

Masaaki Shirakawa: The outlook and challenges for Japan's economy

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at a meeting with business leaders, Osaka, 31 October 2011.

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Introduction

Let me first express my heartfelt sympathy for those who have suffered from two typhoons that hit the Kansai region particularly hard last month. I am sure you are still worried about the situation as the business leaders from the region, and I appreciate this opportunity you have given me to speak and exchange views with you at a time like this. I would also like to use this occasion to express my deep gratitude for your cooperation with the Bank of Japan's branches in Osaka, Kobe, and Kyoto.

It is now just over one year since we last met. In the interim, Japan's economy experienced a severe hardship – namely, the Great East Japan Earthquake. Although it is not quite appropriate to describe the effects of the earthquake disaster only in terms of economic aspects, as such effects have spread to various areas of people's lives, I should note that economic activity has fortunately recovered faster than expected. This is attributed to the remarkable capability of Japanese firms and people to respond to the hardship, as seen in the restoration of supply chain disruptions and measures to address power shortages. Consequently, production and exports, which had plunged immediately after the earthquake, almost recovered to their pre-quake levels this past summer. The effects of the disaster clearly spread beyond the disaster areas across the country in various forms. One example of this is the decline in operating rates of nuclear power plants. I am aware that, especially in the Kansai region, electricity supply and demand conditions are likely to be tight in the coming winter. Looking at overseas economies, strains in European economies continue and close attention should be paid to future developments.

Before we exchange views, I will first outline the outlook for Japan's economy and developments in overseas economies that greatly affect its future course. I will then speak about the challenges it faces as well as the Bank's conduct of monetary policy.

I. Outlook for Japan's economy

I will start with the outlook for Japan's economy. During the period between the time of the quake until summer, the pace of economic recovery had been determined by the speed at which supply-side constraints were being resolved. However, as they have now almost been resolved, the key is demand-side developments from now on. The outlook for Japan's economy in this regard can be described as follows. For the time being, the pace of economic growth is likely to remain only moderate compared with the recovery phase following the disaster, reflecting an adverse effect from a slowdown in overseas economies and the appreciation of the yen. After that, Japan's economy is expected to return to a moderate recovery path because the pace of recovery in overseas economies will subsequently pick up led by emerging and commodity-exporting economies, whose mechanism of domestic demand expansion is basically being maintained, and because demand related to reconstruction after the earthquake disaster will gradually materialize. According to the projection in the *Outlook for Economic Activity and Prices* (Outlook Report) that the Bank released last week, the real GDP growth rate is projected to remain relatively low in fiscal 2011, at 0.3 percent, due in part to the effects of the disaster (Chart 1). However, it is projected to be 2.2 percent in fiscal 2012, partly because of an increase in reconstruction-related demand, and 1.5 percent in fiscal 2013, continuing to register positive growth.

Turning to prices, the year-on-year rate of decline in the consumer price index (CPI) has continued to slow consistently since the summer of 2009, and registered 0.2 percent in September this year. As for the outlook on the basis of such a broad trend, the year-on-year rate of change in the CPI will remain at around 0 percent for the time being. Expressing the outlook in numerical terms shown in the October 2011 Outlook Report, the year-on-year rate of change in the CPI is projected to be 0 percent in fiscal 2011, 0.1 percent in fiscal 2012, and 0.5 percent in fiscal 2013.

As illustrated, in the longer run, Japan's economy will eventually return to a sustainable growth path with price stability. At the same time, the Bank fully recognizes that such an outlook is attended by various uncertainties. There are two particularly salient points. One is financial and economic developments in overseas economies – in particular, future developments in the sovereign debt problem in Europe. Another is the medium- to long-term growth potential of Japan's economy.

II. Sovereign debt problem in Europe

Mechanisms for transmission to economic activity

I will now talk about the sovereign debt problem in Europe.

The origin of the problem is that in October 2009, triggered by a change of government in Greece, the country's fiscal deficits turned out to be much more serious than suggested by the data that were already released, and the country's debt repayment became doubtful. Greece has subsequently implemented fiscal consolidation measures while receiving financial support by euro area countries and the International Monetary Fund, but has remained to face a tough situation with negative economic growth and slow progress in fiscal consolidation. At the same time, the decline in market confidence in fiscal sustainability has spilled over to Ireland and Portugal, as well as bigger economies such as Spain and Italy, although the degree varies. The prices of government bonds issued by countries whose fiscal conditions became the subject of concern have declined, and financial institutions that were considered to be holding a large amount of such government bonds have come under close scrutiny (Chart 2). As illustrated, the decline in confidence in fiscal conditions caused the financial system problem, which in turn has started to affect the global economy through the following two channels.

The first channel works as follows. Many financial institutions in Europe continue to face difficulty in terms of raising funds in the markets. Therefore, they restrain lending and put priority on hoarding cash. As a result, borrowing costs and funding of firms that depend on European financial institutions are adversely affected. If such a situation continues, this could also affect project financing and trade financing in emerging economies.

The second channel is as follows. Global investors have become increasingly risk averse, which affects the flow of funds and prices of various assets worldwide. This materialized in the form of the fall in global stock prices and the widening of credit spreads of corporate bonds – that is, additional interest rates charged on government bond rates – in Europe and the United States since this past summer. Correspondingly, assets considered relatively safe have invited investors' purchases; for example, yields on government bonds issued by the United States, Germany, and the United Kingdom were at historically extreme low levels. As for currencies, the Swiss franc, Japanese yen, and U.S. dollar have been regarded as having low risks, and this has led to the rise in these currencies in the exchange market. As illustrated, it can be said that the recent appreciation of the yen is one example of the spillover effect of the sovereign debt problem in Europe into Japan through the increasing risk aversion by global investors. In this regard, the Ministry of Finance intervened to the foreign exchange market today. The Bank strongly expects that such an action will contribute to the stable price formation in the market.

The sovereign debt problem in Europe was triggered by the fiscal deficits, but it has started to affect economic activity in Europe through the financial system. If the economy deteriorates, it becomes more difficult to make progress with fiscal consolidation, which is the starting point of the problem. It should be recognized that the problem entails the risk that the adverse feedback loop among the fiscal situation, the financial system, and economic activity will intensify further.

Japan's financial environment continues to ease

Fortunately, so far in Japan, unlike in the United States and Europe, the markets from which banks and firms raise their funds remain in a stable condition, without strains (Charts 3 and 4). Looking at firms' funding conditions, they have actually continued to ease. Bank lending rates have declined moderately and credit spreads on corporate bonds and CP have remained stable at low levels. Underlying such stability is the fact that Japanese financial institutions do not hold a large amount of government bonds issued by those European countries that are a source of concern. Moreover, Japanese financial institutions in recent years have strengthened their capital and restrained their total amount of risks within their capital. They face no significant difficulty in terms of funding in foreign currencies. In addition, firms hold ample on-hand liquidity. The Bank's extremely accommodative monetary policy, including the purchase of such risk assets as corporate bonds and CP, which a central bank does not usually purchase – I will touch upon this later – also contributes to the stability in Japanese financial markets.

Given the stronger correlation among increasingly globalized financial markets, Japanese financial markets cannot remain immune from negative developments overseas, as these further materialize. As I mentioned earlier, the problem in Europe has already spilled over to Japanese markets, in the form of the yen's appreciation and weak stock prices since this past summer. Due attention should be paid to future developments in global financial markets.

The response to the sovereign debt problem in Europe

As I have mentioned, the sovereign debt problem in Europe poses a significant downside risk to the global economy at present. I would raise four challenges to be addressed to prevent the sovereign debt problem in Europe from developing into a crisis.

First, what is most important in the immediate future is to fully ensure financial market stability and prevent the problem from developing into a global financial crisis akin to the one engendered by the Lehman shock. In this regard, the European Central Bank, which is the central bank at the epicenter, has continued to provide ample liquidity to financial markets. Central banks in major economies, including the Bank of Japan, have worked together to establish frameworks in U.S. dollar funding markets for providing funds, including those with longer maturities covering the year-end, which marks a great improvement from the time prior to the Lehman shock (Chart 5). On October 19, the Bank of Japan and the Bank of Korea agreed to substantially increase the size of the yen-won swap agreement. The Bank of Japan believes that this action will mitigate adverse influences of heightened uncertainty in the global financial markets on the two economies and contribute to enhancing stability in regional financial and exchange markets in East Asia.

Second, euro area countries need to strengthen the implementation of specific measures to restore confidence in the financial system. On this point, there has been some progress in the past several weeks. The 17 countries in the euro area have given approval to expand the functions of the European Financial Stability Facility (EFSF) and discussions about financial institutions' recapitalization have started. At a series of meetings on October 26, European leaders agreed on comprehensive measures including a new Greek bailout package. I strongly hope that each measure will be specified and then implemented promptly.

Third, those euro area countries drawing strong market concern over their fiscal conditions should steadily work to reduce their fiscal deficits. This is a very difficult challenge, but without addressing it, the risk of the situation evolving into a crisis will persist.

And fourth, it is necessary to strengthen the euro area's growth potential through structural reform of the economy. The root of the European sovereign debt problem lies in the decline in international competitiveness. Therefore, the countries in trouble need to make efforts to regain such competitiveness through an increase in productivity and via cost reductions.

Sovereign debt problem as a lesson to be learned from

The sovereign debt problem has many aspects that Japan should learn from. One important lesson is that, as government bonds have a privileged position in financial transactions based on the assumption that they are absolutely safe, once doubt about government bonds' safety emerges, this will exert a wide range of effects on the financial system and subsequently on economic activity.

Although the ratio of government debt to GDP in Japan is the highest among advanced economies, yields on Japanese government bonds have remained stable at low levels. As for the background to this stability, it is often pointed out that government bond markets in Japan are basically dominated by domestic investors backed by ample excess funds in the household and corporate sectors within the country. However, it is not quite appropriate to discuss this issue only in terms of the supply and demand balance. Needless to say, there is no problem if market participants are convinced by evidence that the government will work toward fiscal consolidation in the medium term. If not, however, the possibility cannot be ruled out that, as in Europe, some events could cause market participants to become aware of risks to government bond holdings, which could in turn lead to a discontinuous rise in interest rates. Confidence in government bonds is also a significant issue in Japan given the large share on an international comparison of government bond holdings in the assets of financial institutions, which are the main suppliers of funds to firms. It is important to clearly present the medium-term roadmap for fiscal consolidation and implement specific measures to bring it to realization.

III. Medium- to long-term growth potential of Japan's economy

So far, I have talked about the sovereign debt problem in Europe and related matters, which constitute one of the two main points concerning the outlook for Japan's economy. I will now turn to the other point – namely, the medium- to long-term growth potential of Japan's economy.

Increasing importance of strengthening the growth potential

Looking at the long-term developments of Japan's real GDP growth rates, the average growth rate was 5 percent in the 1970s and maintained relatively high growth of around 4.5 percent in the 1980s (Charts 6 and 7). It dropped substantially to around 1.5 percent in the 1990s and further to less than 1 percent in the 2000s. As illustrated, since before the earthquake, Japan's economy has faced a long-term downtrend in growth rates on the back of the rapid aging of the population and sluggishness of labor productivity growth. Post-earthquake, Japan's economy faces the new challenges of steadily promoting reconstruction from the disaster, securing a stable electricity supply, and recovering the reputation abroad for Japanese products. I have recently heard concern over whether the expansion of overseas production by Japanese firms could lead to a hollowing-out of domestic industries. These are all serious challenges, but in what follows I would like to discuss my observations about concern over the hollowing-out of domestic industries and thereby highlight the importance of strengthening the growth potential of Japan's economy.

Meeting expanding overseas demand

Among many reasons behind Japanese firms' recent expansion of their overseas production, surveys targeting firms show that the predominant one is to meet expanding local demand overseas. The working-age population in Japan has been declining since peaking in the middle of the 1990s, and GDP growth rates abroad began to exceed those in Japan from around that time. In line with such structural changes, the overseas production ratio of Japanese firms – that is, the ratio of production value of overseas bases to Japanese firms' total production value – has been trending upward.

The recent expansion of overseas bases can be understood in the context of this long-term trend of corporate strategies that correspond to expanding global demand (Chart 8). In recent years, firms not only in the manufacturing sector but also in the nonmanufacturing sector have accelerated their establishment of overseas bases. In emerging economies, there continues to be robust demand for social infrastructures. Furthermore, against the background of an ongoing shift in the growth model from dependence on exports to a self-sustaining expansion of domestic demand, those markets that are already mature in Japan are expanding rapidly in emerging economies, including markets for retail, distribution and logistics, food service, food and drink, and housewares. Amid expansion of global markets, firms in every country face an equal increase in business opportunities. However, an international comparison of the outstanding amount of outward foreign direct investment as a percentage of GDP as of 2010 shows that the ratio is 75 percent in the United Kingdom, 44 percent in Germany, and 31 percent in the United States, while the ratio in Japan is only 15 percent (Chart 9). These data suggest that Japanese firms' overseas strategies are still lagging behind firms in other advanced economies. As a population decline has started in Japan ahead of other countries, actively capturing global demand is much more of a pressing challenge for Japan than for other countries.

Dual strategy of expanding business globally and exploring domestic demand

The question is whether the expansion of overseas production will induce a hollowing-out of domestic industries – specifically, a contraction of domestic production activity and a decline in employment – and thereby put downward pressure on growth rates of Japan's economy in the medium to long run. Although the danger of a hollowing-out of domestic industries has been an issue many times since the Plaza Accord in 1985, experience dictates that the expansion of overseas production has not resulted in a long-lasting overall negative impact on the domestic economy. This is because the increase in overseas production has also generated some positive effects on the domestic economy, such as the rise in exports of parts to overseas factories and the increase in dividends received from overseas subsidiaries.

How should we factor in the effects of the yen's appreciation? While the overseas production ratio of Japanese firms continues to be on a fairly consistent uptrend, there are times when the pace of increase is relatively fast or relatively slow. The trend of expanding overseas businesses is greatly determined by the pace of expansion of overseas demand, but within this trend the specific timing of individual firms' decisions to go international is influenced by foreign exchange rate developments. Let me touch on one example of recent developments. Toward the middle of the 2000s, the pace of increase in the overseas production ratio of Japanese firms temporarily paused when the yen depreciated substantially in the foreign exchange market, causing a shift back to domestic production in some ways. Although it is hard to evaluate the absolute level of foreign exchange rates, relatively speaking, the yen is without doubt getting much stronger in the exchange market than before the Lehman shock. At present, against the background of this swing in foreign exchange rates and the fundamental factor of the expansion of global markets, Japanese firms' strategies for the location of operations are again shifting back from returning home to going overseas. Therefore, in the short run, Japanese firms' shifting of production sites to overseas might accelerate at a faster rate than the past average. It is difficult to imagine that production

bases would return home once they shift to overseas. Therefore, if core companies and factories move overseas, it will be difficult for Japan's economy to regain the merits of business clusters even with a correction in the yen's appreciation. In addition, if the yen's rapid appreciation accelerates the pace of firms' shifting of production to overseas, there will be an increased risk that the pace of fostering new businesses and industries at home cannot keep up with the accelerated pace of the production shift.

At any rate, the medium- to long-term trend of expanding overseas bases is likely to continue given that the driving force behind global economic growth is shifting to emerging economies. In this regard, it is important for individual firms to review their domestic and overseas business operations from the perspective of enhancing corporate value. In a rapidly aging Japan, a potential serious problem in the long run is not excess employment but indeed the shortage of labor. Therefore, it is also important to transfer the work that can be done overseas and to focus on goods and services that can be generated most advantageously in Japan. For example, Japanese firms should sophisticate the functions of their domestic bases by shifting their precious management resources and personnel to the development and manufacture of new technologies and high value-added goods. They will also need to divide the functions of their business operations by allocating domestic human resources to meet diversifying consumer needs as well as develop businesses targeting the elderly in Japan.

It is also necessary to create an environment that attracts overseas firms and personnel to Japan. Earlier, I mentioned the data for outward foreign direct investment, but I must say that Japan is lagging far behind other advanced economies in inward foreign direct investment, or in "globalization of domestic markets." The outstanding amount of inward foreign direct investment as a percentage of GDP for 2010 shows that the ratio is 48 percent in the United Kingdom, 29 percent in Germany, and 18 percent in the United States, while the ratio in Japan is low at only 4 percent – literally, an order of magnitude difference (Chart 9). The low ratio of inward investment basically reflects that overseas firms consider investment in Japan as having low profitability. The other side of the coin is that Japanese firms are doing business in the market with such low profitability. At any rate, if firms in every country exert their strength and deepen the international division of labor across national borders, this will lead to the advancement of the global economy as a whole. It is important to enhance not only outflow to overseas but also inflow to Japan, as well as create a competitive environment that attracts overseas firms and personnel to Japan. With a view to strengthening the growth potential of its economy, Japan should implement a dual strategy of expanding business globally and exploring domestic demand.

Need to explore frontiers by exerting Japan's strength

In a macroeconomic analysis of economic growth of the country as a whole, the concept of potential growth rate is often used. This corresponds to the ability of firms' management to keep generating new added value at the microeconomic level. Seeing that the role and profitability of businesses change as time passes, firms are able to increase the added value per worker – in other words, to increase wages and shareholder returns – by creating highly profitable businesses and shifting their resources to those businesses, instead of fixing personnel and capital to businesses with low profits. Such improvement in economic metabolism illustrates the abstract concept of strengthening the growth potential of Japan's economy.

Needless to say, the process of exploring frontiers is very tough. However, we should note that Japan has an advantage in international competition in terms of geography, in that it is located in Asia, which is the driving force behind global economic growth. Japan also enjoys sophisticated "soft power," as exemplified by the credibility of made-in-Japan products and courteous service. Moreover, as I mentioned earlier, the great advantage at present is that financial system stability is being maintained in Japan, unlike in the United States and Europe. The results of various surveys including the Bank's *Tankan* (Short-Term Economic

Survey of Enterprises in Japan) show that the lending attitude of Japanese financial institutions has recovered to a level exceeding the average since 2000, despite the strains in financial markets around the world. In the past, Japan alone suffered from the disposal of nonperforming loans, and the weakness in the financial sector dragged down economic activity. However, on the back of their sound balance sheets, I believe that Japanese financial institutions at present are able to effectively provide support to firms' strategic efforts. This embodies the strength of Japan. If firms and financial institutions reconcile their growth strategies, they will discover ideas and methods for exploring new markets.

IV. The bank's conduct of monetary policy

In my remarks today, I first mentioned the outlook for Japan's economy and noted that it is likely to return to a moderate recovery path. In terms of points to be kept in mind concerning the outlook, I then talked about the sovereign debt problem in Europe and challenges regarding the medium- to long-term growth potential of Japan's economy. The Bank, in recognition of such outlook and risks, has been pursuing powerful monetary easing under the framework of comprehensive monetary easing (Chart 10). This framework has the following three pillars.

First, the Bank sets the policy rate at 0 to 0.1 percent, which can be deemed a virtually zero interest rate. Second, the Bank is publicly committed to continuing this virtually zero interest rate policy until it judges that price stability is in sight. And third, as an exceptional measure for a central bank, it purchases from the markets not only long- and short-term government bonds but also risk assets such as CP, corporate bonds, and exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs). A program for purchasing financial assets, called the Asset Purchase Program, started at 35 trillion yen, but has been repeatedly expanded in size on a significant scale. Last week, on October 27, the Bank decided to increase the size by 5 trillion yen, to about 55 billion yen. This decision is based on the recognition that some more time will be needed to confirm that price stability is in sight and due attention is paid to the risk that the economic and price outlook will further deteriorate depending on developments in global financial markets and overseas economies. As I have noted earlier, such pursuit of powerful monetary easing has become one of the factors responsible for stability in the financial environment in Japan, despite continued strains in the U.S. and European financial markets.

Although an accommodative financial environment has been maintained, as illustrated, demand has been declining for a protracted period and thus deflation has been continuing. This is because there exist fundamental factors – namely, a long-term downtrend in economic growth rates in Japan and the resultant reduction in growth expectations by firms and households. In this regard, the Bank has been supporting firms' positive efforts since summer 2010 by providing funds to financial institutions under the new framework of the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth. Raising the medium- to long-term growth potential of Japan's economy requires vigorous efforts from concerned parties in both the private and government sectors. In order for Japan's economy to overcome deflation and return to a sustainable growth path with price stability, the Bank for its part will continue to consistently make contributions as the central bank.

Concluding remarks

As I have already used up most of my time, I would now like to conclude my remarks. At present, all regions of the world face difficult challenges. I mentioned earlier that the sovereign debt problem in Europe was triggered by Greece, but the more fundamental factor is that the structural problem that was originally rooted in the present euro area framework was revealed by the Lehman shock. In the United States, debt in the household and

government sectors – specifically, excess debt in the household sector that accumulated during the housing bubble period and government debt that ballooned in the course of addressing the financial crisis and economic downturn after the Lehman shock – have become factors in destabilizing financial markets and the economy.

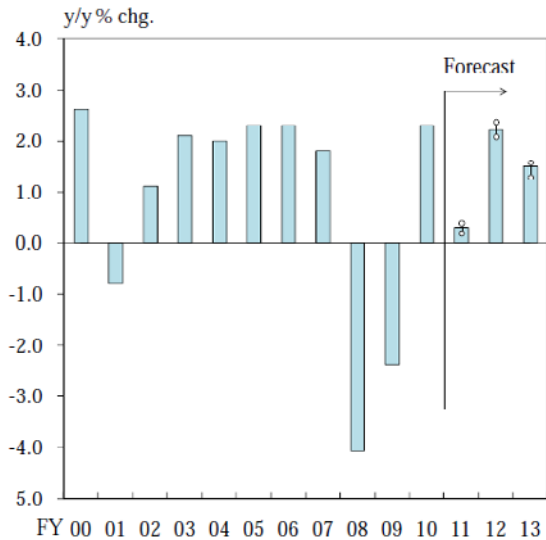
Emerging economies are likely to increase their presence as engines driving global economic growth. For the time being, however, there is a high degree of uncertainty as to whether they can ensure the sustainability of economic growth by containing inflationary pressure. In the medium to long run, not a few Asian countries will experience rapid aging of their societies, following the lead of Japan. There is also an issue of whether the global capacity to supply energy and food will manage to continue to meet the robust demand from emerging economies.

As I have described, every country and every region in the world has its own challenges. Japan, for its part, needs to positively tackle its challenges without falling into pessimism. The biggest challenge for Japan is to raise its growth potential. As the working-age population is declining, future generations cannot maintain the current high standard of living unless labor productivity is improved. As you may know, labor productivity is added value, or the sum of wages and profits, divided by labor input. Based on this definition, productivity growth is made possible by providing goods and services for which people are willing to pay. Without such efforts, economic growth cannot be achieved.

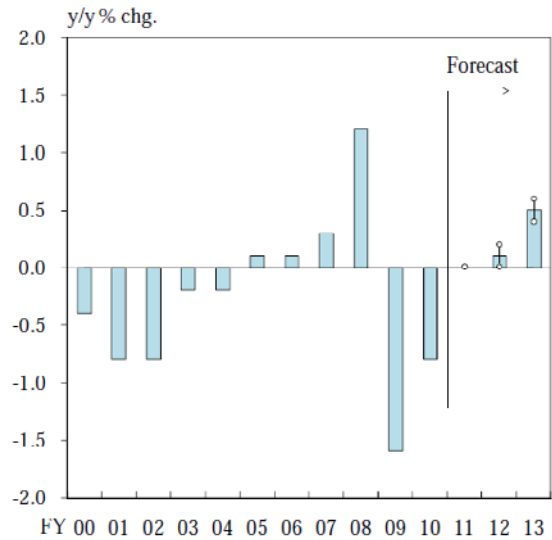
Japan can be called an “advanced country” in the sense that it has faced various challenges ahead of other countries. That is why Japan, if it explores visionary solutions to address natural environment problems, energy constraints, and the declining and aging population, will be able to contribute to the advancement of the global economy as well as determine new growth strategies for itself. In the Kansai region, there are many firms whose advanced technologies have a large global market share in various areas such as the natural environment and energy, medical and nursing care, high-tech manufacturing, and high-end materials. The region also offers a number of tourist attractions; for example, five World Heritage sites designated by the United Nations Educational, Scientific and Cultural Organization (UNESCO). In addition, the region is easily accessed from other Asian countries. There are new initiatives that convey the region’s abundant spirit in tackling challenges, such as the broad-based collaboration between industry and academia across prefectural borders. The Bank places its hope in and will provide support for the region’s efforts so that innovations as well as business models created in the region will help activate Japan’s economy.

The Bank of Japan's Economic and Price Forecasts

A. Real GDP



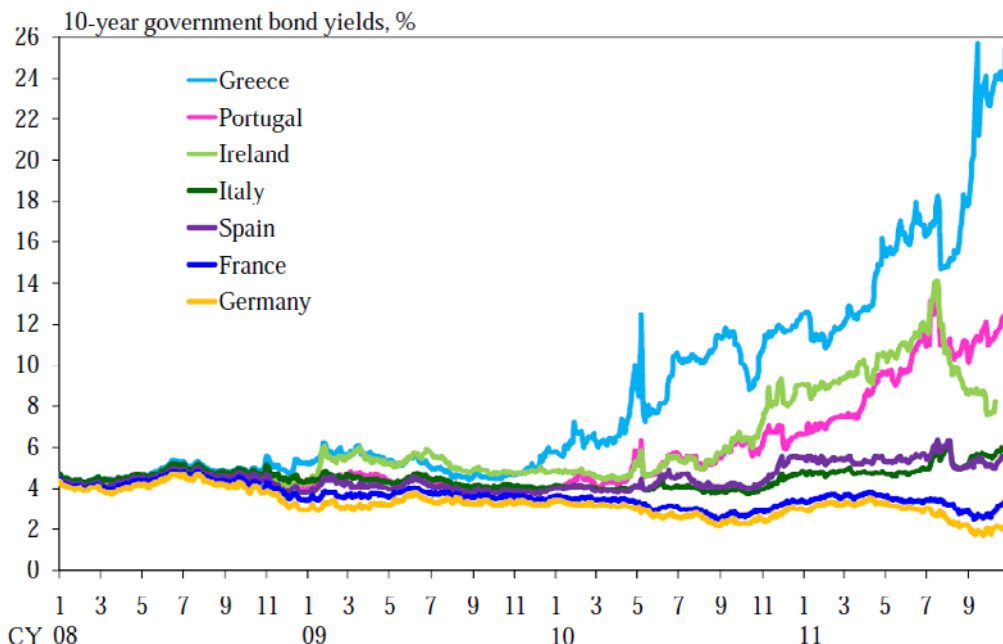
B. CPI (all items less fresh food)



Note: The forecast bars show the median of Policy Board members' forecasts, and the white dots show the range of forecasts of the majority members (excluding the highest figure and the lowest figure from the point estimates, to which each member attaches the highest probability of realization) presented in the October 2011 *Outlook for Economic Activity and Prices*.
Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Consumer Price Index"; Bank of Japan.

Chart 2

The euro area continues to face strains surrounding the sovereign debt problem, and yields on peripheral countries' government bonds have risen further since summer 2011.

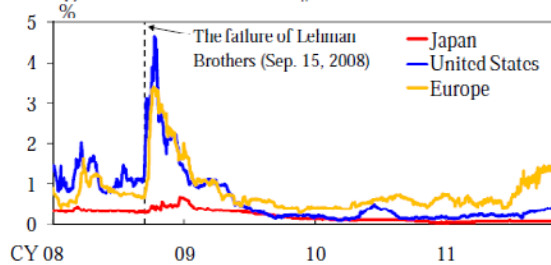


Note: Data for yields on Irish bonds have been discontinued as of October 11, 2011 due to the suspension of market issuance since October 2010.
Source: Bloomberg.

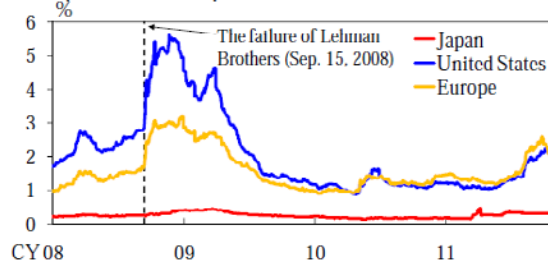
Chart 3

On the back of the sovereign debt problem in Europe, banks' and firms' funding rates are increasing in the U.S. and Europe. The rates in Japan remain stable at low levels.

A. Degree of Strain in Money Markets



B. Spreads on Corporate Bonds

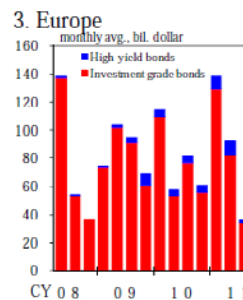
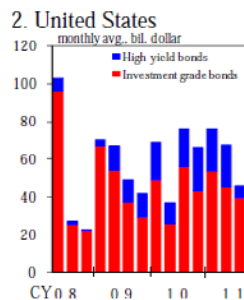
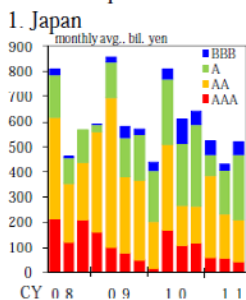


Notes: 1. The degree of strain in money markets is 3-month Libor minus yields on 3-month government securities.

Data for German government securities are used for Europe.

2. The spreads on corporate bonds (rated AA) are corporate bond yields minus government bond yields.

C. Volume of Corporate Bond Issuance



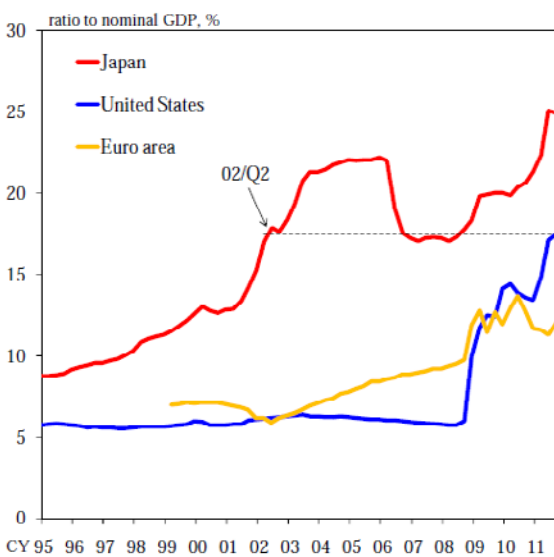
Note: Based on the launch date. Bonds issued by banks are excluded for Japan, and some government-guaranteed bonds are excluded for the U.S. and Europe.
Sources: Bloomberg; Japan Securities Dealers Association; I N Information Systems; Thomson Reuters.

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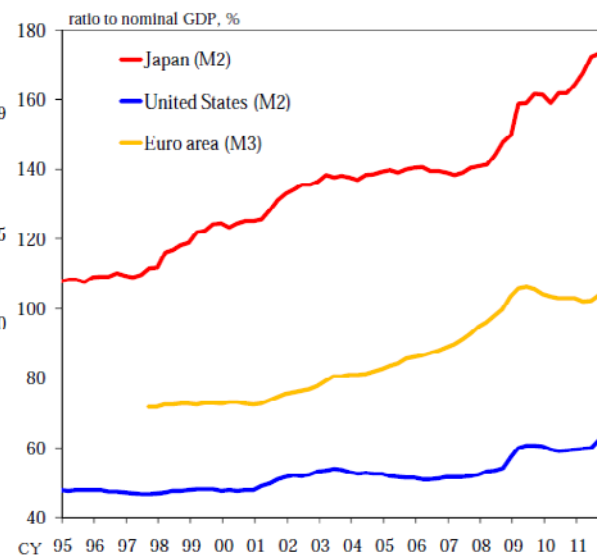
Chart 4

Japan's money supply as a ratio to nominal GDP has been at a high level compared to the U.S. and Europe, and recently increased further.

A. Monetary Base



B. Money Stock



Notes: 1. The latest data are as of 2011/Q3. Nominal GDP for Japan and the euro area are the 2011/Q2 data.

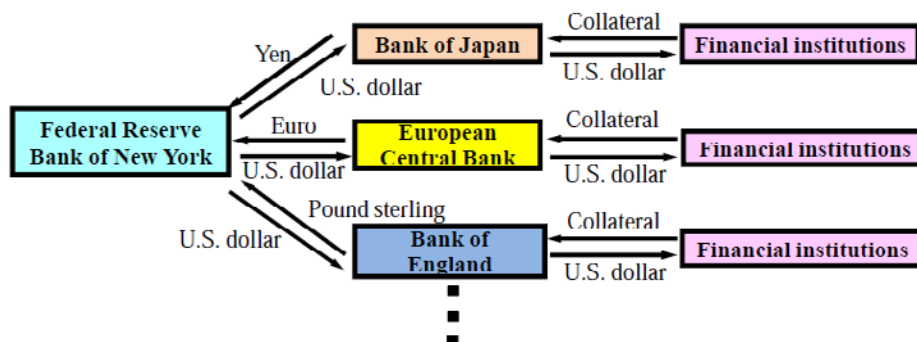
2. Monetary base is the sum of banknotes in circulation, coins in circulation, and current account deposits at a central bank.

Sources: Cabinet Office, Bank of Japan, FRB, BEA, ECB, and Eurostat.

4

Central banks in major economies have strengthened the frameworks for providing U.S. dollar liquidity.

A. The Basic Scheme of U.S. Dollar Funds-Supplying Operations



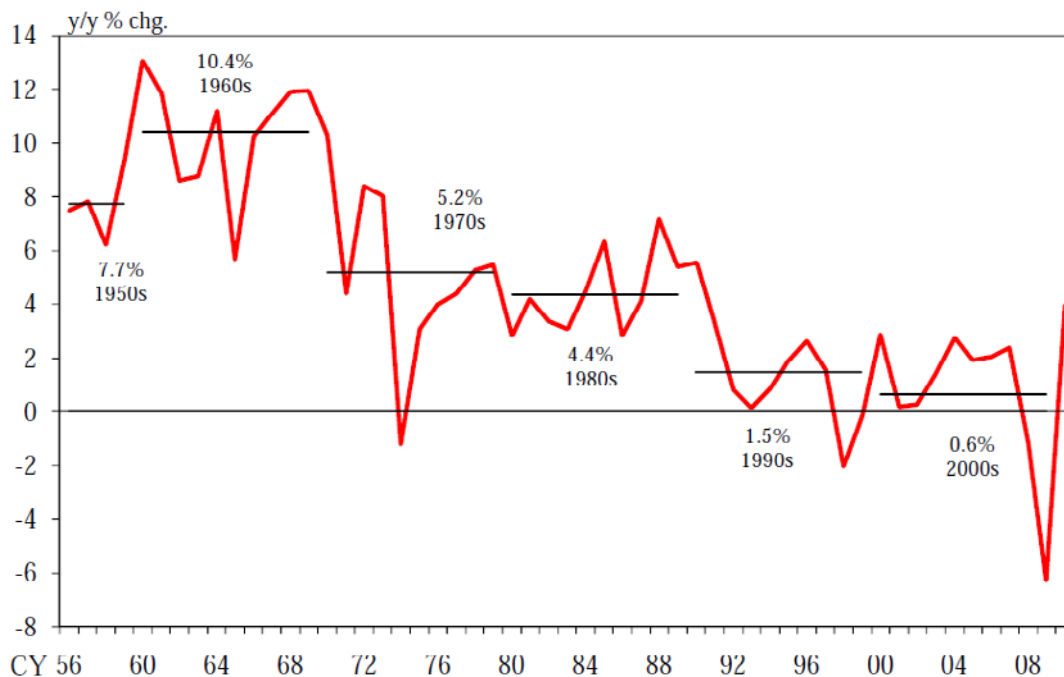
- A coordinated measure among six central banks in the U.S., Japan, U.K., Europe, Switzerland, and Canada.
- Introduced in September 2008 immediately after the Lehman shock and ended in February 2010.
- Reestablished in May 2010 in response to the increased strains in U.S. dollar short-term funding markets in Europe.

B. The Decision Made in September 2011

- ✓ On September 15, three central banks in Europe (the Bank of England, the European Central Bank, and the Swiss National Bank) and the Bank of Japan announced the conduct of U.S. dollar liquidity-providing operations over the year-end.
- ✓ These three central banks decided to introduce the 3-month operations in addition to the ongoing weekly 7-day operations with a view to fully ensuring the funding of financial institutions in Europe. The Bank of Japan, which had already conducted 3-month operations, decided to bring forward the conduct of such operations covering the year-end in coordination with measures taken by European central banks.

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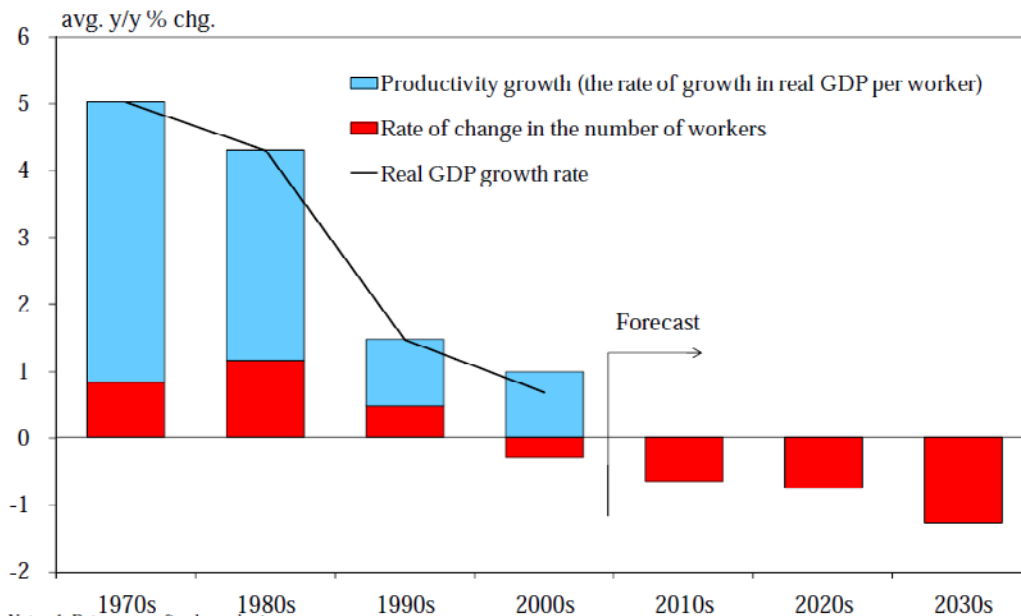
Japan's growth rate is trending down.



Note: Data up to 1980 are based on the 68SNA (System of National Accounts), while those from 1981 are based on the 93SNA. The average for the 1950s is the average from 1956 to 1959. Source: Cabinet Office, "National Accounts."

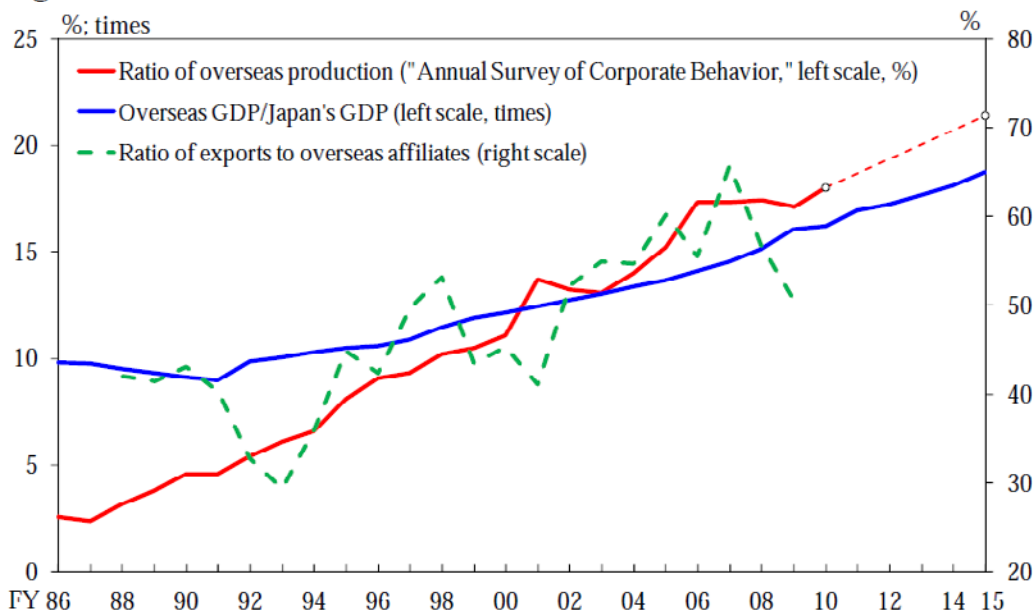
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The sluggishness of labor productivity growth and the decline in working-age population affects the long-term downtrend in Japan's growth.



Notes: 1. Data are on a fiscal-year basis.
 2. The rates of change in the number of workers from the 2010s onward are calculated using the projected future population (medium variant) and the projected labor force participation rates (assuming that the labor force participation rates in each age/sex group remain the same as those in 2009).
 Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Labour Force Survey"; National Institute of Population and Social Security Research, "Population Projections for Japan: 2006 2050."

The overseas production ratio has been increasing due to the expansion of overseas demand. The ratio of exports to overseas affiliates has also been rising overall.

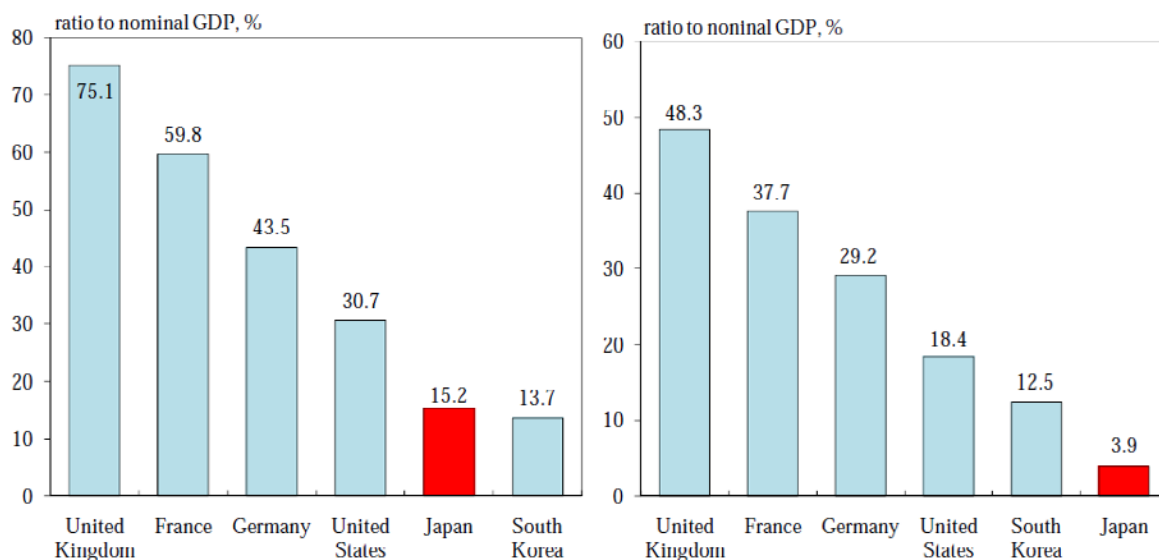


Notes: 1. For the ratio of overseas production ("Annual Survey of Corporate Behavior"), the figure for fiscal 2010 is the forecast and data from fiscal 2011 are linearly interpolated by using the fiscal 2015 outlook.
 2. Taken from the "World Economic Outlook (calendar year basis)." Data from 2010 are IMF estimates.
 Sources: Cabinet Office, "Annual Survey of Corporate Behavior"; Ministry of Economy, Trade and Industry, "Survey of Overseas Business Activities"; IMF, "World Economic Outlook."

Chart 9

Japan's outward and inward foreign direct investment as a ratio to GDP greatly falls short of other advanced economies.

A. Outward Foreign Direct Investment Stocks B. Inward Foreign Direct Investment Stocks



Note: Data are as of 2010.
Source: OECD.

9

Chart 10

The Bank of Japan's Conduct of Monetary Policy

Pursuing Powerful Monetary Easing via the Comprehensive Monetary Easing

- Implementing the virtually zero interest rate policy.

- Committed to continuing the virtually zero interest rate policy until it judges that price stability is in sight on the basis of the "understanding of medium- to long-term price stability."^[Note]

[Note] On the basis of a year-on-year rate of change in the CPI, a positive range of 2% or lower, centering around 1%.

- Establishing the Asset Purchase Program

Ensuring Financial Market Stability

Providing Support to Strengthen the Foundations for Economic Growth

➤ Increase in the Asset Purchase Program

- The Program has had three increases, expanding to about 55 trillion yen from the initial size of about 35 trillion yen (the latest increase was decided on October 27).
— The increased purchases are to be completed by around the end of 2012.

	Started in Oct. 2010	Mar. 2011	Aug. 2011	Oct. 2011
Total size	About 35	About 40	About 50	About 55
JGBs	1.5	2.0	4.0	9.0
T-Bills	2.0	3.0	4.5	4.5
CP	0.5	2.0	2.1	2.1
Corporate bonds	0.5	2.0	2.9	2.9
ETFs	0.45	0.9	1.4	1.4
J-REITs	0.05	0.1	0.11	0.11
Fixed-rate operation	30.0	30.0	35.0	35.0

Note: In addition to purchases under the Program, the Bank regularly purchases JCBs at the pace of 21.6 trillion yen per year.

10