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Bank of Japan

**Japan's Monetary Policy and Developments
in Economic Activity and Prices**

*Summary of a Speech at a Meeting
with Business Leaders in Ehime*

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I. The Bank of Japan's Conduct of Monetary Policy

Let me begin by briefly explaining the framework of monetary policy. Monetary policy is discussed and decided by the Bank's Policy Board at the Monetary Policy Meetings (MPMs) held each month. The decisions are announced immediately after each meeting. The discussions at the MPMs are made public through the minutes, which are usually released three business days after the following MPM, while the complete transcripts are made public after a period of 10 years.

The Bank of Japan Act stipulates: "Currency and monetary control by the Bank of Japan shall be aimed at achieving price stability, thereby contributing to the sound development of the national economy." The Bank pursues the appropriate conduct of monetary policy in accordance with this principle. Price stability is a state where various economic agents, including households and firms, can make decisions regarding economic activities such as consumption and investment without being concerned about the fluctuations in the general price level.

Changes in monetary policy, in pursuit of price stability, take time to work their way through to actual economic activity. Moreover, swings in economic activity may actually be amplified if monetary policy attempts to absorb every short-term change in prices resulting from various shocks originating from, for example, financial markets, social and economic developments at home, or events abroad. Therefore, in making monetary policy decisions, the Bank strives to forecast developments in economic activity and prices from a long-term viewpoint and to realize price stability over the medium to long term.

To this end, aside from discussing economic activity and prices at the MPMs held each month, the Bank releases the "Outlook for Economic Activity and Prices" -- also known as the Outlook Report -- in April and October each year, in which the Bank makes public its forecasts for economic activity and prices for the next two to three years. Furthermore, at the MPMs in July and January, three months after the Outlook Report is released, the Policy Board examines whether deviations have occurred to the scenario presented in the Outlook Report.

II. The Outlook Report for October 2008 and the Future Conduct of Monetary Policy

The Outlook Report released on November 4, 2008 states: "Economic activity in Japan has become increasingly sluggish due to the effects of earlier increases in energy and materials prices and the leveling-off of exports." The Bank's projection from the second half of fiscal 2008 through fiscal 2010 is as follows: increased sluggishness in economic activity will likely remain until around the middle of fiscal 2009; economic growth is then expected to pick up gradually, as the effects of earlier increases in energy and materials prices abate and overseas economies move out of their deceleration phase. The median of Policy Board members' forecasts for real GDP growth was revised downward significantly from the forecasts made in July 2008 to 0.1 percent for fiscal 2008, 0.6 percent for fiscal 2009, and 1.7 percent for 2010. Furthermore, the Risk Balance Charts -- which present the aggregated probability distributions compiled from the distributions attributed by individual Policy Board members to the likelihood of divergence upward or downward from their forecasts -- for the real GDP growth rate are skewed to the left, indicating that Policy Board members anticipate high downside risks.

The key features of the outlook are as follows.

A. Overseas Economies

Growth in overseas economies is likely to continue to slow in coming quarters.

In the United States, the economy has been stagnant. Downward pressure is increasing, and the employment situation is deteriorating further. Housing prices continue to decline, and inventories of both new and existing homes are at high levels equivalent to about 10 months' sales, reflecting sluggish sales.

Corporate activity is on a downward trend, as is evident in the index of industrial production for September and the manufacturing indexes for October reported by regional Reserve Banks. Private consumption, which accounts for about 70 percent of GDP, in the July-September quarter declined on a quarter-on-quarter basis for the first

time since 1991. As for the outlook, with banks tightening lending standards due to concerns about the financial system and the sharp fall in the value of houses and financial assets, consumers are not in a position to borrow money from banks to purchase houses or cars and, in fact, are being forced to reduce their accumulated debts. Car sales dropped sharply, by 31.6 percent, in October compared with the same month a year earlier. Assuming that car sales continued at the current level for one year, total annual sales would come to 10.8 million cars, the lowest level in 25 years. Reflecting the situation, concerns are increasing over the viability of the Big Three U.S. automakers. As I have just indicated, not only has the housing market slowed down, but the U.S. economy as a whole has become sluggish together with the contraction in credit.

In Europe, the situation is similar to that in the United States. The economy has also been stagnant and is on the verge of falling into a vicious circle of deepening problems in the financial system and deteriorating economic activity. Exports from the euro zone declined by 0.6 percent in August compared with July. The Purchasing Managers' Index (PMI) for eurozone manufacturing, an indicator of business sentiment, in October showed a steep decline in new export orders, and firms expect exports to decrease further. Housing investment and private consumption are also falling. Furthermore, emerging economies with strong ties to Europe have been affected by the spreading financial turmoil, leading to the selling of local stocks, bonds, and currencies. It is feared that these developments will have a negative impact on the economies of Germany and Spain, which have strong trading ties with Central and Eastern Europe and Latin America, respectively.

Growth in Asian economies, especially the Chinese economy, is also slowing, and the outlook is a cause for concern. Although China's real GDP increased by 9 percent in the July-September quarter, supported by buoyant domestic demand, it is now clear that the country's economy is decelerating. Downside risks to the economy are increasing. It is likely that the deceleration of the world economy will cause slower export growth, which in turn may lead to a decline in fixed asset investment in export-related sectors and a decline in demand for steel and commodities. Real estate prices, which had been increasing sharply, are now clearly falling. Against this background, the People's Bank

of China, China's central bank, took measures to ease financial conditions, cutting interest rates twice in October. On the fiscal side, on November 9, the government announced a massive economic package worth around 57 trillion yen to stimulate the economy through the end of 2010. Since China is becoming the largest buyer of Japanese exports, close attention needs to be paid to developments in the economy.

In sum, the outlook for overseas economies largely depends on the outcome of the financial crisis and its real economic impact in the United States and Europe. The U.S. economy is projected to gradually return to a sustainable growth path as the adjustments in the housing market progress and measures introduced to stabilize the financial system start to take effect. However, this will likely occur in the latter half of the projection period. Therefore, recovery in the growth rate of overseas economies as a whole is not likely to become evident before the middle of fiscal 2009.

B. The Japanese Economy

In the corporate sector, the earning environment for firms is likely to remain severe in coming quarters as the effects of the slowdown in overseas economies and the appreciation of the yen are felt on top of earlier increases in materials prices. Exports in the July-September quarter increased by a mere 1.6 percent from the previous quarter, which saw a decrease of 3.3 percent, indicating that the upward momentum that began in 2005 is peaking out. Turning to production, the index for industrial production decreased by 1.2 percent in the July-September quarter, marking a decrease for the third consecutive quarter. Producers of cars and electronic parts and devices are cutting output further, and blast furnace steel manufacturers, which had been operating at full capacity, have also started to reduce production. Against this background, firms are revising downward their earnings estimates. On average, firms that are listed on the First Section of the Tokyo Stock Exchange (excluding financial firms) and had released earnings estimates by November 7 expected a decline in current profits of 25.1 percent for fiscal 2008.

Business fixed investment is likely to remain sluggish over the next few quarters as increased uncertainty over the future is prompting firms to postpone investments.

However, so long as firms expect global demand to continue to grow over the medium to long term, it is unlikely that investment will drop significantly, particularly since firms are expected to push forward with their investment plans to save on energy and resources. Growth in business fixed investment will likely pick up gradually, as the effects of earlier increases in materials prices dissipate and overseas economies move out of their deceleration phase.

Private consumption is unlikely to increase much in the near future due to a further weakening in consumer sentiment, rises in energy and food prices, and the deterioration of the employment and income situation. Thereafter, growth in private consumption is expected to recover gradually, as the pace of increase in energy and food prices moderates and the employment and income situation improves.

Regarding the outlook for prices, the rate of increase in the consumer price index (CPI), excluding fresh food, is expected to decline gradually as prices of energy and food stabilize with the output gap remaining negative and wages weak. On a year-on-year basis, the CPI (excluding fresh food) is projected to rise by around 1.5 percent in fiscal 2008, remain more or less flat in fiscal 2009, and register an increase in the range of 0.0-0.5 percent in fiscal 2010. Commodity prices peaked around July and have since fallen because it became increasingly clear that the global economy was headed for a slowdown and also because speculative funds, as a result of the financial crisis, were withdrawn from commodity markets. Inflationary concerns consequently subsided rapidly not only in Japan but throughout the world.

C. Upside and Downside Risks to the Outlook

Against this background, upside and downside risks for the economic outlook include the following: (1) the ongoing financial crisis in the United States and Europe and its impact on the real economy; (2) developments in emerging economies and commodity-exporting countries; (3) developments in energy and materials prices; (4) Japanese firms' expectations of future growth; and (5) developments in Japanese financial conditions and their effects on the real economy. Upside and downside risks to prices, other than changes in prices reflecting swings in the real economy, include the

following: (1) changes in the inflation expectations of households and the price-setting behavior of firms; and (2) developments in import prices influenced by developments in commodity prices such as crude oil and fluctuations in foreign exchange rates.

It has long been argued that it is important for Japan's economic growth to be driven by domestic demand. This, unfortunately, has not happened, and the economy still depends to a large extent on external demand. Therefore, it is essential to keep a close eye on developments in overseas economies. The recent turmoil in international financial markets has increased adjustment pressures on the real economy, increasing the risk of a further deceleration of the world economy and making it difficult to foresee when the world economy will move out of its deceleration phase and start to accelerate again. Another downside risk is the subsiding of growth expectations in emerging economies and commodity-exporting countries, which had been considered to support global growth.

Furthermore, Japanese corporate managers' expectations regarding future growth are becoming increasingly cautious due to the growing uncertainties with respect to economic and financial conditions worldwide. A plunge in growth expectations will suppress corporate activity such as fixed investment, and this will weigh on the economy as a whole. Therefore, firms' growth expectations are an important key to the outlook for future growth.

D. Future Conduct of Monetary Policy

Based on the assessment and forecast of the economy that I have described, the Bank will continue to carefully assess the outlook for economic activity and prices, closely considering the likelihood of its projections materializing as well as risk factors, and will implement monetary policy appropriately. The Bank will, for the time being, be particularly vigilant regarding downside risks to the economy. Furthermore, the Bank will do its utmost to ensure market stability through appropriate money market operations.

III. Changes in Monetary Policy on October 31

At the MPM on October 31, the Policy Board decided to make the financial environment more accommodative. At that time, the policy interest rate was already at an extremely low 0.5 percent, and this accommodative financial environment had contributed to supporting private demand. However, based on the judgment that it was necessary to provide further support for economic activity through more accommodative financial conditions, it was decided on October 31 to lower the target for the policy rate -- the uncollateralized overnight call rate -- by 20 basis points and encourage it to be at around 0.3 percent.

At the same time, the spread between the basic loan rate applicable under the complementary lending facility and the target for the overnight uncollateralized call rate was narrowed to 0.2 percentage point. The Bank also decided to introduce a complementary deposit facility. Under this temporary facility, the Bank will pay interest of 0.1 percent (i.e., 20 basis points below the uncollateralized overnight call rate target) on excess reserve balances held at the Bank. In the coming months, the active provision of liquidity by the Bank toward the year-end and the fiscal year-end to ensure stability in financial markets may exert downward pressure on the uncollateralized overnight call rate. The new facility is expected to help prevent the uncollateralized overnight call rate from falling excessively, and to maintain the policy interest rate at around its targeted level as the interest rate of 0.1 percent should provide a lower limit for the uncollateralized overnight call rate.

These decisions were prompted by data released after the MPM of October 6 and 7 that pointed to drastic changes in the economic and price situation. These data showed that (1) adjustments in the world economy stemming from the financial crisis in the United States and Europe had further increased in severity, (2) downside risks and concerns that the recovery of Japan's economy may take longer than expected had increased, and (3) the risk of inflation had subsided reflecting the decline in energy and materials prices due to the slowdown in the world economy and to the appreciation of the yen.

Regarding the real economy, downside risks are intensifying: the world economy is

decelerating due to the negative feedback loop between financial markets and the real economy, and Japan's economy itself appears to be on the brink of a long-term adjustment phase. U.S. data released following the MPM of October 6 and 7 showed, in addition to continuing sluggishness in the housing market, that private consumption and industrial output were weak, and that consumer sentiment had deteriorated substantially. In Japan, exports and production, which had been the engines of economic growth, were weak in the July-September quarter. Furthermore, the medium-term economic outlook, prepared as part of the Outlook Report for October, indicated that it would take longer than previously assumed for the economy to return to a sustainable growth path and that downside risks had increased.

The impact of the turmoil in global financial markets, which started in the United States, is increasingly turning into a worldwide financial crisis: first spreading to other developed economies, and now expanding to European nations such as Iceland, Ukraine, and Hungary, as well as to emerging nations such as Brazil and South Africa. Despite a string of unprecedented policy measures by the authorities, such as the injection of public funds into financial institutions and government guarantees for their funding, there are no signs that the markets are stabilizing. The turmoil overseas has started to affect Japanese financial markets, which so far had been relatively stable. The fall in Japanese stock prices since the beginning of October was the steepest among the major developed countries, and the Nikkei 225 Stock Average dropped to its lowest level since the bursting of the economic bubble in the early 1990s. In foreign exchange markets, the yen has appreciated, and particularly against the euro has risen sharply, leading to a deterioration in exporters' business performance. As for corporate finance, conditions for firms to carry out funding in the capital markets through CP have deteriorated due to the extremely cautious stance of investors, and this has led to firms' greater dependence on bank loans. At the same time, financial institutions are tightening their lending standards due to concerns about the outlook for the economy and business results, and there has been a change from the previously accommodative financial conditions.

IV. Turbulence in Global Financial Markets

Given that the current financial crisis is said to be the most severe since the Great Depression, I would like to spend a moment looking at the turbulence in global financial markets since last year in more detail.

The subprime mortgage problem, the source of the turbulence in global financial markets since the summer of 2007, had been a cause for concern since 2006. However, because subprime mortgage loans accounted for only about 10 percent of outstanding loans in the United States according to the U.S. Mortgage Bankers Association, few believed then that subprime mortgage loans would have major implications for the U.S. economy or even the world economy. But in the second half of 2007, the fall in housing prices and the reassessment of credit risks led to the downgrading of credit ratings of many securitized products backed by subprime mortgage loans. This led to widespread wariness about the credibility of rating agencies and the market prices of a wide range of securitized products, triggering a tumble in their prices in general and sharp deterioration in the function of the market's price formation mechanism. As a result, various assets held by investors and financial institutions started to deteriorate.

Since last autumn, the increased risk aversion of investors and financial institutions has made it difficult for structured investment vehicles (SIVs) set up by financial institutions to raise funds against securitized products as collateral. As a result, many U.S. and European financial institutions were forced to provide funds directly to those SIVs or to buy their assets, and this in turn caused the balance sheets of these financial institutions to expand. U.S. and European financial institutions, themselves suffering from heavy losses from securitized products, became doubtful of the financial health of their counterparties. This mutual mistrust among financial institutions caused liquidity in the money market to shrink sharply. Such market conditions forced U.S. and European financial institutions to tighten their lending standards, and the effects of the consequent credit contraction spread gradually.

During this time, U.S. and European financial institutions, seeing deterioration in their financial structure due to disposal and appraisal losses on securitized products, tried to

reinforce their capital through the issuance of preferred stocks, among other means. Repeated increases of capital by financial institutions, however, failed to convince the market of their financial soundness, since one of the main causes for their losses -- the slide in U.S. housing prices -- continued. Around February and March 2008, concerns grew regarding the creditworthiness of monoline insurers -- financial guarantors that provide insurance on bonds -- and government-sponsored enterprises (GSEs) such as Freddie Mac and Fannie Mae. This development created turbulence in the markets for U.S. municipal bonds insured by monoline insurers, and for GSE bonds, causing serious damage to the functioning of the repo market, where funds are borrowed against collateral of these bonds. Under these circumstances, Bear Stearns, a major U.S. investment bank, failed to raise necessary funds, and on March 14, it was decided that the Federal Reserve Bank of New York would provide financing to facilitate JP Morgan Chase's acquisition of Bear Stearns.

On top of these developments, financial markets were further aggravated by financial institutions' scramble to reduce the level of leverage due to difficult market conditions. Many financial institutions, in a bid for higher returns, had actively raised their level of leverage, in some cases to 20 to 30 times their cash in hand, through borrowing, margin transactions, and financial derivatives. In September, concerns mounted over the financial health of two GSEs, prompting the U.S. government to launch a rescue package. Soon after, Lehman Brothers filed for bankruptcy on September 15, while American International Group (AIG), one of the world's largest insurers and financial guarantors, was placed under government control.

Since the collapse of Bear Stearns, financial institutions have continued to try to repair damaged balance sheets. However, investors such as sovereign wealth funds that had previously provided capital now had unrealized losses and were reluctant to extend further funds. The bankruptcy filing of Lehman Brothers, which in the view of market participants had been "too big to fail," proved that even major financial institutions could go under. Market participants grew even more doubtful of each other, causing U.S. dollar funds, in particular, to become difficult to obtain, and trading in the interbank market dried up for instruments with maturities longer than overnight. Obtaining U.S.

dollar funds became difficult also for firms outside of the financial sector, and with rising rates, the environment for issuing U.S. dollar-denominated corporate bonds and CP deteriorated sharply. The situation has since improved to some extent due to measures taken by central banks, including the Bank of Japan, to increase liquidity. However, the extent of dependency by financial institutions on central bank funding remains high. Central banks have the responsibility in times of emergency to act as the "lender of last resort." It seems, however, that not infrequently nowadays they are the "first and only lender."

The escalating turmoil in markets increased awareness among market participants of a negative feedback loop between financial markets and the real economy, boosting concerns about the soundness of major financial institutions. As a result, the financial system as a whole came under substantial stress.

To respond to the situation, in addition to taking measures to increase liquidity provision, in October, authorities around the world announced measures to ensure stability in the financial system. The three main pillars of those measures are as follows: (1) injection of public funds into financial institutions; (2) provision of government guarantees for fund-raising by financial institutions; and (3) beefing up of bank deposit protection.

With regard to these measures, the total amount of public funds pledged by the United States and major European countries for injection in financial institutions is on the order of 60 trillion yen, which compares to a total of 12.4 trillion yen of public funds injected into Japanese banks from March 1998 to December 2006. Thus, based on these figures, it can be said that the size of funds set aside for capital injections is sufficiently large.

While so far I have outlined the course of the financial crisis, the subprime mortgage loan problem was not necessarily the only cause for the build-up and subsequent collapse of the bubble.

From 2002 to 2006, annual rates of increase in the volume of container shipping from Asia to North America and Europe reached double-digit figures. This indicates that the

stable world economic growth during this time was supported largely by economic growth in emerging countries and consumption in the United States. At the same time, the shift toward economic globalization encompassing emerging countries helped contain upward pressure on prices, keeping interest rates low throughout the world, and financial conditions were extremely accommodative. The protraction of an extremely favorable economic environment nurtured expectations that economic growth and asset prices, including those for real estate, would remain stable for a long time. Against this background, investors' reduced risk awareness resulted in a massive flow of funds into financial markets, and combined with an increase in leverage (excessive borrowing of funds), the formation of asset prices in the market was seriously distorted. The effects of the bursting of this bubble can be seen as an adjustment of the large gap that had opened up between actual prices of assets and liabilities and prices warranted by economic fundamentals. The situation is similar to Japan's experience of the emergence and bursting of its own economic bubble followed by financial crisis and recession. The prospect that it may take quite a while before balance sheets recover is worrying.

During the current financial crisis, Merrill Lynch was acquired by Bank of America, and Morgan Stanley and Goldman Sachs, while avoiding either failure or mergers with other banks, both became bank holding companies. It is symbolic of the current financial crisis that the five leading U.S. investment banks, which had prided themselves on their extremely high profitability, no longer exist as unique, independent firms.