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Bank of Japan

Recent Economic and Financial Developments and the Conduct of Monetary Policy

Speech at a Meeting with Business Leaders in Tochigi

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Introduction

The Bank of Japan regularly holds a meeting of this kind in various regions where a member of the Policy Board explains developments in Japan's economy and the thinking behind the conduct of monetary policy, and exchanges opinions with business leaders in the region. Today, I am much honored to have my first opportunity to visit Tochigi Prefecture and speak before business leaders here.

I understand that our staff in the Research and Statistics Department and the Financial Systems and Bank Examination Department visit you frequently to collect information on the economic and financial situation of the region. The information is very valuable for accurately understanding Japan's economic and financial situation as well as for formulating the conduct of monetary policy. I would like to take this opportunity to thank you for your cooperation.

Today, I would first like to explain the Bank's view on Japan's economic and financial situation and our thinking behind the conduct of monetary policy.

The Bank publishes semiannually, in April and October, a document called *Outlook for Economic Activity and Prices*, which explains the Bank's economic outlook and its thinking behind the conduct of monetary policy, and three months after its publication, in July and January, mid-term assessments of the projections are conducted. We just conducted a mid-term assessment at the Monetary Policy Meeting (MPM) held last week, and revised the projected growth rates and inflation rates significantly downward. To explain the reasons for this downward revision, I must begin by discussing the financial crises in the United States and Western Europe as well as the deceleration in overseas economies, which are major factors responsible for the deterioration in Japan's economic conditions. Then I would like to proceed to Japan's financial conditions, the current situation of and outlook for Japan's economy, and the Bank's policy responses.

I. The U.S. and Western European Financial Crises and the Deceleration in Overseas Economies

The turmoil in global financial markets stemming from the subprime mortgage problem in the United States was exacerbated by the bankruptcy of Lehman Brothers in September 2008. The turmoil has advanced to become a financial crisis where not only U.S. but Western European financial institutions either failed or faced severe difficulties. Currently, the influence of the financial crisis is spreading to emerging economies in regions such as Central and Eastern Europe and Latin America. As a result, economic conditions are deteriorating globally: emerging economies that had continued to show high growth are experiencing a decline in exports reflecting the deterioration in the U.S. and Western European economies, and the impact of the financial crisis is taking its toll on internal demand in emerging economies, leading to a clear deceleration in economic activity. Another distinctive feature of the current deceleration is the speed with which financial crises spread and economic conditions deteriorate. Since the world economy has never experienced such sudden changes before, this is further increasing future uncertainty and has led to a further deterioration in economic conditions.

The largest factor contributing to this rapid and simultaneous deterioration in world economic conditions is the progress of globalization in financial and economic activity. The widespread use and popularization of advanced technology in information and communications have supported globalization through increased speed of transactions, reductions in the interregional information gap, and a global network of transactions. Paradoxically, one cannot deny that once financial transactions and economic activity supported by these advanced information and communications technologies decrease, this causes a sudden unwinding.

With respect to financial activity, financial institutions around the world are currently utilizing these advanced information and communications technologies to carry out a large volume of cross-border financial transactions and invest in a variety of financial assets. The direct causes of the U.S. subprime loan problem leading to balance-sheet constraints and failures of Western European financial institutions were their large investment in securitized products backed by U.S. subprime mortgage loans and their commitment to provide backstop liquidity, just as in the case of U.S. institutions. While the deterioration of economic conditions in the United States and Western Europe and the increase in bad assets were gradually proceeding, Lehman Brothers went bankrupt, triggering a sharp decline of confidence in U.S. and European financial institutions, which are mutually involved in a web of complex trade, and this led to a chain of failures and poor performance of financial institutions in the United States and Western Europe. In addition, these financial institutions had an important role channeling funds to emerging economies in regions such as Central and Eastern Europe and in Latin America. With the outbreak of financial crises in the United States and Western Europe, these institutions suddenly scaled back their exposures to emerging economies, creating problems for these economies too.

With respect to economic activity, the progress of globalization increased the role of emerging economies not only as production bases for the leading economies but also as a huge market for the latter's own products. Given this increased presence in the global marketplace, emerging economies are now faced with a marked decrease in internal demand due to declining exports reflecting a downturn in the U.S. and Western European economies and downward pressure from the financial side as a consequence of financial crises in the United States and Western Europe. With the widespread use and popularization of advanced information and communications technologies, these developments are taking place at a speed not imaginable in the past. As a manager of a manufacturing firm has stated, "Demand has evaporated in a market where, until recently, supply could not keep up with the increase in demand." With the clear deceleration in growth of emerging economies, exports to them from the United States and Western Europe are decreasing, adding further downward pressure on economic activity there. And this is causing in turn a further decline in exports from emerging economies, subsequently decreasing internal demand in these economies. Currently, there are two adverse feedback loops operating globally and leading to a sharp deterioration in world economic conditions: one where a decrease in production, income, and expenditure takes place in a spiral with a decrease in exports as a starting point, and another where negative developments in financial and economic activity mutually reinforce each other.

Confronted with a sharp global deterioration in financial and economic conditions, governments and central banks have taken various measures. To alleviate the economic downturn, considerable monetary easing and fiscal stimulus have been enacted in many countries. To alleviate the financial crisis, central banks in various countries are providing funds not only in their own currency but in U.S. dollars as a concerted action. Governments are placing troubled financial institutions under their control, injecting public funds, expanding their deposit insurance schemes, and insuring the liabilities of financial institutions.

In spite of these successive expeditious measures taken by governments and central banks, there are still uncertainties as to how the financial crises in the United States and Western Europe will be resolved and how the world economy will recover. With the adverse feedback loop operating between financial and economic activity, losses incurred by financial institutions and the amounts of capital that need to be raised tend to increase as time passes, and it is not clear whether the actions taken so far are sufficient to deal with the problem. For the financial system to regain stability, the amount of losses that financial institutions will incur needs to be clarified and the institutions need to be sure that the amount of capital they hold is enough to cover these losses. Since it is not clear that these conditions are met, a high level of uncertainty remains regarding how the financial crises will be resolved.

With regard to the recovery of the world economy, a turning point will arrive when adjustments in asset prices proceed in major economies, recovery in total demand is foreseen, and pressures acting to depress economic activity from the financial side dissipate with the progress in stabilizing the financial system. Although we expect these signs of recovery to emerge by the latter half of this fiscal year, the timing of recovery in the world economy remains highly uncertain since it is unclear how financial crises will be resolved.

II. Financial Conditions

Japan's economy, until recently, was not burdened by excesses in production capacity and labor, and the financial system remained relatively stable. Therefore, it was thought to be resilient against supply and demand shocks as long as they remained local. However, with multiple shocks hitting the world economy like tidal waves since last autumn, Japan's economic conditions have deteriorated sharply. In the last several years, Japan has developed a growth mechanism based on increases in global demand -- especially for automobiles and capital equipment -- but decreases in exports of these goods, due to a sharp deterioration in world economic conditions, have led to a substantial decline in production, income, and labor. The decline was also augmented by increased tightness in Japan's financial conditions.

With regard to firms' funding costs, while bank lending rates have decreased somewhat owing in part to the reductions in the policy interest rate, credit spreads on CP and corporate bonds remain elevated reflecting strong risk aversion worldwide among investors. As a result, funding costs of firms as a whole have remained mostly unchanged. With regard to the amount of funds available, the amount outstanding of CP and corporate bonds issued is currently substantially less than a year ago due to the deterioration in issuing conditions, and demand for bank lending is rising sharply due to firms' strong desire for ample liquidity to hoard in view of increased future uncertainty. Financial institutions, while examining borrowers' creditworthiness and past business relations with them, have been attentive to these funding needs. In addition, an increasing number of financial institutions are utilizing the emergency guarantee scheme introduced by the government to provide lending to small firms with growing funding needs due to deterioration in their business conditions. Bank lending, therefore, rose through the end of last year to exceed, in November and December, the highest year-on-year rate of increase recorded since the publication of such statistics began.

With stock prices remaining low and economic conditions deteriorating sharply, financial institutions are becoming increasingly conscious of future rises in credit costs as well as their capital constraints. This is further worsening the severity of financial institutions' lending attitudes. Also in the area of trade credits, small firms are facing tighter settlement conditions.

With the tightening of financial conditions and the decline in corporate profits, an increasing number of firms are indicating that their funding conditions are severe, and are scaling down their fixed investment plans. In this sense, an adverse feedback loop between economic and financial activity is starting to operate in Japan.

In addition to the state of the financial crises in the United States and Western Europe and the degree of recovery in the world economy, the appropriateness of the level of capital held by Japanese financial institutions will also be important in judging how financial conditions will change and whether the adverse feedback loop between financial and economic activity will intensify.

In Japan, bank lending accounts for the majority of corporate funding. Banks also serve an important role in direct financing, since they underwrite a large proportion of CP and corporate bonds issued by firms. Therefore, the amount of risk that banks can assume becomes an important issue. In other words, given that banks' capacity to take on risk is determined by the level of capital they hold, whether that level is sufficient has an important bearing on developments in corporate financing.

This could be conceptually summarized as follows. Even if the business condition of banks deteriorates and losses expand, the financial intermediary function of banks will not be harmed as long as losses can be sufficiently absorbed by capital. In other words, capital serves as a buffer in the financial intermediary function. If, however, the ratio of losses to capital exceeds a certain critical point, there is a possibility that the financial intermediary function will become significantly impaired; in other words, the relationship between the scale of capital and the financial intermediary function is nonlinear. This was observed after the economic bubble burst in Japan. For several years, the workings of the financial intermediary function did not become an issue, although increases in nonperforming loans were recognized as a big problem. However, in the latter half of the 1990s, a credit crunch materialized where lending could not be increased due to capital constraints.

With regard to the current situation of the financial system in Japan, the level of capital held by financial institutions, or their capital strength, remains adequate on the whole. This is very different from the situation in the United States and Western Europe, where large-scale capital injection of public funds into a wide range of financial institutions became necessary. Also, the situation in Japan is currently quite different from that in a credit crunch, where financial intermediation becomes largely dysfunctional. Having said this, global financial markets still remain under significant strain and this is gradually affecting Japanese financial institutions as well as their financial intermediary function through declines in stock prices and increases in credit costs, although the degree may differ with the institution. This reinforces the argument for strengthening the capital base of financial institutions and is the background against which an institutional framework embodied in the Act on Special Measures for Strengthening Financial Functions is being prepared. The Bank will be closely monitoring the capital conditions of financial institutions and developments in the financial intermediary function.

III. Outlook for Japan's Economy

I will now turn to the outlook for Japan's economy. As I said earlier, economic conditions in Japan have deteriorated significantly due to a substantial decrease in exports, reflecting a slowdown in overseas economies and the resultant adverse effects on domestic demand, and also to tighter financial conditions, and they are likely to continue deteriorating for the time being.

Uncertainty about the prospects for Japan's economy continues to be extremely high, but the Bank's baseline scenario is that the economy will start recovering as global financial markets regain stability and overseas economies move out of their deceleration phase. The timing of recovery, however, is likely to be no sooner than the latter half of fiscal 2009. Based on the interim assessment made at the MPM held on January 21 and 22, 2009, the growth rate of real GDP on a fiscal-year basis is projected to be negative for two consecutive years, recording minus 1.8 percent in fiscal 2008 and minus 2.0 percent in fiscal 2009. The growth rate is unlikely to recover to its potential until fiscal 2010.

The outlook for Japan's economy relies heavily on the recovery of overseas economies, the stability of global financial markets, firms' medium- to long-term growth expectations, and financial conditions in Japan. Depending on developments in financial conditions worldwide, overseas economies, medium- to long-term inflation expectations, or Japanese financial conditions, growth rates may turn out lower than expected.

With regard to inflation, the consumer price index (CPI) inflation rate, which had been around 0 percent since around 2003, rose at a rapid pace from around the end of 2007 reflecting increases in the prices of petroleum products and food due to the surge in commodity prices, and reached 2.4 percent last summer. Thereafter, it began to decline at a rapid pace reflecting a significant drop in commodity prices, and recorded 1.0 percent in November 2008. Looking ahead, it is expected to continue its sharp downtrend and turn negative due to increasing slackness in domestic supply and demand conditions in addition to the declines in the prices of petroleum products and the stabilization of food prices. The CPI inflation rate is projected to record a decline of around 1 percent in fiscal 2009. Thereafter, the rate of decline is expected to diminish gradually through fiscal 2010 as the economy returns to a sustainable growth path.

Given that the CPI inflation rate will likely remain negative through fiscal 2010, one question that may be raised is whether this decline in prices will lead to a deflationary spiral -- a situation in which a decline in prices induces a further decline, thereby accelerating the pace of decline and at the same time adversely affecting economic activity. If households expect wide-ranging price declines, they will reduce consumption, and this in turn will accelerate the decrease in demand. If firms expect their competitors to reduce prices on a broad range of products, they have no choice but to reduce their prices, and this may decrease firms' profitability further. However, the most important factor in assessing whether a deflationary spiral will materialize is not the short-term inflation expectations, which have been affected by the rapid changes in commodity prices, but developments in the medium- to long-term inflation expectations of households and firms. During the last twelve months, they have remained mostly unchanged, little affected by last year's rise or the recent rapid decline in the inflation rate. If the inflation rate remains negative for a protracted period, however, there is a risk of a gradual decline in medium- to long-term inflation expectations. Future developments in medium- to long-term inflation expectations should therefore continue to be monitored closely.

IV. Conduct of Monetary Policy

Next, I will talk about the Bank's conduct of monetary policy.

As I said earlier, economic conditions in Japan have deteriorated significantly. In response to the economic situation and its weaker prospects, the Bank reduced its policy interest rate to 0.3 percent from 0.5 percent at the end of October 2008, and reduced it again to 0.1

percent in December. To produce maximal effects of reductions in the policy interest rate, it is a necessary precondition that markets function in a stable and smooth manner. From this viewpoint, the Bank has been taking various policy actions. The first is to ensure stability in money markets by providing liquidity. In addition to the substantial provision of liquidity in yen, the Bank has been providing liquidity in U.S. dollars without limitation on the amount, as long as it is within the value of collateral, under an internationally coordinated framework. Furthermore, in December 2008 the Bank increased its outright purchases of Japanese government bonds (JGBs) from 14.4 trillion yen per year to 16.8 trillion yen per year. In order to supply funds more smoothly, provision of longer-term funds is desirable rather than providing short-term funds through frequent operations. Hence, the Bank decided to increase its outright purchases of JGBs, which provide longer-term funds.

The second policy action comprises measures to facilitate corporate financing. Since last fall, when financial conditions began to tighten, the Bank has been taking various measures with a view to making it easier for firms to obtain funds.

The Bank has for some time been conducting purchases of CP under repurchase agreements, and these have been significantly increased in terms of frequency and size to support the better functioning of the CP market. In addition, with a view to facilitating corporate financing during the run-up to the calendar and fiscal year-ends, the range of corporate bonds and loans on deeds accepted as eligible collateral was expanded in early December 2008 and it was decided, as a temporary measure, to include BBB-rated corporate bonds and loans on deeds in eligible collateral. Furthermore, a decision was made to introduce a special operation to facilitate corporate financing, starting in early January. This special operation enables financial institutions to obtain funds over the fiscal year-end with no explicit ceiling on the total funds available, although the maximum loan available to an individual financial institution will not exceed the value of the corporate debt it has pledged as collateral. In addition, the interest rate on these funds is set lower than the corresponding market interest rates. With these measures, the Bank is aiming to support, in terms of the availability and cost of funds, the lending activity of financial institutions and transactions on the CP and corporate bond markets.

In addition, given that the environment surrounding corporate financing had deteriorated and the tightness in corporate financing might increase further during the run-up to the end of the fiscal year, the Bank decided, in mid-December 2008, to introduce outright purchases of CP from financial institutions, and to investigate additional measures. However, since these measures involve taking on the credit risks of individual firms, they represent an exceptional step for a central bank, and when taking such a step, a central bank should of course implement measures that have maximal effects in terms of facilitating corporate financing. At the same time, however, it should also consider possible actions to be taken should losses occur, so that the Bank's financial health and confidence in the currency and in monetary policy are not impaired. After close investigation of the present environment surrounding corporate financing and careful examination of the range of CP to be accepted under this exceptional measure and the measure's duration, the Bank decided, at the MPM held on January 21 and 22, 2009, to introduce outright purchases of CP and asset-backed CP (ABCP) for a total outstanding amount not exceeding 3 trillion yen until the end of March 2009. If the Bank purchases CP from financial institutions, this gives them additional capacity to accept more CP, which would improve the functioning of the CP market, or to increase lending, including that to small firms. The underlying assets of ABCP are mainly credit receivables, loans, and bills, and the Bank's outright purchases of ABCP are therefore expected to contribute to facilitating corporate financing, especially among small firms. The Bank also decided to accept, when providing funds to financial institutions, bonds, such as J-REIT bonds, issued by real estate investment corporations as collateral. Through this measure, the Bank expects the market liquidity of these products to increase, leading to better functioning of the real estate securitization market.

In addition to the measures just described, the Bank decided to examine practical ways to introduce outright purchases of corporate bonds. Corporate bonds are debts with longer maturities than CP, and thus outright purchases by a central bank involve taking on the credit risks of individual firms for a longer term than in the case of CP. In order to prevent outright purchases of corporate bonds from adversely affecting long-term resource allocation in individual firms and avoid prolonging markets' dependence on the central bank as a buyer, a central bank should only purchase corporate bonds with a short residual maturity and purchase them from financial institutions that are counterparties of the central bank instead of purchasing directly from the issuers. Bearing these factors in mind, the Bank intends to purchase corporate bonds with a residual maturity of up to one year, and will decide on the specifics of this measure as swiftly as possible after careful examination.

As I mentioned earlier, to deal with increasing demand for funds during the run-up to the calendar and fiscal year-ends, the Bank has been providing substantial liquidity to stabilize financial markets. And to deal with tighter conditions in corporate financing, the Bank implemented various measures, including the introduction of a new operation, to facilitate corporate funding, and to exert influence upon the formation of longer-term interest rates, which are the actual interest rates that apply when funds are acquired. The Bank will continue to carefully assess economic and financial conditions and do its utmost as a central bank by introducing the monetary policy measures that it judges most effective.

Closing Remarks: Toward a New Path of Growth for Japan's Economy

You may have the impression that newspaper articles and television news and even my speech today communicate nothing but the severity of the current economic and financial conditions. In a situation like the current one, where changes in global financial markets and in overseas economies come flooding in all at once like tidal waves, one tends to lose sight of the broad picture and focus only on recent events. In closing, therefore, I would like to give my brief overview of the current situation.

As I mentioned at the beginning of my speech, innovation in information and communications technology made great strides from the latter half of the 20th century through the early 21st century, and globalization progressed based on the rapid entry of a growing number of emerging economies into the world of market economies made possible by these advances. As a result, the supply of goods increased due to the added production in regions newly integrated in the world of market economies, and at the same time, economic development in these regions increased demand for goods and financial assets. This generated increased business opportunities in the markets for goods and financial assets, and accelerated the growth of the world economy. However, such an environment is likely to invite an accumulation of various excesses and imbalances. Thus, the situation we are currently facing can be explained as a sudden reversal of a rapid growth process that depended heavily on excesses and imbalances.

Looking back, while overseas economies had been increasing their growth rates by taking advantage of globalization, Japan's economy was still suffering from the aftereffects of the bubble economy of the 1980s. Japanese industries, with the exception of exporting industries, were not able to benefit from the growth mechanism based on the progress of globalization. This means, however, that excesses and imbalances inherent in Japan's economy are small relative to those of the economies that fully enjoyed the benefits of globalization, and they require only moderate adjustments. If Japan can redefine its area of comparative advantage and implement measures to strengthen these areas, Japan's economy is likely to show its true worth when overseas economies return to a recovery path.

There are two requirements for this to be realized. First, Japan should protect and strengthen the areas where it has an advantage. Japan has an edge in manufacturing in a broad sense, especially where coordination is necessary. For example, in the process of producing an automobile, parts makers and the assembler discuss various ideas and techniques to make improvements. The quality of the final product is thus improved and at the same time productivity is increased to reduce costs. Demanding that parts makers reduce costs without providing any support in increasing productivity would just be forcing them to bear an additional burden. This is not the way Japanese manufacturers increase the value of products. Increasing the value of products is important in non-manufacturing industries too. For example, I was informed by a retailer that, with a slight change of focus in its sales strategy, it came up with the idea of selling goods that were easy for the elderly to use and that these became big sellers. This made me realize the importance of going back to the basic idea that value is created by a continuous accumulation of improvements. I believe that such strenuous efforts will be rewarded when the world economy returns to a recovery path.

Second, Japan should directly confront and tackle current problems. Although the problems are numerous, it can be said that this is due to the fact that Japan is one of the world's leading economies. Solving the problems will bring about technological innovation that will give Japan's manufacturing industry a more prominent place in the world economy. Japan has an aging population, and there must be a need for innovative new products that turn this to advantage, such as automobiles with increased safety so that the elderly, with decreased physical functioning, can drive them safely and easily. Japan also faces environmental problems such as global warming as well as water and air pollution. Technological innovation that contributes to solving these problems will definitely help to increase Japanese firms' competitiveness.

Tochigi Prefecture has a history of achievement in manufacturing, and the prefecture's strength in manufacturing has been supporting an expansion into a wide range of fields. Many firms in the prefecture have the top market share in Japan in technologically advanced products, for example, medical and optical equipment, and I am aware of efforts to further develop and strengthen these fields through cooperation between industry, government, and academia. I hope that these efforts will bear fruit, and lead to a recovery of Japan's economy and positive new developments in the future.

The Bank is determined to support these movements through appropriate conduct of monetary policy.

Thank you very much for your kind attention.