Masaaki Shirakawa: Japan's economy and monetary policy

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at a meeting held by the Naigai Josei Chousa Kai (Research Institute of Japan), Tokyo, 4 June 2012.

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Introduction

It is a great honor to have this opportunity to address you today at the Naigai Josei Chousa Kai.

The last time I spoke here was in late May 2011. At that time, Japan's economic activity had just started picking up from the sharp decline in production following the downturn resulting from the Great East Japan Earthquake. The pace of the subsequent economic recovery was much faster than initially expected thanks to firms' strenuous efforts. After the beginning of autumn 2011, however, economic activity temporarily became flat due to the effects of the slowdown in overseas economies, the appreciation of the yen, and the flooding in Thailand. Since then, it has become increasingly evident that the economy is shifting toward a pick-up phase, particularly in domestic demand, which shows signs of firming. Price developments have gradually been improving as well. On the other hand, as evident in financial markets recently, some nervousness has been seen in developments regarding the European debt problem.

Today, I will first discuss economic and price developments. I will then explain the Bank's conduct of monetary policy. After doing so, I will offer my thoughts on the importance of engaging in efforts to overcome challenges facing Japan's economy, such as strengthening the economy's growth potential and ensuring fiscal consolidation.

I. Current developments in and the outlook for economic activity and prices

Current developments in economic activity and prices

I will start with developments in economic activity and prices. Overseas economies obviously have the largest impact on developments in Japan's economy. These economies have yet to emerge from a deceleration phase, but some improvement has been observed. On the whole, the U.S. economy is in the process of moderate recovery. As for domestic demand, reconstruction-related demand including public investment has clearly started to increase. In the corporate sector, business fixed investment has been on a moderate increasing trend, with improvement in business sentiment reflecting a favorable turn in the outlook for corporate profits. In the household sector, private consumption has been increasing moderately against the background of improvement in consumer sentiment. Consequently, as I mentioned earlier, the Bank judges that it has become increasingly evident that Japan's economy as a whole is shifting toward a pick-up phase.

Reflecting these economic developments, gradual changes in prices start to emerge (Chart 1). Deflation is often referred to when discussing developments in Japan's economy. As for the consumer price index (CPI, all items less fresh food), the year-on-year rate of change registered minus 2.4 percent in August 2009. Thereafter, the rate of decline moderated at a steady pace, recovering to 0 percent in fiscal 2011. The year-on-year rate of change in the CPI for the past two months, for which data is available, registered 0.2 percent. Looking at a breakdown by item, the rates of change are negative for items that are infrequently purchased and for which prices have declined substantially as a result of technological innovation, such as personal computers and televisions, whereas they are around 1.9 percent for those purchased more than about once a month. Focusing solely on items closely related to consumers' daily lives, such as food, the year-on-year rate of change has more clearly entered positive territory than in the case of other items.

Baseline scenario for the outlook through fiscal 2013

Next, I would like to talk about the outlook for economic activity and prices. At the Monetary Policy Meeting (MPM) held at the end of April, the Bank released its assessment of the outlook through fiscal 2013. An economic outlook undoubtedly entails various uncertainties and depends on relevant assumptions. The most important assumption made in the latest outlook rules out the possibility that an extreme intensification of the European debt problem would trigger a significant downturn in the global economy through the turmoil in global financial markets. On this basis, in the baseline scenario – that is, the scenario for economic activity and prices considered to be the most likely by the Bank – Japan's economy is expected to return to a sustainable growth path with price stability in the longer run.

More specifically, the economy is expected to return to a moderate recovery path in the first half of fiscal 2012 as the pace of recovery in overseas economies picks up, led by emerging and commodity-exporting economies, and as reconstruction-related demand after the earthquake disaster gradually strengthens. In terms of figures, the growth rate of real GDP is projected to be 2.3 percent and 1.7 percent for fiscal 2012 and 2013, respectively. Concerning prices, as the level of economic activity continues to rise moderately, the year-on-year rate of change in the CPI is expected to gradually rise to a range of above 0.5 percent and less than 1 percent by fiscal 2013, the latter half of the projection period. Thereafter, it will likely be not too long before the rate reaches 1 percent, which is the inflation rate that the Bank aims to achieve for the time being.

Upside and downside risks to the outlook

Such an outlook entails various uncertainties.

The first concerns developments overseas, including those in global financial markets (Chart 2). Of these, the European debt problem should be a risk factor that requires the closest attention. From the summer of 2011 to the end of that year, strains in global financial markets intensified due to the effects of the European debt problem. Thereafter, financial markets regained stability temporarily, mainly due to liquidity provision by the European Central Bank (ECB). Recently, however, some nervousness has started to be seen once again. In Greece, a re-election is scheduled for mid-June, as the government failed to form a ruling coalition following the general election in May due to public opposition to fiscal tightening measures. In Spain, concern about financial institutions' non-performing loan problem has heightened with the delay in efforts toward fiscal consolidation. Reflecting these circumstances, global investors have become increasingly risk averse on the whole. Government bond yields in Greece and Spain have risen while those in the United States, Germany, and the United Kingdom have recorded historical lows, or reached levels close to them. As suggested by the Lehman shock in autumn 2008, whether a risk will materialize in an extreme manner, leading to a significant economic downturn, largely depends on whether stability can be maintained in interbank funding markets. So far, interbank funding markets have generally been stable, mainly due to the massive liquidity provision by the ECB, a situation that stands in sharp contrast to that observed around the end of 2011. Nevertheless, liquidity provision by a central bank is a measure to "buy time", so to speak. It is therefore vital that governments and authorities steadily proceed with efforts toward achieving sustainable growth and stability in the European economy before time runs out.

In addition to risks stemming from developments in Europe, the global economy entails various uncertainties. With regard to the U.S. economy, while business fixed investment and private consumption have been firm, the effects of the bursting of the housing bubble remain deeply ingrained and the pace of recovery in employment is weakening. Although inflation rates have declined compared with some time ago, developments in emerging and commodity-exporting economies – which are expected to lead the global economy – also remain highly uncertain in terms of the extent to which they can grow without causing a resurgence of inflation.

In terms of uncertainties, we monitor the recent appreciation of the yen. The development in the foreign exchange market since last summer is closely linked to changes in global investors' risk aversion against the background of the European debt problem. The adjustment of the yen's appreciation from February to the first half of March reflected abating risk aversion by global investors as the situation in Europe improved. The movement of the yen thereafter was merely a reflection of the reversal of such investors' behavior. In any case, the Bank carefully monitors the development of the foreign exchange rate from the viewpoint of how it affects the economy through its impact on business sentiment.

Second, developments in reconstruction-related demand at home remain uncertain. The portion of the budget earmarked for reconstruction amounts to about 19 trillion yen – a sizable budget over five years – and most of this is ready for disbursement. This represents about 4 percent of Japan's nominal GDP and 60 percent of the total nominal GDP of the four severely disaster-stricken prefectures of Iwate, Miyagi, Fukushima, and Ibaraki. Steady disbursement is expected to significantly increase demand. However, a bottleneck – such as a shortage in construction workers – could also occur at various stages of implementation given the large scale of the budget.

Third, there is uncertainty with regard to firms' and households' expectations or their degree of confidence as pertains to the medium- to long-term growth outlook for Japan's economy. Japanese firms are currently increasing production overseas against the background of high growth in emerging economies. While this is a rational business strategy, medium- to long-term growth expectations are bound to change in either direction depending on whether new businesses will be created at home. With regard to problems concerning the supply and demand of electric power, the issue for the time being is how businesses will operate during the upcoming summer. Other important points to pay attention to are (1) whether concern about electricity supply constraints and a rise in electricity costs would lead to an eventual decline in medium- to long-term growth expectations, and (2) whether efforts to conserve, create, and store energy would lead to a strengthening of growth potential.

Fourth, there is uncertainty with respect to various issues regarding Japan's fiscal sustainability. Despite unfavorable fiscal conditions, some argue that the situation in Japan is not a problem given the abundant domestic savings and little need to rely on foreign investors. Having said this, no government can keep expanding its liabilities forever. The current stable low level of the government bond yields reflects market participants' confidence that Japan ultimately has the ability to work on fiscal consolidation. As I will get into later, confidence in fiscal sustainability is the most fundamental prerequisite for stability in prices and the financial system. Once damaged, it will adversely affect the economy. By contrast, considering the possibility that concern about the outlook for the fiscal situation is causing a decline in households' and firms' propensity to consume, a clear path toward fiscal consolidation may in fact heighten economic growth over a relatively long term.

II. The Bank's conduct of monetary policy

The price stability goal in the medium to long term

I will now explain the Bank's conduct of monetary policy, taking into account the aforementioned economic and price developments.

The Bank recognizes that the critical challenge for Japan's economy is to overcome deflation and return to a sustainable growth path with price stability. Based on this recognition, it has been implementing powerful monetary easing measures for a while. Looking at its policy decisions since the beginning of 2012, it introduced "the price stability goal in the medium to long term" in February while simultaneously further enhancing monetary easing. Taking another step forward, the Bank decided to enhance monetary easing again at the end of April. Let me explain in more detail.[1]

The first point is "the price stability goal in the medium to long term". The objective of monetary policy is price stability. As stipulated in the Bank of Japan Act, the Bank conducts monetary policy based on the principle that the policy shall be aimed at "achieving price stability, thereby contributing to the sound development of the national economy". In light of such principle, the price stability that the Bank aims to achieve must be one that is sustainable in the medium to long term. Among major central banks, the need to place importance on medium- to long-term price stability has been widely accepted. For example, the United Kingdom – known for its adoption of inflation targeting – has continued to register an actual inflation rate exceeding its goal by more than 1 percent for over two years. During this period, however, its central bank has conducted monetary easing, not tightening. Considering that the effects of monetary policy are transmitted with a time lag, price developments in the medium to long term, not those in the short term, must be taken into account, and policy conduct in the United Kingdom is based on its assessment that the inflation rate is expected to decline, judging from the output gap.

The level of inflation at which prices can be perceived as stable in the medium to long term depends on such factors as the characteristics of the economic structure of respective countries and the perception of prices held by those who have adapted to such an environment. Taking these into account, the Bank decided to express "the price stability goal in the medium to long term" with a degree of latitude, judging it to be in "a positive range of 2 percent or lower in terms of the year-on-year rate of change in the CPI". Furthermore, the Bank more specifically expressed that it set a goal of "1 percent for the time being" and that it would aim to achieve this goal in conducting monetary policy. I will elaborate upon why we chose "1 percent" later in my talk.

Pursuit of powerful monetary easing

The second point involves the specifics of the monetary easing measures. Given that the overnight call rate, or the policy rate, is already virtually zero, generating easing effects in terms of monetary policy calls for a new approach. This is where the Bank's comprehensive monetary easing measures implemented in autumn 2010 come in. The first part of its efforts focuses on its commitment aimed at generating policy duration effects – in other words, the Bank's determination to continue with its monetary easing. The other involves working on longer-term interest rates and risk premiums by establishing a program through which to mainly purchase financial assets, such as Japanese government bonds (JGBs) and risk assets. The Bank, establishing a link with its "price stability goal in the medium to long term", clarified at the February MPM that it would aim to achieve the goal of 1 percent inflation in terms of the year-on-year rate of increase in the CPI through the pursuit of powerful monetary easing, conducting its virtually zero interest rate policy and implementing the Asset Purchase Program (hereafter the Program) through the purchase mainly of financial assets, and that it will continue with this powerful easing until it judges the 1 percent goal to be in sight. As for the size of the Program, the Bank increased the amount by about 10 trillion yen at the MPM in February and about 5 trillion yen at the MPM at the end of April. In doing so, while reducing its funds-supplying operations with a 6-month term reflecting a decline in market needs, it substantially increased its purchase of JGBs by about 10 trillion yen and expanded the range of eligible JGBs and corporate bonds to be purchased from those with a remaining maturity of up to two years, to those with a remaining maturity of up to three years.

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[1] For more details on the Bank's measures to enhance monetary easing in February 2012, please see Masaaki Shirakawa, "The Bank of Japan's Efforts toward Overcoming Deflation" (Speech at the Japan National Press Club in Tokyo), February 17, 2012. http://www.boj.or.jp/en/announcements/press/koen_2012/data/ko120217a1.pdf

Through these measures, the Bank intends to proceed with and complete its purchase of financial assets under the Program, amounting to about 65 trillion yen by the end of 2012 and about 70 trillion yen by the end of June 2013 (Chart 3). Given that the amount outstanding of the Program has recently been about 51 trillion yen, the Bank is to accumulate nearly 20 trillion yen worth of financial assets in over a year from now and is currently in the process of enhancing monetary easing every month. However, the simple truth about its monthly efforts tends to be overlooked, since the Bank announces such efforts in advance in a collective manner. In any event, this pursuit of powerful monetary easing is expected to exert positive effects on economic activity and prices through the following transmission mechanism, together with the cumulative effects of easing to date.

First, the Bank's purchases of financial assets through the Program and the clarification of the policy time horizon mentioned earlier will encourage a decline in longer-term interest rates and a reduction in risk premiums. For example, while yields on JGBs tend to rise in accordance with an increase in maturity, those on JGBs with a remaining maturity of three years have recently declined to around 0.1 percent, reaching levels close to money market rates. Reflecting these developments in market interest rates, firms' funding costs have decreased at a moderate pace.

Second, such effects of low interest rates in terms of stimulating the economy will strengthen with improvement in economic conditions (Chart 4). Let us consider, for example, an interest rate in two different environments: one in which it is difficult to make profits, and the other in which an adequate return can be anticipated by investing with the use of loans. Of the two cases, the latter provides a larger economic stimulus. Monetary easing effects in Japan are expected to strengthen further in the future, considering that economic conditions and prices are heading toward improvement.

Third, financial markets remain extremely stable compared to other countries, as market participants have been reassured by ample fund provision. Reassuring firms and households about their funding plays a role in supporting their confidence, especially at a time when we are witnessing high uncertainty at home and abroad, particularly with regard to the European debt problem.

III. Some points about monetary policy

So far, I have explained the Bank's powerful monetary easing and its effects. In the conduct of monetary policy, we recognize that there are different opinions. One opinion is that the Bank should pursue more aggressive easing. Another is that it is too risky to embark on such aggressive measures. For our part, we listen to these opinions and conduct monetary policy as we judge most appropriate. Bearing these differences in mind, let me explain our thinking behind the conduct of monetary policy in order to facilitate better understanding of our policy making.

Level of the "price stability goal in the medium to long term"

The first is the level of the price stability goal. The general public's perception of prices is deeply ingrained and it influences their actions; thus, it is hard to imagine a situation that does not take account of experiences over the decades (Chart 5).

Although the year-on-year rate of change in the CPI turned negative in 1998, the average rate of inflation since the middle of the 1980s – after the effect of the second oil shock dissipated – is nearly 0.5 percent. It has consistently been lower than the equivalent rates in overseas economies. During the bubble period (1987–89) when the economy was booming, the CPI inflation was 1.3 percent. Over the last 30 years or so, there were only three cases when the year-on-year rate of change in the CPI reached 2 percent. The first was at the beginning of the 1990s, when the remnants of the bubble were still in place. The second was in 1997, when the consumption tax was lifted. The third was in 2008, when the sharp rise in energy and food prices hit the household sector.

Notwithstanding these past benchmarks, simply announcing out of the blue that the Bank aims to achieve 2 percent inflation is not enough. Above all, this might raise unnecessary uncertainties for businesses and households. Furthermore, if the announcement was trusted and inflation expectations rose accordingly, it is financial markets that would respond most quickly. There would then be a risk of a premature rise in long-term yields before actual prices and wages start to rise. Under such circumstances, the prices of Japanese government securities, a large share of which is owned by financial institutions, would go down, thereby heightening the risk of undermining such institutions' lending activities. Owing to these concerns, we judged that it was best to leave the CPI inflation rate at 1 percent for the time being and exert efforts to achieve that goal. On top of this, the Bank will review "the price stability goal in the medium to long term" once a year while analyzing the level of progress that has been made toward strengthening the growth potential and the changes that have occurred in the general public's perception of prices.

Achieving the "price stability goal" and conduct of monetary policy

The second point concerns the timing of achieving the price stability goal and its relationship with the conduct of monetary policy. In the Outlook Report published in April 2012, the median of the Policy Board members' forecasts of CPI (all items less fresh food) for fiscal 2013 was 0.7 percent year on year. Our decision to enhance monetary easing at that time was not made simply because our forecast fell short of the goal of 1 percent. Rather, given that it will likely be not too long before the year-on-year rate of change in the CPI reaches the Bank's "price stability goal in the medium to long term" of 1 percent for the time being, the Bank judged from a somewhat long-term perspective that the likelihood of Japan's economy returning to a sustainable growth path was fairly high. It was against such a background that the Bank enhanced monetary easing. A central bank aims to achieve price stability in the medium to long term, and no country has accepted the idea that its central bank must achieve a certain percent of inflation by a certain period of time in an automatic manner.

Having said that, we are hoping that 1 percent inflation, specified as the Bank's "price stability goal in the medium to long term" for the time being, is achieved at the earliest possible time. However, there are structural and corrosive problems behind the cause of deflation. Furthermore, one has to take into consideration that there is a long time lag before the effects of monetary policy permeate the economy.

Under such circumstances, if the Bank presses on too aggressively with the purchase of financial assets – the monthly purchase of JGBs, for example, has already reached a significant level – this could hold down long-term yields temporarily; however, it subsequently could trigger an event that would lead to a jump in such yields as a result of the government bond market being too dependent on the central bank's purchases (Chart 6). This will have a significant impact on financial institutions' management, and will jeopardize price stability as well as the sound development of the economy.

The Bank continues to examine whether economic activity and prices are moving in the right direction, and to assess risks including the accumulation of financial imbalances. The Bank will conduct policy in an appropriate manner while carefully assessing the effects of further monetary easing in the pipeline.

Large-scale purchase of government bonds and the credibility of currency

The third point is related to the large-scale purchase of government bonds and its relationship with maintaining the credibility of currency. Related to this point, we sometimes hear the criticism that once the purchase of government bonds by a central bank is perceived as financing government debt, and not conducted for the purpose of monetary policy, this could entail a risk of undermining the credibility of currency.

The Bank conducts such purchases for two different purposes. First, it regularly purchases long-term government bonds under the ceiling of the amount of banknotes in circulation. This is based on the rationale that, as long as such purchases are in line with an increasing trend of demand for banknotes, the Bank should hold long-term assets instead of short-term assets. From this viewpoint, a ceiling has been set that is equivalent to the amount of banknotes in circulation.

The second purpose is to purchase long-term government bonds through the aforementioned Asset Purchase Program, with a view to pursuing its powerful monetary easing. Such purchase is aimed at encouraging a decline in longer-term market interest rates on the basis of its conduct of monetary policy, and is not restricted to the ceiling of the amount of banknotes. At the end of May, the amount of JGBs held by the Bank for this purpose was about 10 trillion yen, and it will be increased by about 29 trillion yen by the end of June 2013. Adding these values together, the total amount of the Bank's holdings was approximately 73 trillion yen at the end of April 2012, is expected to total 92 trillion yen at the end of this year, thereby exceeding the amount of banknotes in circulation, and reach 97 trillion yen at the end of June next year (Chart 7).

Given that special deficit-financing bonds issuance in fiscal 2012 is about 38 trillion yen, the growth in size of the Bank's purchase of JGBs appears fairly straightforward. Nevertheless, the Bank's purchase of long-term government bonds has never been – and will never be – intended as financing government debt. I emphasize that the Bank's intention is crystal clear on this point.

Considering the relationship between currency and government securities, it is important to go back to basics.[2] The Bank purchases the government securities because the banknotes it issued against such purchases are ultimately accepted by the public, whose confidence in banknotes is maintained. However, such confidence is backed by the government securities. Put differently, it is hard to imagine a situation where public confidence in banknotes is maintained but not that in the government securities. Hence, once the confidence in the government securities is lost, so is that in banknotes. After all, if the central bank's purchase of the government securities exceeds the amount of banknotes the public wishes to hold, this will eventually lead to inflation. Alternatively, the anticipation of inflation will lead to a preemptive hike in long-term yields, exerting a negative influence on the economy and the financial system. Thus, the amount of the government securities that the Bank can purchase has a ceiling that is specified by "confidence". The Bank has been purchasing a significant amount of JGBs, but its operation rests on a subtle balance that is based on sustaining such confidence. Above all, it is vital that steps toward fiscal consolidation make steady progress in order not to create any room for misunderstanding the Bank's action as financing government debt.

Role of monetary easing

The fourth point is the role of monetary easing and its relationship with other policies and measures. Related to this point, we hear the view that insufficient monetary easing has caused both the persistent deflationary pressure and the resurgent appreciation of the yen. At the same time, we are aware of the opposing view that monetary easing has delayed structural reforms in the economy and fiscal situation. Our thinking on this is clear: we need

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2 On the relationship between currency and government securities, please see Masaaki Shirakawa, "The Importance of Fiscal Sustainability: Preconditions for Stability in the Financial System and in Prices" (Remarks at the Banque de France Financial Stability Review Launch Event in Washington D.C.), April 21, 2012. http://www.boj.or.jp/en/announcements/press/koen_2012/data/ko120422b.pdf

to make efforts to strengthen growth potential and provide support from the financial side. For our part, we will make our utmost efforts from the financial side.

Monetary easing permeates the economy through two stages. The first consists of the central bank's action influencing financial conditions, and the second involves such conditions inducing increased spending by firms and households. As far as financial conditions are concerned, the levels of interest rates in Japan – whether they be interest rates on loans or issuance rates of corporate bonds – are at least as low as those in the United States (Chart 8). This is also the case whether they be nominal interest rates or real interest rates adjusted for inflation expectations.

Nevertheless, the reason behind the recurring argument for insufficient monetary easing comes from a misunderstanding concerning the amount of currency the central bank supplies. Under a zero interest rate, the cost associated with holding either banknotes or the central bank's current deposits is negligible; no matter how much money it supplies, this will be held in such a form as the central bank's current deposits. In terms of quantity, this is completely ineffective. In fact, Chairman Bernanke has stated that the degree of monetary accommodation cannot be measured properly based on the quantity. Having said that, the fact is that the quantity itself is the highest in Japan. Considering that Japan had been increasing its quantity well before European countries and the United States, which started boosting their quantities after the Lehman shock, perhaps the public has been used to such an environment without being particularly aware of it. It is our strong desire that advantage be taken of such accommodative conditions.

IV. Importance of strengthening growth potential

Up to now, I have explained our thinking behind the conduct of monetary policy. In order for Japan's economy to overcome deflation and return to a sustainable growth path with price stability, support from the financial side is an important and necessary condition, and the Bank will do its utmost while examining the developments in economic activity and prices, as well as assessing risks. Nevertheless, this is not enough to lead Japan's economy toward overcoming deflation and returning to a sustainable growth path with price stability. Efforts to strengthen growth potential are particularly important. With this in mind, I would now like to change the subject and talk about how to strengthen growth potential.

Growth potential is the potential growth rate of real GDP. In the short run, the economy fluctuates at a rate around the potential growth path, but will converge to that path in the long run, say over 10 and 20 years.

The real GDP growth rate is decomposed into the growth rate of the workforce and the growth rate of real per capita GDP. Japanese data for the last 10 years show that the working-age population declined by 0.3 percent year on year and labor productivity increased by 0.8 percent year on year. When combining these numbers, the real GDP growth rate increased by around 0.5 percent. The decline in the workforce reflects the rapid aging that is in progress. For the next 10 years, assuming that the labor participation of male/female workers and that of different age groups remain constant, the working-age population is expected to decline by 0.6 percent. Meanwhile, labor productivity in Japan increases at a somewhat higher rate than in other major economies. With that in mind, there are only two ways to boost economic growth: either raise the rate of growth in the working-age population or raise labor productivity. Of course, the economic growth rate can still increase somewhat once the output gap has been filled through the process of encouraging an unutilized labor force to participate. According to the Cabinet Office, the recent output gap estimate is nearly 2 percent, and it appears that this does not provide enough impetus to lift the economic growth rate once the output gap is filled (Chart 9).

Raising labor participation and productivity

Based on the information provided thus far, the direction in which we should be heading is clear.

The first move would be to increase labor participation, or at least make efforts to stop its decline. In particular, society has to take steps to allow more females and the elderly to participate in the labor market. If, by 2030, (a) the labor participation of female workers became as high as that in Sweden, (b) the participation of those at the age of 60–64 became as high as those at the age of 55–59, and (c) the participation of those at the age of 65+ went up accordingly, then the working-age population would rise by 0.2 percent in the 2010s, not decline by the 0.6 percent that I mentioned earlier (Chart 10).

The second is to exert efforts to raise productivity. This sounds as though we need technological advances in order to achieve efficiency gains, but this is not necessarily the case. Labor productivity is the value added – the sum of wages and profits – per worker, and raising productivity is equivalent to creating goods and services that satisfy consumers' needs and shifting resources to produce such goods and services. Here, it is imperative to further efforts toward cultivating overseas demand and capturing domestic demand. Given that emerging economies are the driving force of global economic growth, it is imperative not just to accelerate exports but also to increase production in those areas. While Japanese firms' aggregate income associated with foreign direct investment and M&A activity is not included in the GDP, it will lead to an increase in the GNI, which represents the aggregate income earned by Japanese.

As for domestic demand, efforts are called for that aim to realize potential demand that has been increasing as the aging of the population proceeds. In this regard, there have been some promising episodes. The recent firming in household consumption is not just supported by policy measures such as tax credits for the purchase of hybrid cars and other eco-friendly cars. It is also supported by firms' efforts to successfully provide products and services – at somewhat higher prices than usual – that meet the diversifying needs of households, particularly those of the elderly.

Related to the aging of the population, the prospects for medical and nursing services will become all the more important. In fact, the number of employees in the medical and nursing service industry is clearly on an increasing trend over the long run. Moreover, in this industry, there are many firms that have only recently started up but have expanded their businesses successfully. However, given that one often hears about a lack of medical and nursing services that meet the needs of elderly people who have enough cash, it seems likely that, in Japan, either not enough of these services have been provided or not enough progress has been made in facilitating an infrastructure that makes the provision of these services possible in view of the potential demand arising from the aging population. In fact, among leading economies, the growth rate of the elderly population during the last 10 years is the highest in Japan. During the same period, expenditure related to medical and nursing services increased at the slowest pace in Japan (Chart 11). The case for the medical and nursing service industry merely serves to illustrate the point concerning increasing potential demand. Indeed, there are a number of opportunities that lead to the strengthening of economic growth potential, such as capturing the diversifying consumer demand and purchasing power in a rapidly growing Asia, in addition to efforts dealing with resources, energy, and environmental problems.

Relationship between strengthening growth potential and overcoming deflation

Next, how should we interpret the importance of strengthening growth potential or making efforts to raise the growth rate of real GDP, and their relationship with raising nominal GDP or overcoming deflation? Here, I stress the importance of generating domestic demand through making efforts to raise economic growth in order to overcome deflation. The reason I say this is that it has been the case that prices start to rise as the output gap improves. There were cases in the past where upticks in inflation took place without economic improvement, but these occurred as a result of rising import prices – crude oil prices, for example – that were then passed on to domestic prices. We are not waiting for such a situation to take place. Of key importance is how to raise growth expectations.

Will to overcome deflation

The issue is how we should encourage efforts to raise economic growth in Japan. I believe that, if Japanese make a collective effort, the goal of overcoming deflation can surely be achieved. On this issue, the following two factors provide good starting points.

The first is that we ourselves need to accurately recognize the challenges facing Japan. While the country still enjoys a fairly high level of income, this will not be sustainable without taking necessary measures. The fundamental problem facing Japan's economy is its declining growth, and deflation is a reflection of such a problem.

At this juncture, however, neither pessimism nor fatalism is called for. For example, both the declining birthrate and the aging population generate strong headwinds for Japan, but they are not the fundamental cause of low economic growth and deflation. Delayed responses to structural changes such as these and to globalization – a large structural change for Japan – are the fundamental causes of low growth and deflation.[3] Based on such recognition, necessary measures will surely be made.

Second, be it raising economic growth or overcoming deflation, all economic entities – including business firms, financial institutions, the government, and the Bank – need to share the recognition that it is imperative that they continue to exert themselves in their respective roles. Without delving into the Schumpeterian view of innovation, the challenging spirit of enterprises is all the more important. More concretely, it is necessary for firms to switch their fundamental strategy from the "Red Ocean Strategy", under which they continue price competition in the shrinking markets, to the "Blue Ocean Strategy", under which they create new markets and provide high value-added. If firms are successful in raising profitability not by cutting costs but by generating value-added, they can pay higher wages to their employees. Subsequently, consumers will have higher incentives to purchase value-added goods and services; hence, a virtuous circle prevails. The role of financial institutions to support such firms' efforts is also important.

In order to lay the foundation for firms to demonstrate their spirit of challenge, such government initiatives as deregulation are also important. I understand that such initiatives will move forward steadily through the launch of the comprehensive strategy for the rebirth of Japan, by mid-2012. Ultimately, these reforms will only move forward with the help of the general public's understanding. In this sense, it is important to build a society, which accepts the economy's metabolism as a concept of values, promotes deregulation to support such metabolism, and provides the safety net that enables entities to embark on a renewed challenge. I have touched on the roles of firms, financial institutions, and the government, as well as the general public's understanding. For our part, the Bank continues to make its utmost effort to overcome deflation and return to a sustainable growth path with price stability.

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[3] As for problems accompanying the aging of the population, please see Masaaki Shirakawa, "Demographic Changes and Macroeconomic Performance: Japanese Experiences" (Opening Remark at 2012 BOJ-IMES Conference hosted by the Institute for Monetary and Economic Studies, the Bank of Japan), May 30, 2012. http://www.boj.or.jp/en/announcements/press/koen_2012/data/ko120530a1.pdf

Concluding remarks

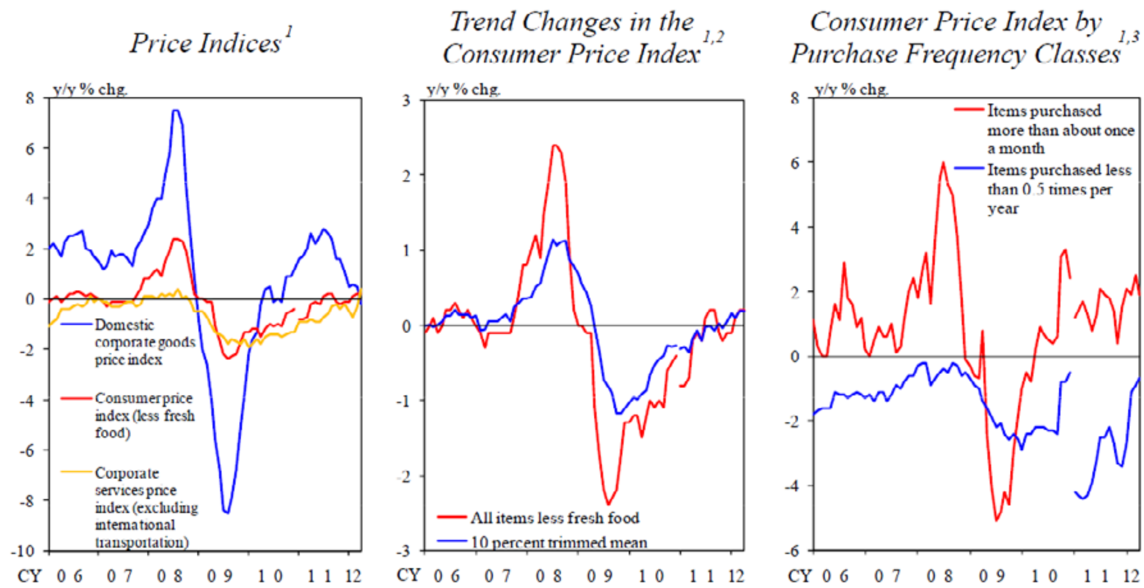
The world now faces a big challenge. Each country, including the United States, those in Europe, and those in emerging economies, also faces respective challenges. Japan is by no means an exception. There is commonality among the challenges each country faces, but there also are differences.

Over the past quarter of a century, Japan has gone through a number of challenges: the emergence and bursting of the bubble, the outbreak of a financial crisis, corrosive deflation, and the rapid progression of an aging population. Japan has faced these challenges much earlier than any other leading economies. While we are accustomed to learning lessons from overseas experiences, these only provide hints – not solutions. We ourselves must face reality, struggle to find solutions, and then put them into effect. Given that Japan managed to significantly change its structure of foreign trades, Japanese certainly have the potential to adapt to and cope with changes. In conclusion, let me reiterate that the Bank continues to do its utmost as a central bank to overcome deflation and achieve sustainable growth with price stability.

Thank you for listening.

Chart 1

Price Developments in Japan

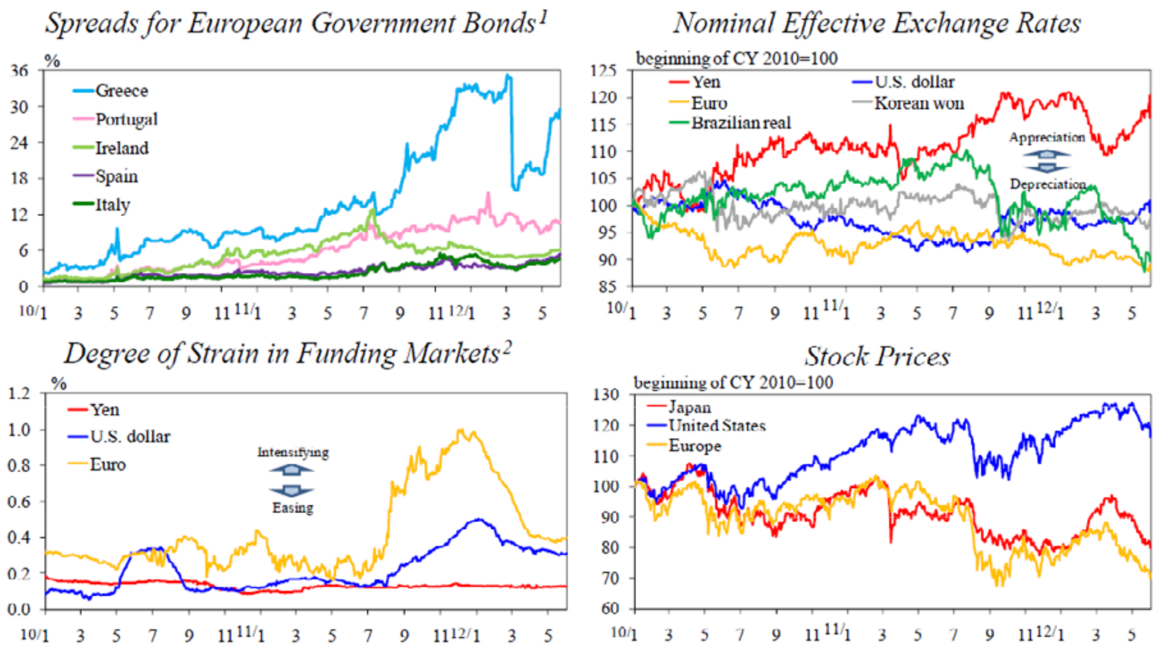


Notes: 1. Figures for the CPI up to 2010 are on the 2005 base, and those from 2011 onward are on the 2010 base.
2. Figures for the 10 percent trimmed mean are weighted averages of items; these items are obtained by rearranging year-on-year rates of price change in ascending order and then excluding items in both the upper and lower 10 percent tails by weight.
3. Figures for "Items purchased more than about once a month" are Electricity, Cooked food, and Tobacco, etc. Figures for "Items purchased less than 0.5 times per year" are TV sets and Package tours to overseas, etc.

Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

Chart 2

Financial Market Developments

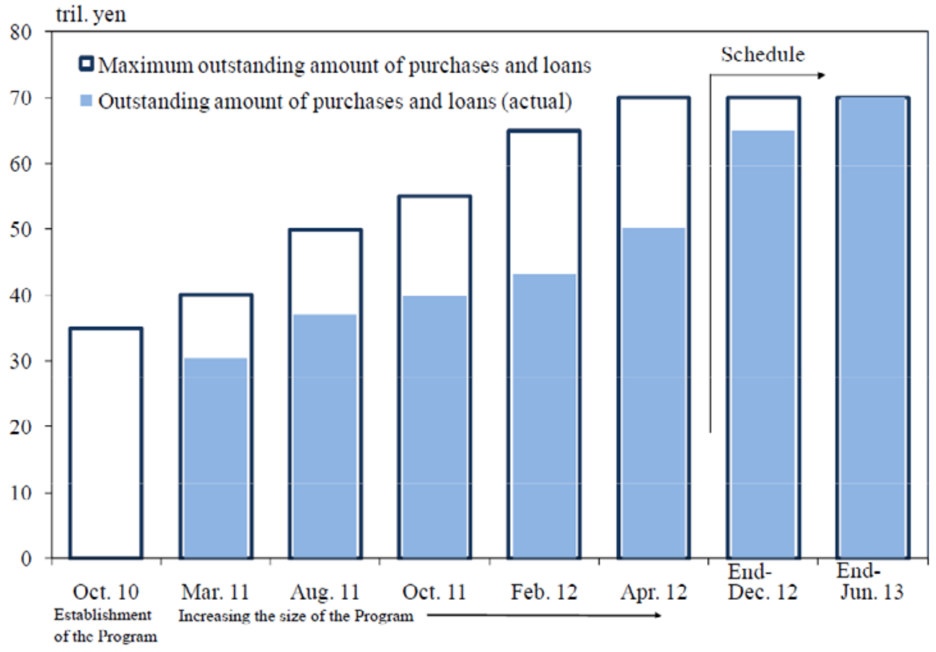


Notes: 1. The spreads for government bonds are the yield spreads for 10-year government bonds issued by European countries minus those issued by Germany. The spreads for Irish bonds are calculated using 9-year government bonds.
2. The degree of strain in funding markets is 3-month Libor minus 3-month overnight index swap (OIS) rates.

Source: Bloomberg.

Chart 3

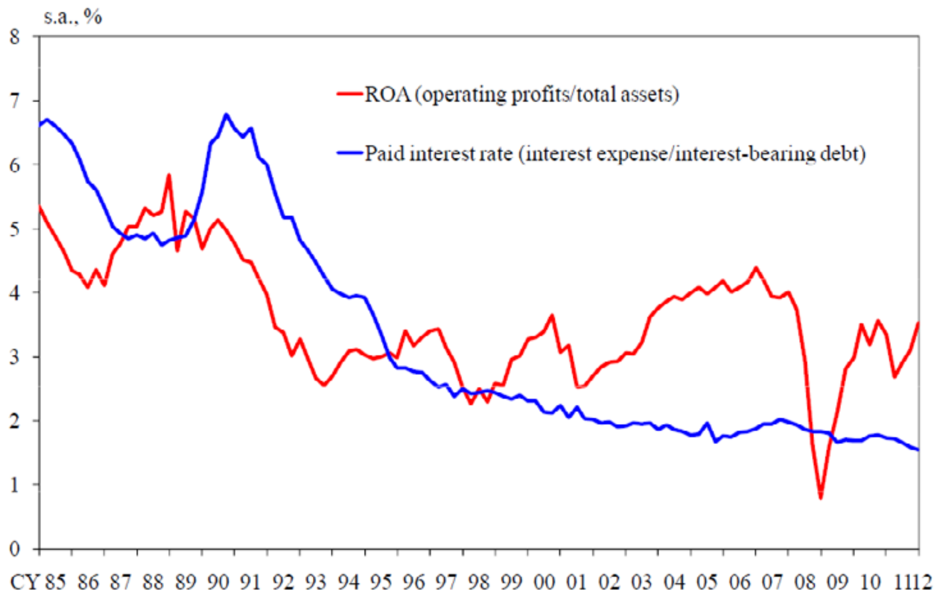
Size of the BOJ's "Asset Purchase Program"



Source: Bank of Japan.

Chart 4

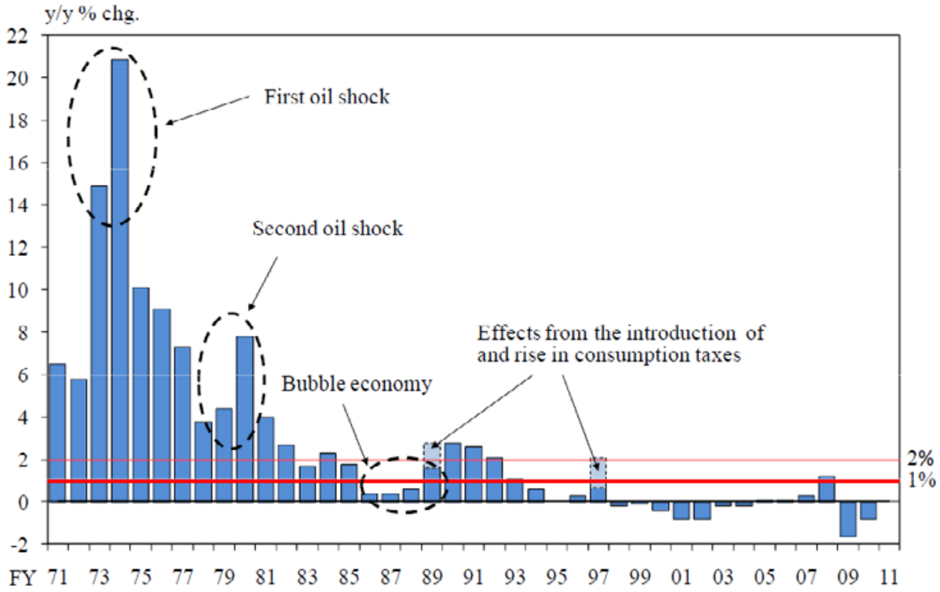
ROA and Paid Interest Rate of Japanese Firms



Notes: 1. Figures are taken from the "Financial Statements Statistics of Corporations by Industry, Quarterly," and are based on all size enterprises and all industries. Finance and insurance are excluded.
2. Interest-bearing debt is the sum of long- and short-term borrowings, corporate bonds, and bills receivable discounted outstanding.
Source: Ministry of Finance.

Chart 5

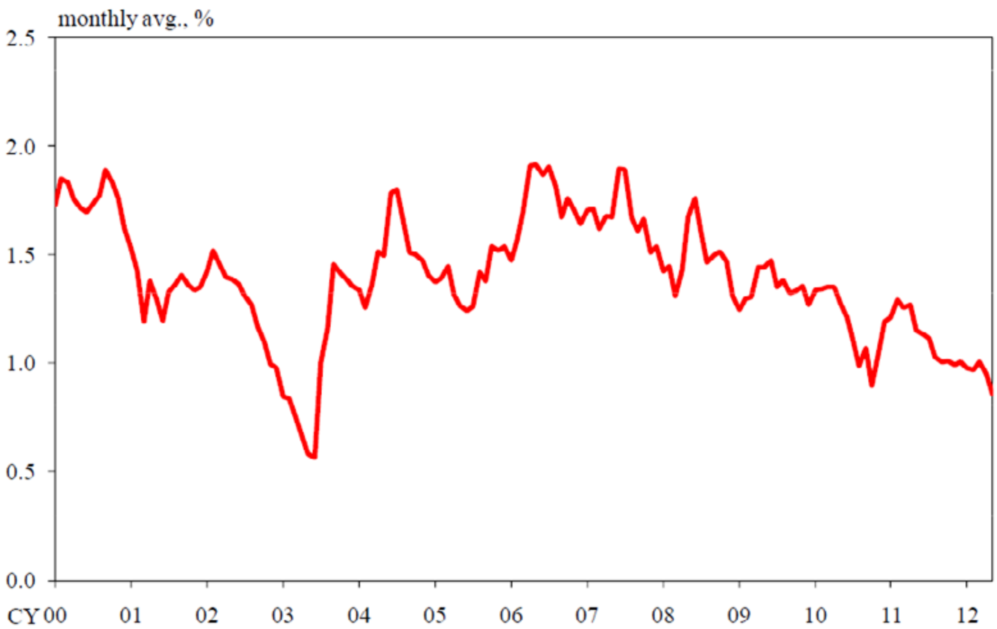
Changes in Japan's CPI



Note: All items less fresh food.
Source: Ministry of Internal Affairs and Communications.

Chart 6

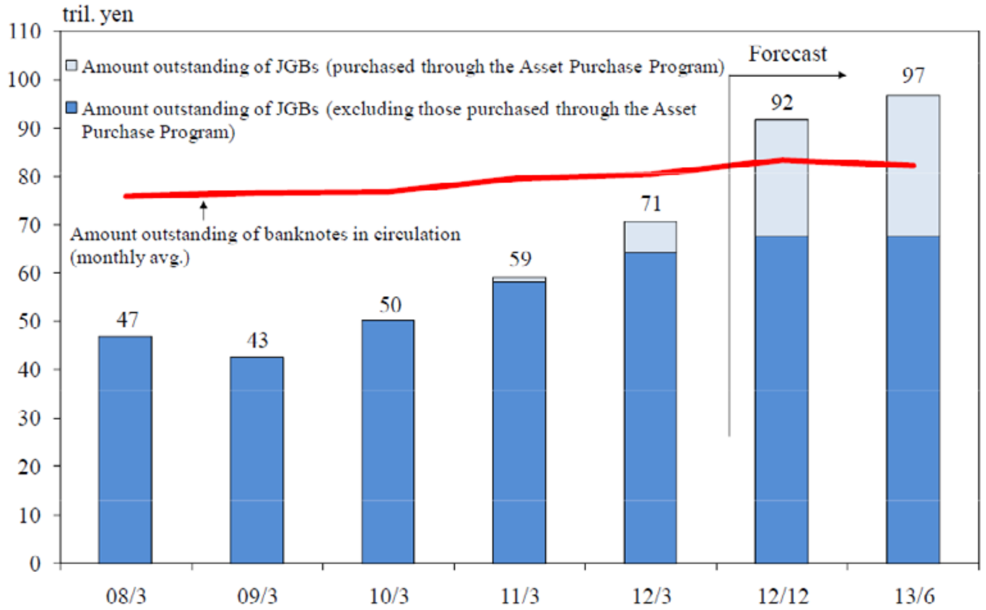
Long-Term Interest Rates in Japan



Note: 10-year government bond yield.
Source: Bloomberg.

Chart 7

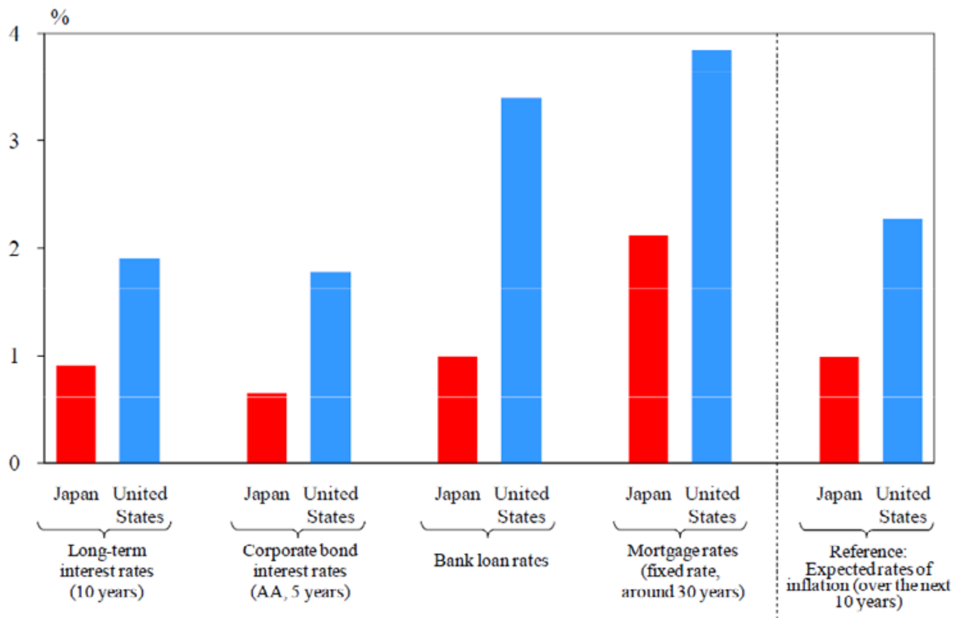
Amounts Outstanding of the BOJ's JGB Holdings



Notes: 1. Figures for the amount outstanding of JGBs are as of the end of each month.
2. The average annual growth rate for the latest three months used to forecast banknotes in circulation in December 2012 and June 2013 is that for December 2011 to February 2012, excluding the figure for March 2012, which was significantly affected by the Great East Japan Earthquake.
Source: Bank of Japan.

Chart 8

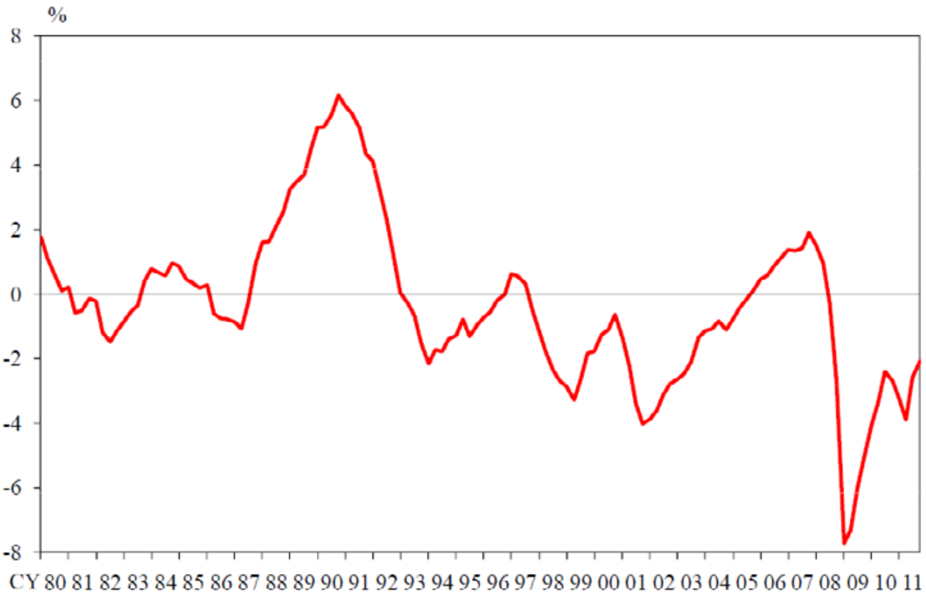
Financial Conditions in Japan and the United States



Notes: 1. Long-term interest rates, corporate bond interest rates, and mortgage rates are the averages for April-May 2012.
2. Loan rates are those for 2012/Q1 and expected rates of inflation are those for 2012/Q2.
Sources: Japan Housing Finance Agency; Freddie Mac; Bank of Japan; FRB; Consensus Forecasts; Bloomberg.

Chart 9

Japan's Output Gap



Note: The output gap is estimated by the Research and Statistics Department, Bank of Japan. Since the estimation of the output gap includes various errors, considerable latitude should be allowed for this estimation.
Sources: Bank of Japan; Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Ministry of Economy, Trade and Industry, Cabinet Office, etc.

Chart 10

Decline in the Labor Force and Economic Growth in Japan

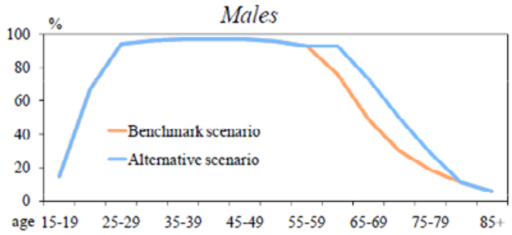
Benchmark scenario: labor force participation rates remain unchanged

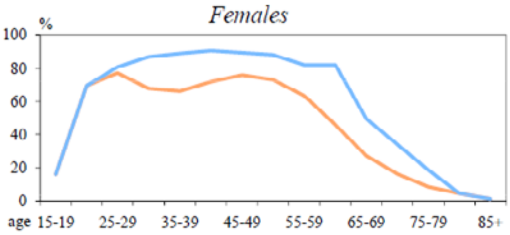
Labor force participation rates for every age and sex remain unchanged from the level of 2010.

Alternative scenario: labor force participation rates for females and elderly people rise

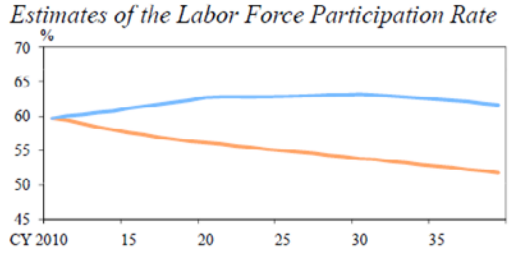
Female labor force participation rates for ages 25-59 rise by 2030 to the level of labor force participation rates in Sweden in 2010. In addition, labor force participation rates for ages 60-64 rise to the level of ages 55-59, and those for ages 65 and over rise consistently. From 2031 onward, the participation rates remain unchanged.

Estimates of Labor Force Participation by Age in 2030





Estimates of the Labor Force Participation Rate



The impact of the decline in the labor force on real GDP growth

avg., y/y % chg.

	Benchmark scenario	Alternative scenario
2010s	-0.6	+0.2
2020s	-0.8	-0.3
2030s	-1.2	-1.0

Note: The projected population (medium variant) is calculated by the National Institute of Population and Social Security Research.
Sources: Ministry of Internal Affairs and Communications, Cabinet Office, National Institute of Population and Social Security Research.

Chart 11

Population Aging and Health Care Expenditure

	Japan	Germany	United States	France	United Kingdom
Population over 65 years (Change from 2000 to 2010, percent)	33	25	16	11	11
Expenditure for health care (Change from 2000 to 2008, percent)	11	25	74	49	85

Sources: United Nations; OECD.