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

Speech by Mr Tadao Noda, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Kumamoto, 3 March 2011.

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I. Overseas economies

I will begin by outlining overseas economies.

Overseas economies are continuing to recover from the downturn following the global financial crisis after the failure of Lehman Brothers in the autumn of 2008. Although there have been inventory adjustments in IT-related goods since summer 2010, this has not exerted much downward pressure on economic activity. Looking ahead, overseas economies are expected to continue to recover, but while emerging economies are likely to continue to show relatively high growth fueled by growth in domestic demand, the recovery in advanced economies is likely to lack strength. This divergence in growth trends has been referred to as the “two-speed recovery” or “two-track recovery.”

A. Recovery in advanced economies lacks strength

Let me first talk about advanced economies.

The U.S. economy continues to recover. Led by increases in exports, corporate profits have been on a recovery trend, and business fixed investment has been rising moderately. In particular, private consumption, the main demand component, is growing quickly at present. Growth in consumption is currently outpacing increases in disposable income, and household saving rates, which rose after the failure of Lehman Brothers, have begun to decline. These developments can be attributed in part to the rise in stock prices fueled by additional stimulus measures, both from the monetary and fiscal sides. The recovery trend is expected to continue against the background of increasing exports, especially to emerging economies, and the accommodative financial environment. Firms, however, remain cautious about hiring new employees, and it will take time to resolve household balance-sheet problems, which were partly responsible for the financial crisis. While the recent rise in stock prices should accelerate the pace of balance-sheet adjustments, the resumption of the decline in home prices will act as a brake. As Japan’s experience after the bursting of the bubble economy shows, balance-sheet adjustments impede the virtuous circle of growth in production, income, and spending. Therefore, the pace of recovery in the U.S. economy is likely to remain moderate.

Economic activity in the euro area as a whole has been recovering moderately, with some differences in pace by country. In particular, the German economy has been growing notably, with exports boosted by a weak euro. Going forward, Germany is expected to enjoy steady growth led mainly by buoyant exports. However, due to the effects of fiscal austerity, economic growth in some peripheral countries is likely to remain sluggish as both the public and private sectors are mired in excessive debt.

B. Continued high growth in emerging economies

Next, I will talk about emerging economies. On the whole, business fixed investment has been increasing reflecting higher capacity utilization rates, and private consumption has been boosted by the improvement in the employment and income situation resulting from increased production. Since emerging economies do not face the kind of structural problems weighing down on advanced economies such as balance-sheet adjustments and deteriorating fiscal conditions, the virtuous circle of growth in production, income, and spending operates normally and emerging economies are expected to continue to show relatively high growth.

China, which takes center stage among emerging economies, continues to enjoy high year-on-year growth in excess of 9 percent. Growth in exports temporarily slowed in the middle of 2010 due to the completion of global inventory restocking following the recovery from the global financial crisis. At present, however, exports have regained their upward momentum. As for the outlook, the Chinese economy is expected to continue to grow at a rapid pace, with infrastructure-related investment remaining on an increasing trend, and private consumption continuing to expand due to increases in household incomes.

II. Japan's economy

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

A. Economy emerging from a temporary pause

Since the early autumn of 2010, there has been a temporary pause in Japan's economic recovery, partly due to the slowdown in overseas economies and the decline in the demand for some types of consumer goods following the previous sharp increase. As a result of the recovery in overseas economies, however, the economy seems to have been emerging from its temporary pause.

Exports have resumed their upward trend amid the reacceleration of growth in overseas economies and the progress in inventory adjustments in IT-related goods I just mentioned. Specifically, real exports declined in January from the previous month, partly reflecting the large increase in December – the first in five months – but are showing signs of resuming their uptrend. As for private consumption, while demand for some goods has fallen back following the sharp, last-minute increase in demand ahead of the expiration of subsidies for purchases of environmentally friendly cars and of the eco-point system for household electrical appliances, consumption of other goods and services has generally been firm. Under these circumstances, production has been showing signs of improvement since November.

As for the outlook, exports are likely to continue to trend upward on the back of the improvement in overseas economies. Private consumption is likely to pick up gradually as the effects of the decline in demand following the previous sharp increase gradually dissipate. With corporate profits showing solid improvements, business fixed investment is also likely to start picking up. Thus, led by the recovery in exports, Japan's economy is likely to return to a recovery path with clear signs of a self-sustaining recovery trend.[1] That being said, however, private consumption is likely to remain subdued given that the employment and income situation – although easing somewhat – remains severe. Furthermore, the pace of improvement in business fixed investment is likely to remain moderate since it will take time until firms' sense of excessive capital stock is dispelled, and the relative share of overseas investment has been increasing reflecting the widening gap between the economic growth potential at home and abroad.

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[1] 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. The Policy Board members' forecasts for real GDP are presented as reference figures in the respective months. In January, the median of Policy Board members' forecasts for GDP growth was 3.3 percent for fiscal 2010, 1.6 percent for fiscal 2011, and 2.0 percent for fiscal 2012.

B. *Weaker downward pressure on prices*

As for prices, the year-on-year pace of decline in the consumer price index (CPI), excluding fresh food and the effects of the special subsidies for high school tuition introduced in April 2010 as part of the government's economic stimulus measures to reduce the cost of high school education, is slowing moderately due to the gradual improvement in the aggregate supply and demand balance in the economy as a whole.[2] Regarding the outlook, this mechanism whereby the improvement in the aggregate supply and demand balance exerts upward pressure on prices is likely to continue as a trend.

However, it is also likely that the year-on-year rate of growth in the CPI will be revised downward due to the base-year revision for the CPI scheduled for August 2011.[3] Needless to say, regardless of the extent of the revision, prices themselves will remain unaffected and, in conducting monetary policy, such statistical artifacts need to be borne in mind.

C. *Upside and downside risks*

So far, I have talked about the scenario I consider to be the most likely. I will now consider both upside and downside risks that may impinge on the above outlook.

1. Emerging economies

First, I will look at upside and downside risks to emerging economies. The rapid growth of emerging economies, which contrasts sharply with the weak momentum for recovery in advanced economies, continues to lure capital from investors seeking higher returns.[4] The inflows appear to have been amplified by the continued large-scale monetary easing in advanced economies as well as the fixed or semi-fixed exchange rate regimes adopted by some emerging economies with the aim of keeping their currencies from appreciating. The further expansion of emerging economies will – for the time being – exert large positive effects on the economies of advanced countries, including Japan, through higher exports. However, if emerging economies continue with easy monetary policies, they may fall behind the curve.[5] This could cause their economies to overheat, and any adjustment that follows could result in a rapid unwinding of excesses, leading to a contraction of economic activity.

2. Global commodity markets

Next, I will talk about the rise in overall commodity prices. There is no doubt that the fundamental cause is a tighter supply and demand balance caused by robust demand from emerging economies and decreasing supply due to unseasonable weather in some

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[2] The year-on-year rate of change in the CPI excluding fresh food – the core CPI – has remained negative (with a value of minus 0.4 percent in December 2010, and minus 0.2 percent in January 2011). However, when the effects of the special subsidies for high school tuition introduced in April 2010 are excluded to gauge the trend changes in consumer prices, the year-on-year rate of change in the core CPI has turned positive, registering 0.1 percent in December 2010 and 0.3 percent in January 2011.

[3] At present, calendar year 2005 is used as the base year for calculating the year-on-year rate of change in the CPI. In August, the base year will be changed to 2010 and year-on-year figures as far back as January 2011 will be revised retroactively.

[4] At present, the pace of capital inflows to emerging economies is decelerating due to concerns about rising inflationary pressures in emerging economies and heightened uncertainty regarding the situation in the Middle East.

[5] With regard to emerging economies with *de facto* fixed exchange rate systems, there appears to be a tendency for monetary tightening to fall behind. In open economies, it is said that three objectives are not attainable simultaneously: (1) independent monetary policy; (2) fixed exchange rate systems; and (3) free international movement of capital. Many advanced countries, including Japan, have adopted independent monetary policy and free movement of capital, while in principle the foreign exchange rate is determined by the market mechanism.

commodity-exporting economies. In addition, the recent political unrest in North Africa and the Middle East, triggered by the riots in Tunisia, has been adding to the uncertainty over the supply of crude oil, sending prices sharply higher. Furthermore, the nature of commodity transactions has changed with the introduction of commodity futures trading. In the past, the price of each commodity moved independently of other commodities, reflecting the differing supply and demand structures. However, since around the mid-2000s, advances in the infrastructure for commodity futures trading have led to the creation of products such as commodity indexes and exchange-traded funds (ETFs) that combine exchange-traded futures on commodities and financial assets. The growing use of these products has resulted in the price movements of various commodities, as well as the prices of commodities and financial assets such as stocks, to be more closely linked. Against this background of "financialization" of commodities, it cannot be denied that accommodative monetary conditions around the world have fueled expectations of higher commodity prices and accelerated the rise in global commodity prices.

Inflationary pressures have increased in emerging economies due to higher food and raw material prices reflecting the rise in global commodity prices, coupled with higher utilization rates of production factors such as labor and facilities.[6] If global commodity prices continue to rise beyond what is warranted by fundamentals such as the increase in demand in emerging economies, resource-importing economies – both advanced and emerging – will see a decrease in consumption expenditure through a decline in real purchasing power. If the increases in costs cannot be passed on to prices of final products, corporate profits will be squeezed, resulting in a negative impact on consumption through a deterioration in the employment and wage environment.[7]

3. Industrialized economies

The third risk concerns advanced economies. As I mentioned earlier, the U.S. economy is burdened with balance-sheet adjustments. Dealing with them will take time, and U.S. economic activity therefore still looks unlikely to accelerate and remains vulnerable to downside risks. I personally have remained cautious about the outlook for the U.S. economy throughout. However, forecasts by private-sector economists have fluctuated greatly since the beginning of 2010.[8] The divergent views regarding the outlook have probably been caused by differing opinions regarding the time it will take to resolve the balance-sheet problems.

A risk common to many advanced economies is the sharp growth in public debt. When the market's confidence in fiscal sustainability declines, economic activity is negatively affected due to the adverse feedback loop between financial and economic activity. In some peripheral European countries, such a negative feedback loop has already materialized, creating persistent tensions in financial markets. However, this has not spread to other regions so far thanks to the establishment and expansion of support mechanisms to maintain stability in the region such as the European Financial Stability Facility.

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6 The political unrest in North Africa and the Middle East is believed to have been triggered by rising food prices, which meant that a growing part of the population was thrown into poverty.

7 At the meeting of the Group of Twenty (G-20) Finance Ministers and Central Bank Governors held in February 2011, it was agreed to create a new study group charged with examining the impact of rising global commodity prices on global economic and financial conditions and reporting back to the G-20.

8 Forecasts for U.S. economic growth for both 2010 and 2011 by private-sector economists as of the beginning of 2010 averaged between 3.0 and 3.5 percent. In the summer of 2010, the forecasts were revised downward to levels well below 3.0 percent, and were then revised upward again toward the end of 2010. These fluctuations in the forecasts caused swings in the sentiment of households, firms, and financial markets, and led to increased volatility in economic activity.

III. Growth potential of the Japanese economy

So far, I have talked about the outlook for the Japanese economy from a cyclical perspective. I would now like to discuss it from a longer-term perspective.

Since 1990, following the bursting of the bubble economy, Japan's average annual growth has hovered at a low level of around 1–2 percent. The sustained economic expansion from fiscal 2002 to 2007 was in reality supported by a global financial bubble. With the benefit of hindsight, I am afraid I have to say that it is clear the self-sustaining growth mechanism during that period was not sufficiently robust.

In the high-growth era during the 1960s and the stable growth period from 1970 to the 1980s, the Japanese economy was blessed externally with an international competitive environment that was beneficial to Japan's economic model designed to catch up with advanced economies, and internally, with an upward trend in the working-age population.[9] From the 1990s onward, however, international competition intensified and the working-age population started to decrease. As a result, growth had to be based increasingly on a "pioneering spirit," that is, the ability to discover hitherto unknown demand and create new markets. Thus, the main reason for Japan's decline in productivity and in the economic growth trend has been an inability to cope with fundamental structural changes in the world economy. How should Japan address these challenges?

It is clear that the expanding global economy provides ample potential demand, particularly in emerging economies. Though less obvious, it is also true that there are no limits to demand at home. Statistics show that there remains an output gap in Japan. This gap, however, only shows the size of the shortage in demand relative to the *current* supply capacity. Looked at from a different angle, this simply means there is a shortage of the kind of supply that meets the kind of latent demand which is there. Let me be more specific. Although the aging of society has generated wide-ranging potential demand for medical and nursing care as well as demand in other related areas, a regulatory framework that is rooted in Japan's traditional economic system has hindered potential demand from materializing. Thus, it could be said that the ability to "pioneer" I mentioned earlier requires economic actors capable of tapping potential demand and a nation that provides an institutional environment encouraging the production of valuable goods and services through free market competition.

With regard to overseas markets, it is important for Japan to open up and steer boldly toward the objective of integrating domestic and overseas markets. Needless to say, this challenge needs to be tackled immediately so as not to miss out on the enormous demand for goods and services in expanding global markets. At the same time, this greater integration with the global economy would allow the free movement not only of goods and services but also of human resources and capital, and would both require and promote deregulation. While it may sound a bit hyperbolic, such integration could further advance the international division of labor to an extent where the distinction between domestic and foreign demand becomes irrelevant except for statistical expedience.

Another pressing issue is the improvement of the fiscal balance. Restoration of the fiscal balance is necessary not only from the perspective of fiscal sustainability but also from the perspective of restoring economic growth. The public debt being accumulated under the current social security system increases intergenerational differences in lifetime incomes, and the growing burden for future generations is weighing down income expectations and restraining consumption by the working-age population.

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9 Characteristic features of Japan's economic model include (1) government intervention in a wide range of private-sector economic activities; (2) the importance of long-term business relationships as exemplified by cross-shareholdings, the main bank system, and lifetime employment; and (3) an income distribution mechanism that helps to prevent large disparities in income.

IV. Conduct of monetary policy

A. Policy responses by the Bank of Japan

Next, I will explain the policy measures implemented by the Bank so far.

1. Pursuing powerful monetary easing

In October 2010, the Bank introduced a policy of "comprehensive monetary easing" consisting of three measures. First, the Bank lowered the target for the uncollateralized overnight call rate to around 0 to 0.1 percent and clarified that it was pursuing a virtually zero interest rate policy. Second, the Bank announced its commitment to maintaining the virtually zero interest rate policy until it judged, on the basis of the "understanding of medium- to long-term price stability" (hereafter the "understanding"), that price stability was in sight. The "understanding" is the inflation rate level that each of the nine Policy Board members understands as being consistent with price stability over the medium to long term. On the basis of a year-on-year rate of change in the CPI, each Policy Board member's "understanding" falls in a positive range of 2 percent or lower, and the midpoints of most Policy Board members' "understanding" are around 1 percent. In other words, the Bank provided clarification of the time horizon of the virtually zero interest rate policy. And third, given that there was little room for a further decline in short-term interest rates, the Bank established a program on its balance sheet to purchase various financial assets, such as government securities, ETFs, and Japan real estate investment trusts (J-REITs), to encourage a decline in longer-term interest rates and various risk premiums.

Developments in financial markets since the implementation of the "comprehensive monetary easing policy" reveal that, in the money market, interest rates on term instruments have declined, spreads on corporate bonds have narrowed, and various risk premiums have generally been declining, as seen in the rise in prices of stocks and J-REITs. The environment for corporate financing has been favorable, with issuing conditions for CP and corporate bonds improving, as illustrated, for example, by the decline in lending rates and the increased variety of corporate bond issuers. Long-term interest rates, however, have risen somewhat. The reason is that although the Bank continues to steadily implement the comprehensive monetary easing policy and remains firmly committed to pursuing powerful monetary easing, it is fundamentally difficult for interest rate policy to directly influence long-term interest rates, and the rise in overseas interest rates seems to be affecting Japanese long-term interest rates to some extent.[10]

The outlook for Japan's economy I presented earlier – the scenario considered to be the most likely – is based on the assumption that financial markets will fully factor in the Bank's monetary policy measures taken so far. That is, I judge that, under the Bank's monetary policy, Japan's economy will likely continue to make steady progress toward overcoming deflation and returning to a sustainable growth path with price stability.

2. Providing support to strengthen the foundations for economic growth

Following the implementation of the above measures, in June 2010 the Bank introduced a new fund-provisioning framework, the "Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth." Given the decline in the economic growth trend mentioned earlier, the Bank established the new framework in order to play its part in

[10] Previously, it was widely thought that international bond markets were segmented, and therefore bond yields – at least in the short run – tended to follow idiosyncratic country factors. However, analysis by the Bank published in the February 2011 issue of the *Financial Markets Report* has shown that it is highly likely that government bond yields across countries are linked as a result of common risk perceptions among global bond investors. Please refer to pp. 36–42 of the February 2011 issue of the report, which is available on the Bank's web site at http://www.boj.or.jp/en/index.htm.

addressing this challenge by making use of its central bank functions. The framework provides long-term funds at a low interest rate to financial institutions in accordance with their efforts in terms of lending and investment toward strengthening the foundations for economic growth.

The outline of the fund-provisioning measure is as follows: (1) the total amount of loans shall not exceed 3 trillion yen; (2) the total amount of loans to each counterparty shall not exceed 150 billion yen; and (3) the last disbursement of new loans shall take place by June 30, 2012. The Bank is aware that it is not possible to raise Japan's growth potential solely through this fund-provisioning measure. Rather, the aim is for the measure to act as a catalyst to bring about a shared awareness among financial institutions and firms on the need to raise Japan's growth potential and to make various efforts of their own accord to raise the potential economic growth rate and productivity. On March 7, 2011, the Bank will carry out the third new loan disbursement under the fund-provisioning measure to support strengthening the foundations for economic growth, and the total outstanding balance is expected to exceed 2 trillion yen as of March 7. The number of borrower financial institutions[11] has increased to 149 as of the end of February 2011, and the breakdown of these institutions reveals that loans will be provided to various types of institutions across wide regions. Individual investments and loans under the measure cover all of the 18 areas suggested by the Bank as possible investment areas, with investment in "environment and energy business" in the lead. In this context, what has particularly caught my attention is that a large number of financial institutions, on participating in the Bank's disbursement of loans, started to actively make a range of efforts such as establishing new dedicated funds and lending schemes for investments and loans to support strengthening the foundations for economic growth. The Bank believes that this situation suggests that the Bank's measure is producing positive effects as a catalyst, its intended purpose.

B. Future monetary policy conduct and communication

In order for Japan's economy to overcome deflation and return to a sustainable growth path with price stability, I believe it is important for the Bank to steadily continue to carry out the measures I mentioned earlier. In addition, the Bank will continue to carefully examine new economic data and information, so that appropriate policy measures can be taken flexibly if the probability rises of a significant deterioration in the outlook for economic activity and prices or it becomes uncertain that Japan is on the road to overcoming deflation.

In order for these measures to be fully effective, it is vital that they are properly and widely understood by the public. To this end, the Bank holds meetings such as the present one between Policy Board members and business leaders and press conferences by the Governor after Monetary Policy Meetings, and promptly publishes the minutes of the Monetary Policy Meetings. In addition, the Bank makes use of various other communication channels such as its web site as a means of providing information to the public. I think that these efforts do not compare unfavorably with those of other central banks. Moreover, the Bank is doing its utmost to further improve the quality of such forms of communication.[12] For example, as part of such efforts, the Bank launched a renewed web site in January.[13] We

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[11] This refers to the number of financial institutions that obtained the Bank's confirmation for their plans to participate in the new loan disbursement.

[12] For information on the Bank's previous measures to enhance the transparency of monetary policy, please refer to "Transparency of Monetary Policy" on the Bank's web site.

[13] As part of the renewal of the web site, the content structure was rearranged, the pages were redesigned, and the content was expanded, so that users can access more easily the information they need. For more details, please refer to "Renewal of the Bank of Japan Web Site," released on January 14, 2011 on the Bank's web site.

would be delighted to hear your opinions and views regarding the Bank's dissemination of information.