

## **Kiyohiko G Nishimura: Japan's economy and monetary policy – comprehensive monetary easing and strengthening of the foundations for economic growth**

Speech by Mr Kiyohiko G Nishimura, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Hiroshima, 20 October 2010.

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### **Introduction**

First of all, I would like to express my sincere gratitude for your cooperation in interviews and surveys conducted by the Hiroshima branch of the Bank of Japan. Information from these interviews and surveys is invaluable and utilized fully in our business operations.

Before we exchange views, I will first explain economic developments at home and abroad. I will then speak about the Bank's thinking on monetary policy by focusing on recently-introduced "Comprehensive Monetary Easing" and the "Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth."

### **I. Overseas economic developments**

The pace of growth in overseas economies has been slowing. Here I will explain the developments in the United States and emerging economies, which have a particularly significant impact on Japan's economic activity and prices.

In the United States, while a relatively strong recovery was forecasted around this spring due mainly to the policy effects, anxiety about the future increased as a series of weak economic indicators such as GDP and employment were released in August. Since some favorable data such as durable goods orders were released in September, I have been maintaining the view that the U.S. economy has been recovering moderately. However, compared with this spring, the possibility of prolonged low growth has increased.

Economic growth in the United States has been restrained partly because the household sector has been burdened by debt such as mortgage payments and thus has been constrained from consuming. The process of restoring the sound asset condition by repaying debt is called "balance-sheet adjustment," and is a factor in lowering spending in a continuous manner following the burst of "a bubble." As seen in the case of Japan, such adjustments are bound to take time and thus we have been holding the view that the recovery in the U.S. economy, where the household sector faces significant balance-sheet adjustment pressure, will remain modest. Yet, if there is an increase in the growth of employee income or a rise in house prices, the debt repayment capacity of the household sector will increase and the adjustments will be completed in relatively a short period. Thus, the U.S. employment- and housing-related indicators are particularly drawing attention. A typical employment-related indicator is the unemployment rate. It surged to about 10 percent after the Lehman shock, slightly declined around this early spring, rose again thereafter and has remained at an elevated level. House sales picked up due to the effects of preferential tax breaks for buyers of residential houses, but plunged immediately after the tax breaks expired at the end of April and have remained at a low level thereafter. Meanwhile, house prices have been more or less unchanged following the significant decline. As you can see, employment and housing conditions are weaker than expected, and thus it is becoming likely that "balance-sheet adjustments" might take more time than previously envisaged.

Emerging economies are also slowing, although their adjustments are relatively light. From a longer-term perspective, there is a strong possibility that those economies will maintain stable high growth as there is robust potential domestic demand toward spreading durable

goods and building social infrastructure. Some emerging economies have been shifting away from accommodative policies to prevent the economies from overheating, but there are still many economies whose measures to contain overheating are not considered to be sufficient, and thus there remains a risk of overheating that the pace of growth in emerging economies might accelerate amid continued capital inflows. At the same time, since sizable exports have been made from those countries to the United States, the slowdown in the U.S. economy might have no small effect on emerging economies and such downside risks also require vigilance.

## **II. Developments in economic activity and prices in Japan**

Japan's economy has been showing signs of recovery until recently. This summer, sales of air conditioners and beverages were buoyant due to the extremely hot weather, and a last-minute increase in demand ahead of the expiration of the subsidies for purchasing energy efficient cars turned out to be extremely large. Both factors have elevated the economy. However, amid increased uncertainty due mainly to fiscal problems in European peripheral countries and the outlook for the U.S. economy, global investors have become increasingly risk averse, which increased demand for the yen that was considered as a relatively safe currency and resulted in the yen's appreciation. In addition, overseas economies have slowed, and the pace of growth in exports has recently been rather moderating. Taking into account that exports, which have been leading economic activity, have been showing weak signs, it is appropriate to judge that Japan's economy still shows signs of moderate recovery, but that the pace of recovery is slowing down.

While the economic outlook is to be examined in the *Outlook for Economic Activity and Prices* that will be published after the next Monetary Policy Meeting on October 28, compared with the outlook presented in the Bank's July interim assessment, the economic growth rate is likely to be somewhat lower than expected. During this fiscal year, the slow recovery pace is likely to continue mainly due to the slowdown in overseas economies and the expected decline following the last-minute increase in demand ahead of the expiration of subsidies for energy efficient cars. The fact that the recent appreciation of the yen is deteriorating business sentiment is also a big factor in putting downward pressure on economic activity. In the recently-released September *Tankan* (Short-Term Economic Survey of Enterprises in Japan), business conditions D.I. has substantially improved, compared with three months ago, but the D.I. is forecasted to deteriorate considerably in three months ahead, suggesting that firms have come to be cautious due partly to the appreciation of the yen. However, when looking from a somewhat longer perspective, Japan's economy is expected to return to the moderate recovery path as emerging economies with high growth potential will complete the current mild adjustment phase.

While there are various risks associated with such outlook, we need to keep an eye on developments in overseas economies, mainly the U.S. economy. An important risk factor unique to Japan would be developments in car sales in the future, and I think that there is considerable uncertainty associated with the sales. From August through early September, the last-minute increase in demand ahead of the expiration of the subsidies for purchases of energy efficient cars was extremely large, which might suggest that consumers have become sensitive to prices. While it is expected that car sales will plunge for some time following the expiration of the subsidies, what pace the sales will subsequently recover will be critical since that would gauge the strength of Japan's potential demand. Moreover, the automobile industry has a wide range of supporting industries and its developments affect business conditions of many small- and medium-firms, and thus, from such a viewpoint, the developments warrant close attention.

As for prices, the year-on-year decline in the CPI (excluding fresh food) has been slowing. However, the possibility that weaker-than-expected economic activity will affect price developments requires vigilance. Moreover, there is a risk that the yen's appreciation will

lower consumer prices not only through worsening economic activity but also through changes in import prices.<sup>1</sup> Given those circumstances, it has become more likely that the return of Japan's economy to the sustainable growth path with price stability will be delayed than previously envisaged.

### III. Comprehensive monetary easing

Under the situation in which “it has become more likely that the return of Japan's economy to the sustainable growth path with price stability will be delayed,” it is necessary to further enhance monetary easing. On that basis, at the Monetary Policy Meeting on October 4 and 5, the Bank decided to carry out “Comprehensive Monetary Easing,” or “Comprehensive Easing” for short, composed of the following three measures.

First, a change in the guideline for money market operations. The most fundamental policy of the Bank is to guide the overnight rate, that is, the interest rate applied in the market where banks borrow or lend money only overnight, to a pre-determined target rate. At the Monetary Policy Meeting on October 4 and 5, the Policy Board changed the target rate for the overnight rate from “at around 0.1 percent” to “at around 0 to 0.1 percent.” While the Bank said it has been maintaining the extremely low interest rate level of virtually zero percent, this time it changed the target interest rate to further clarify that it has been pursuing the virtually zero interest rate policy. If the Bank is to make further ample liquidity provision through, for example, a purchase of assets I will mention later, there might be strong downward pressure on the overnight rate. In that situation, if the Bank tries to maintain the overnight rate at around 0.1 percent, some flexibility in market operations might be lost. That is another reason the Bank allowed the overnight rate to shift downward.

Second, the clarification of a condition that the virtually zero interest rate will be maintained. The Bank, regarding the criterion for being consistent with price stability, indicates that on the basis of the year-on-year rate of change in the CPI, each Policy Board member's judgment falls in a positive range of 2 percent or lower, and that the midpoints of most Policy Board members' judgment are around 1 percent. The Bank calls this criterion the “understanding of medium- to long-term price stability” (the “understanding”). At the Monetary Policy Meeting on October 4 and 5, the Policy Board confirmed that the Bank will maintain the virtually zero interest rate policy until it judges that the price stability is in sight from a medium- to long-term perspective.

What I would like to emphasize here is that the Bank employs as its judgment criterion, whether developments in the inflation rate expected in the future, not the rate at the moment, is consistent with the “understanding.”<sup>2</sup> Given that it takes some time for the effects of monetary policy to spread, in order to achieve price stability from a long-term perspective, it would be necessary to pay attention not only to the short-term inflation rate at the moment but also to the forecast of how the future inflation rate will develop and to consider its consistency with the “understanding.” Moreover, it is essential to learn from the experience that stability in economic activity and prices from a long-term perspective was undermined in the emergence and bursting of the recent global credit bubble, as a result of significant risks

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<sup>1</sup> While rather technical, as for the CPI, effects of a revision of the base year should also be noted. The change in the base year from 2005 to 2010 is scheduled to be made in the summer of 2011. In general, a year-on-year change in the CPI tends to be overestimated as it goes farther from the base year, and such distortion tends to be corrected at the time of a base year revision. Namely, at the time of base year revision in 2011, it is likely that the year-on-year changes in the CPI will be revised downward. While it is difficult to estimate the degree of downward revision at this point, we should keep in mind a possibility that, looking back in the future, the degree of decline in the CPI could have been larger than previously recognized.

<sup>2</sup> This thinking is similar to that called “forecast targeting,” which uses whether a forecast will reach the target rate as a judgment criterion.

including the accumulation of financial imbalances being overlooked. In other words, if one becomes complacent about the current price stability and overlooks the accumulation of financial imbalances such as a “bubble,” there is a possibility that the economy will face a continued decline in prices after the burst of a “bubble.” The Bank stated that it will maintain the virtually zero interest rate policy on condition that examination of risk factors, including the accumulation of financial imbalances, does not reveal any problems.

Third, the Bank will specifically examine a program to purchase financial assets. The program aims at purchasing various financial assets, such as government securities, commercial paper, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs). That deserves some detailed explanation.

Taking a firm for an example, when it raises funds, it is conventional to pay higher interest rates than those of safe assets such as government bonds. That is because fund providers request adding interest rates worth the factors such as a firm’s default risk. The interest rates on safe assets are called risk-free interest rates and the additional interest rates are called risk premiums. The added interest rates depend on the probability of a firm’s default as well as to what extent fund providers’ want to avoid risk, namely, the degree of risk aversion. The stronger anxiety about the future and risk aversion are, the bigger the added interest rates become.

Taking into account that there is little room for short-term interest rates to decline, the measure taken this time aims to encourage the decline in longer-term risk-free interest rates and risk premiums on risk assets, to pursue further enhancement of monetary easing.<sup>3</sup> The Bank has been encouraging a decline in slightly longer-term risk-free interest rates by utilizing what we call the “fixed-rate operation,” through which the Bank provides funds with a maturity of three or six months at a low interest rate of 0.1 percent. This time the Bank decided to encourage the decline in further longer-term interest rates by purchasing long-term government bonds and corporate bonds with a remaining maturity of about one to two years. Moreover, to reduce risk premiums, the Bank will examine the purchases of ETFs and J-REITs. While such purchases are the first attempt for the Bank, its risk-taking through the purchases could have an effect of reducing risk premiums of stocks and real estate.<sup>4</sup>

Such purchases of assets are extraordinary measures for a central bank, especially the purchases of financial assets to encourage a decline in risk premiums. Interest rates of risk-free assets have already become rather low and there is little room, albeit some in longer-term interest rates, for further reduction. Nevertheless, firms’ funding activity has not become active. Therefore, the Bank decided that it was appropriate to further support firms’ forward-looking activity from a financial side by encouraging a reduction in risk premiums.

The asset purchase should be examined deliberately also from a viewpoint of national burden. If prices of purchased assets decline, the consequent losses will be borne by the Bank. Since the Bank makes payments to the national treasury out of earnings obtained through the issuance of the currency, if the Bank incurs losses, it will eventually become a public burden in that the national treasury could not receive payment it was supposed to

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<sup>3</sup> When there is strong anxiety about the future of the economy, namely, when there is the so-called Knightian uncertainty, there is a tendency that aversion against assets that are considered to be risky, such as stocks and real estate, becomes excessive and demand for those assets declines, leading to risk premiums of those assets remaining high (Meanwhile, it could happen at the same time that demand concentrates on assets whose risks are considered to be small, thereby lowering risk premiums of those assets). In such a case, there is a possibility that the central bank’s purchase of risk assets will lead the central bank to play a role as a “catalyst” to alleviate the tendency of excessive risk aversion. For reference, please see Nishimura, K.G., and H. Ozaki, “Irreversible Investment and Knightian Uncertainty,” *Journal of Economic Theory*, 136 (2007), 668–694.

<sup>4</sup> For the purchases of ETFs and J-REITs, the Bank needs to seek approval from the government and it will do so in due course.

receive. The reason the Bank puts emphasis on its financial soundness and is cautious about carrying out a policy that takes such risk is that, it considers it natural for a central bank to be cautious about a policy that could risk the public burden. Nevertheless, taking into account the outlook for economic activity and prices as well as the situation in which there is little room for further reduction in short-term interest rates, the Bank judges it appropriate to take certain risks. To clarify that the measure is an extraordinary and temporary one, the Bank will newly establish a program on its balance sheet and manage separately from other assets held for different purposes. Meanwhile, since the fixed-rate operation, through which the Bank provides financial institutions with funds with a maturity of three or six months at a low interest rate of 0.1 percent, has the same purpose of encouraging a decline in longer-term interest rates through the purchase of assets, the Bank judged it appropriate to manage the operation under this program. The Bank will examine the size of the program centering on about 35 trillion yen, which is the sum of assets to be newly purchased – about 5 trillion yen – and the size of the fixed-rate operation – about 30 trillion yen.

#### **IV. Fund-provisioning to support strengthening the foundations for economic growth**

The “Comprehensive Easing” I have described can be considered as a policy, when a decline in future demand is worried but is expected to pick up after some time, to support such return of the demand or to underpin the demand by powerful monetary easing.

The challenges Japan’s economy is faced with are not only the temporary decline in demand. It faces the medium- to long-term challenge of overcoming the trend decline in the growth rate that would still remain even after the temporary decline in demand is resolved. In other words, elevating the economy in a sustainable manner is considered to be an important challenge. Taking the developments after the Lehman shock as an example, demand declined rapidly and temporarily due partly to inventory adjustments, but picked up as time passed. On the other hand, global demand for, for example, automobiles, which had been at a high level amid the “credit bubble” in the United States prior to the Lehman shock, will not pick up so easily. In the world following the burst of the credit bubble, to return to the previous high level and to further grow, there is no choice but to increase the strength for growth through the efforts such as further innovation in product development and sales network formulation. On the basis of such recognition, the Bank introduced the “Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth.” In what follows, I will explain my views about the background against which the Bank introduced the measure.

Let me first overview the changes in the environment surrounding Japan’s economy. Japan has been faced with the low birth rate and the aging population for a long period. Meanwhile, emerging economies, especially in Asia, have been growing rapidly. Therefore, the main demand has shifted from the youth and middle-aged to the aged people, and from advanced to emerging economies, and it has been required to establish a supply system of products and services that could meet such new demand. Looking at the history of hit products as an example of such changes in demand, the main purchasers of the so-called 3Cs – color television sets, air conditioners, and cars – were young couples and were a relatively homogeneous group. By contrast, recently, demand for low calorie foods preferred by elders and services that deliver purchased products to elders with weak mobility have been growing, and the purchasers have become heterogeneous.

The development of information technology has also brought a significant environmental change. For example, even in a traditional industry like agriculture, it has become possible to directly provide information to customers through the internet and deliver products. Firms now have to tap the new demand by utilizing such information technology and establishing a supply system that promptly responds to the niche, diversified demand of high-mix, low-volume production.

Amid such changing environment, while Japanese firms have been trying to reform their supply system to incorporate new types of demand, there seems to be much room remaining for further reform. So far as the new demand goes, the supply system is lagging far behind potential demand. Meanwhile, because the transition of the supply system has not been sufficiently progressing, there remains a substantial supply capacity for the old-type demand. Therefore, the output gap with respect to the old-type demand is in the state of excess supply, and firms have no choice but to reduce the prices of their products and services. The fact that the transition to a supply system corresponding to the new demand has not sufficiently progressed seems to be a major factor behind the phenomenon called deflation Japan is plagued with.

To promote the transition of the supply system, it goes without saying that firms play a significant role. I also hope that financial institutions will enhance their risk management capacity and increase fund provisioning to firms that are promoting supply system transition. The policy authorities also need to play their respective roles in preparing an environment that encourages innovative activity of firms and financial institutions. If the authorities' policy becomes a certain trigger to lead to an increase in fund provisions to firms that are trying to reform their supply system, a virtuous cycle can be generated in which financial institutions accumulate the know-how, enhance their risk management capability, and provide further funds. A related example is that, in the United States, venture capital has been playing an important role in nurturing firms, and what triggered an increase in investments by the venture capital was said to be a law revision to relax the restrictions on investments by corporate pension funds in venture capital funds. The accumulation of know-how in the process of managing the increased inflow of funds seemed to have enabled venture capital funds to increase their yields and generated a virtuous cycle of attracting further investment funds.

In my view, the Bank's "Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth" could be a trigger for the transition of the supply system. The measure is not only different from the conventional monetary policy of controlling the policy rate, but also a completely new and unique measure even among the so-called unconventional policy measures. Therefore, we have received many opinions mainly at the outset of the introduction that "it is not a policy measure a central bank should take." Nevertheless, I believe that if the transition of the supply system is to be promoted by the measure and firms become able to tap the new demand, it will contribute to overcoming deflation and thus will be consistent with the mission of monetary policy of "achieving price stability, thereby contributing to the sound development of the national economy" as stipulated in the Bank of Japan Act. Moreover, financial institutions' accumulation of know-how to provide funds to new areas and the expansion of their business bases will not only contribute to the sound development of the national economy but also increase financial institutions' profitability and increase their capital strength, thereby also contributing to "financial system stability," which is the other objective of the Bank.

In designing the "Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth," the Bank has aimed at supporting as broad as possible the various approaches taken by financial institutions on their own initiatives. Therefore, it has been designed so that many financial institutions can participate in, and, in terms of areas and plans, due attention has been paid to make an extremely flexible framework so as not to inhibit financial institutions' voluntary approach. Moreover, by striking a balance between the views that exploiting innovative areas needs time and that the time limit is necessary in letting financial institutions use the measure as soon as possible, the lending period was set for a maximum of four years.

The 47 participating financial institutions at the first round of loan disbursement carried out on September 6 included various types of financial institutions such as the major banks, regional banks, and *shinkin* banks and covered a wide area geographically. The areas of loan disbursement expanded to all the 18 areas illustrated by the Bank, centering on "environment

and energy business” and “medical, nursing care, and other health-related business,” and, besides, there was a range of plans in local industries. Moreover, the average duration of lending or investment projects was 8.2 years, suggesting financial institutions’ stance to support over time the firms’ efforts to exploit innovative areas. Such financial institutions’ efforts have been showing depth and width in line with the intention of the measure, which I feel quite encouraging.

### **Concluding remarks**

Today I have focused on the economic situation at home and abroad as well as “Comprehensive Monetary Easing” the introduction of which was decided in October and “Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth” introduced in June. The Bank will continue to carefully examine the outlook for economic activity and prices, and take policy actions in an appropriate manner as a central Bank.

As I have mentioned earlier, to meet the critical challenge of reforming the supply system, which is faced by Japan’s economy, the role of the policy authorities and, even more than that, of firms and financial institutions would be crucial. To meet the challenge, it is necessary to respond to the new demand created in accordance with the changes in the economic environment such as a rise in emerging economies as well as to nurture new businesses that tap potential demand.

In that regard, in Hiroshima Prefecture, manufacturing industry including automobile, machinery, and steel has been actively engaged in exporting to Asian countries and has been exerting their strength. Moreover, there are not a few firms, inclusive of non-manufacturers, which were established here and developed to run nation-wide business, and thus this region seems to be equipped with a basis to nurture new businesses. This region already holds a variety of elements necessary for growth such as a geographical merit that it is close to other Asian countries, ample tourism resources with two world heritage sites and the rich natural environment, a distinguished reputation as an international city, and high education level with Japan’s fourth highest college advancement rate. That shows that the region has enormous potential.

On the financial front, financial institutions in Hiroshima Prefecture have been pursuing forward-looking approaches such as establishing a system to support firms that are strengthening their businesses toward Asian countries. Moreover, several financial institutions have participated in the Bank’s “Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth” and have been using it as an opportunity to expand new lending methods that enable long-term lending.

I sincerely wish you every success in your endeavor to achieve growth and I also hope that the economy of this region will further fulfill its potential.