Hidetoshi Kamezaki: Recent economic and financial developments in Japan

Summary of a speech by Mr Hidetoshi Kamezaki, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Saga, 2 February 2011.

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I. The economy and prices

A. The global economy

Let me start by describing the situation in which the global economy currently finds itself. From 2000 onward, the global economy – after a period of stagnation in the wake of the bursting of the IT bubble – enjoyed sustained high growth led by improved productivity in many economies, owing to the advance of globalization and increased participation of emerging economies in the global market. In the United States, household consumption was buoyant, based on borrowing using increased home values as collateral. The hike in housing prices was due in part to increased demand from a growing population and the baby boomers, with funds made available by financial institutions. Through financial engineering, these institutions in turn raised low-cost funds from around the world in exchange for securitized products with a high credit rating backed by such housing loans. Furthermore, in the southern European and Baltic economies, growth accelerated because they were able to attract considerable foreign investment on the basis of a stable exchange rate and low interest rates due to the adoption of, or a peg to, the euro. China registered robust growth as its entry into the World Trade Organization (WTO) helped it to attract direct foreign investment. It was around this time that the emerging economies of Brazil, Russia, India, and China, which saw continued high growth driven by domestic demand, were collectively dubbed the BRICs.

However, housing prices in the United States peaked around 2006 and started to decline, leading to an increase in defaults by households that had taken out mortgages based on the belief that housing prices would continue to rise. This resulted in an increase in defaults on mortgage-backed securities, and investors around the world that had purchased these products suffered losses. Investors increasingly withdrew funds from risk assets, causing turbulence in financial markets in Europe and the United States from around summer 2007, culminating in a full-blown financial crisis with the failure of Lehman Brothers in autumn 2008. Credit concerns gave rise to turmoil in financial markets and led to a deterioration in economic activity, which in turn affected financial institutions and markets, giving rise to a vicious circle that resulted in a severe global downturn. In addition, the fall in asset prices created a heavy debt burden for some financial institutions and households, forcing them to adjust their balance sheets and curtail spending, putting further downward pressure on the economy.

Against this background, countries around the world introduced large-scale monetary and fiscal measures with the aim of bringing the deterioration in the economy to a halt. As a result of these measures, the global economy started to pick up around spring 2009, helped by the completion of inventory adjustments. Thereafter, emerging economies swiftly returned to a high growth path, while advanced economies recovered due to the strength of increased demand from emerging economies, monetary and fiscal measures, and the rebuilding of inventories. The United States, for example, is continuing to recover at a moderate pace, as is the euro area as a whole, although the pace of recovery there differs by country. Meanwhile, a number of developments have caused concerns, such as the Dubai debt crisis in autumn 2009, the Greek financial crisis in spring 2010, and the economic deceleration from summer to autumn 2010 after the completion of fiscal stimulus measures and inventory restocking, but these concerns have been overcome. It must be noted, however, that the pace of recovery in the advanced economies, particularly in Europe and the United States, is showing little sign of accelerating, since many economic entities are burdened with heavy debt repayments, and as a result, refrain from forward-looking spending and investment. In the United States, for instance, the sharp fall in housing prices means that many households have negative equity, making it also difficult for financial institutions to collect mortgage repayments. Furthermore, in some peripheral European countries, governments and financial institutions that borrowed a large amount of funds from overseas when their economies were strong are finding it difficult to repay loans due to the economic downturn.

The global economy is expected to continue recovering, although the stark difference in the pace of growth – with high growth in the emerging economies and weak growth in the advanced economies, particularly in Europe and the United States – is set to persist. Yet, I think there are substantial downside risks with regard to the U.S. and European economies, since domestic demand remains vulnerable to shocks given the heavy debt burden in these countries. It is also necessary to be aware of the risk that problems in some peripheral European countries may trigger turmoil in international financial markets, exerting a negative shock on the global economy again. On the other hand, although emerging and commodity exporting economies – which are enjoying a virtuous cycle of growth in production, income, and spending – are in the process of tightening monetary policy, there is a risk that growth will accelerate further due to inflows of surplus funds from advanced economies, which are continuing to pursue loose monetary policies. From a longer-term perspective, however, this represents a downside risk, since it could lead to inflation or an overheating of asset markets, which would necessitate strong tightening measures.

B. The Japanese economy

The Japanese economy also got off to a weak start at the beginning of the 2000s, but then from 2002 to 2007 experienced the longest period of economic expansion since the end of World War II, owing mainly to robust external demand. Thereafter, the economy declined, falling steeply in response to the crisis triggered by the failure of Lehman Brothers in autumn 2008, but started to recover after leveling off around spring 2009. The driving force of the recovery in Japan was the recovery in overseas economies and government measures to stimulate sales of environmentally friendly goods, boosting exports and durable consumer goods sales. The increase in production then positively affected corporate profits, employment, and business fixed investment.

The economy has been recovering moderately, but the recovery appears to have paused since autumn 2010 due to the deceleration in overseas economies, the phasing out of the various stimulus measures to increase demand for environmentally friendly goods, and the appreciation of the yen. At present, the economy is at a critical juncture and could either start to grow again or, if it fails to gain momentum, start shrinking. Fortunately, the deceleration of overseas economies appears to have ended and exports are thus expected to start recovering soon. Furthermore, it seems that the economy will not be weighed down long by the end of measures to stimulate demand for environmentally friendly goods, given that car production and sales have recovered somewhat due to efforts by automakers to launch new models after the expiration of subsidies. Moreover, the appreciation of the yen has also come to a halt for the time being. Therefore, the Japanese economy is highly likely to soon emerge from the present pause and resume its moderate recovery. Consequently, the general improvement in the employment and income situation and in business fixed investment is likely to continue. A strong recovery, however, is unlikely, as households and firms will be wary of undertaking forward-looking spending and investment due to persistent concerns about the future.

Naturally, this outlook is subject to uncertainty. As mentioned, there are both upside and downside risks to overseas economic developments that are likely to influence exports and overall corporate activity in Japan. On the domestic front, a downside risk is that spending and investment by households and firms will be dampened further by weak growth expectations due to population decline as well as concerns regarding the pension system and the fiscal deficit. On the other hand, if, such concerns were to ease, this could lead to an increase in spending and investment.

C. Recent price developments

Next, I will move on to price developments. Prices in international commodity markets have recently been increasing, reflecting particularly the growth in emerging economies and inflows of surplus funds due to monetary easing in advanced economies. As a result, import prices in Japan have been rising, despite the considerable downward pressure from the ongoing appreciation of the yen. The domestic corporate goods price index (CGPI), which measures fluctuations in prices of goods traded between firms in Japan, has also been rising moderately.

In contrast, the year-on-year rate of change in the consumer price index (CPI) excluding fresh food (the core CPI), which measures the price of goods and services purchased by households, has been in negative territory since March 2009, indicating that deflation is continuing. However, since reaching a year-on-year rate of decline of 2.4 percent in August 2009, the pace of decline in the core CPI has been moderating. Meanwhile, the pace of decline in the CPI excluding food and energy, or the core-core CPI, which is less susceptible to international commodity price fluctuations, has also been moderating after the year-on-year rate of decline reaching 1.6 percent in April and May 2010. Likely reasons are the increase in international commodity prices and the narrowing of the negative output gap as a result of the recovery of the Japanese economy.

In terms of the outlook, the year-on-year pace of decline in the core CPI is expected to continue slowing, reflecting the rise in international commodity prices and the narrowing of the negative output gap, and I think that the rate of change in the CPI may even enter positive territory in fiscal 2011. However, needless to say, there are risks to the outlook for prices, just as there are risks to economic activity. First, there is the possibility of an upswing in international commodity prices caused by strong growth in emerging economies. On the other hand, if pessimism among the public spreads due to a slower-than-expected recovery of the economy, there could be a decline in the medium- to long-term inflation expectations – which are stable at the moment – possibly leading to a fall in the actual inflation rate. Lastly, a technical factor is the possible effects of the base year revision for the CPI, which is scheduled to take place in summer 2011. Taking into account the experience of past such revisions, it is highly likely that the year-on-year rate of change in the CPI on the basis of the new base year will be lower than that on the basis of the current base year. Of course, such statistical changes leave economic activity unaffected, and with medium- to long-term inflation expectations stable and prospects for a moderate improvement in the aggregate supply and demand balance, it seems certain that the Japanese economy is headed in the direction of overcoming deflation.

D. Outlook for economic activity and prices

The outlook I just presented is my own personal assessment. Let me now turn to the *Outlook for Economic Activity and Prices*, known as the Outlook Report, which the Bank of Japan releases semiannually, in April and October. The Outlook Report presents the Policy Board members' assessments for economic activity and prices based on the forecasts in the form of numerical values. In addition to the semiannual Outlook Report, the Bank releases interim assessments in July and January, which present the Bank's revised projections.

In the most recent projection released in January 2011, Policy Board members considered it most likely that real GDP in fiscal 2010 would grow 3.3 percent on a year-on-year basis reflecting the rebound from the contraction in the preceding year. Following the relatively high rate of growth in fiscal 2010, real GDP is then projected to continue increasing moderately in the following years, at a rate of 1.6 percent in fiscal 2011, and 2.0 percent in fiscal 2012. The year-on-year change in the core CPI is projected to remain negative in fiscal 2010 at minus 0.3 percent – this excludes the effects of subsidies for high school tuition, which would cause a further decline of 0.5 percentage point – but is expected to turn moderately positive thereafter, to plus 0.3 percent in fiscal 2011 and plus 0.6 percent in fiscal 2012. It should be noted, however, that these figures do not incorporate possible effects of the base year revision for the CPI this summer.

Policy Board members make their forecasts in terms of a range of values rather than a point estimate, and they then attach a probability of realization to each of the values. The collective view of the Policy Board has been that risks are balanced on the whole.[1]

II. Measures taken by the Bank

Next, I will outline the policy measures taken by the Bank following the Lehman shock.

A. Measures to address the financial crisis

After the failure of Lehman Brothers in autumn 2008, financial market participants around the world became overly cautious about a possible chain reaction of bankruptcies and started to retain funds as on-hand liquidity rather than lend them to other participants, resulting in a sharp financial contraction. In order to address this situation, the Bank, as emergency measures to provide liquidity for financial markets, successively conducted same-day funds-supplying operations, introduced U.S. dollar funds-supplying operations, and accepted bonds issued by the governments of the United States, the United Kingdom, Germany, and France as eligible collateral. Furthermore, the Bank decided to introduce outright purchases of commercial paper (CP) and corporate bonds, based on the recognition that a significant decline in the functioning of markets, such as the serious shortage of liquidity in the CP and corporate bond markets, was causing a tightening of overall corporate financing conditions. In addition, the Bank introduced a series of temporary emergency measures to facilitate corporate financing, including the easing of the rating requirement for corporate debt to be accepted as eligible collateral and the special funds-supplying operation to facilitate corporate financing, through which the Bank provided 3-month funds for an unlimited amount against the value of corporate debt pledged as collateral at a fixed interest rate of 0.1 percent.

Furthermore, in order to ensure an accommodative financial environment, the Bank reduced the target level of the policy interest rate (the uncollateralized overnight call rate) from 0.5 percent to 0.1 percent, which is the lowest level in the world. In order to provide ample liquidity by maintaining the policy interest rate at this low level, the Bank also introduced the complementary deposit facility, whereby interest is made payable on excess reserve balances held at the Bank by financial institutions.

Moreover, the Bank introduced temporary measures to secure the stability of the financial system, given that the strains in global financial markets and the subsequent fall in stock prices and rise in credit costs had greatly affected financial institutions' intermediary function and financial soundness. Such measures include the purchase of stocks held by financial institutions to help them reduce the market risk associated with stock holdings and the provision of subordinated loans to banks to help them maintain sufficient capital bases.

The Bank gradually brought some of these temporary measures to an end as financial markets regained stability.

[1] For details, see Appendix 2 (Risk Balance Charts) of the "Statement on Monetary Policy" released on January 25, 2011.

B. Recent conduct of monetary policy toward a sustainable growth path with price stability

Financial markets have recently been stable and the economy has been showing signs of a moderate recovery, but the Bank recognizes that the Japanese economy is still experiencing deflation. With a view to overcoming deflation and returning the Japanese economy to a sustainable growth path with price stability, the Bank continues to consistently make contributions as the central bank and is currently utilizing a three-pronged approach of pursuing powerful monetary easing through comprehensive monetary easing, ensuring financial market stability, and providing support to strengthen the foundations for economic growth.

1. Pursuing powerful monetary easing

The Bank aims to pursue powerful monetary easing through the implementation of the comprehensive monetary easing policy decided in October 2010. This policy consists of three measures: a change in the guideline for money market operations; a clarification of the policy time horizon; and the establishment of an Asset Purchase Program.

Regarding the first measure, the change in the guideline for money market operations, the Bank lowered the uncollateralized overnight call rate target from previously "around 0.1 percent" to "around 0 to 0.1 percent." Although the target rate of 0.1 percent was already extremely low, by allowing the target rate to fall below 0.1 percent, the Bank clarified that it is pursuing a virtually zero interest rate policy.

As for the second measure, the clarification of the policy time horizon, the Bank made it clear that it will maintain the virtually zero interest rate policy until it judges that price stability is in sight, on condition that an examination of risk factors, including the accumulation of financial imbalances, reveals no problems. Price stability here is defined on the basis of the "understanding of medium- to long-term price stability" (hereinafter, the "understanding") announced by the Bank and refers to the level of inflation that each Policy Board member understands, when conducting monetary policy, as being consistent with price stability over the medium to long term, with the midpoints of most Policy Board members' "understanding" being around 1 percent. The Bank has made it clear that the Policy Board does not tolerate a year-on-year rate of change in the CPI equal to or below 0 percent. Usually, in an economic recovery phase, there are various forecasts as to when the policy rate will be changed and projections for longer-term interest rates consequently vary. The clarification of the policy time horizon – that is, the clarification of the conditions necessary for a change in the policy rate – should lead to a convergence in market expectations regarding future changes in policy and therefore help to stabilize longer-term interest rates. As the economic recovery progresses and corporate profits improve, this "policy duration effect" should exert significant further easing effects, since firms' funding costs decline relative to their profits.

As the third measure of the comprehensive monetary easing policy, the Bank established the Asset Purchase Program worth about 35 trillion yen to purchase various financial assets, such as government securities, CP, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs), as well as to conduct fixed-rate funds-supplying operations against pooled collateral whereby funds with a maturity of three or six months are provided at an interest rate of 0.1 percent. In the money market, where the Bank conducts daily operations as the central bank of Japan, most short-term interest rates are already close to zero, and there remains little room for further declines. Therefore, to achieve additional monetary easing, it is necessary to influence longer-term interest rates and prices of risk assets. It is for this reason that the Bank established the Asset Purchase Program, which aims at purchasing financial assets, including risk assets, thereby encouraging a decline in longer-term market interest rates and a reduction in various risk premiums. While the purchase of risk assets such as ETFs and J-REITs is an extraordinary measure for a central bank, the aim is that this will act as a catalyst for market participants to take a more active investment stance, thereby helping to smooth the intermediation of risk money and further improve firms' funding conditions.

2. Ensuring financial market stability

In order to fully ensure financial market stability, the Bank has been implementing a variety of measures including the utilization of various funds-supplying operations, even in the current situation where Japanese financial markets have been relatively stable. Specifically, the Bank has provided ample funds to financial markets, with the year-end outstanding balance of current accounts at the Bank last year exceeding 22 trillion yen, which was above the 20 trillion yen in 2009, and the 15 trillion yen in 2008, the year of the Lehman shock. However, measures include not only the amount of funds supplied but also steps to provide financial institutions with the confidence that they can obtain sufficient funds whenever necessary. For example, temporary measures introduced in response to the financial crisis that continue today include the complementary deposit facility, the acceptance of foreign government bonds as eligible collateral, and U.S. dollar funds-supplying operations. These measures aim to forestall a return of instability in financial markets.

3. Providing support to strengthen the foundations for economic growth

Moreover, in order to strengthen the foundations for economic growth, the Bank has been implementing a measure 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. Currently, financial markets and financial institutions have abundant funds, firms have strong cash flows, and households hold an enormous amount of financial assets. Nevertheless, the Japanese economy has yet to show robust growth, indicating that the issue at stake is not a shortage of funds, but the unwillingness of economic entities to undertake forward-looking spending and investment. Underlying this situation is the fact that the decline in the growth trend of the economy has led to a decline in firms' and households' growth expectations, which in turn gives rise to insufficient domestic demand – the fundamental cause of the current deflation. In this situation, the Bank aimed to address the fundamental cause of the current deflation by making use of its function as the central bank and making more funds available to new areas of growth to raise growth expectations. While this fund-provisioning measure alone is unlikely to be enough to raise Japan's growth potential, the Bank hopes that by acting as a catalyst it will prompt discussions on this issue as well as efforts to strengthen the foundations for economic growth.

Looking at the outcome so far, I would say that most of the objectives of the fund-provisioning measure implemented in June 2010 have been achieved. Many financial institutions nationwide have shown an interest in the measure, and among the 140 financial institutions that applied, more than 100 financial institutions have been selected as counterparties. The total amount of loans provided through the two rounds of loan disbursements carried out by the Bank so far is about 1.5 trillion yen, which is already about half of the maximum amount of loans – 3 trillion yen – to be disbursed under the measure, with a year and a half still remaining until June 30, 2012, when the last disbursement of new loans is to take place. Areas eligible for loans or investment range, for example, from environment and energy business, development of social infrastructure, medical and nursing care business, and regional revitalization business to business deployment in Asian countries, and include efforts to support local industries. The measure is gradually producing positive effects as a catalyst – its intended purpose – since, although the maximum duration of loans provided under the measure is four years, more than 70 percent of actual individual loans or investments exceed this period. Moreover, following the introduction of the measure, financial institutions have been establishing new dedicated funds and lending schemes, and some of them in certain cases have set a higher ceiling on the total amount of lending or investment than the 150 billion yen ceiling for the total amount of loans that they could obtain from the Bank.

III. Toward a sustainable growth path with price stability

I will talk next about the structural problems facing the Japanese economy. As I have explained, the economy has been showing signs of a moderate recovery but is still experiencing deflation because the growth momentum remains weak. The "lost decade" following the bursting of the bubble economy has unfortunately turned into "two lost decades." It is necessary to consider what can be done to avoid a third lost decade.

A. Japan's process of economic development

Let us look back on Japan's process of economic development in the past. Right after the end of World War II, Japan looked to the affluent advanced economies of Europe and the United States. At this point, Japan enjoyed a latecomer advantage and, with hard work, was in a position to aim at catching up and even overtaking these economies relatively quickly. Moreover, benefiting from a rise in the working-age population and the so-called population bonus – the increase in the share of the working-age population in the total population – it was easy to accelerate growth. Furthermore, with industrialization having already gotten underway before the war, Japan at the time was among the few countries that could produce high-quality manufactured goods at a low price and had few competitors in the international market. This favorable environment and Japan's economic model – based on detailed government industrial policy, strong support for firms from the main bank system, and strong employee loyalty based on the seniority system and lifetime employment – helped form a positive cycle facilitating a high rate of growth.

As a result, in 1968, Japan became the world's second largest economy, and in the 1970s entered the ranks of the advanced economies, almost equal in terms of per capita GDP with the advanced economies of Europe and the United States. However, by joining the world's leading economies, it lost its latecomer advantage. Moreover, around this time the population bonus also started to fade. Thus, the conditions that had propelled high-speed growth changed drastically, and with the outbreak of the oil crises and the appreciation of the yen, high-speed growth came to an end. Stable growth, however, was maintained thanks to the continued upward trend in the working-age population and the absence of competitors in the production of manufactured goods. In the 1980s, a large proportion of the population was able to enjoy a satisfactory standard of living. At the same time, however, the increased presence of the Japanese economy in international markets intensified trade friction, leading to a rising yen after the Plaza Accord. Foreign pressure rose for a wider opening of Japanese markets and for financial deregulation. It is against this background that the bubble economy emerged.

The 1990s started with the tumbling of the Nikkei Stock Average, which had set a record high at the end of 1989. The bubble had burst, and Japan had to contend with the disposal of nonperforming loans (NPLs), slow growth, and the onset of deflation, marking the first lost decade. During this period, critical changes took place that affected Japan's growth potential. The first is that the working-age population peaked in 1995 and then started to decline. The decade also saw the globalization of world markets following the end of the Cold War, the liberalization of international capital flows, and advances in information and communications technology, paving the way for the rise of emerging economies. Taken together, these developments clearly signaled the end of the favorable environment that had supported Japan's economic growth. Consequently, growth in domestic demand remained weak in the 2000s, even after the disposal of NPLs had almost been completed. As a result, the lost decade turned into the two lost decades.

B. Restrengthening Japan's economic growth potential

As illustrated by what I just described, the cause of the two lost decades appears to have been the vanishing of the favorable conditions that had propelled economic growth. In order to restrengthen Japan's economic growth potential, efforts need to be made to create a favorable environment. For example, to reduce the negative effects of the fall in the working-age population on economic growth, measures should be taken to raise the labor force participation rate of women and the elderly. There is no question that the government, firms, and society as a whole need to work together, for example, to improve the environment for child rearing and actively promote employment policies that encourage the acquisition of new skills. Furthermore, to cope successfully with competition in global markets, Japan should improve its competitive environment by, for example, concluding more free trade agreements (FTAs) and economic partnership agreements (EPAs). Japan also needs to maintain and improve its model of growth based on benefiting from rapid growth in overseas economies, which has served it well so far. To this end, it is necessary to boost productivity in agriculture to strengthen the sector's international competitiveness and ensure that it is not left behind in overall economic growth.

In addition, we need to build a new growth model that reflects the changing economic environment. To stay in the forefront of global competition, it is necessary to devise and develop new areas of growth – simply following the example or copying the products of others will allow latecomers to catch up in no time. Firms need to take risks and pioneer new areas of business. It is also necessary to shift factors of production among industries to improve the efficiency of resource allocation. Areas where efforts should be strengthened without delay include environment-related sectors, where Japan has a technological edge, and areas linked with population aging, such as the nursing care and medical industry, since Japan has the fastest-aging society in the world. Successful implementation of efforts to this end should result in highly competitive new business models capable of capturing global demand.

In order to strengthen economic growth potential, existing business structures must also be modified to suit the new environment. For example, it is important to proceed with further deregulation to encourage creativity and entrepreneurship by firms and individuals. Furthermore, some of the institutions that were devised on the assumption of high growth are becoming too costly to maintain in the current period of low growth; for the sake of efficiency, it is necessary to take measures to promote structural reform. In the past, deregulation has led to the birth of new areas of business such as mobile phones and door-to-door parcel delivery services and increased diversity in employment patterns, which has expanded employment opportunities. Moreover, increased efforts to correct high-cost structures have narrowed the differences between prices in domestic and foreign markets. Endeavors such as these will in due course inject vitality into the Japanese economy.

At the same time, it is extremely important to reform the social security systems and to work on fiscal consolidation, since public concerns over the future of the pension system and public finances hamper economic growth by putting a brake on forward-looking spending and investment. Weak economic growth has made firms, individuals, and the government reluctant to take on new challenges and push ahead with painful reforms, and has made the economy heavily dependent on fiscal spending for a prolonged period. As a result, government debt has ballooned, and the combined long-term debt outstanding of the central and regional governments in Japan is forecast to reach 869 trillion yen at the end of March 2011, which is about 1.8 times Japan's nominal GDP. Japan is thus in no position to merely sit back and observe the sovereign debt problems in Europe, which I touched upon earlier, and which were triggered by concerns about fiscal sustainability. A solution must be found before Japan suffers a serious loss of credibility in the markets.

C. Measures taken by the Bank

As I said earlier, the Bank continues to consistently make contributions as the central bank in order to overcome deflation and return the Japanese economy to a sustainable growth path with price stability. The Bank's efforts through the conduct of monetary policy also aim to help strengthen Japan's economic growth potential. The Bank must always be ready to proactively implement the necessary policies to achieve its objectives. Going forward, the Bank should continue to be proactive and do its utmost to bring the Japanese economy back to a sustainable growth path with price stability.