Seiji Nakamura: Japan's monetary policy and developments in economic activity and prices

Speech by Mr Seiji Nakamura, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Okinawa, 9 November 2011.

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I. Recent economic developments at home and abroad

A. Changes in Japan's economy after the Great East Japan Earthquake

Following the Great East Japan Earthquake on March 11, 2011, Japan's economy faced two major supply constraints: supply chain disruptions and electric power shortages. As a result, production plunged, and exports dropped considerably, with those of cars and related goods, for example, falling by 50 percent from the level in February 2011. Uncertainty heightened further due to the electric power supply constraints following the nuclear power plant accident. In these circumstances, business and consumer sentiment deteriorated, and Japan's economy came under strong downward pressure. The restoration of supply chains, however, progressed faster than expected thanks to the many different creative solutions found at the individual firm level – something at which Japanese manufacturers excel. Moreover, because of changes in the way production is organized as well as wide-ranging efforts to reduce the use of electric power, production levels were not considerably hampered even though electric power shortages during peak hours in the summer had been expected. In this manner, Japan's economy has more or less resolved the supply-side constraints caused by the damage from the disaster, and is now in a phase where the level of demand at home and abroad – rather than the level of production – plays the key role in determining the outlook for the economy. Today, I will talk about recent economic developments at home and abroad, the outlook for Japan's economy, uncertainties regarding the outlook, and the Bank of Japan's monetary policy stance.

B. Overseas economic developments

Although the pace of growth in advanced economies has been decelerating, the global economy as a whole has been on a moderate recovery trend, led by emerging and commodity-exporting economies. In September 2011, the International Monetary Fund (IMF) projected that the year-on-year growth rate of the global economy would be 4.0 percent in both 2011 and 2012 and 4.5 percent in 2013. Although these projections are down from those in June, taking into account the fact that advanced economies are decelerating, they are not necessarily low given that they are at around the same level as the average annual growth rate of 4.1 percent observed in the period from 2000 until 2008, the year that Lehman Brothers failed. The contribution of emerging and commodity-exporting economies, particularly China, to overall global growth is more than 70 percent, highlighting the importance of these economies.

Next, I would like to talk about the economy of each major area. Starting with the U.S. economy, it has been recovering at a moderate pace, although the pace of recovery has been slowing. The annualized quarter-on-quarter growth rate of real GDP on a seasonally adjusted basis for the July–September quarter of 2011 was 2.5 percent, up from 1.3 percent in the previous quarter. The growth rate increased slightly because private consumption, particularly car sales, was firm and business fixed investment rose against the background of favorable corporate earnings. Developments in the housing market, on the other hand, have remained sluggish, preventing meaningful progress in the adjustment of household balance sheets. According to Zillow, a firm that provides information on the U.S. real estate market, almost 30 percent of all single-family homes with mortgages in the United States are in

negative equity, that is, the value of the real estate is below the outstanding amount of debt. This figure illustrates how seriously the balance sheets of U.S. households have been damaged. The unemployment rate has also remained high at around 9 percent, and the recovery in employment has been slow. Moreover, the European debt crisis has started to affect U.S. financial markets, and at the meeting of the Federal Open Market Committee (FOMC) on November 1 and 2 the members of the Federal Reserve Board revised downward their projections of real GDP growth in the United States. While the U.S. economy is likely to continue to recover, the pace of growth is likely to remain only moderate partly due to limited room for additional fiscal or monetary stimulus measures.

In Europe, growth in exports has become sluggish owing to the deceleration in the pace of recovery of the world economy, and the pace of recovery of the euro area as a whole has also been slowing. The most critical issue in the European economy at present is the sovereign debt problems. These began in peripheral European economies such as Greece, but have rapidly grown into problems involving the whole of Europe. As these problems spread, investors quickly have grown increasingly risk averse and strains in financial markets have heightened. Business and consumer sentiment has also been under strong downward pressure. Moreover, financial institutions' lending attitude has been tightening and their asset base been shrinking. Consequently, the sovereign debt problems are starting to have a negative impact on economic activity in Europe. As for the outlook, the pace of recovery of European economies is likely to remain slow in general, with some differences in pace by country, due to the continuation of downward pressure arising from the prolongation of the European debt crisis and to cuts in fiscal spending as part of fiscal consolidation measures in the euro area economies. Under these circumstances, the European Central Bank (ECB) decided to lower the key ECB interest rates at the meeting of the Governing Council held on November 3, 2011. There remains considerable uncertainty as to how the European debt crisis will unfold, and the timing of a recovery in market confidence is unclear.

Emerging and commodity-exporting economies have continued to grow at a relatively rapid pace led mainly by vigorous domestic demand, although the pace of increase in exports has been slowing due to the deceleration in the U.S. and European economies. In some emerging and commodity-exporting economies, the policy stance toward monetary tightening has been eased due to concerns about instability in domestic financial markets and the negative effects on economic activity. However, in many other emerging and commodity-exporting economies, inflationary pressure remains high. Meanwhile, in China, the year-on-year growth rate of real GDP in the July–September quarter was 9.1 percent. Although this is a slight decline from the previous quarter, the pace of economic growth remains relatively high. The year-on-year rate of increase in the consumer price index (CPI) in September was 6.1 percent, significantly above the Chinese government's full-year target of 4 percent for 2011. As for the outlook, the Chinese economy on the whole is likely to maintain its relatively high rate of growth as the authorities work to contain inflation and curb upward pressure on real estate prices.

C. Current conditions of and outlook for Japan's economy

Japan's economic activity has continued to pick up thus far. The September 2011 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) released by the Bank showed significant improvements in the diffusion index for business conditions, particularly in the motor vehicles industry, and confirmed the rising trend in business fixed investment reflecting upward revisions in plans for such investment for the second half of fiscal 2011. Although the rapid recovery in production appears to have paused, as indicated by the slight month-on-month decline in the preliminary figure for the industrial production index in September, production is expected to resume its upward trend. It should be noted, however, that this assessment does not take full account of the effects of the flooding in Thailand and therefore needs to be treated with caution. Reflecting the pickup in production, real exports, particularly those of motor vehicles and related goods, have been increasing and have surpassed pre-

quake levels. Corporate activity has been improving in general. With consumer sentiment heading toward a pick-up, private consumption has been showing signs of improvement in a wide range of areas, including retail sales, outlays for travel, and spending in restaurants and the like. While the number of foreign visitors to Japan in September was 25 percent below the previous year's level due in part to rumors about radiation contamination and to the appreciation of the yen, the extent of the year-on-year decline has gradually been shrinking since April.

As for the outlook, it is possible that the pace of increase in exports will level out because of the effects of the appreciation of the yen and because we are likely to see a waning of demand associated with inventory restocking and the recapturing of market share temporarily lost due to supply constraints. As for the domestic economy, however, there are signs of a rise in demand related to reconstruction after the disaster, and domestic demand as a whole is likely to grow at a moderate pace. Demand related to reconstruction is likely to increase further as a third supplementary budget for fiscal 2011 is currently being deliberated in the Diet.

Semiannually, in April and October, the Bank releases the *Outlook for Economic Activity and Prices*, or the Outlook Report for short, in which it makes public its forecasts for economic activity and prices for the next two to three years. In the October Outlook Report released recently, the forecasts for the year-on-year growth rate of Japan's real GDP were 0.3 percent for fiscal 2011, 2.2 percent for fiscal 2012, and 1.5 percent for fiscal 2013. Figures were revised slightly downward from the forecasts made in the interim assessment in July 2011, reflecting the effects of the appreciation of the yen as well as the deceleration of overseas economies.

As for prices, against the background of the gradual improvement in the aggregate supply and demand balance, the forecasts for the year-on-year rate of change in the CPI for all items less fresh food were 0 percent for fiscal 2011, 0.1 percent for fiscal 2012, and 0.5 percent for fiscal 2013. Compared to the forecasts made in July, figures were revised downward, mainly because of the change in the base year for the CPI, which takes place every five years and was conducted in August 2011. The base year is changed to revise the composition of the CPI basket and the weight of individual items, so that the CPI reflects changes over time in the variety of goods consumed, in lifestyles, and in consumer behavior. As a result of the base-year change, the average year-on-year rate of change in the CPI for January–July 2011 was revised downward by 0.6 percentage point.

D. Uncertainty regarding the outlook

While uncertainty persists regarding the outlook for Japan's economy both in terms of upside and downside risks, developments with respect to the following downside risks in particular require close attention.

First, it remains highly uncertain how the European debt crisis will unfold. It will likely take a long time before the crisis is resolved. At the Euro Summit held on October 26, agreement was reached among the member states of the euro area on the reduction of Greek debt, the strengthening of European financial institutions' capital bases, and the boosting of the lending capacity of the European Financial Stability Facility (EFSF) aimed at serving as a safety net at a time of crisis. The announcement of the agreement on these issues temporarily calmed international financial markets. However, as shown by the subsequent turmoil in the domestic political situation in Greece and the discussions at the Group of 20 (G-20) Leaders Summit in Cannes, the details and implementation of the comprehensive set of additional measures agreed at the Euro Summit as well as the austerity measures of the relevant countries remain extremely uncertain. Consequently, market participants remain wary with regard to the creditworthiness of European financial institutions. For example, interest markups, which serve as a risk premium, in interbank funds transactions in Europe remain elevated and the situation is still tense. This is because the European debt crisis is no

longer confined to the problems of countries with excessive liabilities, such as Greece and Italy, but is spreading throughout the euro area, and – triggered by a fall in confidence in bonds issued by these heavily indebted countries – a negative feedback loop has started to operate in which the decline in creditworthiness of European financial institutions and growing downward pressure on economic activity reinforce each other. Under these circumstances, with the market extremely sensitive to any negative news, careful attention should be paid to "tail risks", that is, risks with a low probability of materialization but a devastating impact if they do materialize. For the European economies to overcome the negative feedback loop, it is crucial that peripheral countries carry out fundamental reforms of their fiscal structures and that medium- to long-term economic growth is raised through the strengthening of productivity and competitiveness. However, it inevitably takes time to press ahead, through democratic processes, with decisions that will entail pain, and the discrepancy between the amount of time required and the time span the market can tolerate is a cause of concern. Moreover, the current European debt crisis has revealed problems in the governance of economic and fiscal affairs in the euro area. To avoid this type of crisis in the area from recurring, not only reforms of the fiscal structures of the heavily indebted countries but also fundamental reforms of institutions, including the issue of fiscal management of the euro area, will be necessary.

Second, as for the U.S. economy, it is likely that balance-sheet adjustments in the household sector will continue to be a drag on economic growth, making it difficult for the economy to gain upward momentum and creating vulnerability to downside risks. Recovery in the housing market and the employment situation is likely to take some time. The risk of the U.S. economy registering low growth for longer than expected should be borne in mind, as room is limited for additional policy measures on both the fiscal and the monetary front.

And third, the risk persists that business sentiment may deteriorate further. Many Japanese firms did their utmost to overcome supply constraints resulting from the damage caused by the Great East Japan Earthquake, and only recently have finally returned to full-scale production. They are now working to recover the market shares at home and abroad that had been lost due to the disaster. The deceleration of overseas economies and the continued appreciation of the yen at this crucial stage – just when Japanese firms are returning to full-scale operation – are depressing business sentiment, particularly among exporting firms, by, for example, causing downward revisions of their profits. In addition, there are concerns about electric power supply constraints resulting from uncertainties regarding the resumption of operations at currently idle nuclear power plants, and such concerns could have a negative impact on business fixed investment and consequently the employment situation.

At the same time, as the devastating flooding in Thailand is likely to negatively affect production in Japan through a decline in exports from Japan to Thailand and damage to supply chains in Asia, including those in Thailand, the situation warrants careful monitoring.

E. Efforts toward fiscal consolidation around the world

Restoring the health of public finances is a policy priority common to all advanced countries. Even before the financial crisis, the fiscal balances of advanced countries were generally deteriorating against the background of a long-term trend of declining economic growth and expanding social security burdens due to population aging. Following the failure of Lehman Brothers in autumn 2008, the fiscal health of advanced countries deteriorated further as a result of economic stimulus and support measures on the fiscal front to combat the sharp economic downturn. With concerns intensifying over the European debt problem, market views are hardening regarding excessive public debts, as these could disrupt the global economy. Since the beginning of 2011, rating agencies have downgraded the government securities of the United States, Japan, Spain, and Italy, because these countries were seen to be taking insufficient measures to reduce their fiscal deficits. The G-20 Cannes Summit held on November 3 and 4, 2011 reaffirmed member countries' commitment to achieve fiscal consolidation as agreed at the Toronto Summit on June 26 and 27, 2010, as part of the

action plan to strengthen medium-term foundations for growth.[1] Advanced countries have been working on fiscal consolidation as a policy priority with a high degree of urgency:[2]

(1) In the United States, the Budget Control Act of 2011, in which deficit reductions of more than 2.1 trillion U.S. dollars in the period from fiscal 2012 to fiscal 2021 were agreed, was enacted by Congress in August.

(2) As for the euro area economies, the Maastricht Treaty states that, in order to maintain confidence in the single currency, the euro, the deficit-to-GDP ratio should not exceed 3 percent, and that the government debt-to-GDP ratio should not exceed 60 percent. In Germany, the deficit-to-GDP ratio was 3.3 percent in 2010, but in the Stability Programme submitted to the European Commission in April 2011, the government stated that the ratio would be reduced to below 3 percent in 2011. In France, the deficit-to-GDP ratio was 7.0 percent in 2010, but the government stated that it would reduce this ratio to no more than 3 percent by 2013 and achieve fiscal balance by 2016.

(3) In the United Kingdom, Prime Minister David Cameron's government raised the rate of value-added tax in January 2011 and aims to halve the ratio of public-sector net borrowing (borrowing by the general government and public firms) to GDP by the end of fiscal 2013, and to substantially reduce the public-sector net debt-to-GDP ratio by the end of fiscal 2015.

Meanwhile, in Japan, the ratio of general government gross financial liabilities to GDP stands at 199.7 percent, while the deficit-to-GDP ratio stands at 8.1 percent. The former is considerably higher than in other advanced countries, such as the 93.6 percent in the United States, 94.1 percent in France, 87.0 percent in Germany, and 82.4 percent in the United Kingdom. It is even far higher than that in Greece, which – at 147.3 percent – triggered the European debt problem, or the 126.8 percent in Italy, which is suffering from a loss in market confidence. Nevertheless, yields on 10-year Japanese government bonds (JGBs) have generally remained below 2 percent for more than ten years and have recently been fluctuating at around 1 percent. According to data from the Ministry of Finance, the outstanding amount of government bonds has increased by about 70 percent during the past ten years, from 392 trillion yen in fiscal 2001 to 667 trillion yen in fiscal 2011. During this period, however, interest payments on JGBs have remained more or less unchanged, rising only slightly from 9.4 trillion yen to 9.9 trillion yen. Despite this secular increase in the outstanding amount of government bonds, the Japanese government has been able to raise funds at low interest rates without difficulties. This fact seems to have dulled the sense of crisis in Japan and led to procrastination in addressing the problem.

Demand for government bonds in Japan has been sustained by the accumulation of surplus funds at financial institutions, partly reflecting efforts by firms to strengthen their balance sheets and reduce borrowing amid low economic growth since the bursting of the bubble in the early 1990s. The sustained demand for JGBs, with yields of only around 1 percent, is attributable to the sense that – in a situation where the opportunities for Japanese financial

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[1] The Toronto Summit Declaration stated that "advanced economies have committed to fiscal plans that will at least halve deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016". However, on Japan, it stated that "recognizing the circumstances of Japan, we welcome the Japanese government's fiscal consolidation plan announced recently with their growth strategy". The "Fiscal Management Strategy", decided by the Japanese Cabinet before the Toronto Summit, set the target of reducing the ratio of the primary balance deficit relative to GDP to half its fiscal 2010 level by fiscal 2015, and to achieve a primary balance surplus by fiscal 2020.

[2] The government debt-to-GDP ratios for 2010 quoted below are the "general government gross financial liabilities" taken from *OECD Economic Outlook*, No. 89, released in May 2011, while the fiscal deficit-to-GDP ratios are the "general government financial balances" from the same publication.

institutions to invest their funds are limited – JGBs are safe and liquid assets that will continue to command market confidence.

This confidence in JGBs rests on the confidence that payments of interest and principal are backed by future government revenues and, moreover, that the government and the Bank have the will and ability to restore long-term fiscal health and maintain the value of the currency. In the case of Greece, even though there was no major change in the level of economic activity, yields on 10-year government bonds surged from around 4.5 percent in October 2009 to nearly 9 percent six months later in April 2010 and are hovering at around 28 percent at present. This increase was due to abrupt changes in market participants' confidence in the Greek government's will and ability to improve the fiscal balance in the medium to long term, which forms the basis for its capacity to redeem government securities.

In Japan, more than 60 percent of the outstanding amount of JGBs is held by banks, insurance companies, and pension funds,[3] which receive their funds in the form of bank deposits and insurance premiums. It could therefore be said that the public is the ultimate holder of JGBs, although the general public probably is not aware of this. It should be noted, however, that, amid the rapid aging of the population in Japan, there is no guarantee that in the future financial institutions will continue to channel personal savings into JGBs in a stable manner.

When these points are taken into account, the possibility cannot be ruled out that long-term interest rates, which at present are hovering at around 1 percent, could start to rise for whatever reason and the consequent increase in the interest burden could exert inordinate pressure on public finances.

The "Fiscal Management Strategy," decided by the Japanese Cabinet in June 2010 sets a clear target of achieving a primary balance surplus by fiscal 2020, followed by a stable reduction in the amount of public debt relative to GDP.

For the time being, it is possible for the government to raise funds at low interest rates and it is unlikely that there will be a major disruption in the supply and demand balance for JGBs. However, debts must be repaid and cannot be defaulted on. Reducing the real value of debt through inflation is also not a solution, given the enormous economic costs this would involve. There are no shortcuts to fundamental fiscal reform, and although it may entail a great deal of pain, it cannot wait much longer, since fiscal consolidation inevitably takes time. Thus, giving due consideration to developments in economic activity, Japan urgently needs to steadily implement concrete measures toward medium- to long-term fiscal consolidation while interest rates are low and JGBs still command the confidence of the market.

II. Conduct of monetary policy

I will now move on to the Bank's conduct of monetary policy. The Bank has been consistently making its utmost contributions through the three-pronged approach of pursuing powerful monetary easing consisting of comprehensive monetary easing that was introduced in October 2010, ensuring financial market stability, and providing support to strengthen the foundations for economic growth. The Bank further enhanced monetary easing following the Great East Japan Earthquake in March 2011 due to increased concerns about the effects of the deceleration in domestic and overseas economies and instability in the foreign exchange and financial markets.

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[3] See the Flow of Funds Accounts released by the Bank of Japan. The figure is the share of JGBs held by banks, insurance companies, and pension funds in the outstanding amount of JGBs and Fiscal Investment and Loan Program (FILP) agency bonds.

Given the extremely limited room for a further decline in short-term interest rates, the Bank has been pursuing the comprehensive monetary easing policy introduced in October 2010 mainly through the purchase of financial assets under the Asset Purchase Program (hereafter the Program). The Program has been repeatedly expanded in size on a significant scale. In addition, the Bank has made it clear that it will continue the virtually zero interest policy until it judges that price stability on the basis of the "understanding of medium- to long-term price stability" – inflation of around 1 percent – is in sight, provided that no problem is identified in examining risk factors, including the accumulation of financial imbalances.[4]

More recently, in August 2011 the Bank significantly increased the total size of the Program by about 10 trillion yen, from about 40 trillion yen to about 50 trillion yen, in response to the rise in various risks. However, subsequently, downside risks to the economy materialized in the form of, for example, greater adverse effects on Japan's economic activity from the deceleration in overseas economies and the appreciation of the yen. Consequently, in the October 2011 Outlook Report, the Bank's forecasts were revised slightly downward from those made in July 2011. Moreover, the Bank judged that there was increased risk that the outlook for economic activity and prices could deteriorate further depending on developments in international financial markets and overseas economies. Therefore, even though purchases of financial assets under the Program were still approximately 10 trillion yen below the maximum amount decided in August, at the Monetary Policy Meeting held on October 27, 2011 the Bank decided to further enhance monetary easing by increasing the total size of the Program by about 5 trillion yen, to about 55 trillion yen, for additional purchases of JGBs.

The Bank needs to do all it can – by vigorously implementing these monetary easing measures – to help Japan's economy overcome deflation and return to a sustainable growth path with price stability.

[4] The "understanding" is the level of inflation that each Policy Board member understands as being consistent with price stability over the medium to long term. The current "understanding" shows that "on the basis of a year-on-year rate of change in the CPI, it falls in a positive range of 2 percent or lower, centering around 1 percent".