Masaaki Shirakawa: Japan's economy and monetary policy

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the Kisaragi-kai meeting, Tokyo, 4 November 2010.

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Introduction

I am privileged to have an opportunity to speak before such a large audience. Having said that, the timing of today's speech has become somewhat uneasy for me. The Policy Board of the Bank of Japan has decided last week to bring forward the next Monetary Policy Meeting to today and tomorrow to discuss and decide the principal terms and conditions for purchases of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) with a view to starting such purchases promptly. Therefore, in my speech today, based on the *Outlook for Economic Activity and Prices* released last week, I will talk about the developments in the global economy, and then mainly about Japan's economic and price developments and the Bank's "comprehensive monetary easing." While I make clear at the beginning that there will be no information that implies the decision to be made at tomorrow's Monetary Policy Meeting, I hope that my speech today will be of any use in enhancing your understanding on economies at home and abroad, as well as on the Bank's monetary policy.

I. Developments in the global economy

The developments in the global economy since the failure of Lehman Brothers

I will start with the developments in the global economy.

The global economy plunged after the failure of Lehman Brothers in September 2008. Behind that economic downturn were two factors. The first factor was a panicky contraction of economic and financial activity due to the financial crisis triggered by the failure of Lehman Brothers. That brought about acute effects on the economy. The second factor, which could be said as more fundamental, was the unwinding of various excesses that had been accumulated globally up to the mid-2000s mainly in the United States and Europe. That was a disposal process of excesses such as excess debt in the household sector, excess production capacity in firms, and impaired assets of financial institutions. Namely, the process of repairing and adjusting balance sheets. During the repair and adjustment process, spending activity of each economic entity will be restrained. Consequently, chronic downward pressure will be exerted on the economy for a protracted period.

The global economy leveled out in the spring of 2009 and started to pick up, and that was mainly because the first-mentioned acute symptom settled. Thanks to liquidity provision by central banks and measures such as capital injections into financial institutions by the governments, the panicky contraction of economic and financial activity calmed down. With the settling of the acute symptom, the demand-boosting measures taken in each country in response to the financial crisis became further effective and firms' moves toward inventory restocking progressed. As a result, the global economy has been growing at an annual rate close to 5 percent since the second half of 2009.

However, the recovery pace of the global economy has recently been slowing. As firms' inventory restocking, which has been leading the recovery, has run its course, in advanced economies, the effects of various demand-boosting measures have been waning. For example, after the expiration of the homebuyer tax credits in June, the U.S. home sales have been sluggish. In Japan, new passenger-car registration in October declined by about 30 percent, on a year-on-year basis, following the last-minute significant increase in demand ahead of the expiration of subsidies for purchasing energy efficient cars. Emerging economies have been still growing at a high rate, but the pace of growth has started to slow somewhat. That slowdown in the pace of growth is partly attributable to the fact that, in response to the increased upward pressure on general prices and residential house prices in accordance with rapid economic growth, emerging economies have been making adjustments to their accommodative monetary conditions. However, measures to restrain overheating are necessary policy responses from the perspectives of restraining overheating in economic activity and asset prices and ensuring sustainability of economic expansion. The Bank judges that if sustainable growth in emerging economies is to be secured by those measures, it will have favorable effects on the global economy in the long run.

Future of the global economy

While the pace of economic recovery has been somewhat slowing since the mid-year, the Bank judges that the recovery trend in the global economy will be maintained. That view is widely shared in many of the forecasts of international organizations and the private institutions. For example, according to the world economic outlook by the International Monetary Fund (IMF), the global economy is projected to grow at a relatively high pace of more than 4 percent from 2011.

In that regard, it is, above all, emerging economies that are expected to play the role of leading the global economy. There are several major reasons why a continued high growth in emerging economies is expected. First, it can be pointed out that there has been strong domestic demand from the beginning such as activation of consumption activity in accordance with the improvement in living standards and the needs for establishment of social infrastructure. A typical example is China. Urbanization has been rapidly progressing in China, and the urban population in China has rapidly increased from 200 million to 600 million in the past 30 years. The number of the so-called “million cities” in Japan, a country considered to have a high population concentration, was five in 1955, when the high-growth period began, or twelve at present. In China, the number already reached 190 cities in 2008 and is expected to increase further in the future. Progress in urbanization generates massive housing constructions as well as demand for establishing utilities including electricity, gas, and water. The fact that expressways, which correspond to the total road length of Japan’s expressways, have been built almost annually since 2005 is also a typical example showing the great demand for infrastructure in China. Therefore, emerging economies have, potentially, a capacity to achieve a relatively high growth rate. Second, it can be pointed out that the large-scale accommodative monetary policies in advanced economies have led to an increase in capital inflows to emerging economies, thereby accelerated the economic expansion in emerging economies.

Meanwhile, in advanced economies, the pace of recovery is likely to remain moderate for the time being, since those economies are burdened by the balance sheet adjustments.

According to the IMF’s world economic outlook, the contribution to the global growth was 60 percent by advanced economies and around 30 to 40 percent by emerging and commodity-exporting economies until the 1980s and 1990s. The relationship between advanced and emerging and commodity-exporting economies was reversed and became 30 percent by advanced economies and 70 percent by the others in the 2000s, and the difference between the two groups of economies further widens in the projections for 2010 and 2011. Since such marked difference in the pace of future economic recovery between advanced economies and emerging and commodity-exporting economies will have a significant implication from a viewpoint of achieving sustainable growth of the global economy, I will explain again later.

Uncertainty about the future of the global economy

As I have just explained, a baseline scenario shared by, for example, the Bank and international organizations, is that the global economy is likely to maintain the recovery trend, led mainly by emerging economies, and follow the sustainable growth path, but such projection is associated with some uncertainties. Here, taking also into account the focus of interest at recent international meetings, I will explain two points I think particularly important. One is the uncertainty about the outlook for advanced economies and the other is, amid the difference in the pace of recovery between advanced and emerging economies, the effects accommodative monetary policies in advanced economies will have on the global economy through capital flows.

Let me explain the first point.

As I mentioned at the beginning of the speech, from the second half of 2009 to early spring 2010, when the acute symptom after the failure of Lehman Brothers settled and the economy was recovering rapidly, there were, from our point of view, somewhat optimistic views about the future of the economy dominant in the United States and European countries. The forecasts by international organizations and private institutions were constantly revised upward and U.S. and European stock prices were on an uptrend. When looking at the yield curve of interest rates in the U.S. dollar markets, up to early spring 2010, it factored in a possibility that the Federal Reserve will raise the federal funds target rate by the end of 2010.

However, since the summer of 2010, triggered by a standstill in improvement in many indicators of the U.S. economy, such as employment- and housing-related ones, a pessimistic view spread that the balance sheet adjustments in the households and financial institutions might continue for a considerable period and thus might substantially slacken the pace of recovery in the U.S. and European economies.

The fact that resolving the balance sheet problems takes time is exactly what Japan has experienced since the 1990s. Therefore, many in Japan including the Bank have seemed to consider that the pace of economic growth in the United States and Europe, which were burdened by balance sheet adjustments, might remain moderate. On the other hand, the dominant view in the United States has appeared to be more optimistic about the effects of the balance sheet adjustments compared with the views in Japan. Putting aside whether such recognition was correct or not, a feeling that prompt and effective policy responses have been implemented taking into account Japan's experience might also have been behind such view. However, after looking at the ensuing sluggish developments in economic activity, concern whether the economy might tumble into deflation or protracted stagnation has started to be felt.[1]

Let me next explain the second factor that has induced uncertainty about the future of the global economy, namely, amid the stark difference in the pace of recovery between advanced and emerging economies, the effects of accommodative monetary policies in advanced economies on the global economy through, for example, capital flows and foreign exchange rates.

In many advanced economies, the pace of economic recovery has been sluggish and inflation rates are projected to be lower than what is considered desirable. As a result, those countries have been conducting accommodative policies. However, as advanced economies at present are in the virtually zero interest rate environment while being burdened by balance sheet adjustments, aggressive monetary easing will not lead to an increase in bank lending and thus, in that regard, stimulus effects on the domestic economy will be unlikely. As a result, it has been pointed out that accommodative monetary conditions in advanced economies have probably induced an excessive capital inflow to emerging economies and brought about risk-taking in those economies, and thus have become one of the reasons for

[1] Also see Masaaki Shirakawa, "Uniqueness or Similarity? – Japan's Post-Bubble Experience in Monetary Policy Studies – ," keynote address delivered at the Second IJCB Fall Conference entitled "Monetary Policy Lessons from the Global Crisis" hosted by the Institute for Monetary and Economic Studies, September 16, 2010 (available at http://www.boj.or.jp/en/type/press/koen07/ko1009c.htm).

the overheating in those economies. It has also been pointed out by emerging economies about a difficulty that, if they raise interest rates while advanced economies are continuing with accommodative monetary policies, capital inflows to emerging economies will further increase against the background of the interest rate differential, thereby offsetting the effects of measures taken to restrain overheating of the economy.

There have also been various discussions concerning the policy conduct of emerging countries. For example, if an emerging country's foreign exchange system lacks sufficient flexibility and its foreign exchange rate is maintained at low levels compared with economic fundamentals, that could, together with the effects of capital inflows from advanced economies, excessively stimulate economic activity in that emerging country, thereby resulting in generating economic and financial excesses and their unwinding over time. In such a case, both emerging and advanced economies would be affected in the form of destabilization in the economy. In addition, the issue of correcting unsustainable current account imbalances has been discussed as a global challenge. In the situation where the foreign exchange rates, which should serve as one of the adjusting valves to cope with such imbalances, lack flexibility, it could become a factor in delaying the necessary adjustments.

At the G20 meeting of Finance Ministers and Central Bank Governors held in October at Gyeongju, Republic of Korea, it was confirmed that, for the global economy, with an uneven pace of recovery among countries, to achieve a sustainable and balanced growth, not only efforts in macroeconomic policy but also those in regulation and structural reform would be necessary. The policy authorities in each country are required to carefully examine economic and price developments in each country or region and take necessary measures to achieve their stability. While it may seem to stating the obvious, I emphasize two points about its implications. One is, the policy authorities in each country have, after all, responsibility for the stability of their own economy. The other is, due to the advancements in the globalisation of the economy and financial markets, the extent to which each country's economic and financial conditions as well as policy conduct affect each other has increased. Thus, policies that are supposed to be carried out to maintain the stability of domestic economic activity and prices need to be implemented by recognizing the path in which such policies affect the global economy and international financial markets and, in turn, affect again the domestic economy. It seems to be becoming more important for both advanced economies and emerging economies to consider the stability of their own economies in carrying out policies while taking account of mutual spillover effects of their policies.

II. Japan's economic activity and prices

Taking into account the developments in the global economy, let me turn to Japan's economic activity and prices.

Current state of the economy

On the back of an increase in exports and production due to the recovery in overseas economies and the boost from policy measures targeted at durable consumer goods, Japan's economy has been improving. Given the sharp drop after the failure of Lehman Brothers, the pace of recovery has been considerably faster, compared with that in the United States and Europe.

However, Japan's exports and production, which have been leading the improvement in the economy, have recently been slowing. Exports were increasing at a pace of more than 40 percent, on an annual basis, since the spring of 2009, but the pace of increase became moderate since the middle of 2010 due partly to the slowdown in overseas economies and an inventory adjustment in information-related goods, and exports have become more or less unchanged in the July–September quarter. The Bank judges that the current state of Japan's economy is in the process of a gradual recovery following the rapid pickup since the spring of

2009, but, as I have just explained, the signs of improvement have been weakening due partly to the slowdown in the pace of increase in exports and production.

Outlook for economic activity and prices, and associating risk factors

What is important here is how we can view the future of economic activity that once slowed. The Bank released last week the *Outlook for Economic Activity and Prices*, the so-called “Outlook Report.” To put the conclusion of the Report first, the Bank views that, in the second half of fiscal 2010, the pace of Japan’s economic recovery is likely to slow temporarily due to the factors such as the slowdown in overseas economies and the ending of the boost from policy measures targeted at durable consumer goods, as well as the recent appreciation of the yen. After entering fiscal 2011, albeit with some lingering effects of the yen’s appreciation, the economy is expected to return to the moderate recovery path, given that exports are projected to continue increasing as the growth rate of overseas economies is likely to rise again, and that firms’ sense of excessive capital stock and labor is likely to be dispelled gradually. Thereafter, in fiscal 2012, Japan’s economy is expected to continue growing at a pace above that in fiscal 2011, as the transmission mechanism by which the strength in exports and production feeds through to income and spending, will likely operate more effectively due to a continued relatively high growth in overseas economies, especially emerging and commodity-exporting economies. Showing that in term of the midpoints of Policy Board members’ projection, Japan’s economy is projected to grow annually at 2.1 percent in fiscal 2010, 1.8 percent in fiscal 2011, and 2.1 percent in fiscal 2012.

The key to the outlook for prices is not only the outlook for economic activity but also developments in people’s inflation expectations in the medium to long term. On this point, judging from various surveys, no significant change has been observed and such inflation expectations seem to have been stable. On that basis, the Bank considers that the year-on-year pace of decline in the CPI excluding fresh food is expected to continue slowing as the aggregate supply and demand balance improves gradually. However, given that the drop in demand after the financial crisis was considerable and the pace of economic recovery has been moderate, the pace of improvement in the supply and demand balance is likely to remain moderate, and the timing of the year-on-year rate of change in the CPI entering the positive territory is likely to be sometime in fiscal 2011. As the rate of growth for the fiscal year, following 0.1 percent in fiscal 2011, the pace of growth is expected to increase to 0.6 percent in fiscal 2012. While taking some more time, Japan’s economy is expected to steadily move toward the sustainable growth path with price stability.

The outlook for economic activity and prices is associated with various risk factors. In particular, in the area of economic activity, there are some upside risks including faster growth in emerging and commodity-exporting economies. However, amid continued heightened uncertainty about the future, especially for the U.S. economy, attention should also be paid to downside risks to Japan’s economy. Regarding the outlook for prices, there is a possibility that inflation will rise more than expected mainly due to an increase in commodity prices brought about by high growth rates in emerging and commodity-exporting economies, while there is also a risk that the rate of inflation will fall due, for example, to a decline in medium- to long-term inflation expectations. The Bank will carefully check, including those factors, whether Japan’s economy is steadily making strides to the sustainable growth path with price stability.

III. Conduct of monetary policy

Let me turn to the Bank’s conduct of monetary policy, taking into account the developments in economic activity and prices at home and abroad.

The Bank recognizes that Japan’s economy is faced with an extremely important challenge of emerging from deflation and returning to the sustainable growth path with price stability.

Based on that recognition, the Bank has been making utmost contributions as a central bank through vigorous policy responses based on the three-pronged approach of pursuing powerful monetary easing, ensuring stability in financial markets, and providing support in strengthening the foundations for economic growth.

In terms of pursuing powerful monetary easing, the Bank has lowered twice the policy rate, which was at the lowest level in the world at 0.5 percent even before the failure of Lehman Brothers. In addition, by increasing longer-term funds provision to financial institutions, the Bank has been influencing directly the interest rates of longer terms of 3-month and 6-month. As a result, Japan's interest rates have been stable at extremely low levels, compared with those in the United States and Europe, and firms' funding costs have still been declining. In terms of ensuring stability in financial markets, the Bank has been endeavoring to spread a sense of security on the funding front in financial markets through, for example, providing a large amount of liquidity. Moreover, from a viewpoint of strengthening the foundations for economic growth, and to support voluntary efforts by firms and financial institutions toward raising Japan's productivity, the Bank prepared a framework for providing funds up to four years at a low interest rate equivalent to the policy interest rate, and has already been implementing it.

Having said that, as I explained earlier, the signs of improvement in Japan's economy are likely to wane and the situation in which the pace of economic improvement remains slow is expected to continue for the time being. Uncertainty about the future, especially about the U.S. economy, has also been high. In those circumstances, the Bank judged that it has become more likely that the timing of Japan's economy emerging from deflation and returning to the sustainable growth path with price stability will be delayed, and at the beginning of October implemented "comprehensive monetary easing" to further enhance monetary easing in a front-loaded manner. In order to pursue further accommodative effects by means of monetary policy under the situation in which there is little room for further lowering short-term interest rates, there is no way but to step into a new territory beyond that of traditional monetary policy and to employ a wide range of policy measures in the Bank's policy toolkit, thereby enhancing policy effects. On the basis of such thinking, the Bank has decided to encourage a decline in longer-term market interest rates and a reduction in risk premiums and at the same time to implement the following three measures as a package.

Change in the guideline for money market operations

As the first measure, the Bank changed the guideline to encourage the uncollateralized overnight call rate from the previously set "at around 0.1 percent" to "at around 0 to 0.1 percent." In the future, if further ample liquidity is provided through the implementation of the asset purchase program that I will explain later, there might be days when the uncollateralized overnight call rate becomes substantially lower than 0.1 percent. To meet the purpose of lowering longer-term market interest rates and reducing risk premiums through comprehensive monetary easing, the Bank considered it effective to explicitly allow such swings in the overnight call rate. Moreover, it will also serve to show further clearly that the Bank has been adopting the virtually zero interest rate policy.

From a viewpoint of achieving monetary easing effects, it should be noted that an excessive decline in the overnight rate could have adverse effects of inducing a decline in yield rates on investments of financial institutions and investors and a decline in margins on interest rates, thereby hampering the financial intermediation function. What the Bank is aiming at after all is to prepare an environment in which the effects of monetary easing will be exerted to a maximum extent.

By taking into account such viewpoints, the Bank judges that the current combination of "around 0–0.1 percent" for the guideline for the uncollateralized overnight call rate and 0.1 percent for a complementary deposit facility is the most appropriate. Such combination of the target interest rate and interest rate on reserves has also been introduced overseas. In the United States, the Federal Reserve has adopted the combination of 0 to 0.25 percent for the target range for the federal funds rate and 0.25 percent interest rate for financial institutions' reserves.

Clarification of the policy time horizon based on the "understanding of medium- to long-term price stability"

As the second measure, the Bank clearly stated that it will continue the virtually zero interest rate policy until it judges that price stability is in sight.

Longer-term interest rates are affected substantially by the market's expectations concerning how short-term interest rates will evolve in the future. The measure taken this time aims at encouraging a decline in longer-term interest rates by influencing the market expectations on short-term interest rates developments through clarifying the Bank's ideas of policy conduct, which has significant effects on the formulation of short-term interest rates.

At the same time, the Bank also clarified that it will use the "understanding of medium- to long-term price stability" (hereafter "understanding") as a criterion for judging whether price stability is in sight. The "understanding" is the level of inflation rate that each of the nine Policy Board members understands as being consistent with price stability over the medium to long term, and is now illustrated as "on the basis of a year-on-year rate of change in the CPI, it falls in a positive range of 2 percent or lower, and the midpoints of most Policy Board members' understanding are around 1 percent."

Two effects can be expected from the second measure. First, by explicitly showing the medium- to long-term inflation rate that the Bank has in mind in conducting its policy, there would be effects of giving the people an indication about the future inflation rate and of stabilizing medium- to long-term inflation expectations – an anchoring effect. Second, by linking explicitly the medium- to long-term inflation rate deemed desirable with the conduct of monetary policy, there could also be an effect of making the thinking of monetary policy conduct clear.

Those views are common to the so-called inflation targeting. However, inflation targeting tends to often invite, partly due to its naming, the impression that policy will be conducted by merely focusing on the inflation rate. Being easy-to-understand is of course important, but, at the same time, it is necessary to avoid falling into the so-called "pitfall of easy-to-understand" by conducting monetary policy looking away from the complex structure of the economy.

Among central bankers and academics, discussions have already evolved from discussions on the old-type inflation targeting that focuses only on short-term price stability to the framework for "flexible inflation targeting," in which flexibility in policy conduct is enhanced, and countries that actually adopted inflation targeting have been shifting toward implementing a flexible policy framework. For example, in England, while the annual rate of inflation based on the consumer price index is substantially higher than the inflation target of 2 percent and has been hovering above 3 percent since January 2010, the Bank of England has not tightened monetary policy but rather been discussing further enhancing accommodative monetary conditions.

On the back of the move not to focus too much on short-term price stability but to aim at ensuring stability of economic activity and prices from a long-term perspective, there is bitter experience of the past at home and abroad. For example, during Japan's bubble period in the second half of the 1980s, consumer prices had been extremely stable and the average year-on-year inflation rate of the five years was 1.0 percent. Also, through the mid-2000s in the run-up to the recent global financial crisis, an optimistic assessment has spread in the United States that the economy finally achieved an ideal combination of high growth and low inflation and a phrase "Great Moderation" has been widely used to express such a situation. However, as revealed a few years later, just when the phrase was used, financial imbalances, such as an excessive rise in asset prices and excessive debt, which caused the recent global financial crisis were accumulating.

In that regard, the Bank introduced a framework for assessing the economic and price situation from two perspectives – a baseline scenario of the outlook for economic activity and prices, and risk factors and, on that basis, it conducts monetary policy. The framework was adopted by incorporating the merits of other countries' policy conduct frameworks, including the aforementioned inflation targeting, and also paid due consideration to the demerits. And thus, the Bank believes that its policy framework is a more advanced one for monetary policy. Based on such line of thinking, the Bank, in clarifying the policy time horizon, confirmed that the criterion for continuing the virtually zero interest rate policy is the "understanding of medium- to long-term price stability," and the policy will be continued on condition that no problem will be identified in examining risk factors, including the accumulation of financial imbalances that could threaten economic and price stability from a long-term perspective as the conditions.

Establishment of an asset purchase program

The third measure is to establish a program for carrying out, for example, asset purchases.

In order to aim at a decline in longer-term market rates and a reduction in various risk premiums, the Bank decided this time to purchase a variety of financial assets. Specifically, as a temporary measure, the Bank will establish a program on its balance sheet and purchase various assets, such as government securities, commercial paper (CP), as well as exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs). The sum of those assets to be purchased was set to be about 5 trillion yen. The total size of the program, including the fixed-rate operation, was set to be about 35 trillion yen.

If the Bank's risk-taking asset purchases could activate the investment stance of market participants and attract funds into the markets, it could work in the direction of reducing risk premiums. The Bank intends to begin the purchases as soon as possible. As mentioned in the beginning, the reason why the Monetary Policy Meeting was moved forward to today and tomorrow is to promptly discuss and decide on principal guidelines for the purchase of ETFs and J-REITs, which obtained the authorization by the government pursuant to the Bank of Japan Act, and to lay out a framework that can begin the purchases as soon as possible.

The measures included in comprehensive monetary easing are extraordinary ones as monetary policy instruments of a central bank, and the Bank is fully aware of that. A policy measure to encourage a decline in longer-term interest rates and a reduction in various risk premiums will be implemented for the first time, and, in particular, a policy to purchase risk assets by a central bank itself shouldering, for example, credit risk is unprecedented in central bank policies. That might lead to taxpayers' burden in case the purchases should eventually make losses, and will expand the extent of central bank's involvement in micro resource allocation for individual industries or firms. While it goes without saying that the Bank devises ways to minimize such adverse effects as much as possible, still it cannot be denied that the asset purchases are approaching from the realm of traditional monetary policy of liquidity provision to the realm that has the character of fiscal policy to be shouldered by the government. The Bank has thoroughly considered a grave issue of to what extent those policies should be pursued based on a central bank's own independent judgment in a democracy. Upon that consideration, the Bank has judged that, as a central bank which has been bestowed from the public the authority to create money, it is required as a responsibility to conduct more effective policies, if they can be devised, in a flexible manner for the economic and financial stability.

The establishment of the Asset Purchase Program has been decided on the Bank's own responsibility by taking into account such contradicting two factors and upon thorough insight into the economic and price situation. Therefore, as for the asset purchase, the Bank decided to bundle it into a program and manage separately so that not only the Bank itself but also market participants and the public will be able to examine the operations conducted under the program and the effects and side-effects of the program.

Those are the Bank's thinking about the comprehensive monetary easing. In the future policy conduct, as described in the Outlook Report, I believe it is important to carefully examine the outlook for economic activity and prices, and take policy actions in an appropriate manner.

Closing remarks

Today I have explained the developments in the global economy and the domestic economy, as well as the conduct of monetary policy since the failure of Lehman Brothers. As I have been mentioning on various occasions, and I am sure that you have also been recognizing, in terms of the challenges for Japan's economy, the response to a more medium- to long-term challenge of a trend decline in growth potential is also critical, together with short-term and cyclical problems. In concluding my speech, I will briefly touch on that point.

Looking back on Japan since the 1990s, the economic growth rate is on a declining trend, and the labor force has been declining after peaking in 1998 and the population started to decline from 2005. Such shift in demographics, especially the decline in the labor force, will have a significant impact on Japan's economy like a body blow. That will be evident just by considering some issues such as whether there are prospects for any expansion in domestic markets, whether they can have stable employment and income in the future, and whether fiscal conditions are sustainable. If anxiety among the public spreads concerning those issues, it will restrain the current households' consumption activity and firms' business fixed investment. A more fundamental background behind stagnant demand over a long period, and the phenomenon of deflation under an output gap stemming from such stagnant demand, could be ascribed to the weakening of medium- to long-term growth expectations.

At present, Japan's economy is faced with difficult challenges, and thus it is essential to accurately and calmly recognize the big picture of Japan's economy. Eventually, it is necessary that the activity of private firms, which are the central player of the economy, becomes spurred, and future growth expectations rise. On that point, in all ages, what blazed the economic path was the exertion of innovation by private firms. Innovation blazing a new area, in particular, does not emerge naturally nor being promoted by the efforts of specific firms or individuals. Respective and consistent efforts by each firm including financial institutions will, while favorably influencing each other, lead to elevating Japan's economy as a whole. As I noted earlier, if the root cause of the problem is the decline in the labor force, there are many issues that society should address, including the increase in the labor-force participation rate of women and the elderly people. In any case, it is clear that, if each economic entity considers institutions and practices as given and only takes an approach to pursuing optimization at a micro level for a continued existence of its own, it could lead to lowering the equilibrium level of the economy and is unlikely to produce the dynamism of Japan's economic advancement. Of course, to bolster such vigorous activity of the private sector, including firms, preparation of the environment by the public sector including the government will be important. At present, the government is making efforts to increase growth potential, and the efforts are expected to pay off, combined with the efforts by the firms.

The Bank also continues to make utmost efforts. Since the second half of 1990s, the Bank has been hammering out new various policy measures. Looking back, those measures seemed very innovative as suggested by the fact that the most of the policies introduced by the central banks in Europe and the United States after the global financial crisis had already been adopted by the Bank. On the quantity side, the Bank entered the low interest rate level, which is currently reached by the European and U.S. counterparties, in the middle of 1990s, and since then its balance sheet has been expanding substantially. That may be part of the reason why the Bank's aggressiveness tends to have been underappreciated. However, in terms of the ratio of a central bank's assets size to nominal GDP, the Bank's ratio is bigger than that of central banks in the United States and Europe, which have increased significantly through the recent financial crisis. The Bank is also the largest in terms of the extent of increase in the ratio after being faced with a low interest rate environment like the present. On the quality side, the Bank has been introducing new measures which are not seen in other countries, including a fund-provisioning measure to support strengthening the foundations for economic growth this year. And this time, the Bank has taken a step further to encourage a reduction in longer-term market rates and risk premiums by asset purchases. The success of that measure depends on whether the private sector, making use of the accommodative financial environment to be realized due to the measure, tries for new challenges and whether an environment in which such a try is enabled is prepared. In that sense, the efforts made by the private sector, the government, and the central bank are essential. The Bank will continue to make contributions as a central bank so that the effects of extremely accommodative monetary policy are fully exerted and will lead to the development of Japan’s economy.