Tadao Noda: Recent economic and financial developments and the conduct of monetary policy

Summary of a speech by Mr Tadao Noda, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Shimonoseki, 15 September 2010.

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I. Overseas economies

I will begin by outlining the current situation of and outlook for the overseas economies.

The world economy deteriorated significantly after the failure of Lehman Brothers, which filed for bankruptcy two years ago, but it has been recovering moderately since the second half of 2009. This recovery has been supported by the effects of both fiscal stimulus measures adopted around the world and inventory restocking in a bid to get them back to pre-slump levels. However, the pace of the global economic recovery has been slowing, as the effects of the stimulus measures and restocking have waned.

A. The U.S. economy: burdened with balance-sheet adjustments and deceleration concerns

The U.S. economy is recovering at a moderate pace, with the second preliminary estimate for the real GDP growth rate for the April-June quarter of 2010 marking 1.6 percent on an annualized quarter-on-quarter basis, but the rate has fallen from its peak of 5.0 percent for the October–December quarter of 2009. Given the gradual recovery in private consumption and business fixed investment, as well as the increase in exports, the main causes of the fall in GDP growth appear to have been the sharp rise in imports[1] and the slower growth in inventory investment.

The U.S. economy is undergoing balance-sheet adjustments, to reduce the huge debt resulting from excessive consumption that had accumulated up to the 2008 financial crisis. With the very slow improvements in employment and income, recovery – particularly in household spending – lacks momentum. Housing investment weakened again as the boost in demand ahead of the expiration of the home-buyer tax credit diminished, and it is likely to be some time before we see a self-sustained recovery.

The pace of economic recovery is expected to slow temporarily by the 2010 year-end, due to decelerating exports following completion of the restocking of inventories worldwide, and the waning of effects of the government's economic stimulus measures, which will push down the growth rate temporarily. The economic recovery trend, however, is likely to be maintained, since exports, particularly to emerging and commodity-exporting economies, are expected to continue increasing, while private consumption and business fixed investment will probably remain on an upward trend amid an accommodative financial environment.

B. The euro area economy: facing intraregional disparities and fiscal problems

Turning to Europe, I will focus on the economic activity in the euro area. Economic activity in the euro area as a whole has been recovering moderately, with intraregional disparities increasing. The real GDP growth rate in the April-June quarter marked a large increase of 3.9 percent on an annualized quarter-on-quarter basis, up from the previous quarter's

[1] When growth in imports exceeds that in exports, net exports (exports minus imports) decrease, pushing down GDP growth. The sharp increase in imports in the April-June quarter seems to have been only temporary.

1.3 percent. The increase mainly reflects a steady growth in exports due in part to the depreciation of the euro.

The economy, however, has been facing two challenges that have arisen from fiscal issues, and have intraregional disparities.

The first issue concerns fiscal consolidation. Looking at the April-June quarter's real GDP indicators by country, Germany marked the highest growth since the country's reunification in 1990 and was supported by strong exports. Meanwhile Greece, the first to adopt substantial fiscal tightening measures to combat its severe fiscal problems, saw declines for the seventh consecutive quarter. Although the extent of the area's problems varies, fiscal consolidation must be carried out not only by the most seriously troubled countries such as Greece, but by all member states of the European Union.

The second issue concerns stability in financial markets. Since the start of 2010, concern about fiscal problems in some European countries has caused the prices of government bonds in these countries to fall, leading to heightened anxiety about the soundness of European financial institutions that hold large amounts of the bonds. After the July release of the stress test exercise results for these institutions, European financial markets restored stability for a while, but a resurgence of fiscal problems in Ireland has revived market instability.

It is anticipated that the two issues just mentioned will add downward pressure on the euro area economy, thereby moderating the pace of future economic recovery.

The root of the two issues may lie in the use of a single currency, the euro, the structural factor unique to the area. Its introduction, while stimulating an increase in the euro area's intraregional trade, expanded the fiscal and current account deficits of some European countries because of the disparity in productivity and competitiveness. Furthermore, fiscal policy is the only tool available to the member states, given that monetary policy has been centralized and that foreign exchange rates can no longer be adjusted to control deficits in the area.

C. The Asian economy: adjusting for a soft landing

Asian economies, free of the need for balance-sheet adjustments, have been the driving force of the world economy as they exhibit high growth as a whole led by recovery in domestic demand. Private consumption is expected to increase steadily with robust demand for durable goods reflecting the rising level of income and increase in the number of households resulting from progress in urbanization. Capital inflows from abroad will support the virtuous circle of growth in production, income, and spending, and so will help maintain strong growth. The risk of overheating has caused more economies to conduct tighter policies such as adjustments to accommodative monetary policy, but as a whole the financial environment remains lax.

The Chinese economy, the most powerful engine of growth, continued to grow at a rapid pace and marked a double-digit real GDP growth rate of 10.3 percent on an annualized quarter-on-quarter basis for the April-June quarter of 2010, decelerating slightly from 11.9 percent in the previous quarter. Concerned about the hike in real estate prices, the Chinese government this April introduced measures, including a higher down-payment ratio for housing purchases, to restrain the increase in real estate transactions. These measures are expected to place added downward pressure on economic activity to a certain extent by slowing the pace of growth in fixed asset investments. This would be achieved by restraining the increase in real estate transactions and, at the same time, decelerating production growth, particularly of steel and other construction-related materials. As a result, the balance between orders and inventories in the manufacturing sector is improving at a slower pace, and the pace of economic expansion is expected to decelerate for a while. The Chinese economy, however, is likely to continue growing at a rapid pace into next year, as private consumption is expected to increase steadily, generated by higher income levels, while the government will be ready to intervene flexibly to help support the economy.

II. Japan's economy

Next, I will outline the current situation of and outlook for Japan's economy.

A. The economy: recovering moderately, but with the self-sustaining momentum still weak

Japan's economy has been showing signs of a moderate recovery supported by the continued improvement in overseas economic conditions mentioned earlier. The real GDP growth rate for the April-June quarter of 2010 in the second preliminary estimate was 1.5 percent on an annualized quarter-on-quarter basis, showing a clear deceleration in growth compared to the previous two quarters. However, exports have been increasing; private consumption has been picking up, due to the government's economic stimulus measures favoring energy-efficient products; and business fixed investment is showing signs of picking up, led by the increase in exports. Yet, the main economic indicators confirm that the level of economic activity remains lower than its recent peak. In this situation, there has been a persistent sense of excesses in capital stock and the workforce, and thus firms remain cautious about spending despite a notable improvement in corporate profits. Therefore, prospects for a self-sustaining recovery in domestic private demand remain uncertain.

In terms of outlook, the economy is likely to recover at a moderate pace on the whole, with exports continuing to increase. However, the pace of increase in exports is likely to remain moderate for the time being, mainly due to the following: (1) the waning effects of inventory restocking in overseas economies; (2) the slowdown in the high growth of emerging economies, primarily reflecting tighter economic policies; and (3) the yen's recent appreciating trend. A decline in private consumption seems inevitable in reaction to the waning effects of the government's economic stimulus measures favoring energy-efficient products. Thus, the pace of recovery in Japan's economic activity is likely to slow temporarily.

Nevertheless, it is anticipated that Japan's GDP growth rate for fiscal 2010 will exceed the potential economic growth rate. For reference, the median of the Policy Board members' forecasts in July for real GDP was 2.6 percent for fiscal 2010, and 1.9 percent for fiscal 2011.[2]

B. Prices: weaker downward pressure from the negative output gap

Although prices continue to decline due to the substantial slack in the economy as a whole, the pace of decline is slowing as a trend due to the gradual improvement in the aggregate supply and demand balance. Excluding the effects of the special subsidies for high school tuition introduced in April 2010, the year-on-year pace of decline in the consumer price index excluding fresh food, or the core consumer price index (CPI), is gradually slowing. The median of the Policy Board members' forecasts in July for the core CPI was at around minus 0.4 percent for fiscal 2010, and at around 0.1 percent for fiscal 2011.

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[2] Every April and October, the Bank releases its *Outlook for Economic Activity and Prices* (the Outlook Report), and in the intervening January and July makes an interim assessment of the outlook laid out in the report. In October, the Policy Board will review its outlook by assessing the upcoming economic indicators and relevant information.

C. Risk factors surrounding the outlook

I believe the outlook just outlined for Japan's economy and prices is the most probable scenario. Projections, however, are always subject to many uncertainties. Let me elaborate on major uncertainties that are also risk factors surrounding the outlook of the economy and prices in Japan.

Since Japan's economic recovery has been induced by improving overseas economic conditions, and a self-sustaining recovery in domestic demand remains uncertain, any delay in the recovery of overseas economies could derail Japan's economy from a self-sustaining recovery path. Therefore, I consider that developments in overseas economies represent the greatest risk that Japan's economy faces.

1. Risks posed by the U.S. economy

The quarter-on-quarter slowdown in the real GDP growth rate for the April-June quarter and declines in many economic indicators released since July have sparked serious concern about the outlook for the U.S. economy. For example, forecasts by private-sector economists for the real GDP growth rate have been revised downward from a mean of around 3.0 to 3.5 percent for 2010 and 2011, to a mean of just below 3.0 percent for both years. I believe that these revisions are only corrections to the overoptimistic forecasts that resulted from an incorrect appraisal of the substantial pressure exerted on economic growth by the U.S. economy's balance-sheet adjustments. The recent developments are in line with my forecasts: I had expected that the adjustment process would require a considerable amount of time and money, considering Japan's long and harsh experience following the bursting of the economic bubble and the scale of excesses in the run-up to the recent financial crisis.[3] In addition, it is possible that a negative chain reaction of downside risks will emerge: a slower-than-expected recovery in the employment situation or a renewed fall in housing prices would further delay adjustment in household balance sheets. This would affect the corporate sector negatively by restraining private consumption.

2. Risks posed by emerging and commodity-exporting economies

In addition to the underlying strength of self-sustaining growth, economic activities in emerging and commodity-exporting countries are in part being supported by capital inflows from advanced countries, which are persisting with large-scale monetary easing. Should capital inflows continue and economic conditions in emerging and commodity-exporting economies turn out to be stronger than expected, the greater exports thereby generated could represent an upside risk for Japan's economy. Nevertheless, if the aforementioned risk concerning the U.S. economy materializes and economic activities in advanced countries are weaker than expected, growth in emerging and commodity-exporting economies might come under downward pressure, generated by a decline in trading volume and an outflow of capital. Furthermore, although a growing number of countries are making adjustments to accommodative monetary policies,[4] a delay in adjusting policy appropriately could lead to economic overheating in the economies that fall behind the curve by delaying appropriate monetary policy adjustment. Should this be the case, in the short run Japan's exports could rise even further, while at the same time the worsening in the terms of trade associated with

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3 The recently released annual revision of GDP data showed the saving rate for the April-June quarter increasing to 6.0 percent; the 3.9 percent in the pre-revision data rose to 6.2 percent in the post-revision data. This upward revision is notable as it reflects the magnitude of the pressure from balance-sheet adjustments. For reference, the average saving rate in the United States was about 2.8 percent from the beginning of 2000 through summer 2008 – the period when overspending seemed to have continued.

4 Asian countries that have raised their benchmark interest rates include Malaysia and India in March, Taiwan in June, and South Korea and Thailand in July. In addition to the Asian economies, Australia and Brazil have been raising their policy interest rates.

a rise in commodity prices could also pose a downside risk for private domestic demand in Japan. Moreover, in the medium to long term, if a sharp unwinding of excessive economic and financial activity takes place in emerging and commodity-exporting economies, the risk of deep adjustments in their economic activity would demand attention.

3. Risks in global financial markets caused by the situation in Europe

Global financial markets have been unstable since the beginning of this year, due partly to growing fiscal problems in some European countries and subsequent growing concern about the financial system. As mentioned earlier, a structural factor – the use of a single currency – may lie at the root of the fiscal problems, and thus it is unlikely that there will be a quick resolution to the volatile situation in financial markets caused by the situation in Europe.

4. Risks related to Japan's corporate sector

The last risk posed by overseas economies relates to the corporate sector in Japan. If expectations are rising that demand in Japan will be lackluster, while expectations for sustainable growth among emerging economies increase, there is a risk that investment in and lending to emerging economies will expand and Japanese firms' spending on business fixed investment and employment will be placed under undue restraint. According to the *Survey on Planned Capital Spending*, released by the Development Bank of Japan, the ratio of the Japanese manufacturing sector's overseas capital investment (capital investment overseas divided by capital investment in Japan multiplied by 100) for fiscal 2010 was a record high of 57.2 percent.[5] Furthermore, according to the *Annual Survey of Corporate Behavior,* conducted by the Cabinet Office, the ratio of overseas production has been on an upward trend. Recently, an argument arose linking the yen's appreciation to the hollowing out of domestic industry. However, I believe it necessary to view this issue from a medium- to long-term perspective, linking it to the issue of productivity and the potential growth rate. I will expand on this topic later in more detail.

III. Conduct of monetary policy

A. Policy responses by the Bank of Japan

Next, I will outline some of the Bank's monetary policy measures, implemented since the Lehman shock in 2008. Policy measures become operative and effective through synergy, however, for the sake of explanation, I will categorize them into three types according to their objectives.

1. Measures responding to cyclical economic changes: pursue powerful monetary easing

Measures taken in response to cyclical economic changes were designed to overcome deflation and return to a path of sustainable growth for Japan's economy, which had deteriorated significantly following the Lehman shock. The Bank undertook interest rate policy, lowering its target for the uncollateralized overnight call rate – the policy rate – by 0.2 percentage point both in October and December 2008, to 0.1 percent, or virtually zero percent. Since then, the policy rate has remained at that level. The Bank has also been encouraging longer-term interest rates to decline. In December 2009, it introduced a fixed-rate funds-supplying operation against pooled collateral (hereafter the fixed-rate

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[5] The survey was conducted in June this year with valid responses by 2,270 firms (1,357 firms were surveyed concerning their ratio of capital investment overseas). The ratio of capital investment overseas in the manufacturing sector peaked at 54.8 percent in fiscal 2005, but declined gradually to 42.0 percent in fiscal 2009, after which it rose to 57.2 percent in fiscal 2010. This fluctuation does not necessarily represent an upward deviation from the past trend, given the sharp decline from fiscal 2008 to fiscal 2009.

operation) to provide three-month funds to financial institutions at a low interest rate of 0.1 percent, the same as the policy rate. Moreover, the Bank decided to start providing additional funds with a six-month term in August 2010. The total amount of loans to be provided through the fixed-rate operation will increase to approximately 30 trillion yen, of which some 20 trillion yen would be available under the existing three-month term operations. In this way, the Bank is working to further enhance easy monetary conditions by providing ample and flexible funds to the money markets.

2. Measures to stabilize financial markets: promote recovery from the "acute symptom"

The stabilization of financial markets benefits the economy because the effects of monetary policy spread to the economy through financial markets. With the failure of Lehman Brothers, confidence in the overall financial market was suddenly undermined and the functioning of the market deteriorated substantially. In a bid to recover from the resulting situation, which has been described as an "acute symptom," the Bank adopted a number of measures, including the outright purchases of CP and corporate bonds in early 2009, in response to a fall in the number of CP and corporate bonds transactions; and special funds-supplying operations, collateralized by corporate debt, to facilitate corporate financing that provided funds to financial institutions with funds at a low interest rate equivalent to the policy rate. These steps – completed by March 2010 after market functioning had been restored – were exceptional, in that the central bank had taken on individual private firms' credit risks, which would appear on its balance sheet.

3. Measures addressing structural issues of the economy: support strengthening the foundations for economic growth

The third category of policy measures relates to Japan's economy from a medium- to long-term perspective. The growth rate had remained high until the start of the 1970s, when it started declining gradually, before dropping sharply following the bursting of the economic bubble at the beginning of 1990s, after which the rate has been declining. Prices have been deflationary since the end of the 1990s in terms of the year-on-year change in the CPI. The fundamental cause of deflation is a lack of demand, caused by a protracted negative output gap. A decline in the growth rate seems to have been the cause of the sluggish demand as it dampened the public's expectations for future economic growth, or in other words, expectations for an increase in wages. From a macroeconomic perspective, economic growth comprises growth in both labor productivity and the number of employed. With the birth rate declining and the number of those employed not likely to rise, labor productivity must be raised if growth expectations are to increase and deflation is to be overcome.

While the measures to address cyclical economic changes, involving more or less short-term economic fluctuations, would solve the lack of demand, they alone would be ineffective in addressing the medium- to long-term issue of raising productivity.[6]

Bearing this in mind, the Bank has searched for ways in which it could utilize its functions to raise the potential growth rate through higher productivity. Thus, in June 2010 it introduced a new fund-provisioning framework to support, from the financial side, private financial institutions' efforts of their own accord toward strengthening the foundations for economic growth.

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[6] In March 2010, at a meeting with business leaders in Shiga Prefecture, I made the following statement in "My Answers to the Frequently Asked Questions regarding Monetary Policy," based on the same awareness I have now: "Maintaining the extremely accommodative financial environment is one of the necessary conditions for overcoming deflation. Another is confronting the fundamental cause of deflation – that is, the lack of demand – and making steady efforts to unlock and capture potential demand, as well as to improve productivity."

The first loan disbursement under the new fund-provisioning measure was executed on September 6, involving a total of 462.5 billion yen, disbursed to 47 financial institutions, and covering 1,342 investments and lendings.

The Bank hopes this fund provisioning will act as a catalyst for financial institutions in making efforts on their own initiative toward strengthening the foundations for economic growth. Having had years of experience in the business of loans at a private financial institution, I strongly expect the measure will stimulate bankers in charge of loan disbursement and credit screening to foster the innovation necessary to discover and nurture newly growing firms, eventually leading to improvements in financial institutions' screening abilities and capacity to produce information.

B. Future monetary policy

The Bank has been enhancing easy monetary conditions through various measures, including those I have just outlined, and by also making clear its commitment to maintaining an extremely accommodative financial environment. I am certain that the synergy resulting from these measures has supported economic activity and helped clear the way to overcoming deflation by improving the aggregate supply and demand balance.

As already noted, projections are always subject to uncertainties. Thus, it is necessary to examine closely the forthcoming economic data and information, so that necessary policy measures can be taken swiftly and decisively should downside risks threaten before deflation has been overcome, raising the possibility that the economic outlook might deteriorate significantly.

Today, I have outlined some of the measures the Bank has implemented over the past two years since the collapse of Lehman Brothers. In addition, it implemented various pioneering measures from the latter half of the 1990s to the early 2000s that are similar to those adopted by central banks in other major countries in response to recent financial crises.

The selection of appropriate policy measures and enhancing of policies require that their possible effects on the economic outlook be taken into consideration, based on domestic and overseas expertise.

The selection of suitable measures requires that the costs which may arise from the implementation of measures, their efficacy, potential risks, and means to prevent such risks from materializing should be considered ahead of time. It is necessary, in addition, to keep up-to-date information regarding the effectiveness, probable costs, and side effects of policy measures, since they reflect changes in the economic and financial situation, as well as fiscal and institutional structures.