Masaaki Shirakawa: Japan's economy and monetary policy

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at a meeting with business leaders, Nagoya, 29 November 2010.

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Introduction

I am honored to have the opportunity today to speak and to exchange views with business leaders from the Chubu region. I take this opportunity to express my deep gratitude for your cooperation with the Bank of Japan's Nagoya Branch.

As the Chubu region is one of the largest exporting bases of Japan, we at the Bank, myself included, always listen with great interest to the Nagoya branch manager's report at the branch managers' meeting held every three month. I am glad to be able today to hear your views directly. However, before we exchange views, I would first like to talk about economic and financial developments at home and abroad, and then discuss the Bank's conduct of monetary policy.

I. Developments in overseas economies

I will start with developments in overseas economies.

Overseas economies, which had plunged in the wake of the failure of Lehman Brothers in autumn 2008, leveled out around spring 2009 and picked up sharply from the second half of 2009. The pace of growth in overseas economies subsequently slowed somewhat as the inventory restocking carried out in the early phase of economic recovery ran its course and the demand-boosting effects of fiscal policy measures started to wane. However, international organizations project that the recovery trend itself will not be interrupted and that from 2011 growth in overseas economies as a whole will start to accelerate again, led by emerging economies that will continue to record high growth, particularly in domestic demand. The Bank shares this view. Specifically, the International Monetary Fund forecasts that the growth rate of the global economy will be 4.2 percent in 2011 and 4.5 percent in 2012. Those figures surpass the average of the ten years preceding the financial crisis, when the global economy recorded high growth (Chart 1).

It should be noted that there are some uncertainties regarding the future outlook. The first uncertainty concerns the possible consequences of balance-sheet adjustments in advanced economies. In the United States and European advanced economies, the process of dealing with excessive household debt, excess production capacity in the corporate sector, and impaired assets in the financial sector, that is, the process of repairing and adjusting balance sheets, is continuing. During this, households and firms give priority to debt payment and have to restrain spending. Financial institutions' proactive lending capacity is prone to decline. In these circumstances, the virtuous cycle of growth in production, income, and spending will not operate properly. Therefore, until balance-sheet adjustments are completed, it is likely that growth in advanced economies will be constrained and that they will remain prone to weakness. The second uncertainty concerns whether emerging economies, which continue to grow at high rates, will be able to make a soft landing onto a sustainable growth path. At present, many emerging economies have been shifting away from accommodative monetary policies. While these moves will put downward pressure on emerging economies in the short run, if implemented appropriately, they could provide a boon to the global economy in that they restrain economic overheating and help achieving more sustainable growth.

Additionally, a third uncertainty that can be pointed out is that the large difference in the pace of economic recovery between advanced and emerging economies further complicates the mechanism of the emergence and spread of possible risks. The United States and European advanced economies are continuing to conduct very accommodative monetary policies. While the resulting decline in interest rates has helped to support the domestic economies, it has also given rise to capital flows from advanced to emerging economies in search of higher returns. The most fundamental reason for such capital flows is emerging economies' high growth, but monetary easing in advanced economies also plays a role. Regarding the large-scale monetary easing decided by the Federal Reserve (Fed) in early November, emerging economies have expressed heightened concern and anxiety about the possible overheating of their economies due to the acceleration of capital inflows and about the possible reversal of capital flows as a result of a policy change in Advanced economies in the future. Should one or more emerging economies experience a rise and subsequent burst of a bubble, this would not only have a large impact on the emerging economies concerned but also affect the global economy as a whole, including advanced economies.

On the other hand, though, there are also various discussions going on concerning the management of exchange rate regimes in emerging economies. There is a possibility that if an emerging economy's exchange rate regime lacks sufficient flexibility and its foreign exchange rate is held too low relative to economic fundamentals, this could, together with the effects of capital inflows from advanced economies, provide excessive stimulus to economic activity in that emerging economy, generating economic and financial excesses and, eventually, a correction of such excesses. These discussions on emerging economies' foreign exchange rates remind me of developments in Japan's economy following the Nixon shock and the Plaza Accord as well as various discussions occasionally held in Japan.

Policy authorities in each country need to act appropriately taking the above developments in the global economy into account. In this context, I would like to emphasize the following two points. The first is that the first responsibility of policy authorities in each country is the stability of their own economy, and this holds true in any era. Second, however, the way to fulfill this responsibility has changed with the advance in economic and financial globalization. I feel that in the conduct of monetary and foreign exchange policies, it has become increasingly necessary to be aware of the global mechanisms of how one's own policies and actions affect the world economy and international financial markets and of how these in turn affect one's own economy. In this context, I think that Japan – through the experiences and lessons it holds, such as with regard to balance sheet adjustments, quantitative easing, and the conduct of policy following the Plaza Accord, which are all relevant to the various problems facing advanced and emerging economies today – can actively participate in discussions and contribute to global economic stability.

II. Developments in foreign exchange markets

While bearing in mind the developments in overseas economies, I will next touch upon developments in foreign exchange markets. Since summer 2010, the U.S. dollar has depreciated to the lowest level since the 1970s in terms of the trade-weighted nominal effective exchange rate, due mainly to market uncertainty about the future of the U.S. economy and associated market expectations of monetary easing (Chart 2). The yen at one time appreciated to near 80 yen against the dollar. However, following the Fed's decision of additional monetary easing in early November, the yen has depreciated somewhat against the dollar. Meanwhile, with regard to exchange rates vis-à-vis Asian currencies, the yen has been following more or less the same trend against the Chinese renminbi as against the U.S. dollar, reflecting China's foreign exchange rate policy. Against the Korean won, the yen appreciated around spring 2010, but has been more or less unchanged since then (Chart 3).

In the short run, the appreciation of the yen depresses the revenue and profits of exporting firms, but the effects differ for each currency depending on the structure of trade and are not uniform. For example, Japan and Korea have recently been in heightened competition in the global market for many final goods such as electronic appliances and automobiles. For this reason, the relative value of the currencies greatly affects the competitiveness of each country's exports. On the other hand, looking at the trade relationship between Japan and China, the two countries play much more complementary roles in the international supply chain, meaning that exchange rate effects differ. These issues are also highlighted in the reports from the Bank's branches across Japan and the Bank, taking them into account, in detail examines foreign exchange rate developments and their effects with great interest.

It should also be noted that, the appreciation of the yen, from a longer-term perspective, has the positive effect of bringing about an improvement of the terms of trade through a decline in import prices, that is, it leads to an increase in Japan's overall real income. The Bank also pays attention to how developments in the foreign exchange market affect Japan's economy from such a long-term perspective and how firms respond.

III. Developments in Japan's economy

Let me now turn to developments in economic conditions in Japan. What I mean by *economic conditions* here are short-term developments in economic activity measured by indicators such as those related to GDP, corporate profits, and employment. On the other hand, I assume that business leaders such as yourselves probably associate with the term *economic conditions* developments that reflect more structural or longer-term factors in your region or industry. Keeping this subtle difference in mind, let me first talk about economic conditions in terms of short-term developments in economic activity.

Japan's economy has been improving on the back of the increase in exports and production brought about by the recovery in overseas economies and due to the effects of policy measures targeting durable consumer goods, but it seems that the recovery has been pausing since early autumn. Exports have recently been more or less flat mainly due to inventory adjustments in IT-related goods and the slowdown in overseas economies. As for private consumption, demand for cars has suffered a reverse following the last-minute increase in demand for energy-efficient cars ahead of the expiration of subsidies. In these circumstances, the increase in production has come to a pause. As for the outlook, it is projected that the pace of economic improvement will continue to be slow for the time being, mainly due to the slowdown in overseas economies and the waning effects of various policy measures, as well as the effects of the earlier appreciation of the yen. However, once we enter fiscal 2011, Japan's economy is expected to return to a moderate recovery path, based on the following developments. Exports are projected to regain momentum as inventory adjustments in IT-related goods progress and growth in the U.S. economy, where additional policy measures were implemented, and in emerging economies, which are expected to recover from the slight adjustment phase caused mainly by the shift from accommodative monetary policy, accelerates again. Firms' sense of excessive capital stock and labor is expected to dissipate gradually with the improvement in corporate profits, and spending by firms and households is projected to become active. Japan's economy is expected to continue growing in fiscal 2012, and at a pace that exceeds that in fiscal 2011, as the transmission mechanism by which increased exports and production feed through to income and spending gains in strength (Chart 4).

Next, I would like to talk about price developments. The consumer price index (CPI) in Japan registered a substantial decline of 2.4 percent in summer 2009, but since then the year-on-year pace of decline has been slowing steadily. The year-on-year rate of decline in the CPI for October slowed to 0.1 percent if the effects of subsidies for high school tuition are excluded. With regard to the outlook, as the aggregate supply and demand balance will gradually improve, the year-on-year change in the CPI is projected to enter positive territory in fiscal 2011 and thereafter rise through fiscal 2012 (Chart 5).

Of course, the outlook presented here is subject to substantial uncertainty, since the economy changes continuously. Above all, as I will explain later, Japan's economy faces the structural problem of a decline in the economic growth trend. In this situation, the Bank will carefully examine whether Japan's economy is making steady progress toward a sustainable growth path with price stability while paying attention to the various risk factors regarding overseas economies highlighted earlier.

IV. Conduct of monetary policy

Let me next explain the Bank's conduct of monetary policy.

In early October, the Bank, with a view to further enhancing monetary easing, decided to implement *comprehensive monetary easing*, the so-called *comprehensive easing*, which bundles together the following three measures (Chart 6). First, the Bank changed the target for the uncollateralized overnight call rate from "around 0.1 percent" to "around 0 to 0.1 percent," thereby further clarifying its adoption of a virtually zero interest rate policy. Second, the Bank clearly stated that it would continue the virtually zero interest rate policy until it judged that price stability was in sight, provided that no problems such as the accumulation of financial imbalances arise. Third, the Bank established an Asset Purchase Program that aims at purchasing various financial assets, such as government securities, commercial paper (CP) and corporate bonds, as well as exchange-traded funds (ETFs) and Japanese real estate investment trusts (J-REITs). The total size of the Program, including the existing fixed-rate operation, was set to about 35 trillion yen (Chart 7).

These measures have the effect of supporting economic recovery through various channels. The first channel is that the recent monetary easing measures, by lowering funding costs for firms and households, will aid private sector economic activity from the financial side. Fed Chairman Bernanke, regarding the recently-decided additional monetary easing through large-scale purchases of longer-term Treasury securities, stated that the use of the term *quantitative easing* to refer to the policy was inappropriate, explaining that the aim was to achieve more accommodative financial conditions by lowering interest rates on securities of longer maturities. The Bank's comprehensive easing is motivated by the same purpose in that it aims at achieving accommodative financial conditions through a decline in interest rates. Moreover, as part of comprehensive easing, the Bank decided to purchase risk assets such as ETFs and J-REITs, which is an extremely extraordinary step for a central bank. It is expected that, if the Bank's purchase of risk assets, acting as a *catalyst*, leads market participants to take a more active investment stance, this will smooth the intermediation of risk money and firms' funding conditions will improve further.

The second channel is what is called the *policy duration effect*. As part of comprehensive easing, the Bank has made it clear that it "will maintain the virtually zero interest rate policy until it judges that price stability is in sight." The Bank will judge whether price stability is in sight based on the *understanding of medium- to long-term price stability* (hereafter *understanding*), which the Bank releases separately. The *understanding* is the inflation rate level that each Policy Board member understands as being consistent with price stability over the medium to long term and takes the form that "on the basis of the 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." Usually, in an economic recovery phase, there are various forecasts as to when the accommodative monetary policy will be changed and projections for the future level of interest rates consequently vary. However, with the recently announced framework in place, it is expected that stable projections about future interest rates will be formed in the markets and long-term interest rates will be stabilized. In this way, the *policy duration effect* could exert significant easing effects, especially when economic recovery progresses and corporate profits improve.

The third channel is that the recent monetary easing measures, through their effect on business and household sentiment, will underpin the economy. The recent measures are likely to have been effective in stabilizing the sentiment of firms and households, which have been worried about the adverse effects of the slowdown in overseas economies and the appreciation of the yen. The Bank has been stating for quite a while that it "will carefully examine the outlook for economic activity and prices, and, if judged necessary, take policy actions in a timely and appropriate manner." I believe that public confidence in the central bank's conduct of monetary policy, by alleviating anxiety about a possible economic downturn, will boost the momentum for a self-sustaining recovery in Japan's economy.

In addition to the comprehensive easing I have just explained, in June 2010 the Bank introduced a new program through which it provides long-term funds at a low interest rate to private financial institutions in accordance with their efforts in terms of lending and investment to strengthen the foundations for economic growth. The reasoning underlying this measure is the Bank's view that the decline in the growth trend of the economy has brought about sluggishness in business fixed investment and private consumption through a decline in firms' and households' growth expectations, which in turn is the fundamental cause of the current deflation. Related to this point is that when we look at Japanese firms' funding conditions, overall, they have abundant on-hand liquidity. At the same time, deposits at financial institutions far exceed loans and financial institutions use those surplus funds to invest in securities such as government bonds. This suggests that the biggest problem is not a shortage of cash or currency but limited investment opportunities resulting from the decline in growth expectations. The Bank strongly hopes that these measures, by acting as a *catalyst*, will prompt discussions on this issue as well as efforts toward strengthening the foundations for economic growth.

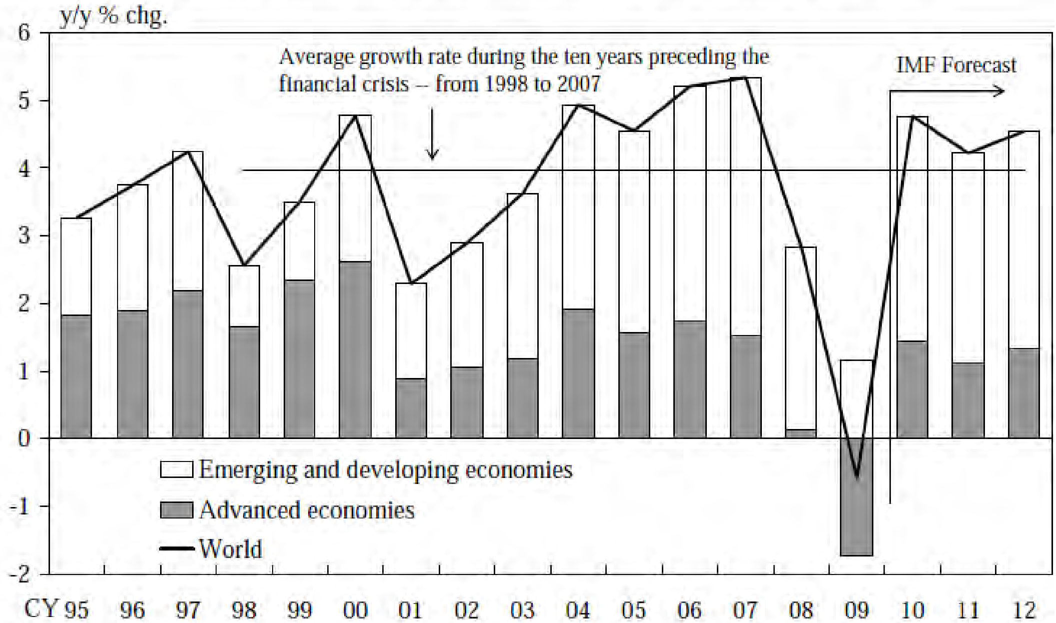
Concluding remarks

As I have just mentioned and as you experience on a daily basis, the biggest challenge facing Japan's economy is how to stop the decline in the potential rate of growth (Chart 8). Moreover, the fact that we as a country have not found an effective solution for this problem also affects short-term cyclical developments and is a fundamental cause of deflation. An economy's growth potential is essentially determined by the rate of growth in the number of employed persons and in labor productivity. Japan's labor force population peaked in 1998 and has been declining since, while the total population started to decline in 2005. For this reason, existing domestic markets in many areas, such as automobiles, have been shrinking. The demographic situation is a given. Thus, if the labor force participation rate for each age/sex group remains the same, the number of persons employed will decline further in the next ten years. What is obvious from this is that what is necessary for increasing the growth potential of Japan's economy as a whole is to increase the labor force participation rate and raise productivity. With regard to the latter, even today, Japan ranks relatively high among the advanced economies in terms of labor productivity growth (Chart 9). Therefore, while it may not be easy to increase productivity growth, it is necessary. To this end, it is essential to create, at home and abroad, new markets where a large increase in demand can be enjoyed, that is, to create added value, thereby raising productivity in the economy overall. This applies not only to state-of-the-art products but also to, for example, services addressing the needs of an aging population. Services demanded by the elderly tend to be labor-intensive, but responding to such demand effectively will lead to an increase in added value in the form of an increase in labor income. It is important to note that in any era, it is firms that serve as the engine for economic growth. Financial institutions are expected to play their part by actively supporting firms' vigorous efforts through their function as financial intermediaries. Meanwhile, the government needs to provide an environment that makes such efforts by private economic entities possible. It is necessary to constantly examine whether there are institutional factors that put Japanese firms at a disadvantage in global competition. The conclusion of free trade and economic partnership agreements currently being discussed, as well as issues related to tax and regulatory policies, are important issues that will affect the future management strategies of Japanese firms.

For the sake of our children and grandchildren, we have a great responsibility to develop a vision for future economic growth. To this end, it is essential for private entities as well as policy authorities to sincerely examine what they can do from their respective standpoints, and make positive efforts in a specific manner. For its part, the Bank will consistently make contributions as the central bank.

Chart 1

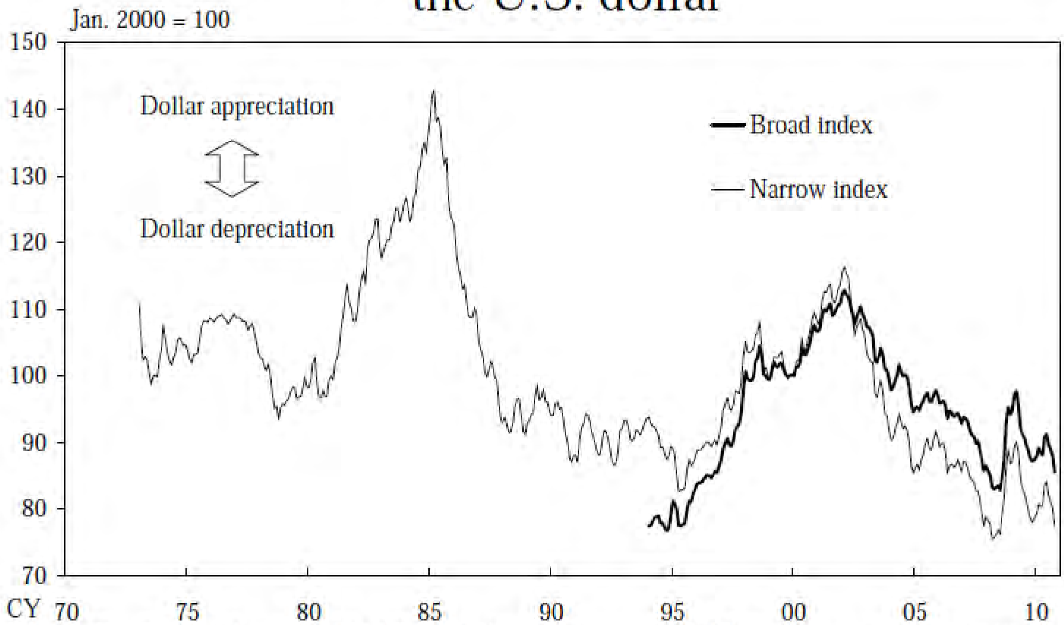
Global Economic Growth Rates



Source: IMF, "World Economic Outlook, October 2010."

Chart 2

Nominal Effective Exchange Rate of the U.S. dollar

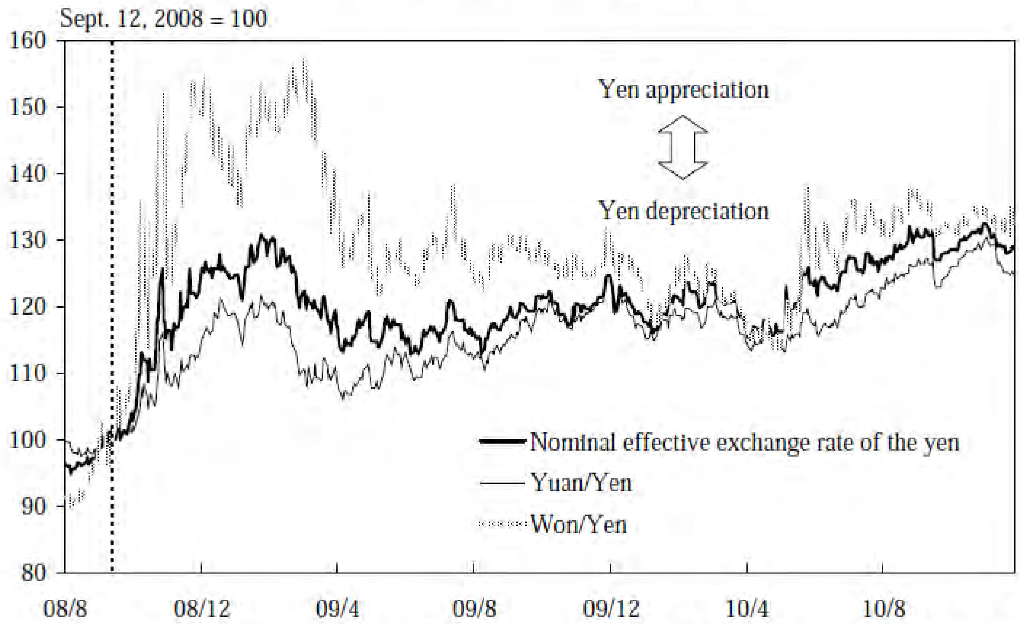


Note: The effective exchange rate of the dollar is calculated as the average of the dollar's exchange rate versus major currencies, weighted by the volume of trade. The narrow index is calculated for a basket of 25, mainly advanced, economies. The broad index is calculated for a basket of 56 economies, including both advanced and emerging economies.

Source: BIS.

Chart 3

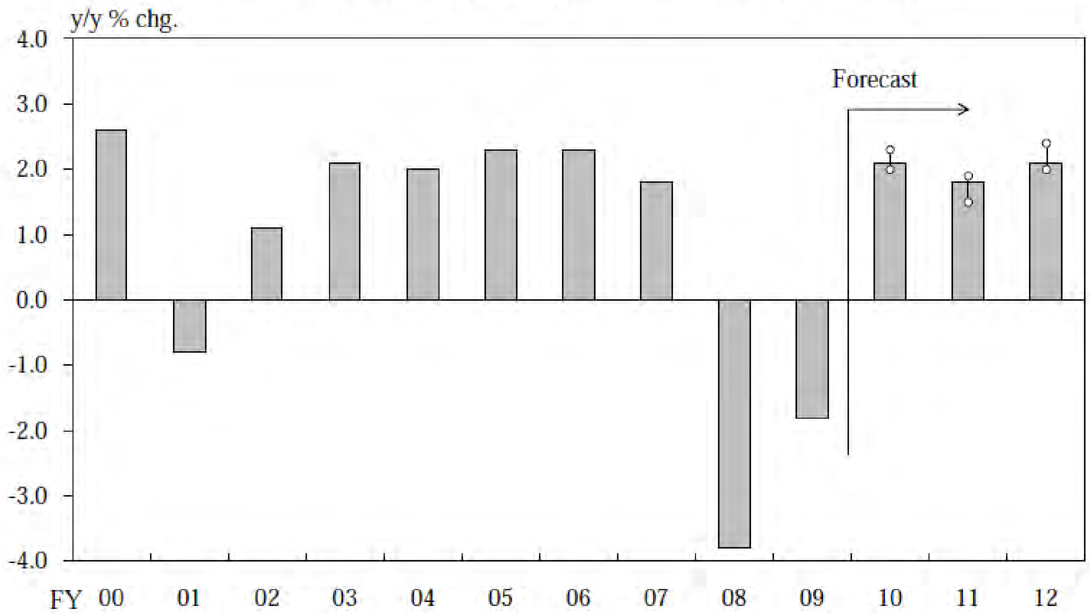
Yen Exchange Rate



Note: The nominal effective exchange rate of the yen is calculated by the Bank of Japan based on the BIS's method for calculating broad indices of the effective exchange rate.
Sources: Bloomberg; Bank of Japan.

Chart 4

Forecast for Japan's Real GDP



Note: The forecast bars show the median of Policy Board members' forecasts and the white dots the range of forecasts of the majority members presented in the October 2010 *Outlook for Economic Activity and Prices*.
Sources: Cabinet Office, "National Accounts"; Bank of Japan.

Chart 5

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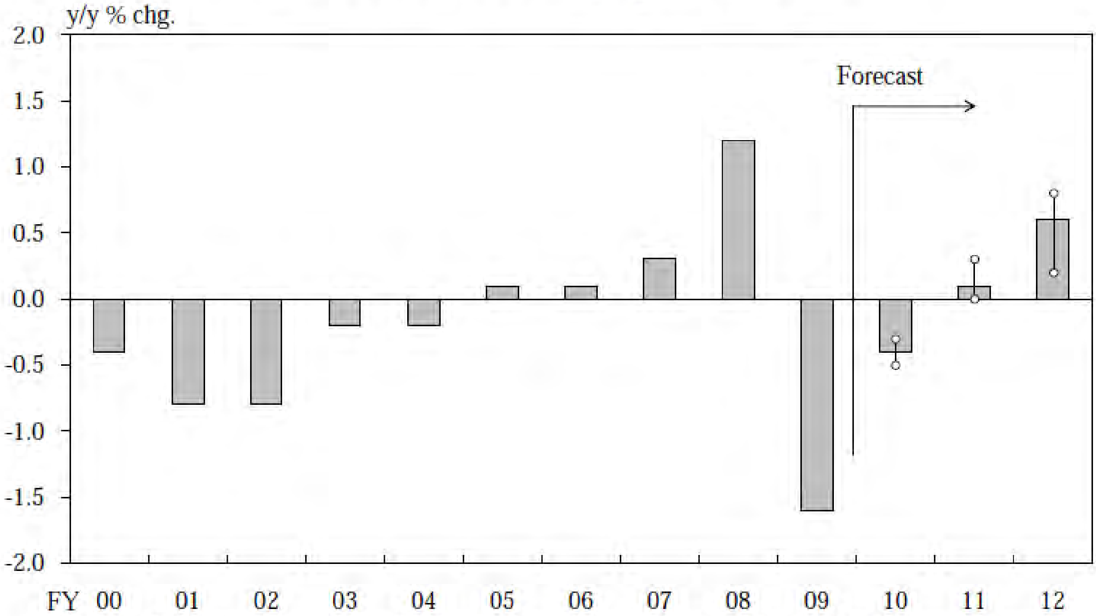
Forecast for Japan's CPI



Notes: 1. The forecast bars show the median of Policy Board members' forecasts and the white dots the range of forecasts of the majority members presented in the October 2010 *Outlook for Economic Activity and Prices*.
2. The forecast for the CPI for fiscal 2010 excludes the effects of subsidies for high school tuition.
Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index"; Bank of Japan.

Chart 6

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Comprehensive Monetary Easing

1. Change in the guideline for money market operations
   - The target for the uncollateralized overnight call rate: "around 0.1 %" → "around 0 to 0.1% "

2. Clarification of the policy time horizon based on the *understanding of medium- to long-term price stability*
   - Maintaining the virtually zero interest rate policy until the Bank judges, on the basis of the *understanding of medium- to long-term price stability*, that price stability is in sight
     -- On condition that no problem is identified in examining risk factors, including the accumulation of financial imbalances

3. Establishment of the Asset Purchase Program
   - Establishing, as a temporary measure, the Asset Purchase Program to purchase various financial assets and to conduct the fixed-rate operation

Note: The current *understanding* states that "on the basis of the 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."

Chart 7

日本銀行 BANK OF JAPAN

Asset Purchase Program

Fixed-rate operation	・Supplying funds at a fixed interest rate of 0.1 percent : about ¥30 trillion (amount outstanding: ¥23.2 trillion)		
	3-month funds: about ¥20 trillion		
	6-month funds: about ¥10 trillion		
Asset Purchase	・Purchasing various financial assets: about ¥5 trillion		
			(Start Date)
	JGBs	About ¥1.5 trillion	(Nov. 8)
	Treasury discount bills	About ¥2.0 trillion	(Nov. 9)
	Corporate Bonds	About ¥0.5 trillion	(Dec. 3)
	CP	About ¥0.5 trillion	(Dec. 10)
	ETFs	About ¥0.45 trillion	(Around mid-Dec.)
	J-REITs	About ¥0.05 trillion	(Around mid-Dec.)

Chart 8

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Japan's Real GDP Growth

avg. y/y % chg.

	1960s	1970s	1980s	1990s	2000s	2010s
Real GDP growth rate (A) + (B)	10.4	5.0	4.3	1.5	0.8	—
Rate of change in the number of employed persons (A)	1.5	0.8	1.2	0.5	-0.3	-0.6
Rate of increase in labor productivity (B)	8.7	4.1	3.1	1.0	1.1	—

Notes: 1. Figures are on a fiscal year basis.
2. The rate of change in the number of employed persons for the 2010s is calculated using the projected future population (medium variant) and the projected labor force participation rate (on the assumption that the labor force participation rate in each age/sex group remains the same as that in 2009).

Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Labour Force Survey"; National Institute of Population and Social Security Research, "Population Projections for Japan: 2001-2050."

Chart 9

Labor Productivity Growth in the G-7 Countries

avg. y/y % chg.

	Japan	US	Canada	Germany	France	UK	Italy
Real GDP growth rate (A) + (B)	1.4	2.4	2.6	1.5	1.9	2.4	1.2
Rate of change in the number of employed persons (A)	-0.1	0.6	1.9	0.5	1.0	0.9	1.3
Rate of increase in labor productivity (B)	1.5	1.8	0.7	0.9	0.9	1.6	-0.1

Note: Figures are calendar 2000-2008 averages to exclude the effects of the financial crisis after the failure of Lehman Brothers.
Sources: National statistical offices.