

## **Masaaki Shirakawa: Japan's economy and monetary policy**

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the Kisaragi-kai Meeting, Tokyo, 25 July 2011.

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### **Introduction**

I am privileged to have this opportunity to speak before such a large audience today.

Four and a half months have passed since the Great East Japan Earthquake, an unprecedented tragic event. Immediately after the earthquake, production plunged mainly due to the destruction of capital equipment, supply-chain disruptions, and electric power shortages. After passing through the worst period, however, production activity has been recovering at a faster-than-expected pace with a gradual easing of various supply-side constraints. At the same time, there is also the harsh reality that many still bear hardships that cause them restless days. The conduct of monetary policy is by nature mainly based on a macroeconomic analysis. However, we recognize that the damage from the earthquake disaster varies by area and industry. I myself visited the disaster areas and now have a greater recognition that macroeconomic perspectives are not enough to fully describe the true state of our economy. Even from a macroeconomic perspective, although downside risk has been receding with respect to the supply-side constraints that emerged immediately after the earthquake, Japan's economy is starting to confront another new problem of uncertainty regarding electric power supply in the long run. Even before the earthquake, our economy had faced various pressing structural problems, including the rapid aging of the population.

So, this brings us to the end of a somewhat lengthy introduction. Today I will first describe the current state of Japan's economy and its outlook. After illustrating the challenges confronting our economy, I will explain the Bank of Japan's conduct of monetary policy. In my remarks, I would like to pay due attention to the time horizon by clearly delineating short-term and medium- to long-term periods.

### **I. Developments in overseas economies**

I will begin with developments in overseas economies, which form the basis for analyzing those in Japan's economy. The impact of the recent earthquake has been enormous, and recent economic debate tends to focus on the effects of the disaster. Needless to say, the global economy and financial markets keep changing while we deal with the aftermath of the disaster. After all, when the supply-side constraints are resolved, developments in overseas economies will be the most significant driver of Japan's economic activity in the short run.

The U.S. economy has been growing at a slower pace since this spring. This is partly because households' real purchasing power has declined due to the rise in gasoline prices seen until around spring, and there have been difficulties in procuring automobile parts due to the disaster in Japan. It should be noted, however, that gasoline prices have fallen back somewhat since May and Japan-led supply-chain disruptions have started to be resolved. Therefore, the view held by the U.S. authorities and economists is that the recent economic slowdown is generally transitory, and their baseline scenario is that the pace of growth will resume a recovery supported by the accommodative financial environment. Of course, such an outlook entails uncertainties. The focal point is on how to assess balance-sheet adjustment pressure. Recent data on household debt and housing prices indicate that balance-sheet adjustment in the household sector is ongoing. The recovery in employment has also been disappointing. Just as in the case for Japan in the 1990s, after the bursting of the large credit bubble, the economy often continues to face a low growth rate for a

protracted period, although there are some short-term boosts reflecting the implementation of fiscal stimulus packages or accommodative monetary policies. Having said that, it might not be appropriate to conclude that the U.S. economy will follow a path similar to the one Japan once experienced, taking into account the U.S. economy's distinctive flexibility and the fact that it is a commodity-exporting country. Careful attention should be paid to how strongly balance-sheet adjustment pressure continues to constrain growth in the U.S. economy.

The European economy as a whole continues to recover moderately, although there are large differences in the economic growth rates between the euro area's major countries, such as Germany, and its peripheral countries, including Greece. The German economy maintains its robustness; for example, the latest unemployment rate is 7.0 percent, the lowest level since the reunification of West and East Germany. On the other hand, peripheral countries are experiencing a tough time, as witnessed by the recent Greek growth data, which showed an 8.1 percent decline on a year-on-year basis. Regarding prospects for the European economy, the focal point clearly is developments in the sovereign debt problem in peripheral countries. The essence of the problem is an adverse feedback loop among fiscal conditions, the financial system, and the real economy. This feedback loop works as follows. If confidence in the government declines due to the expansion of fiscal deficits, the government bond rate increases and the creditworthiness of financial institutions deteriorates. An overall increase in interest rates could cause further fiscal deterioration because an associated economic downturn reduces tax revenue. As a result, interest rates, including those on government bonds, could increase further. Such an adverse feedback loop among fiscal conditions, the financial system, and the real economy is the inherent nature of the sovereign debt problem. If the sovereign debt problem in Europe triggers instability in global financial markets, it will exert an adverse impact on the global economy as a whole. To address the problem, further efforts in the following two areas are indispensable. One is strenuous efforts by Greece and other problem-stricken countries to reduce their fiscal deficits and to advance a structural reform to strengthen competitiveness. The other is to "buy time." The European Union (EU) and the International Monetary Fund (IMF) need to work together to provide financial support to the problem-stricken countries until those countries' efforts produce noticeable outcomes. In this regard, Greece, the EU, and the IMF have been taking necessary steps. The Bank has been monitoring the situation carefully.

The growth rates in emerging and commodity-exporting economies are still at high levels, but these have recently been slowing somewhat mainly due to the heightened inflationary pressures and associated monetary tightening. In China, the year-on-year rate of increase in the consumer price index (CPI) was 6.4 percent in June 2011, up substantially from the 2.9 percent exhibited a year ago. In response, the People's Bank of China has raised the renminbi benchmark rates five times since October 2010. Other emerging economies have also raised interest rates, but in many cases the real short-term interest rate, which subtracts the inflation rate from the nominal interest rate, is significantly below the long-term trend of the economic growth rate. In any case, deceleration in growth is inevitable and necessary for emerging and commodity-exporting economies to achieve sustainable growth. Yet, there is a considerable degree of uncertainty as to whether these economies will be able to make a soft landing by achieving price stability and economic growth at the same time.

I have explained the current state of the economy, the baseline scenario of the outlook, and associated risks by region – namely, the United States, Europe, and emerging economies. The Bank projects that the global economy as a whole is likely to continue realizing relatively high growth led by growth in emerging and commodity-exporting economies. The forecasts by the IMF released in June represent an upbeat projection for the growth rate of the global economy, with growth of 4.3 percent in 2011 and 4.5 percent in 2012. For reference, the average annual growth rate of the global economy over the 30 years since 1980 was 3.3 percent and that over the 10 years to 2007, which includes the period of the global credit bubble, was 4.0 percent. This suggests that the projected growth rates this year and next

year are at a historically high level. Therefore, the global economy as a whole is likely to continue realizing relatively high growth; however, as I mentioned earlier, when considered by region, such an outlook entails uncertainties and various risks warrant sustained attention.

## **II. The current situation of Japan's economy and the bank's baseline scenario**

Based on the outlook for overseas economies, now I would like to explain the current state of and outlook for Japan's economy.

As I mentioned at the beginning, production plunged immediately after the earthquake as the economy abruptly faced supply-side constraints. Although the initial problem was supply-side constraints, private consumption also weakened because the combination of increased uncertainties about the future and voluntary restraint by consumers led to a deterioration in household sentiment. As a result, in March, industrial production registered the largest month-to-month drop on record, surpassing the decline following the Lehman shock. It should be noted, however, that the economic plunge after the earthquake was different from the one following the Lehman shock. The recent plunge was mainly caused by the supply shock, while it was the "evaporation of demand" after the Lehman shock that took corporate activity into a downward spiral of contraction. Therefore, unlike the time after the Lehman shock, we were able to make a reasonable projection at an early stage that production would recover once the supply-side constraints eased.

In fact, production is recovering quickly as progress in the restoration of supply-chain disruptions has been made at a faster-than-expected pace. This recovery is led by the automobile industry, which experienced an especially sharp downturn. At least for this summer, it seems the electric power shortages are not constraining economic activity as significantly as projected immediately after the earthquake, reflecting a strengthening of supply capacity by electric power companies and successful efforts to conserve energy and level out demand. Based on an overall judgment, taking into account the information from our business contacts, production is expected to recover to the pre-earthquake level sometime during July to September. Household sentiment is also improving somewhat. With regard to business sentiment, we are carefully monitoring business fixed investment plans. In this regard, business sentiment is becoming firm, as evidenced by the June *Tankan* (Short-Term Economic Survey of Enterprises in Japan), in which business fixed investment plans were revised upward from the March *Tankan*.

After overcoming the supply-side constraints, which has been the most serious cause of concern, the short-term prospects for Japan's economy will rely on demand-side developments. In this regard, there are two important factors. First, it seems that the economy can count on exports, which are likely to continue increasing on the back of strong growth in overseas economies. Second, demand arising from the rebuilding of capital stock that was damaged by the earthquake, or the so-called "rebuilding demand," is expected to increase gradually. Although we have seen only a limited amount of rebuilding demand so far, such demand will become more noticeable as we get a clear overall picture of rebuilding in the coming period. Furthermore, although it might be slightly different from the rebuilding demand, private consumption data in the Tohoku region shows that there has been a large increase in the so-called "rebuilding-related consumption" – namely, consumption for the purpose of rebuilding daily lives, including the purchase of new durable consumer goods such as cars and electrical appliances.

Based on the various information as I just described, Japan's economy is expected to return to a moderate recovery path from the second half of fiscal 2011. The Bank published the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) in late April and made an interim assessment in July. Looking at the median of individual Policy Board members' forecasts in the interim assessment, the year-on-year rate of increase in real GDP for fiscal 2011 is 0.4 percent. The figure is somewhat of a downward revision from the April 2011 Outlook Report. This is mainly attributable to a smaller carry-over effect from fiscal

2010 on GDP growth for fiscal 2011, reflecting the fact that the earthquake disaster resulted in significant negative growth in the January-March quarter of 2011. The forecast for the year-on-year rate of increase in real GDP for fiscal 2012 is 2.9 percent, broadly unchanged from the relatively high growth projected in the April 2011 Outlook Report.

Let me turn to price developments. The pace of decline in the CPI has moderated steadily reflecting the improvement in the aggregate supply and demand balance. In April 2011, the year-on-year rate of change in the CPI turned positive for the first time in two years and four months since December 2008, and in May of this year it marked an increase of 0.6 percent. With regard to the outlook for price developments, the projection of international commodity prices is one key factor. The Bank projects that international commodity prices will continue to increase moderately along with strong growth in emerging economies. Another key factor is medium- to long-term expected rates of inflation. Based on forecasts made by economists, such rates remain stable at around 1 percent. The Bank has released the “understanding of medium- to long-term price stability” (hereafter the “understanding”) – that is, 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. Members’ “understanding” centers at around 1 percent, which is the same as the medium- to long-term expected rates of inflation forecasted by economists. We expect that medium- to long-term expected rates of inflation are likely to remain stable going forward. In this situation, the year-on-year rate of change in the CPI is expected to remain slightly positive with the aggregate supply and demand balance improving as a trend amid economic recovery. In the July interim assessment of the April 2011 Outlook Report, the median of Policy Board members’ CPI forecasts was an increase of 0.7 percent both for fiscal 2011 and 2012.

It should be noted, however, that the base year of the CPI is revised every five years in Japan. As the Bank has explained on various occasions, there will be a downward revision to the year-on-year rate of increase in the CPI to be released in mid-August this year, based on the new base year. While rather technical, based on the methodology currently employed to compile the CPI in Japan, the CPI basket that comprises the goods the consumers would purchase is fixed. Therefore, as a longer period of time has elapsed since the base year, it becomes increasingly difficult for the CPI to fully reflect the impact of substantial price declines for some goods for which the volume of purchases has increased due to a price decline. This is the so-called “Laspeyres bias.” Typical examples of such bias are found in the prices of goods such as personal computers and televisions. As a result, after almost five years from the previous base-year revision, the recent figures for the year-on-year rate of increase in the CPI have a somewhat large upward bias, and therefore are likely to be revised downward all at once in the scheduled base-year revision. Although some economists make public their estimates, it is difficult to accurately project the specific degree of downward revision in advance. This is because, in addition to the easy-to-estimate Laspeyres bias, the revision will be affected by the composition of a new basket and the methodology of measuring prices of individual items. Firms and households make their day-to-day decisions on production and spending on the basis of the observed prices of individual goods. Therefore, the underlying trend of prices and people’s economic activity will not be affected by the base-year change of the price index, which is a technical revision in statistics. Nevertheless, the Bank will examine how this revision will be made, as well as its implications.

### **III. Risk factors for the outlook**

I have explained the baseline scenario of the outlook for economic activity and prices that the Bank considers most likely. As the outlook is always subject to uncertainties, we should acknowledge the risk that the economy will deviate from the baseline scenario.

### ***Risks regarding overseas economies***

The first risk factor concerns prospects for overseas economies. I will not go into detail on this point, as I already covered this earlier, but I emphasize that there are respective risks in the United States, Europe, and emerging and commodity-exporting economies. In relation to the risk regarding overseas economies, attention should also be paid to developments in the foreign exchange markets. If uncertainties about the prospects for the global economy heighten, investors increasingly become risk averse and upward pressures tend to be exerted to those currencies perceived as relatively safe. In terms of changes in the nominal effective exchange rate of advanced economies after the earthquake, the Swiss franc has appreciated most followed by the Japanese yen. Although the appreciation of the yen has some benefit of reducing the cost of imported energy and raw materials, it could have adverse effects on the economy as a whole through a decline in exports and corporate profits, as well as a deterioration in business sentiment, when the appreciation is caused by increased uncertainties about overseas economies. Careful monitoring is warranted in this regard.

### ***Risks regarding the effects of the earthquake disaster***

The second risk factor regarding the outlook for economic activity and prices concerns the medium- to long-term effects stemming from the recent earthquake disaster. The focal point of the effects of the disaster keeps changing as time passes. The risks that became apparent immediately after the earthquake – such as a delay in the restoration of supply-chain disruptions and electric power shortages in this summer – have receded. However, I must say that the somewhat improved household sentiment is still weak compared with the pre-earthquake level, and recovery in some components of private consumption such as eating out and travel expenses has been slow. Therefore, developments in private consumption for the time being warrant careful examination.

Recently, uncertainty has increased with regard to electricity supply constraints, which will occur when more nuclear power plants fail to resume operations following their regular inspections. In that case, it will probably be difficult for some time to completely cover a reduction in electricity supply by other measures. Even if various efforts are made, the economy will likely continue to suffer from electric power shortages, mainly in summer and winter, in the coming years. Moreover, we are likely to bear higher costs anyway, either when some of the electricity generated through nuclear power is replaced by thermal power, or when the use of nuclear power plants is maintained after strengthening safety measures. In either case, a rise in electricity costs will oppress corporate profits and households' real purchasing power, which could in turn restrain business fixed investment and private consumption. Furthermore, from a longer-term perspective, we should recognize the risk that the electricity supply problem will dampen the medium- to long-term growth potential of Japan's economy. The recent experience of supply-chain disruptions has renewed awareness that domestic production is exposed to the risk of earthquake disasters. In addition, if high uncertainties continue with regard to electric power supply, both in terms of stability and costs, we cannot ignore the risk that the shift to overseas production will be accelerated.

## **IV. The strengthening of medium- to long-term growth potential of Japan's economy**

I have discussed the outlook for Japan's economy with emphasis on the impact of the earthquake and developments in overseas economies. After long deliberation on the issue of rebuilding the economy after the earthquake disaster, I am increasingly convinced that we need to make renewed decisive efforts to tackle the challenge of strengthening medium- to long-term growth potential, which Japan's economy had faced even before the disaster. I will now describe measures to strengthen Japan's growth potential.

## ***Need to strengthen the growth potential***

In order to ascertain a specific prescription, we need to make an accurate assessment of the confronting problems. Although political and social difficulties are often pointed to as obstacles, I think that implementation of the correct prescription is also hampered by insufficient recognition of the bottom line for Japan's economic problems and the causes of declines in the growth rate.

In the long run, Japan's economic growth rate has been on a declining trend: the average annual growth rate was 5 percent in the 1970s, around 4.5 percent in the 1980s, around 1.5 percent in the 1990s, and less than 1 percent in the 2000s. After making a successful take-off to high growth, every economy will sooner or later shift into stable growth. Japan was no exception, but abruptly got trapped in the financial bubble that was formed in the process of shifting to stable growth. After declining sharply in the 1990s on the impact of the bursting of the bubble, we have not managed to change the declining trend of Japan's growth rate. In the time horizon of two to three years, a growth rate is dominated by changes in demand, except in periods following supply-side shocks such as earthquakes. However, in terms of an average growth rate in the time horizon of 10 to 20 years – namely, the medium- to long-term growth potential – it is natural to consider that key determinants are supply-side factors. Real GDP can be expressed as a product of “the number of workers” and “real GDP per worker.” As a corollary, the real GDP growth rate can be understood as the sum of the rate of increase in the number of workers and the labor productivity growth rate. Using these simple figures, I would like to highlight the following facts.

The first is that the impact of declines in the number of workers on Japan's growth rate has been gradually increasing in the 1990s and the 2000s. After peaking around 1995, the working-age population started to decline and the pace of decline accelerated in the 2000s. The working-age population plays a core role in production activity, and such a decline will constrain economic growth from the supply side through a reduction in the number of workers. The working-age population is also a major driver of private consumption and significantly contributes to tax revenue. Therefore, even from the demand side, a decline in the working-age population will lower growth potential unless necessary measures are taken. Such measures include deregulation in the areas of health care and nursing care services for the elderly to meet rising demand from the aging population, as well as measures to offset a rising fiscal burden on the working-age population.

The second fact is that, despite some declines in recent years, Japan is still in the group of advanced countries with the highest labor productivity growth rate, along with the United States. The labor productivity growth rate is an important determinant of growth potential of the economy. As I will explain later, I think it is necessary to continue making efforts to raise the labor productivity growth rate, and there are good prospects for such efforts to bear fruit. At the same time, it is not realistic to expect that the labor productivity growth rate, which has been at around 1 percent on average, will rise by 1 or 2 percentage points at once. There is no significant difference in the productivity growth rate among countries that have already gone through a high growth period. While we must make the utmost efforts, we also need to be cool-headed and recognize that the already matured economy cannot expect to see a dramatic increase in its growth potential.

So, what is the bottom line for Japan's economic problems? In my view, the most serious problem is that, if we maintain the current situation, it becomes difficult for Japanese people to sustain the current relatively high level of living standards on an international comparison. Speaking of which, the level of real GDP per capita in Japan is still high on an international basis. In addition, the fact that the average lifespan of Japanese people is extremely long indicates that the country has achieved a significantly high standard of health on an international comparison. Health is an important condition for people's happiness and cannot be measured by GDP statistics. The question is whether our children and grandchildren can sustain such a high standard of living, and I am afraid it is not possible if we choose to keep

the status quo. The key word is “sustainability.” We can make a simple interpretation of a country’s economic activity as follows. The working-age population earns income through production activity and raises their children, the future workforce. The elderly, who once earned income as part of the workforce, now make their living by relying on their accumulated savings and the social security system, which is supported by the working-age population. In this way, human society continues to raise the standard of living through generational change. What is important here is a smooth transition to the next generations. In this regard, unless measures are taken to review existing institutions and customs to adjust to objective changes in the environment such as a rapidly aging and declining population, the sustainability of the economy will be threatened. In the following, I will explain the necessary measures to ensure sustainability.

### ***Encouraging labor participation***

First, we should make efforts not to reduce but rather increase the number of workers by raising the labor participation rate of women. By age group, this rate displays an M-shaped curve, with a dip in the age group of those aged in their 30s. This feature makes Japan different from other advanced countries, indicating that Japan is not a friendly society for working women raising children. Efforts to improve the environment for women, such that they can handle both a career and raising children, are meaningful not only for economic growth but for the society. Moreover, we should not overlook the fact that Japanese people are living longer and the number of the elderly blessed with good health and physical strength is increasing. There is research showing that the physical conditions of elderly people have improved and those who can work vigorously have increased. Building a society where elderly people who have the will and capability to work are able to actually do so, depending on their situation, will not only have a positive impact on economic growth but also lead to enriching people’s lives.

### ***Raising labor productivity***

Second, efforts are needed to raise labor productivity. The phrase “raising productivity” is often used to mean improving efficiency and streamlining. But I would like to emphasize the other aspect of higher productivity, which is that it leads to an expanded equilibrium, in that individual workers can generate higher added value. Added value is a source of funds that ultimately will be allocated as corporate profits and wages. Therefore, increasing added value is the same as saying that firms boost profits while expanding wages to be paid. To this end, firms need to increase their profits by exploring new markets, not solely relying on cost reductions. In what follows, I will highlight three strategies for exploring new markets.

First of all, it is all the more important to actively capture global demand amid the world economy’s continuing strong growth. In this regard, the expansion of firms’ overseas bases would likely have a positive impact on Japan’s economy if it is motivated by the aspiration for growth to strengthen their global strategies, instead of the passive choice of giving up on Japan. The share of Japanese firms’ overseas production, which is currently a little less than 20 percent, has been increasing in inverse proportion to the gradual decline in Japan’s share in global GDP. In other words, as emerging economies have grown and Japan’s relative share in global GDP has declined, overseas production by Japanese firms has expanded to capture the demand for the increasing consumption of locally made products. In the process of continuous expansion of overseas production, domestic offices and factories have always constituted an integral part of international division of labor by changing their role. Specifically, they have started to assume the function of a global headquarters and to focus on advanced research and development while increasing exports of intermediate goods to overseas bases.

For Japanese firms to be winners in the rapidly changing global markets, mergers and acquisitions have acquired increasing importance. In this regard, although Japan is

experiencing declining growth potential in terms of flow, it still has strengths in terms of economic stock, such as abundant financial assets and technological competitiveness. In fact, an increasing number of firms, taking advantage of their ample funds, have recently concluded vigorous investment deals to purchase overseas firms with growth potential.

Capturing global demand is not limited to the areas of *monozukuri*, or manufacturing. Efforts to further enhance Japan's attractiveness as a tourist destination will generate a significant outcome in the medium to long run. As I have illustrated, Japan should pursue global strategies in a wide range of areas and in a variety of ways. In order to make the best use of Japan's potential, it is extremely important to steadily enhance the framework of free trade agreements and economic partnership agreements.

To raise labor productivity, it is also important to promote technological innovation and explore potential demand in areas related to the natural environment and energy. The earthquake disaster is expected to further heighten the need for technological innovation in these areas. Having nurtured sophisticated technologies for years, Japan is well placed to raise its growth potential by pursuing the following three strategies together: "saving energy," to conserve energy through the wider use of LED lighting; "creating energy," through the use of solar power; and "storing energy," through the improvement of batteries in terms of efficiency and capacity.

Furthermore, efforts are needed to further explore domestic markets and thereby generate added value by discovering potential demand. I often hear the pessimistic view that domestic markets will shrink steadily because of the declining and aging population. However, even in an aging society, people's potential needs are diverse and unlimited, and continuously exploring such needs is a significant source of added value.

## **V. Efforts toward fiscal consolidation**

I have talked about efforts to encourage labor participation and raise labor productivity as necessary measures to ensure the sustainability of the economy. In this regard, there is another policy goal of extreme importance that requires further efforts – namely, fiscal consolidation. As government debt outstanding has already reached a tremendous level in Japan, an increasingly aging population will act to exert pressure to further deteriorate fiscal balance. Deterioration in fiscal balance has adverse effects on economic activity through two channels. First, an increased burden on the part of the working-age population would constrain consumer spending. Second, as I explained earlier by taking the example of the sovereign debt problem in Europe, if confidence in the government's debt repayment ability is undermined, there would be an adverse feedback loop among fiscal conditions, the financial system, and the real economy. Of course, the strengthening of growth potential is necessary in terms of improving fiscal balance, but the associated natural increase of tax revenue alone is not enough to ensure fiscal sustainability. Overcoming deflation is also important, but this has a limited effect on improving fiscal balance because past experience shows that rising inflation not only boosted revenues but also increased expenditures. This suggests that restructuring of revenues and expenditures is indeed necessary for fiscal consolidation.

Although fiscal balance in Japan is deteriorating, yields on the Japanese long-term government bonds have maintained stability at the lowest level in the world. One possible interpretation of this phenomenon is the market participants' view that the current fiscal conditions will not remain unaddressed and the specific measures to achieve fiscal consolidation will be implemented in due course. Another possible interpretation is the market participants' vague expectation that the stability in interest rates that has continued to date will stay as it is for the time being. What is important is that, in either case, if any of the specific measures toward fiscal consolidation are not actually taken, market participants might suddenly change their views at some point.

Fiscal consolidation is currently a common challenge to many advanced countries. This is because these countries made use of large-scale fiscal spending following the Lehman shock to maintain financial system stability and mitigate the adverse effects on the macro economy. In Europe, fiscal balance is deteriorating not only in those countries with clear symptoms of the sovereign debt problem but also in many other countries. Also, in the United States, the situation remains tense as the government debt has almost reached the ceiling. In these circumstances, we need to recognize the possibility that some events could trigger a worldwide rise in government bond rates, which would have a significant impact particularly on those countries with poor fiscal management. With regard to fiscal management, the often-heard policy suggestions after the earthquake were that the Bank should underwrite government securities or conduct outright purchases of government securities to fund expenses for rebuilding. However, if the view is taken that the central bank conducts monetary policy with the aim of supporting government financing, interest rates will rise, putting adverse effects on Japan's economy. Since the earthquake, there have been active discussions as to whether various risks were beyond expectations. The problem arising from the central bank's underwriting, or outright purchases representing a virtual underwriting of government securities, is not beyond expectations. The prospective risks involved are sufficiently predictable at the moment. In order to reduce the risk arising from fiscal deterioration, it is necessary to clearly present the path for achieving fiscal consolidation and implement specific measures.

## **VI. The bank's conduct of monetary policy**

Let me turn finally to the Bank's conduct of monetary policy, based on the outlook and medium- to long-term challenges for Japan's economy.

I have had many occasions to talk about the Bank's response immediately after the earthquake, so I will not go into detail on this today. It can be summarized as follows. The Bank, with a view to preventing financial shocks from developing into economic instability, worked to provide ample funds to the markets and ensure the functioning of settlement systems, which are the basis of people's lives and economic activity. The Bank also decided to further enhance monetary easing.

Let me explain the Bank's basic policy stance in more detail. It has continued to consistently make contributions as the central bank through the three-pronged approach of pursuing powerful monetary easing consisting of comprehensive monetary easing, ensuring financial market stability, and providing support to strengthen the foundations for economic growth.

Comprehensive monetary easing, which was introduced in October 2010, has three components. First, the Bank has encouraged the policy interest rate – namely, the uncollateralized overnight call rate – to remain at the very low level of around 0 to 0.1 percent. Second, the Bank has made clear that it will continue this virtually zero policy interest rate level until it judges that price stability is in sight, with confirmation that the accumulation of financial imbalances is not identified. The Bank expresses its idea of price stability in the form of the “understanding,” and each Policy Board member's “understanding” falls in a positive range of 2 percent or lower, centering around 1 percent.

The third component of comprehensive monetary easing is the Bank's establishment of the Asset Purchase Program (hereafter the Program) through which it provides longer-term funds at a fixed rate and purchases various financial assets – namely, government bonds, CP, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs). The Program aims at enhancing monetary easing effects by directly influencing longer-term market interest rates and various risk premiums in order to reinforce the indirect easing effects on those variables from the policy interest rate. The Program started with a size of about 35 trillion yen in October 2010. At the Monetary Policy Meeting (MPM) immediately after the earthquake, when an economic downturn was concerned, the decision was made to increase the amount of asset purchases, mainly of risk assets, which

brought the total size of the Program to about 40 trillion yen. Following the decision on the total size of the Program, the Bank is steadily conducting asset purchases.

The purpose of comprehensive monetary easing, which consists of the three components I have mentioned, is to support economic activity such that Japan's economy will be able to achieve sustainable growth with price stability. As I noted earlier, the most fundamental challenge Japan's economy faces is the decline in growth potential, and the so-called "deflation issue" is a manifestation of this fundamental problem. Deflation can be metaphorically expressed as a decline in body temperature, and it should be addressed by the strengthening of growth potential, or basic physical fitness. In this regard, the Bank has been implementing 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 financial institutions that are making efforts in terms of investment and lending to increase the growth potential of Japan's economy. The funds amount to 3 trillion yen in total and are provided against collateral deemed eligible by the Bank, such as government bonds.

At the June MPM this year, the Bank decided to establish a 500 billion yen new line of credit for the measure. With regard to the new line of credit, the Bank decided to support financial institutions' efforts, focusing on loans with equity-like features to firms with growth potential and lending without conventional collateral or guarantees. For the latter, the lending method that is considered most likely is asset-based lending (ABL). ABL takes firms' assets that are closely tied to their businesses – such as their inventories, equipment, and machines, as well as accounts receivables – as collateral. ABL currently plays a limited role in Japan but is a quite popular lending method in the United States. The greatest merit of ABL is that it enables firms that do not have sufficient real estate collateral or corporate managers' personal assets to raise financial resources. For example, start-up firms tend to have a high ratio of accounts receivables to total assets. They will be able to raise funds for business expansion more smoothly if they can make use of their accounts receivables as collateral. ABL is said to be more time-consuming compared with lending against real estate collateral. Viewed in another way, however, the process of utilizing ABL allows a borrower firm and a financial institution to take more time and have closer communications regarding the characteristics and future vision of firms' businesses. This will encourage a borrower firm to make business decisions based on more accurate analysis of its growth potential and profitability.

Furthermore, the Bank has taken various measures in terms of supporting the disaster areas. One example is the funds-supplying operation that provides financial institutions in disaster areas with longer-term funds at a low interest rate, with the aim of supporting these institutions' initial efforts to meet demand for funds for restoration and rebuilding. Going forward, in the phase when demand for funds for the purpose of restoration and rebuilding becomes full-fledged, the Bank will examine how to provide additional support appropriately as the central bank, based on the specifics of such demand, measures by private financial institutions, and support from the government.

In this manner, the Bank has continued to make various efforts on the monetary policy front, taking into account the time horizon of short-term and medium- to long-term periods. The Bank will continue to carefully examine the outlook for economic activity and prices, and take appropriate actions as necessary.

## **Concluding remarks**

I see I am running out of time, so I would like to conclude my remarks. The earthquake has posed additional challenges to Japan's economy, which had already faced significant problems to tackle. It is true that Japan's economy is facing very difficult challenges. However, we should avoid falling into pessimism unnecessarily. In the past, for example, at the time of oil shocks, Japan became an energy-saving society through acceleration of

technological innovations. Moreover, the Japanese people's outstanding ability to overcome problems is evident from the early restoration of supply chains following the disaster.

In the process of such restoration, "competitiveness at worksites," or *genbaryoku*, and "knowledge at worksites," or *genbachi*, both demonstrated by Japanese firms, have been in full play. Japan also has a certain "soft power" that elicits confidence and empathy from around the world, as exemplified by its reputation for hospitality, its skill at generating intellectual property with originality, and the orderly and mutual cooperative behavior of its people seen immediately after the earthquake. In the face of the global financial crisis and the recent earthquake disaster, Japan's financial system has maintained stability. Japan also has a geographical advantage in that it is located in East Asia, which is currently the most dynamic region in the world.

As I have illustrated, at present, Japan has many factors that could lead to a bright future. A sense of urgency is necessary, but pessimism is not. We should face up to the real problem and work on reforms with confidence in our potential.