

Hirohide Yamaguchi: Japan's economy and monetary policy

Speech by Mr Hirohide Yamaguchi, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Aomori, 23 February 2011.

* * *

Introduction

I am honored today to have this opportunity to speak and to exchange views with administrative and business leaders in Aomori Prefecture. And I express my gratitude for your cooperation in various business operations of the Bank of Japan's Aomori branch.

I have taken a Tohoku Shinkansen bullet train to come to the region. The full opening of the bullet train line was said to be eagerly awaited by you, and I imagine that you were especially thrilled by the opening. I have heard that you have been working to make the most of the bullet train line to stimulate the local economy, with enhancing the region's rich tourism resources and public relations activity.

As some of you may know, Mitsuru Yoshida, known also for his book *Senkan Yamato no Saigo* (The last days of the battleship Yamato), was the manager of the Aomori branch from 1965 to 1968. He also wrote a book titled *Aomori Sanka* (Praise of Aomori). In a chapter on the economy of Aomori Prefecture, he discussed the potential and challenges to the regional economy, and concluded that tapping the limitless potential of Aomori should be the most pleasant mission for people living here. The phrase still gets to our hearts after more than 40 years, and even if we rephrase "Aomori" to "Japan." Just like your efforts to tap the potential of the Aomori economy, for Japan's economy as a whole, it has become an important challenge of exploring its potential and paving the way for sustainable growth.

Keeping in mind those issues, in my remarks today, I will talk about economic and financial developments at home and abroad and medium- to long-term challenges to Japan's economy. Then, I will explain the Bank's policy response.

I. Global economic developments

Current state and outlook for the global economy

I will begin with the developments in the global economy.

Looking back on the global economic developments in 2010, in the first half, the economy recovered from the plunge following the failure of Lehman Brothers. The pace of growth slowed from the summer to the autumn. That was because the sharp rise often seen in the early phase of economic recovery slowed down and the effects of various demand-boosting measures, such as subsidies for car purchases, implemented in many countries to address the financial crisis almost ran their course.

Since the autumn of 2010, the global economy has gotten out of the temporary deceleration phase and its growth rate has started increasing again.

Looking at the developments by region, the growth in emerging and commodity-exporting economies has started accelerating again since the autumn of 2010. Consumption has been buoyant associated partly with improved household income and growth in investment has been high in a broad range of areas including social infrastructures, such as roads and railways, and factory machines and equipment. In addition, on the back of large-scale monetary easing in advanced economies, funds that could not find profitable investment opportunities in their own economies have been flowing in. That has been stimulating

economic activity through asset transactions and investment, which has also induced economic expansion in emerging and commodity-exporting economies.

Looking at the developments in advanced economies, the U.S. economy has been recovering moderately. Exports, especially to emerging economies, have been increasing, and as for private consumption, Christmas sales in 2010 marked the highest growth since the mid-2000s. While pessimistic views on the prospects for the economy heightened in the summer of 2010, they have rapidly subsided and rather, optimistic views have become prominent, partly reflecting Federal Reserve's large-scale accommodative monetary policy and fiscal measure of the extension of tax cuts. In that situation, stock prices have been rising. In Europe, countries called peripheral ones such as Greece and Ireland have confronted severe fiscal problems, which I will refer to later, and have been forced to make a difficult economic policy maneuver. By contrast, major economies such as Germany have been strong due mainly to the increase in exports to emerging economies. Economic activity in Europe as a whole has continued to recover moderately, with some differences in pace by country as I have just explained.

My projection is that the global economy is likely to continue to record relatively high growth led by emerging and commodity-exporting economies that will continue growing rapidly. The International Monetary Fund projects that the global economy, following a 5 percent growth in 2010, will grow at a high rate of more than 4 percent in 2011 and 2012. The figures are comparable to those during the historical high growth period that had continued for several years prior to the 2008 financial crisis.

Uncertainties over the outlook of the global economy

The projection I have just noted entails various uncertainties.

First, a risk of overheating in emerging and commodity-exporting economies. In those economies, China in particular, amid continuing high growth and capital inflow, economic overheating has become pronounced as seen in rising inflation and asset prices. Therefore, many of those economies have been shifting away from accommodative monetary policies, but concern about overheating of the economy and inflation is not fully dissipated. If overheating of those economies cannot be retrained successfully through somewhat tightened policy conduct, from a longer-term perspective, there is a risk that an unwinding activity from the excess will become large and those economies will be forced to make sharp and substantial adjustments.

Second, developments in advanced economies. In the United States and Europe, through the mid-2000s while asset prices including real estate prices were rising, households made excessive borrowing and home purchases, and financial institutions increased lending to an extent that can be seen as excessive from now. It was the generation of the so-called credit bubble. The bursting of that bubble induced a financial crisis and an economic plunge following the failure of Lehman Brothers. Households have had to continue reducing borrowing to repair their balance sheets, which weakened due to a decline in home prices. Financial institutions have also been pressed to dispose of a large amount of impaired assets and become cautious about new lending. As Japan had experienced since the 1990s, once the economy is burdened by balance sheet adjustments, it is likely that economic activity will continue to be in a situation in which it is unlikely to turn upward and remains vulnerable to downward pressure. As I mentioned earlier, in the United States, the optimistic views for the future have recently become strong reflecting favorable economic indicators. However, one cannot deny a possibility that the optimistic views will change in the future. European peripheral countries, such as Greece and Ireland, have been faced with deteriorating fiscal conditions called as a sovereign risk problem. Amid the investment boom due to the credit bubble, the governments borrowed excessively from overseas and, in the process of crisis responses after the bursting of the bubble, the governments expanded their fiscal spending significantly to replace private financial institutions' risks and debts. That can also be

considered one kind of balance-sheet adjustment in the government sector. Since it takes considerable time to solve the problem of fiscal deterioration, due attention should be paid to how, during the process, a spread of concern about such public debt will affect international financial markets.

The third uncertainty is developments in international commodity prices and their impact on developments in economic activity and prices in the world. International commodity prices have been on an uptrend since the beginning of 2009. The pace of increase has accelerated especially in food prices since the autumn of 2010, and prices of some nonferrous metals and grains have been around or surpassed their historical highs recorded around the summer of 2008. The factors behind that are the rise in demand due to high growth in emerging and commodity-exporting economies and the decrease in grain supply owing to the adverse weather. The rise in commodity prices seems to have been also boosted by the fact that, amid the large-scale monetary easing in advanced economies, some investment funds have flowed into commodity future markets. At any rate, amid uncertainty about the Middle East, attention should be paid to how international commodity prices will develop and how those developments will specifically affect economic activity and prices both in advanced and emerging economies.

II. Developments in Japan's economy

Economic conditions and outlook

Based on the developments in the global economy, I will next talk about the developments in Japan's economy. To state the conclusion in advance, I am currently somewhat optimistic about a short-term economic outlook in the immediate future, but I have no choice but to have a cautious view on a medium- to long-term outlook. Let me first talk about the current state of the economy.

Japan's economy was picking up relatively clearly until around the autumn of 2010, but such improvement paused from the autumn to the end of 2010. As the growth in the global economy decelerated somewhat, exports became somewhat weak, especially of machinery and electronic parts to Korea and Taiwan, partly due to inventory adjustments in IT-related goods such as personal computers. In addition, the plunge following the last-minute increase in demand for energy-efficient cars ahead of the expiration of subsidies has also affected the economy significantly. According to the data released at the beginning of last week, the real GDP growth rate for the October–December quarter of 2010 is minus 0.3 percent on a quarter-on-quarter basis, the first negative growth in five quarters. The GDP data also proved that the improvement in Japan's economy was in a pause.

Economic indicators released after the turn of the year have suggested that Japan's economy appears to be gradually getting out of the pause. Exports have started to resume an uptrend, as evidenced by high growth across almost all the regions and goods in December 2010. Production, partly reflecting such export developments, has been continuing to increase since November. As for private consumption, sales of electrical appliances such as flat panel televisions increased substantially, almost double the previous year's level, in November immediately before the revisions in the eco-point system, but the sales suffered the reverse since then. On the other hand, sales of cars have been recovering gradually since bottoming out around October and November, when the sales plunged following the last-minute surge ahead of the expiration of subsidies. Firms' fixed investment and households' housing investment have started to pick up. According to the Bank's quarterly branch managers' meeting in January, upbeat views expressed by business managers were returning. Such views were that "demand for smart phones and tablet devices has been strong and there are prospects for inventory adjustments particularly of electronic parts to be completed," or that "orders from emerging economies especially for machine tools have been increasing in number."

As for the outlook, it is projected that Japan's economy will get out of the pause in the not so distant future and return to the moderate recovery path, on the back of high growth in overseas economies.

Prices

Let me turn to the price developments. The year-on-year rate of change in Japan's consumer price index (CPI) excluding fresh food registered a substantial decline of 2.4 percent in the summer of 2009, but the rate of decline has steadily continued to slow since then as the economic slack gradually improved in line with the economic recovery. The latest December figure showed that, excluding a one-off factor of subsidies for high school tuition, the year-on-year rate of change in the CPI was plus 0.1 percent. Given that international commodity prices are on an uptrend while the economy is expected to return to the moderate recovery path, the year-on-year rate of growth in the CPI is likely to gradually increase toward fiscal 2012. However, the base year revision for the CPI, which is conducted regularly every five years, is scheduled for August 2011. In the past five years, goods for which prices declined substantially, such as flat panel televisions, have increased their share in consumption. Partly because that factor will be reflected in the base year revision, it is likely that the year-on-year rate of growth will be revised downward. Including that point, there will still be twists and turns until overcoming deflation is in sight.

III. Toward a medium- to long-term revival of Japan's economy

A declining growth rate and its background

I have explained that Japan's economy appears to be getting out of the pause for the time being, and, on the price front, the deflationary situation is improving at any rate. However, there might be not a few people who think that such views do not feel real. One reason for that might be that the recovery is export-led and is mainly enjoyed by large manufacturers and needs some time to feed into domestic private demand and regional economies. However, the greatest concern might be that it is difficult to have prospects for future growth in Japan's economy and for the industrial structure leading the growth. As a result, many might be feeling that it is difficult to imagine the prospects for the regional economy. I mentioned earlier that I have a cautious view on a medium- to long-term outlook for Japan's economy. That view probably more or less coincides with your concern. With that, I will move on to discuss Japan's medium- to long-term growth.

The average annual growth rate of Japan's economy declined significantly from around 5 percent in the 1970s, in the range of 4–5 percent in the 1980s, to around 1.5 percent in the 1990s, and below 1 percent in the 2000s.

When the growth rate trends downward in that manner, firms' and households' expectations for future growth and future income growth will decline and therefore firms and households will become cautious about their investment and consumption. That has caused a protracted demand shortage in the economy and has become a fundamental cause for deflation. On the fiscal front, the decline in the growth rate has led to an increase in fiscal deficits through, for example, a decline in tax revenues. The fact that the decline in the growth rate is not temporary but prolonged suggests that the growth potential of Japan's economy has decreased.

Various factors have been cited as the reason why Japan's growth potential has declined. Some have pointed out institutional factors including the delay in regulatory reform. Others have questioned Japan-style management and labor practice. The role of education has also been discussed. While it is true that those factors have been complexly intertwined, broadly speaking, the following can be pointed out. That is, Japan's various systems, practices, and firms' principle of behavior that were formed to adapt to the high-speed growth era might not

be able to sufficiently adapt to the two significant changes in the environment that evolved since the 1990s. The two changes in the environment were, first the intensification of global competition and second, the demographic vortex.

The first change, the intensification of global competition, started to advance from around the end of the 1980s. In the high-speed growth era, Japan had no formidable rivals among industrial countries except for the United States and European countries. Therefore, Japanese firms introduced advanced technologies in the United States and Europe and then implemented a competition strategy in which they increased exports of low-priced, high-quality standardized industrial products with relatively inexpensive capital and labor. That was an optimal strategy at that time. However, amid the rapid progress in the globalization of a market economy, such as China's and other emerging economies' entry as peers of a market economy, and the striking development of the information and telecommunication technology, the global economy entered the era of so-called mega competition. The environment changed so that competition to reduce capital and labor costs became severe, and at the same time, firms around the world had to compete fiercely seeking for earning opportunities by utilizing IT technologies. It has become difficult for a firm to enjoy high profits unless it uncovered a new business area ahead of other firms around the world and allocated management resources such as personnel and capital promptly and intensively to such new business area. It exactly became an era when selecting and concentrating resources in key strategic areas have increasingly been required.

The second change in the environment is the demographic vortex. Japan's working-age population, namely, the population aged between 15 to 64, started to decline in the mid-1990s, and the total population peaked in 2007. That exactly shows that population aging is rapidly progressing. The rate of the elderly population aged over 65 to the total population was 9 percent in 1980 and more than doubled in 2009 to 23 percent. If the trend continues, the ratio of the elderly population is projected to rise to nearly 40 percent in 2050. Population aging will hamper growth from the supply side of the economy in that it will bring a shortage of workers. To address that issue, it is necessary to make further efforts to increase female labor market participation and accept foreign workers. At the same time, population aging will have a large impact on the demand side of the economy; for example, it will bring a substantial shift in the components of consumer demand. Specifically, there is a possibility that demand for homes, cars, and eating out will decrease, while demand for health and nursing care, as well as businesses such as tours targeting the elderly will increase. A key to winning competition is how firms will be able to respond to such substantial shift in demand for goods and services.

In sum, the two changes in the environment indicate that the source of economic growth would expand substantially from advanced economies such as Japan, the United States, and Europe, to a broader world including emerging economies, and in terms of domestic markets, from markets especially for young and middle-aged generation to broader markets for a wider range of generations including the elderly. The decline in Japan's growth potential since the 1990s suggests that Japanese firms were not able to sufficiently adapt to such changes in the environment.

Policy direction

If we summarize such significant changes in the environment taking place in Japan and their impact in that way, we can see that addressing the change in the demand structure will be a key to increasing the growth potential of Japan's economy. In that regard, it is critical to create an environment, in which firms can embark on new business areas with creative ideas, and smoothly transfer their management resources, such as personnel and capital, to those areas.

If I point out some critical challenges, promoting deregulation remains to be one of those. There have been some areas, such as mobile phones and couriers whose markets have

expanded due to deregulation. Those often pointed out as promising areas are health and nursing care as well as education. While it is true that the institutional design in those areas is required to take account of safety and fairness, it is also the fact that regulations have shrunk room for originality and ingenuity of private firms, as seen in the difficulty in integrating kindergartens and nursery schools. In addition, population aging can provide new business opportunities if new demand is tapped through the collaboration between different areas such as tourism and health and nursing care. Not to hamper the creation of a cross-industrial business model, efforts to constantly review the regulations are essential.

Moreover, in promoting creative corporate activity, it is important to create an environment that will ensure the smooth transfer of resources both in terms of personnel and of capital and funds. As for personnel, while there are industries with excess employment on one hand, there are industries, including nursing, which are short on staff on the other hand. To resolve such mismatch, it is necessary to further enhance the flexibility of the labor market by, for example, making job changes easier. The weakness of Japan's economy is that such lack of market flexibility is observed here and there. In addition, the expansion of a safety net including unemployment policy will be important in generating personnel who make challenges for new business areas. That is because without a framework for supporting those who have taken risks and make challenges by society as a whole, the transfer of personnel resources to new business areas will not make progress.

As for capital and funds, it is critical to have an environment that will enable them to be allocated smoothly to growth areas. It is a fundamental function of financial markets to discover promising businesses and investment areas and allocate capital and funds to them. For firms that raise funds, a hurdle in embarking on new businesses will become lower by obtaining funds from financial institutions and markets. On the other hand, it is also possible to encourage firms' efforts to increase profitability by attaching severe terms to businesses with low profitability accordingly. In that regard, financial institutions are particularly required to identify promising businesses and flexibly provide funds to them. In addition, it is essential to have the so-called risk money to foster new growth areas. In other words, it is important to improve various financial markets such as for stocks, corporate bonds, and asset-backed securities, which are underwritten using firms' receivables and assets such as real estate as collateral.

While the measures I have mentioned are not achieved easily, given that Japan's economy continues to be stagnant for such a protracted period and is burdened by a serious challenge of further aging of the population in the future, there is no time to lose. I do not have time to go into details today, but fiscal consolidation is also an important topic that should be kept in mind. The deterioration in fiscal conditions would become a factor to restrain spending especially of working-age generations by reducing their expectations for future income growth. If firms' and households' sense of security about the outlook will be fostered through fiscal consolidation, it will stimulate spending and also contribute to increasing the growth potential of the economy. I recognize that, with a view to raising the growth potential of Japan's economy, it is significant that various entities including the Bank work on addressing problems, with a widely shared sense of urgency.

IV. The Bank of Japan's policy response

I will now explain the Bank's policy response.

The Bank has implemented various measures not only to address the challenge of ensuring economic recovery and overcoming deflation, but also the medium- to long-term structural challenge of increasing the growth potential of Japan's economy. That is because the Bank considers that the decline in growth potential lies at the root of deflation.

In October 2010, the Bank adopted a powerful monetary policy package of "comprehensive monetary easing." Specifically, the uncollateralized overnight call rate, which is the policy

interest rate, is encouraged to remain at around 0 to 0.1 percent. The Bank has also committed itself to continue the virtually zero percent interest rate level until it judges that price stability is in sight. That is considered to encourage longer-term interest rates to be low and stable. Moreover, the Bank has implemented an Asset Purchase Program to purchase not only safe assets as government securities but also purchase risk assets such as CP, corporate bonds, investment funds that link stock price indexes, and real estate investment trusts. The outstanding amount of total assets purchased, including those through the operation that provides funds at a fixed low rate, has set to be about 35 trillion yen by around the end of 2011. The measure aims at influencing longer-term interest rates and, from a viewpoint of enhancing economic growth potential, is also expected to activate the flow of risk money. In the measure, the purchase of risk assets in particular is extraordinary for a central bank. The Bank ventured to decide to implement it with a view to promptly overcoming deflation.

Moreover, in 2010, the Bank introduced a new framework of lending called the “fund-provisioning measure to support strengthening the foundations for economic growth.” Through the measure, the Bank provides long-term funds at a low interest rate to private financial institutions that are making efforts in terms of lending and investment toward increasing the growth potential of Japan’s economy. The total amount of loans provided so far in two disbursement accounts for about 1.5 trillion yen, and the third disbursement is scheduled for the beginning of next month. In response to the Bank’s measure, financial institutions have been preparing a framework for actively supporting lending and investment by, for example, establishing special sections devoted to investment and lending to the new areas of growth or establishing new credit lines. There seems to be some firms that have taken a more active stance of fixed investment in new growth areas. With such new moves emerging, it seems that the recognition that increasing the growth potential of the economy is a pressing challenge has started to spread. Including such a change in the recognition, the fund-provisioning measure seems to start gradually producing expected positive effects as a catalyst. The Bank will continue to examine possible ways to strengthen the foundations for economic growth.

Concluding remarks

I have talked about the economic and financial developments at home and abroad, the medium- to long-term challenges to Japan’s economy, and the Bank’s monetary policy conduct. In closing, I will offer my view on the potential of Aomori’s economy based mainly on what has been reported from the Bank’s branch.

In the Aomori Prefecture’s basic plan, “A Challenge for the Future,” which indicates the state of the region in 2030, three industries of food, energy, and tourism are identified as major industries.

In the food industry, I hear that agriculture and fishery industries are aiming at increasing profitability by establishing an integrated production and sales system that contains from processing to distribution procedures. I also hear that efforts have been made to expand exports especially to emerging economies. For example, Aomori’s apples have established their brand recognition as high grade fruit, and further expansion of exports is expected.

As for energy-related businesses, nuclear power generation has already been established as a key industry in the region and several nuclear reactors are under construction. In addition, a plant for nuclear fuel cycle, which is the only such plant in Japan and the fourth one in the world, has been preparing for its operation. The volume of wind power generation in Aomori Prefecture is number one in Japan. It is proved that Aomori is exactly in the front line of renewable energy.

With regard to the tourism industry, Aomori Prefecture is blessed with attractive tourist spots such as Lake Towada and Mount Osore. It is also endowed with cultural events including the

Nebuta Festival, as well as an abundance of seafood. It is projected that the full opening of the Tohoku Shinkansen Line will lead to a further increase in the number of tourists. Strengthening tourism is an effective tool for tapping demand not only in Japan but also in emerging economies especially in Asia.

In the meantime, I understand that financial institutions in Aomori Prefecture have been active in supporting firms in such areas as nursing care and other health care and welfare services as well as food-related areas including agriculture by partly utilizing the Bank's "fund-provisioning measure to support strengthening the foundations for economic growth."

With those various efforts, Aomori Prefecture has been demonstrating its potential while incorporating the vitality of rapidly growing Asian countries. I wish you the best of success.

The Bank will continue to firmly support economic activity in various areas from the financial side and continue to consistently make contributions as the central bank in order for Japan's economy to return to the sustainable growth path with price stability.