In particular, the delay in the disposal of impaired assets by financial institutions weakened their financial intermediary functions, impairing their ability to provide sufficient funds for new areas of growth. The pressure on various economic entities to adjust their balance sheets has more or less disappeared since the beginning of 2000. However, the prolonged period of weak domestic demand has been compounded by the recent onset of population decline, pushing down economic entities' expectations for economic growth and forestalling forward-looking expenditure. The Lehman shock in 2008 dealt another serious blow to demand and its impact continues to this day. One reason that supply capacity has not been sufficiently adjusted despite stagnant demand is that, as a result of various regulations and protection measures, factors of production have remained in areas from which demand has shifted away.

There is a possibility that inflation expectations will lessen if expectations for future economic growth continue to decline and the output gap does not narrow steadily. In this case, consumers of goods and services may put off spending, while suppliers may cut prices further to stimulate demand. Under these circumstances, although the output gap remains unchanged, prices may fall further and deflation may become even more difficult to quell. At present, medium- to long-term inflation expectations remain stable and it is important to make sure that they do not decrease.

B. Overcoming deflation

In order for Japan's economy to overcome deflation, it is necessary to narrow the negative output gap. To this end, demand has to be expanded. The task is not impossible and there are various areas with potential demand to be tapped, such as sectors related to the provision of healthy and safe food, the environment, and population aging. An example of such latent demand is the recent government measures that sharply increased demand for environment-friendly durable goods. Needless to say, it is also important to follow developments in overseas demand. As I mentioned earlier, economic growth in emerging and commodity-exporting economies has been astounding, and it is very likely that their demand for Japanese goods and services still has much room for growth.

The issue at stake is how to tap such demand. The government's "New Growth Strategy" and "Fiscal Management Strategy," both announced in June, may provide some pointers. The "New Growth Strategy" aims to create a strong Japanese economy on the basis of the measures for demand creation that I just mentioned, together with steps to overcome constraints on the supply of goods and the circulation of funds to be implemented in accordance with a specific timetable. The "Fiscal Management Strategy," meanwhile, aims to restore a sound and sustainable fiscal structure in a way that is consistent with the "New Growth Strategy." In any event, it is vital that these measures be implemented swiftly and on schedule.

Moreover, private economic entities, in addition to tapping new areas of demand, need to improve productivity through new manufacturing technology and by shifting capital and labor to areas with higher productivity. The "New Growth Strategy" can support such efforts. It could be argued that higher productivity will increase supply, which would cause a further widening of the output gap. However, it should be pointed out that higher productivity would raise the demand for products of highly productive firms and workers; that the anticipation of such an increase in future demand would raise current demand; and that, thus, the efficiency of resource allocation could be improved, which in turn would expand demand overall.

The Industrial Revolution in Britain provides evidence of the pivotal role played by increased productivity in a nation's growth. During the Industrial Revolution in the early nineteenth century, the Luddite movement emerged in which workers destroyed machines that deprived them of their jobs. Mechanization, however, increased productivity and enhanced Britain's growth potential, paving the way for the subsequent ascendancy of the British Empire. There is no doubt that enhancing productivity is indispensable for Japan given the aging and decline of the population. While it will be difficult to avoid the problems arising from a declining population in the short term, increased productivity can help to avoid a decline in the potential growth rate and maintain the vitality of the Japanese economy.

C. Measures taken by the Bank

The fund-provisioning measure to support strengthening the foundations for economic growth introduced by the Bank on June 15, 2010, aims to support private financial institutions' efforts of their own accord to provide funds required by private economic entities to find new demand and enhance productivity. It is hoped that the move will help to increase potential output growth, narrow the output gap, and eventually bring deflation to an end. In this sense, the measure is consistent with the principle stipulated in Article 2 of the Bank of Japan Act that the Bank will aim at "achieving price stability, thereby contributing to the sound development of the national economy." Instead of merely expressing the objective in words, the Bank is taking action in the belief that this policy will work as a catalyst for private economic entities to join in to achieve a common goal.

I am constantly aware that the Bank always must be ready to proactively implement the appropriate policies. Going forward, the Bank should continue to be proactive and do its utmost to bring Japan's economy back to a sustainable growth path with price stability.