Hirohide Yamaguchi: Recent financial and economic developments and challenge of revitalizing Japan's economy

Speech by Mr Hirohide Yamaguchi, Deputy Governor of the Bank of Japan, at the JCIF (Japan Center for International Finance) International Finance Seminar, Tokyo, 22 November 2011.

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Introduction

Thank you for having me at the JCIF International Finance Seminar. Today, I will talk about the financial and economic developments at home and abroad, followed by my thoughts, from a medium- to long-term perspective, against the background of a declining trend in the growth potential of Japan's economy and challenges toward the future.

I. Developments in the global economy

Current situation and future of the global economy

Let me start with the developments in the global economy. Looking back, the global economy continued to mark a high growth rate in the recovery process from the Lehman shock, led by emerging and commodity-exporting economies. The pace of growth has been slowing, mainly in advanced economies, since this spring.

In the United States, which was the epicenter of the Lehman shock, balance sheet adjustment, mainly in households, has been weighing on the economy, and the pace of recovery remains quite moderate. In Europe, the economies were recovering moderately after the Lehman shock, but their growth rates have recently been clearly decelerating as the sovereign debt problem, which started from peripheral countries including Greece, have aggravated.

The pace of growth in emerging and commodity-exporting economies, which have been achieving high growth, is somewhat slowing. That is because real purchasing power has declined due to a rise in energy and food prices, and monetary tightening, which was implemented to contain the overheating of the economies, have shown effects. In addition, there are the effects of the slowdown in advanced economies. While the slowdown in the pace of growth itself in emerging and commodity-exporting economies, which have been somewhat overheating, is desirable in achieving sustainable growth with price stability, inflationary pressure in those economies is yet to be contained.

For the time being, the pace of growth in the global economy will remain decelerated, mainly in the advanced economies, amid lingering strains in international financial and capital markets. Thereafter, the growth rate of the global economy will rise again led by emerging and commodity-exporting economies, which have high growth potential. Such outlook is associated with great uncertainties. In particular, the consequences of the sovereign debt problem in Europe remain unforeseen.

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

European sovereign debt problem and accumulation of financial and economic imbalance

The origin of the sovereign debt problem was Greece's massive fiscal deficits that surfaced toward the end of 2009. In the spring of 2010, Greece faced difficulty in raising funds in the market and was driven into a corner which was said to be a Greek crisis. As a result, Greece received financial support by euro area countries and the International Monetary Fund. The Greek government subsequently announced various fiscal structural reforms including a reduction in public servants' salaries and revisions in the tax system. However, amid negative economic growth, a fiscal deficit reduction was not achieved in a pace initially envisaged, and Greece faced a second round of crisis toward this summer.

In the meantime, a decline in market confidence in fiscal sustainability, which started from Greece, has spilled over to peripheral countries including Ireland and Portugal, which was in a tough fiscal situation, as well as bigger economies such as Spain and Italy.

The yields of government bonds in those countries have risen substantially and market prices have declined significantly. European financial institutions, mainly those which held a large amount of such government bonds, have faced deterioration in their balance sheets and difficulty in raising funds in the markets. They have started to strive to reduce the size of balance sheets through measures including tightening their lending stance. As a result, firms' and households' sentiment has deteriorated and economic activity has been slowing.

At present, in Europe, a rapid adverse feedback loop seen during the Lehman shock has not been generated, but the adverse feedback loop of the fiscal situation, the financial system, and economic activity seems to have started to act.

On the back of the sovereign debt problem in Europe, there are factors that are essentially common to the Lehman shock. Namely, against a backdrop of accommodative financial conditions in the mid-2000s, a rise in asset prices, and optimistic growth expectations, financial and economic imbalances have been accumulated.

In the United States, on the back of "technological innovation in finance" as seen in an expansion of securitized products, financial institutions' and investors' risk awareness concerning financial products including subprime loans became lenient. That, together with accommodative financial conditions and a rise in housing prices, has led to a significant increase in home loans and an accumulation of imbalances, mainly in the household sector, and consequently induced the Lehman shock.

In European peripheral and other countries, due to the ease of fiscal funding on the back of confidence in "a single currency euro" and excessive expectations for economic growth potential and an increase in tax revenue, fiscal discipline has tend to become loose. Of course, a major player in the expansion of imbalances in such a case is the government sector, but also in the private sector, there have been inefficient investment and excessive employment supported by accommodative financial conditions, and productivity and external competitiveness have declined.

Intrinsically, the government sector and the private sector, just because the countries are the members of the Euro, cannot continue to raise funds at low interest rates, which are beyond those sectors' real strength, and continue to increase spending. Once the funding environment for the governments and the private sector becomes severe, due to a decline in confidence in fiscal conditions and a surge in government bond yields, economic activity will decline and a reverse whirl will start.

Toward problem resolution

A quick fix for the problem unfortunately does not exist. The accumulation of imbalances is like a chronic disease induced by the neglect of health for many years. For a cure, it takes time to improve physical health. Namely, the road to normalization is, by restoring fiscal discipline and raising economic growth potential, to repay debt and not to accumulate debt again in the future. While it is important to take responses including funding support and debt restructuring, those are, so to speak, policy measures to "buy time" and, in order to gain market confidence, it becomes necessary to show the market that countries have the capability to repay debt in the future.

If the road toward the resolution of the sovereign debt problem in Europe is understood as just described, economic activity and financial systems in Europe are likely to be unstable for the time being.

In addition, while I do not go into detail today, it should be noted that the United States is faced with a similar problem in that it suffers from the legacy of the accumulation of financial and economic imbalances.

II. Developments in Japan's economy

Japan's economy after the great earthquake disaster

I will next talk about Japan's economy. In the wake of the Great East Japan Earthquake on March 11, economic activity plunged. Because of the damage to production facilities and a severe power shortage, the nationwide and worldwide supply chains were cut off, and production and exports declined substantially. Households' and firms' sentiment slumped and spending declined. Looking at the developments thereafter, supply-side constraints were removed at a pace faster than expected and, around the summer, economic activity almost recovered to the pre-quake level.

Together with the restoration of damaged facilities, firms made various efforts and attempts, including producing in alternative facilities at home and abroad as well as ensuring parts procurement from alternative sources. As for a power shortage in the summer, severe constraints on economic activity were avoided due to the efforts to save electricity and to level electricity usage. In those ways, "strength in the field", or *genbaryoku*, of Japan's economy has been fully exerted in the experience of the recent earthquake disaster

Outlook and risk factors for Japan's economy

Japan's economy is in a situation in which supply-side constraints were almost removed and economic activity will be determined by demand-side developments. For the time being, the economy will be affected by a slowdown in overseas economies and the appreciation of the yen as well as flood damage in Thailand. After that, Japan's economy is expected to return to the moderate recovery path because the pace of recovery in overseas economies will subsequently increase led by emerging and commodity-exporting economies and because demand related to reconstruction after the earthquake will gradually grow.

According to the projection in the Outlook for Economic Activity and Prices (Outlook Report) that the Bank released recently, the real GDP growth rate is projected to remain relatively low in fiscal 2011 due in part to the effects of the disaster. The growth rate is projected to rise in fiscal 2012, partly because of an increase in reconstruction-related demand, and continue to register somewhat high growth in fiscal 2013. Turning to prices, the year-on-year rate of change in the CPI will remain at around 0 percent for the time being, and is projected to be around 0.5 percent toward fiscal 2013 on the back of an improvement in the supply-demand balance.

Such an outlook is accompanied by high uncertainties. First, the source of the utmost uncertainty is the consequences of the aforementioned sovereign debt problem in Europe. Fortunately, as Japanese firms have been performing vigorous management since the burst of a bubble, they have sufficient management vitality at present. Japanese financial institutions have also been restoring soundness in their assets and striving to reinforce their capital. The robustness of the financial system has been maintained. Therefore, despite continued strains in European financial and capital markets, financial conditions in Japan remain accommodative, supporting economic activity from the financial side.

As the US economy is not in its best condition, suffering the aftereffects of the Lehman shock, due vigilance is necessary against a possibility that a shock initiated in Europe will lead to intensify global investors' risk aversion or to a lower-than expected growth in the global economy as a whole. In those cases, downward pressure could also be exerted on Japan's economy through the financial channel of the appreciation of the yen and a plunge in stock prices, the real economic channel including a decline in exports, and the channel of sentiment of economic entities, including firms.

Second, uncertainty about demand related to reconstruction after the earthquake disaster. In the disaster-stricken areas, various activities toward reconstruction that include the reconstruction of disaster-affected facilities have already been underway. Demand for reconstruction in the worst-hit areas, including the Tohoku coast areas, is likely to gradually gain momentum as reconstruction plans that include the overall picture of urban development become specific. However, full-scale reconstruction demand, including private investment, should be seen with a certain margin of error in terms of size and pace of implementation.

Third, uncertainty about firms' and households' growth expectations. After the earthquake disaster, Japan's economy is faced with new difficulties, including the problems of electricity supply, in addition to the problem of the downtrend in economic growth rate due to the demographic vortex. Depending on responses to those problems, firms' and households' growth expectations could change and induce unexpected effects on future developments in economic activity. In what follows, I will talk somewhat in detail about those problems, which relate to the topic of today's seminar "Strategy for Revitalization of Japan's Economy".

III. Japan's medium- to long-term challenges and toward their resolution

Downtrend in growth rates

After the burst of a bubble, Japan's economy has often been referred to as a "lost decade" or "lost twenty years". Recently, in the United States and Europe, in which prolonged economic stagnation has started to be worried about, the phrase "Japanization" has also been used. Looking at Japan's real GDP growth rate, the average growth rate was relatively high at above 4 percent in the 1980s, but fell substantially to around 1.5 percent in the 1990s and further to less than 1 percent in the 2000s. Given such downtrend in the economic growth rate, it is likely that the growth potential of Japan's economy has recently been structurally weakening.

The reasons for the weakening growth potential are complicated. Broadly speaking, it seems that the system and the business practice which were formed in the past higher growth period as well as firms' behavioral principle could not sufficiently adapt to two large changes going on since the 1990s. The two changes in the business environment were the intensification of global competition and the domestic demographic vortex.

The first change, global competition, accelerated in the 1990s. Globalization enabled various and quick combinations of advanced economies' capital and technology and emerging economies' labor force, and opened the door to emerging economies to high growth. Potential business opportunities expanded beyond borders, and, in that regard, globalization was a change that brought new growth opportunities for Japanese firms and, eventually, Japan's economy. At the same time, globalization ushered in a "mega competition" era. Japanese firms were strongly required to gain strength to promote differentiation from many overseas rivals and become among the first to tap potential demand. While it is a fact that Japanese firms have been going in that direction, the speed has not necessarily fast enough, compared with the speed of changes in the business environment.

The second change, the demographic vortex has also progressed markedly since the 1990s. The population of workers, namely, the working-age population, defined as the population between 15 and 65 years old, started to decline since the mid-1990s and the pace of decline has been accelerating.

Such change in the demographic composition could induce a shortage of labor and becomes a factor in reducing growth potential from the supply side. At the same time, on the demand side, the change will prompt structural changes of the demand content because necessary goods and services will differ, according to each stage of life. Mass consumption markets, including housing and consumer durables, will shrink, while demand for various goods and services that raise the quality of life, such as medical and nursing care services, will increase, at least potentially. If changes on the supply side cannot catch up with the substantial changes in the demand structure, potential needs will not lead to actual spending and remain untapped, while excess supply will continue in markets for existing goods and services and economic activity will be under downward pressure. In Japan's economy since the 1990s, it is likely that a supply and demand mismatch has chronically remained and continued to act as one of the reasons for inducing low economic growth.

Background of delayed responses to changes in the business environment

Why Japan's economy failed to adapt to changes including globalization and the demographic vortex? I would like to point out the following three. First, external exclusiveness. Second, rigidity in resource allocation. Third, a lack of the financial function that supports firms' challenges to new businesses. Let me elaborate on those.

First, external exclusiveness. Japan's economy has basically been maintaining high export competitiveness even since the 1990s. The share of exports in the nominal GDP or the sheer size of trade, which is the sum of exports and imports, is by no means large. In addition, while Japanese firms have been actively expanding overseas, if the ratio of foreign direct investment to the nominal GDP is compared with that in other major countries, Japan is at quite a low level. What is more pronounced is a small number of foreign firms' advancement to Japan, namely, a low level of inward direct investment. Also in terms of people, the acceptance of foreign workers is overwhelmingly small and the number of foreign tourists who visit Japan is at a low level.

As described, if one looks at the extent of internationalization in terms of people, goods, and capital, Japan is not necessarily a country opened externally. Since the 1990s, even though business opportunities across borders have substantially expanded, Japan's economy has lacked openness to utilize such chances.

Second, rigidity in resource allocation. In Japan's economic system that was established before the 1980s, long-term stability was valued in the relationship between management and labor, firms and firms, and firms and financial institutions. Such system, which used to be beneficial, has become a factor in hampering economic growth recently, when globalization and the demographic vortex have progressed and speedy metabolism and business model conversion have been called for. In that regard, an old-style safety net also has an aspect of constraining the effectiveness of resource allocation in the economy as a whole.

Third, a lack of the financial function that supports firms' challenges to new businesses. Enhancing competitiveness by improving production efficiency and cost reduction has been techniques of Japanese firms since the high growth era, and I believe it is still the case even now. Since the 1990s, as emerging economies with low production costs have come to the forefront, it is not possible any more for Japanese firms to earn sufficient profits just by improving production efficiency. Firms' strategies to open people's eyes to new values and create new markets should be strengthened. The problem is that such efforts do not always work. If so, the supply of risk money that supports such efforts will become critical. In that regard, restructuring of the financial function that will replace the traditional main-bank system and mortgage-backed loans is only half done.

Direction for strengthening growth potential

Looking at the medium- to long-term future of Japan's economy, the pace of decline in the working-age population is projected to further accelerate.

The economic growth rate can be divided into the growth rate of workers and the rate of productivity growth per worker. The acceleration of a decline in the working-age population in the future implies that there will be greater declining pressure on the number of workers. To avoid a downtrend in the growth rate in such situation, it is necessary to stave off a decline in the number of workers. Given that an increase in population and immigration is difficult in the short run, realistically, it is necessary to make efforts to encourage the employment of potential labor force. In particular, it is critical to solve the so-called "M-shaped curve" problem that women's labor participation rate declines after marriage and childbirth, and raise woman's labor participation rate. It is also necessary to increase opportunities for healthy elderly people to work.

Those measures alone have their limitations. Without an increase in productivity, a decline in the growth rate cannot be staved off. To raise women's and elderly people's labor participation rates, some measures, including the expansion of part-time workers and men's childcare leave, which will rather result in reducing productivity per worker, will become necessary. To overcome such adversities and clearly increase the rate of productivity growth is no easy matter.

To begin with, now that Japan is trying to fight against a headwind of a continued decline in population over several decades and aging, we need to have resolution to convert our sense of value and reconstructing an economic society. Those are daunting tasks, but, as I have explained, the directions of the tasks have become clear to some extent. Let me summarize again.

First, in order to benefit from the positive effects of globalization, open our country as much as possible. We need to increase not only trade but also the inbound and outbound traffic of capital and people. In addition to tourism and medical care, it is important to enhance the openness in various areas including education, culture, arts, and research and development. Attracting people from overseas could stimulate economic activity in terms of demand and innovation.

Second, enhance the latitude and flexibility of the economy as a whole through regulatory reform and improvement in flexibility in the labor market. In the aging society, there are areas, including medical and nursing care services, in which potential demand will indeed increase. Of course, public support will be essential for medical and nursing care services, through which the public should fairly enjoy the benefits. There is room for encouraging market-based growth through deregulation and other measures. In addition, the employment system need to be reconstructed into a further flexible system so that transferring of job, learning of new skills, and various ways of working could be chosen more freely.

Third, the supply of risk money that nurtures entrepreneurship. For firms to venture into new markets and generate profits and employment, the role of finance that shoulders such risk will be inevitable. In that regard, financial institutions are required to refine their own knowledge, find firms' business opportunities, and create demand for funds by themselves. In addition, without relying on mortgage collateral or borrowers' guarantee capability, it is also effective to diversify the form of lending, including the utilization of asset based lending, through being heavily involved in the process of firms' cash flow generation. Furthermore, the activation of equity capital through funds is a critical element in supporting venture firms and speedy business strategy.

IV. Needs for fiscal restructuring

While I have so far talked about the direction for strengthening growth potential of Japan's economy, an important challenge that also relates to that is fiscal consolidation. Japan's government debt outstanding is at an extremely high level, compared with other advanced countries. So far it has not yet led to a situation in which financial and capital markets are severely affected. As one can see from the sovereign debt problem in Europe, the market's view on a country's fiscal condition will change suddenly. It is not too much to say that there is always a risk that government bonds, which used to be regarded as "safe assets", might change discontinuously to "risky assets". Therefore, it is particularly a period like this when the markets are stable, when Japan needs to take steady steps toward fiscal consolidation.

To raise the growth potential of Japan's economy through the aforementioned efforts will lead to a decline in fiscal deficit through an increase in tax revenue. In addition, if Japan's tax system and social security system change to sustainable ones, corresponding to the demographic vortex, it is likely to support the self-sustaining recovery power of the economy through reducing households' future uncertainty, and lead to a rise in the medium- to long-term growth rate. It is critical to pursue the strengthening of growth potential and fiscal consolidation concurrently, and let a positive feedback loop work.

V. Conduct of monetary policy

Finally, let me talk about the Bank of Japan's monetary policy. The Bank has been pursuing powerful monetary easing in the framework of comprehensive monetary easing.

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, 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). The program for purchasing financial assets, called the Asset Purchase Program, started at 35 trillion yen in October 2010, but has been repeatedly expanded in size on a significant scale to about 55 billion yen. Those measures aimed at encouraging a decline in longer-term risk-free interest rates and narrowing of various risk premiums.

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.

Apart from those measures, the Bank started in June 2010 the new lending framework of the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth. It is a measure through which the Bank supplies long-term and low interest rate funds to private financial institutions that lend or invest in the promising areas. The ceiling of the measure was initially set at 3 trillion yen and, taking it into account that the funds actually provided have come close to the ceiling, the Bank established a new line of credit of 500 billion yen to provide funds to financial institutions that undertake equity investments or asset-based lending.

As I have talked today, strengthening medium- to long-term growth potential is a critical challenge Japan's economy is faced with, and if that challenge is met, it could lead to overcoming deflation through raising firms' and households' growth expectations. Based on that recognition, the aforementioned measure aimed at supporting private financial institutions' efforts from the financial front.

The Bank will consistently make contributions as a central bank so that Japan's economy will emerge from deflation and return to the sustainable growth path with price stability.

Concluding remarks

I have today talked such issues as medium- to long-term challenges to Japan’s economy. I strongly hope that Japan will meet those challenges in the near future and restore its luster. At that time, I believe that the word “Japanization” would be used in an exact opposite meaning.