Hidetoshi Kamezaki: Recent economic and financial developments in Japan

Speech by Mr Hidetoshi Kamezaki, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Mie, 27 July 2011.

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I. The Bank of Japan's measures following the Great East Japan Earthquake

Let me start by introducing the measures implemented by the Bank thus far following the Great East Japan Earthquake, whose magnitude and effects were unprecedented.

At 3:00 p.m. on March 11, 2011, right after the earthquake struck at 2:46 p.m., the Bank set up a disaster management team at its Head Office in Tokyo, headed by Governor Masaaki Shirakawa, and implemented the following measures.

First, immediately after the earthquake, the Bank worked to maintain the financial intermediation function and secure the smooth settlement of funds. Specifically, to cope with demand for cash in disaster areas to the maximum degree, it provided cash to financial institutions in disaster areas as necessary, not only on business days but also on weekends and holidays. Moreover, on March 11, the Governor of the Bank, jointly with the Minister of State for Financial Services, released a document regarding financial measures to respond to the disaster triggered by the earthquake, requesting that financial institutions take appropriate measures to accommodate the needs of those affected by the disaster – for example, by permitting the withdrawal of deposits in cases where depositors had lost passbooks or seals. Furthermore, the Bank, in cooperation with relevant parties, maintained the stable functioning of Japan's core payment and settlement systems, such as the Bank of Japan Financial Network System, or the BOJ-NET, even after the earthquake. It also worked hard to provide cash to the disaster areas by taking actions such as establishing a temporary teller window in Morioka City, Iwate Prefecture, for the exchange of damaged banknotes and coins. The total amount of cash exchanged since the earthquake at the Bank's windows in the affected Tohoku region, including the temporary one in Morioka City, amounted to 3.06 billion yen, through July 22. This greatly exceeds the amount exchanged at the Bank's Kobe Branch during the six months following the Great Hanshin-Awaji Earthquake, which was about 0.8 billion yen.

Second, the Bank sought to prevent an excessive increase in risk aversion from emerging in financial markets or other areas of financial and economic activity. To this end, it provided ample funds to meet demand in financial markets for several successive days after the earthquake, and worked to ensure stability in the markets by maintaining confidence on the funding front. As a result, the outstanding balance of financial institutions' current accounts at the Bank temporarily marked a historical high of 42.6 trillion yen, far exceeding that observed during the periods following the Lehman shock and when the Bank implemented quantitative easing. In addition, the Bank shortened to one day the two-day Monetary Policy Meeting that was initially scheduled to be held on March 14 and 15, completing it on March 14. At this meeting, with a view to preventing any deterioration in business sentiment or heightening of risk aversion in financial markets from adversely affecting economic activity, the Bank further enhanced monetary easing by increasing the amount of the Asset Purchase Program, mainly of the purchases of risk assets by about 5 trillion yen, under the comprehensive monetary easing framework. I will discuss the details of this framework later.

Third, the Bank worked to ensure calm in markets at home and abroad by providing accurate information. Specifically, immediately after the earthquake, it expanded the communications offered on its web site, setting up a section in both Japanese and English devoted to the earthquake and releasing a continuous stream of information regarding its business continuity situation. In addition, on various occasions such as at international conferences, in speeches given at home and abroad, and at press conferences, the Bank emphasized the continuing robustness of Japan’s financial markets as well as its financial and settlement systems.

And fourth, the Bank introduced the funds-supplying operation to support financial institutions in disaster areas, with a view to supporting their initial efforts to meet demand for funds for restoration and rebuilding. Through this operation, the Bank extends loans to financial institutions with business offices in the disaster areas – even to small local financial cooperatives that do not hold current accounts at the Bank through the central organization of each type of financial cooperatives – at the low interest rate of 0.1 percent per annum. The total amount of loans is 1 trillion yen with the maximum amount of loans to each counterparty set at 150 billion yen, and the deadline for eligible counterparties’ new loan applications is October 31, 2011. With a view to securing sufficient financing capacity at financial institutions in disaster areas, the Bank also expanded the range of eligible collateral to include BBB-rated corporate bonds as well as bills and loans on deeds where debtor companies are classified as “normal” borrowers in the self-assessment by financial institutions in disaster areas. It conducted the funds-supplying operation three times, with the total amount of loans to date reaching 332 billion yen.

II. Economic activity and prices

A. Overseas economies

Next, I will talk about the current economic situation. Overseas economies achieved robust growth from around 2005 onward, led by improved productivity in many economies, owing to the advance of globalization and increased participation of emerging economies in the global market. During this time, however, various countries experienced economic imbalances, such as the housing bubble in the United States and the investment bubble in some peripheral European countries that resulted from the stable currencies and lower interest rates following the European monetary unification. These imbalances gradually emerged as the financial market turmoil in the United States and Europe, triggered by the drop in U.S. housing prices. The turmoil grew into a global financial crisis after the Lehman shock in the autumn of 2008. The interaction between the financial market turmoil and economic deterioration led to the crisis of a sharp downturn in the global economy. In response, countries around the world adopted large-scale monetary and fiscal measures, and as a result, the global economy started to pick up around spring 2009. Consequently, the global economy as a whole is on a recovery path, although there is a divergence between the performance of slowly recovering industrialized countries and rapidly growing emerging and commodity-exporting economies.

At present, the pace of recovery is slowing. The U.S. economy is being weighed down by damaged balance sheets among households in particular, due to the bursting of the housing bubble, and also by the effects of the disaster in Japan and high crude oil prices. In Europe as a whole, the pace of recovery remains moderate: while the German economy is robust, the economies of some peripheral countries with troubled fiscal conditions, such as Greece, are faltering. In contrast, rapid growth continues in emerging and commodity-exporting economies such as China and Brazil. In some countries, however, there are signs of economic slowdowns due to monetary tightening aimed to counter inflationary pressures, and production has been sluggish due to supply shortages of parts following the earthquake in Japan. As for the outlook, the global economy is expected to stay on a recovery trend; however, the degree of uncertainty remains high because of risk factors such as a further deterioration in the fiscal conditions in some peripheral European countries, an overheating of emerging and commodity-exporting economies, and a surge in international commodity prices.

B. The Japanese economy

The growth in the Japanese economy also declined, falling steeply in response to the Lehman shock, after experiencing the longest period of economic expansion since the end of World War II. Thereafter, the economy continued to recover, after leveling out around spring 2009, due to the recovery in overseas economies and government measures such as the subsidies for purchasers of environmentally friendly cars and the eco-point system for electrical appliances. However, when the earthquake struck Japan, the economy again suffered a steep decline.

The economic downturn observed after the failure of Lehman Brothers was due to the sudden drop in domestic and external demand, reflecting a sharp financial contraction: triggered by the failure, the financial system and economic activity faced a spiral of deterioration, mainly in the United States and Europe, as a result of stagnant economic activity that reflected the difficulty in issuing CP and corporate bonds as well as the cautious lending attitudes of banks, which led to public concern over financial markets and financial institutions in general. The effects of the financial crisis in the United States and Europe spread to markets all over the world, including Japan. In such a situation, production and inventory adjustments took place worldwide, and the level of production dropped particularly sharply in Japan due to the fact that the high-tech manufacturing industries – including automobiles, electrical machinery, and general machinery, which were particularly affected by the downturn in worldwide demand – had a large share in its production. The economic downturn following the earthquake, on the other hand, was due to (1) direct physical damage in the disaster areas, (2) indirect damage due to a shortage of parts, (3) supply-side constraints such as the difficulty in producing and selling goods due to electricity shortages, and (4) a deterioration in household and business sentiment caused by concern about the future and voluntary restraint in consumer spending. It should be noted that, unlike the economic downturn observed after the Lehman shock, external demand was not much affected. Therefore, the economy picked up sooner than expected with the easing of the supply-side constraints due to the progress in the restoration of facilities and efforts to conserve electricity. At present, exports have started to increase. Domestic private demand has also begun to pick up, with some improvement in household and business sentiment.

The Japanese economy is expected to return to a moderate recovery path from the latter half of this fiscal year as production regains traction with further easing of supply-side constraints, backed by an increase in exports reflecting the recovery in overseas economies and by a rise in rebuilding demand. In the longer run, however, attention should be paid to the downside risks to economic activity. In the short run, the restoration of supply chains is making steady progress and there is an increasing probability that the degree of constraints on economic activity due to electricity shortages this summer will be less significant than anticipated, although some concerns remain. On the other hand, uncertainty is also increasing somewhat regarding overseas economies, and therefore the current risks to the Japanese economy are shifting from the supply side to the demand side. In addition, from a relatively long-term perspective, uncertainty about electric power supply is increasing somewhat, reflecting the issues regarding the resumption of operations at nuclear power plants following regular inspections. Considering factors such as the appreciation of the yen, high corporate tax rates, and delays in the negotiation of free trade agreements (FTAs) and economic partnership agreements (EPAs), manufacturers already regard Japan as a somewhat unfavorable place to locate their production sites. It is my great concern that the shift of Japanese firms' production sites to overseas might accelerate if anxiety about electric power supply lingers.

C. Price developments

Next, I will move on to price developments. International commodity prices had been increasing on the back of high growth in emerging economies. They have declined slightly of late due to the instability in global financial markets, but are still hovering at high levels. As a result, import prices in Japan and the domestic corporate goods price index (CGPI), which measures fluctuations in prices of goods traded between firms in Japan, have also been at high levels.

Meanwhile, the year-on-year rate of change in the consumer price index (CPI) for all items excluding fresh food, or the core CPI – which measures the prices of goods and services purchased by households – had been in negative territory for about two years since March 2009 but turned positive in April 2011 against the background of the increase in international commodity prices and the narrowing of the negative output gap. In sum, the Japanese economy continues to be headed in the direction of overcoming deflation.

As for the outlook, the year-on-year rate of change in the core CPI is expected to be slightly positive, reflecting the rise in international commodity prices and the narrowing of the negative output gap. However, this outlook is attended by a range of risks, examples of which include a substantial rise in international commodity prices, a delay in the narrowing of the negative output gap due to slower-than-expected growth of the Japanese economy, and a decline in the public's medium- to long-term inflation expectations reflecting their pessimistic outlook for the economy.

As you may know, the base year for the CPI will be revised in August 2011, and 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 revisions leave economic activity unaffected, and 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 releases semiannually in April and October. The Outlook Report presents the Policy Board members' assessments of economic activity and prices based on the forecasts. In addition to the semiannual Outlook Report, the Bank releases interim assessments in July and January that present the Bank's revised forecasts.

In the most recent forecasts, released on July 12, 2011, Policy Board members considered it most likely that real GDP in fiscal 2011 would grow by only 0.4 percent on a year-on-year basis, reflecting the effects of the disaster, but by 2.9 percent in fiscal 2012 due to an expected increase in demand for rebuilding. The year-on-year change in the core CPI is projected to be 0.7 percent in both fiscal 2011 and fiscal 2012, reflecting an increase in materials prices and the narrowing of the negative output gap. It should be noted, however, that these figures do not incorporate possible effects of the base year revision for the CPI in August 2011.[1]

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 tilted to the downside for real GDP on a year-on-year basis, whereas those for the year-on-year rate of change in the CPI are balanced on the whole.

III. Measures taken by the bank

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

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[1] The figures referred to in this paragraph are the median of the Policy Board members' forecasts.

A. Measures to address the Lehman shock

The Lehman shock in autumn 2008 had caused a sharp contraction in the financial markets around the world. In order to address this situation, the Bank, just after the crisis occurred, successively conducted same-day funds-supplying operations and introduced U.S. dollar funds-supplying operations. In addition to reducing the target level of the policy interest rate, the Bank introduced a series of measures such as the complementary deposit facility, outright purchases of CP and corporate bonds, the easing of the rating requirement for corporate debt to be accepted as eligible collateral, the special funds-supplying operation to facilitate corporate financing, and acceptance of bonds issued by foreign governments as eligible collateral, based on the recognition that market conditions had deteriorated further and a negative feedback loop between financial and economic activity had emerged with a tightening of overall corporate financing conditions. Moreover, the Bank introduced temporary measures to secure the stability of the financial system, including 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.

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

Although financial markets regained their stability, the Bank, with a view to overcoming deflation and returning the Japanese economy to a sustainable growth path with price stability, continues to conduct various measures.

1. Pursuing powerful monetary easing

First, the Bank aims to pursue powerful monetary easing through the implementation of the comprehensive monetary easing policy decided in October 2010. As the first measure for this policy, the Bank set the uncollateralized overnight call rate target at "around 0 to 0.1 percent." It clarified that the policy interest rate is virtually zero. As for the second measure, the Bank clarified the policy time horizon of the virtually zero interest rate policy – specifically, 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 – and it has been working to help stabilize longer-term interest rates. 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 each Policy Board member's "understanding" falling in a positive range of 2 percent or lower, and the midpoints of most Policy Board members' "understanding" being around 1 percent. As the third measure of the comprehensive monetary easing policy, the Bank established the Asset Purchase Program 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. The aim of this measure is to create additional monetary easing effects by encouraging a decline in longer-term interest rates and a reduction in various risk premiums, while in the money market, where the Bank conducts daily operations as the central bank of Japan, there remains little room for further declines in most short-term interest rates. The Bank's purchase of ETFs and J-REITs, which are assets with relatively high risks, 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. At its establishment, the Asset Purchase Program was to be worth about 35 trillion yen, but as I stated earlier, the Bank increased the amount to about 40 trillion yen just after the earthquake.

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. As I stated earlier, when uncertainty began to spread in the financial markets just after the earthquake, the Bank provided ample funds to the markets, the total amount of which represented a historical high. The Bank has also taken measures 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 financial institutions in accordance with their efforts in terms of lending and investment. Currently, financial markets have abundant funds, but recent growth is sluggish and deflationary pressure remains strong as economic entities such as firms and households are skeptical about future growth and unwilling to undertake forward-looking spending. To address this problem, the Bank has made more funds available for financial institutions to utilize in new areas of growth, in order to raise growth expectations.

Many financial institutions nationwide have shown an interest in the measure since it was implemented in June 2010. There were 153 financial institutions granted approval to participate in the new loan disbursement in June 2011, and loans were actually disbursed to 126 of them. Areas eligible for investments and loans range, for example, from environment and energy business, medical and nursing care business, development of social infrastructure, and regional revitalization business to business deployment in Asian countries. The measure has been 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 investments and loans 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 investments and loans than the 150 billion yen ceiling for the total amount of loans that they could obtain from the Bank. The total amount of loans disbursed through the four loan disbursements conducted so far has almost reached the maximum amount of loans allowed under this measure (3 trillion yen), with a year left before the deadline for new applications for loans.

The Bank decided to enhance the measure with a view to supporting financial institutions' efforts to strengthen the foundations for economic growth through the use of a wider range of financial techniques. More specifically, in order to support emerging and small firms in their efforts to solve the problems they face – risk money and a lack of real estate collateral – the Bank provides funds to financial institutions that undertake equity investments and offer the so-called asset-based lending, or ABL, to firms with growth opportunities. The Bank hopes that this enhancement will stimulate further use of financial techniques that have yet to achieve a sufficient level of familiarity, and thereby lead to the nurturing of firms with growth opportunities. If this is accomplished, the Bank believes that Japan's growth potential will increase and the ability of financial institutions to find and support promising firms will be improved.

IV. Revitalizing the Japanese economy

I will now take a look at the Japanese economy from a longer-term perspective. Although Japan has undergone various phases of economic cycles since the bursting of the economic bubble in the early 1990s, growth on average has been poor. The past 20 years or so of weak growth and deflation have been dubbed the “two lost decades.” The devastating earthquake that hit Japan on March 11 this year has further aggravated the situation. In order for the economy to emerge from the current slow growth and regain its strength, it is necessary to introduce drastic measures designed not only for the reconstruction of disaster-stricken northeastern regions but also for revitalization of the Japanese economy as a whole.

A. Causes of the low growth in the Japanese economy

Before moving on to the topic of revitalizing the Japanese economy, I will first touch upon the causes of the high growth experienced after World War II and ensuing period of low growth. Three factors combined to create a favorable environment for the postwar rapid growth. First, Japan was in a position to take advantage of being a latecomer, learning from the growth process of advanced economies such as the United States and Europe. Second, the rise in the working-age population meant an increase in the population bonus, that is, the high share of the working-age population in the total population. And third, Japanese manufactured goods enjoyed a superior competitive edge in the absence of rivals outside the United States and Europe. During this period of soaring growth, Japan’s economic model – based on government industrial policy, the main bank system, the seniority system, and lifetime employment – functioned successfully.

By about 1970, however, Japan had more or less caught up with the United States and Europe. Around this period, the population bonus started to fade. Furthermore, the outbreak of the oil crisis and rapid appreciation of the yen put a brake on the high-speed economic growth. The continued upward trend in the working-age population and the absence of competitors in the production of manufactured goods enabled the Japanese economy to grow steadily. However, downward pressure on the economy intensified as the increased presence of Japan in international markets gave rise to heated trade friction while the Plaza Accord in 1985 led to an appreciating yen. In order to counter the downward pressure, measures were taken to expand domestic demand, which eventually led to the emergence of the economic bubble in the second half of the 1980s.

The bubble burst in the early 1990s. Low growth and deflation continues to this day in spite of repeated measures and monetary easing to stimulate the economy. A recovery appeared to be hampered by adjustments involving the “legacies of the past” – that is, the excessive level of debt, production capacity, and employment coupled with the large housing loans held by households and the massive amount of nonperforming loans held by financial institutions. The situation, however, remained unchanged even though the balance-sheet problems had more or less been resolved by around 2000. The reasons for the low growth must lie elsewhere, and I believe that it must be the critical changes that occurred during this period – namely, the decrease in the working-age population, which peaked in 1995, and the rise of emerging countries as rival producers of manufactured goods.

B. Overcoming low growth and deflation

I have already pointed to the gradual loss of the favorable environment as the cause of the downward trend in the growth potential of the Japanese economy since the end of the high-growth period. The favorable environment consisted of three factors: the easily attained latecomer advantage; the increase in the working-age population; and the absence of competitors in the production of manufactured goods. Regaining this environment might put Japan back on a fast growth path. Such an attempt would be impossible, however, as the world has changed profoundly and the need has arisen to build a new growth model suitable for the new environment.

Japan had long gained from the latecomer advantage in acquiring manufacturing technologies, and it became one of the world's major exporting countries; however, there is still much more to learn from other countries, particularly regarding enhancement of the standard of living. The United Kingdom, Germany, and Australia have overcome long-term economic stagnation by implementing a range of social and economic reforms, while Scandinavian countries have achieved a high level of satisfaction among their citizens as a result of their comprehensive welfare systems, supported by high taxes. The Asian NIEs have improved their standards of living by achieving high economic growth through market competition. There is no shortage of lessons to learn from abroad to establish a new growth model and improve the standard of living.

Institutional reforms and revisions are required in order to increase the working-age population, to raise the birth rate and put a brake on the population decrease. This undoubtedly is the correct approach, but it takes time to produce results. The measures to expand the working-age population in the short term and boost Japan's growth potential should include: raising the labor force participation rate of women and the elderly by establishing incentives as well as providing job training; and introducing an orderly system for foreign workforce employment. In the meantime, given that the aging of society is bound to progress for some time, it is necessary to deregulate the medical and nursing care sectors and proceed with reforms, to facilitate their development into sizable industries led by domestic demand.

In order to emerge victorious from the fierce competition in global markets, Japan needs to further enhance the added value of products with a high competitive advantage. However, it is equally important to venture into new areas by making use of existing technologies. For example, as indicated by the classic adage that says necessity is the mother of invention, the electricity shortages facing Japan have provided a good opportunity in that they have heightened the need to further improve the efficient use of electricity – an area in which Japan already excels out of sheer necessity. In addition, the experience gained by dealing with the aftermath of the accident at the nuclear power plant in Fukushima Prefecture indicates that robotics technology, in which Japan enjoys a high degree of competitiveness, could be developed further for more practical use. In order to encourage firms to carry out such undertakings, outdated regulations must be eased. Furthermore, as preconditions for global competition on an equal footing, Japan needs to improve its competitive environment by, for example, concluding more FTAs and EPAs. To this end, it is necessary to improve the competitiveness of primary industry by increasing productivity to achieve both the development of that industry and growth of the overall economy. In this context, the March earthquake has provided an occasion for primary industry and local governments to review their management strategies and decide whether to expand or streamline them in accordance with the situation in each region.

I would also like to say that it is 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 creating a strong incentive to save, rather than spend. Weak economic growth has made firms, individuals, and the government reluctant to take on new, risky 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 Japan is thus in no position to merely sit back and observe the sovereign debt problems in some peripheral European countries. Although trust in the government's conduct of fiscal policy has been maintained so far, it could crumble without warning and when least expected. Therefore, the burning issue to be tackled is the creation and implementation of a roadmap for fiscal consolidation in an effort to maintain trust both at home and abroad.

C. Measures taken by the bank

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 facilitate economic revitalization. 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.