

## **Recent Economic and Financial Developments in Japan**

*Summary of a Speech Given by Hidetoshi Kamezaki, Member of the Policy Board, at a Meeting with Business Leaders in Shizuoka on June 3, 2009*

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**Bank of Japan**

### **I. The Current Situation and Outlook for the Economy and Prices, and Risk Factors**

#### **A. Overseas Economies**

I will first talk about the current situation and outlook for overseas economies. At present, deterioration continues. Although the pace of decline has moderated somewhat, and overseas economies are likely to hit bottom and then start recovering by the end of this year, the momentum for recovery will probably be extremely weak.

In the United States, some positive signs are slowly emerging in some economic indicators, which had been steadily falling, indicating a slowdown in the deterioration. The implementation of the 787.2 billion U.S. dollar stimulus package, which was signed into law in February, is likely to help push the economy out of a standstill and direct it to recovery. The pace of the recovery, however, is likely to be slow due to the time required to adjust the various excesses that had accumulated over the past several years, such as the heavy spending and borrowing by households and excessive investment in risky assets by financial institutions.

In Europe, indicators gauging economic activity continue to show sharp deterioration. Given the lack of positive factors in sight, the deterioration is likely to continue. In particular, the turmoil in Central and Eastern European economies may weigh heavily on the European economy as a whole, and developments in these economies should be closely watched.

Regarding China, although exports continue to decline, monetary and fiscal measures seem to have succeeded in slowing the pace of economic deceleration. These measures have been effective most probably because problems in the financial system were relatively small,

while potential demand is strong in the emerging economy. However, the robust double-digit growth that has continued over the past few years is likely to come to an end as exports, one of the driving forces of growth, are expected to remain sluggish, reflecting the weak economic recovery in industrial countries.

## **B. The Economy and Prices in Japan**

In Japan, the economy continues to deteriorate. The downhill tumble, however, appears to have moderated with completion of inventory adjustments in prospect due to the substantial reduction in production by the manufacturing sector. As for the outlook, a slowdown in the pace of production cuts and the positive effects of government measures are expected to stem the deterioration and put the economy back onto a recovery path in the near future. In the longer run, however, a considerable amount of time will be required for production and sales to return to previous levels. Given the continued severe situation in corporate profits, a recovery in business fixed investment will be moderate at best. Furthermore, private consumption is likely to weaken further as a result of further deterioration in the employment and income situation for the household sector. Therefore, after the positive effects from the fiscal stimulus and the slowdown in production cuts take hold, recovery will hinge on the momentum for growth in exports with its beneficial impact on domestic demand.

Turning to prices, the year-on-year rate of change in the consumer price index (CPI), which has been around 0 percent recently, is expected to decline sharply to minus 2 percent or below toward summer, primarily in reflection of the tumble in prices of petroleum products since the beginning of autumn 2008. The CPI is likely to stay in negative territory for the time being as slow economic recovery will cause weak demand to continue. Movements in individual items in the CPI basket show that the year-on-year rate of change for many items remains positive, but that the degree of change is narrowing for an increasing number of items. This trend seems to indicate that, in addition to the effects from the fall in materials prices, an increasing number of firms are being forced to sacrifice their profit margins to secure sales volume. Furthermore, the percentage of households that anticipate inflation is declining and consumers are becoming increasingly conscious of prices. As a result, the number of items in the CPI declining on a year-on-year basis is expected to rise

in view of the severe business environment affecting corporate profits, as well as the employment and income situation.

In sum, the most likely scenario for the economy is a gradual recovery in the latter half of fiscal 2009, at first led by moderation in production cuts due to the progress in inventory adjustments and positive effects from government measures, and then sustained in the longer run by recovery in overseas economies stimulating Japan's exports and domestic demand. As for prices, even after the effects of the large negative contribution of price falls in petroleum products diminish, the most likely scenario is a moderate decline caused by weak demand.

### **C. Risk Factors**

The main scenario for the economy and prices is subject to the following risk factors.

The first risk is that the financial market turmoil and ensuing adverse feedback loop between financial and economic activity could intensify further. Recent expectations for a global recovery have boosted stock prices worldwide. However, solutions are yet to be found for serious problems such as the fall in home prices in the United States and Europe, the considerable amount of bad assets, particularly those held by U.S. and European financial institutions, the economic turmoil in Central and Eastern Europe, and the lackluster demand at home and abroad for durable consumer goods such as automobiles. Given the uncertainty lingering in financial markets, it is possible that when the focus returns to these issues, this could cause turbulence in financial markets once again, and subsequent deterioration in economic activity.

The second risk is that positive effects of monetary and fiscal measures on the economy have not been evident in Japan or other countries, with the exception of China, where government measures have proved effective to a certain extent. Uncertainty about the effectiveness of such measures raises the following questions: Will positive effects of these measures be offset by financial system stability concerns? Will tax reductions help boost consumption, rather than lead to an increase in savings? Will the massive amount of government bond issuance lead to rises in interest rates?

The third risk is a possible worldwide decline in the propensity to consume and willingness to invest as a result of structural changes in the behavior of economic units. At present, firms, households, and financial institutions, particularly in the United States, are making efforts to reduce their excessive debt. If these efforts are based on declines in medium- to long-term growth expectations, it is possible that economies will shift to a low-leverage structure, depriving the world economy of its driving force. Such conditions could further dent growth expectations, setting off a vicious circle.

The fourth risk is linked to the new H1N1 flu virus, which is spreading in Japan. The disease has been assigned pandemic status but is considered to be relatively mild. However, a further spread could slow corporate activity and reduce opportunities for individuals to travel and eat out, leading to a downturn in the economy as a whole.

With regard to prices, attention needs to be paid to trends in inflation expectations. If the economy does not recover along the lines of the main scenario, causing a further weakening in demand, expectations of inflation and medium- to long-term growth could also weaken. Such a situation would be highly undesirable, since it may well give rise to a deflationary spiral. Trends in international commodity prices, such as those of crude oil and foods, and in foreign exchange rates also require attention as they have had a considerable impact on domestic price levels of late.

As mentioned, the current risk factors to the economy and prices are mainly related to downward pressures. It is quite possible that the Japanese economy could deteriorate again if recovery in overseas economies is weak and Japan's exports fail to increase steadily. The possibility of upside risks, however, cannot be ruled out either. The economies of newly emerging nations, such as China, could accelerate faster than expected. Many countries, such as those in the G7 and Switzerland, have adopted low interest rate policies, with 1 percent marking the higher end of the range, and have provided ample funds. These countries have also taken large-scale fiscal measures. Late recognition of and response to an excess liquidity situation could also create an upside risk, and therefore it is necessary to consider the possibility of such upside risks to the economy. Indeed, the

current rise in international commodity prices, such as crude oil, could be a sign that markets are aware of such upside risks. In short, downside risks are dominant but there are also upside risks that require due attention. All in all, the outlook for the economy and prices is highly uncertain.

#### **D. The Outlook Report**

So far, I have explained my personal view on the outlook. As for the Bank of Japan, it summarizes the combined outlook of the Policy Board members, presents the projections in figures, and releases this information in the Bank's View of the *Outlook for Economic Activity and Prices* (the Outlook Report) in April and October. The interim assessments of the Outlook Report are released in July and January.

In the most recent April 2009 report, the outlook considered most likely by Policy Board members was as follows:<sup>1</sup> On a year-on-year basis, the rate of real GDP growth was forecast to fall sharply to minus 3.0-4.0 percent in fiscal 2009 but register 1.0-1.5 percent in fiscal 2010, while the consumer price index (CPI; excluding fresh food) was forecast to fall to around minus 1.5 percent in fiscal 2009 and around minus 1.0 percent in fiscal 2010.

Given that the individual outlook made by each Policy Board member varies, a probability distribution is used to show the likelihood of each forecast, from the best to the worst scenario, in the Risk Balance Charts, in which an aggregated probability is used to show the likelihood of divergence upward or downward from each forecast.<sup>2</sup> The peak of the bar graph is low, and both sides of the peak spread widely, indicating a high degree of uncertainty and lack of a concerted view. Furthermore, the probability distribution is skewed to the left-hand side of the median of the Policy Board members' forecasts, suggesting that Policy Board members consider downside risks to be greater.

## **II. Measures Taken by the Bank of Japan**

I will now talk about policy measures taken by the Bank since the autumn of 2008, when the turmoil in global financial markets intensified following the failure of Lehman Brothers

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<sup>1</sup> See Appendix 1 on page 11 of the April 2009 Outlook Report.

<sup>2</sup> See Appendix 2 on page 12 of the April 2009 Outlook Report.

Holdings Inc., leading to the current economic downturn. The Bank normally uses money market rates, particularly the overnight call rate, as its policy target. However, given that the policy rate was already at an extremely low level of 0.5 percent at the time, room to lower it further was quite limited. In light of this situation, the Bank has done its utmost to provide financial support through policy measures in three main areas; namely, further reducing the policy rate, providing liquidity to financial institutions in order to ensure stability in financial markets, and introducing steps to facilitate corporate financing.

#### **A. Providing Ample Liquidity, Reducing the Policy Rate, and Facilitating Corporate Financing**

Let us go over the series of policy measures taken by the Bank, in chronological order. On September 16, 2008, in the wake of the failure of Lehman Brothers Holdings Inc., the Bank started to inject liquidity into the money market by conducting same-day funds-supplying operations, amounting each time to a few trillion yen. On September 18, as a coordinated measure with other central banks in major economies, the Bank introduced U.S. dollar funds-supplying operations against pooled collateral, marking the first time it had provided U.S. dollars to the domestic markets. These operations were initially conducted through multiple-rate competitive auctions, but on October 14, the Bank decided to adopt operations whereby funds would be provided at a fixed interest rate for an unlimited amount against pooled collateral. On the same day, the Bank also announced that it would increase the frequency and the size of CP repo operations in order to facilitate corporate financing.

On October 31, the Bank decided to lower its target for the uncollateralized overnight call rate by 20 basis points and encourage it to remain at around 0.3 percent. Furthermore, the Bank introduced the complementary deposit facility, whereby interest was made payable on excess reserve balances at the Bank held by financial institutions. The facility enabled the Bank to provide a considerable amount of liquidity while preventing the uncollateralized overnight call rate from falling significantly below the targeted level.

On December 2, the Bank decided to expand the range of corporate debt eligible as collateral to be pledged by financial institutions when they borrow funds from the Bank. In other words, the rating requirement of corporate bonds and loans on deeds to companies

to be accepted as collateral was eased from a credit rating of "A-rated or higher" to "BBB-rated or higher." The Bank also introduced Special Funds-Supplying Operations to Facilitate Corporate Financing, which utilizes corporate debt as collateral. These operations allow financial institutions to borrow unlimited amounts of longer-term funds from the Bank at an interest rate as low as 0.1 percent, equivalent to the target rate for the uncollateralized overnight call rate, against the value of corporate debt such as CP, corporate bonds, and loans on deeds, pledged to the standing pool of eligible collateral. These measures aimed to support corporate financing activities indirectly by allowing financial institutions to use corporate debt as collateral to borrow at low cost. After further refinements, this new operation proved to be successful, attracting many bids each time, and the Bank's supply of funds over the fiscal year-end amounted to over 7 trillion yen, more than doubling the initial expected amount of 3 trillion yen.

#### **B. Stepping into Credit Risk Taking in View of Limited Room to Lower the Policy Rate**

On December 19, the Bank lowered its target for the uncollateralized overnight call rate by another 20 basis points, to 0.1 percent. While further cuts were almost impossible at this level, cutting the policy rate was not the only monetary policy action left to take. On the same day, in order to further facilitate the provision of ample liquidity, the Bank decided to increase the amount of outright purchases of Japanese government bonds (JGBs) to 16.8 trillion yen per year, from 14.4 trillion yen per year, and consider introducing additional measures to facilitate corporate financing such as the outright purchases of CP.

The outright purchases of CP involve taking on the credit risks of individual firms, and if losses arise, this could result in a loss to the Bank's reserve surplus and a drop in the amount of funds to be paid to the government. The adoption of such an exceptional measure, which could add to the burden on taxpayers, must be based on serious deliberations such as incorporating a system to limit losses. With this in mind, on January 22, 2009, the Bank made public the basic principles regarding outright purchases of corporate financing instruments to facilitate corporate financing. The principles stated that the Bank should implement such measures only when a significant decline in the functioning of the market for corporate financing instruments had resulted in tight corporate financing conditions on

the whole, and outright purchases of these instruments were thereby judged necessary in light of the Bank's mission. While preventing such purchases from constituting an arbitrary funds allocation among individual firms, due consideration must be given to ensuring the Bank's financial health by conducting purchases only for a term required and at an appropriate scale. Based on these principles, the Bank decided to start outright purchases of CP from January 30, and began to investigate ways to implement outright purchases of corporate bonds with a residual maturity of up to one year.

On February 19, the Bank decided on the expansion of Special Funds-Supplying Operations to Facilitate Corporate Financing, details of the scheme for the outright purchases of corporate bonds, and an extension of the effective periods of the various temporary measures. On March 18, the Bank announced that it would increase the annual amount of outright purchases of JGBs to 21.6 trillion yen, from 16.8 trillion yen. On April 7, the Bank decided to expand the range of eligible collateral for loans on deeds to the government, and to accept loans on deeds to municipal governments as eligible collateral for the Bank's provision of credit to financial institutions. On May 22, the Bank announced that it would accept bonds issued by the governments of the United States, the United Kingdom, Germany, and France as eligible collateral. This temporary measure, accepting as collateral securities denominated in foreign currencies, issued overseas, and governed by the laws of foreign countries, can be described as a venture into new territory given that eligible collateral previously was restricted to instruments denominated in yen, issued in Japan, and governed by the laws of Japan.

In addition to these monetary policy measures, the Bank decided on February 3 to implement measures to ensure financial system stability, by resuming its purchases of stocks held by financial institutions, and on March 17, by starting discussions on a framework for providing subordinated loans to banks. The first auction of these loans was conducted on May 29. Adoption of these highly exceptional measures requiring the Bank to take on credit risk was decided in view of the major role that financial institutions have to play in improving the economic and price situation.

In the current situation, where the economic and price outlooks are highly uncertain, the



Bank will continue to provide support from the financial side to facilitate the recovery of Japan's economy through existing monetary policy measures in the three main areas -- maintaining low interest rates, providing ample liquidity, and facilitating corporate financing -- in order to reduce market uncertainty and stimulate demand in the economic activity. Furthermore, depending on the extent and speed of change in the circumstances, the Bank must formulate feasible and effective measures proactively and implement them promptly.

### **III. Toward Sustainable Economic Growth**

Hereafter, I will talk about the Japanese economy from a longer-term perspective. At present, there is no shortage of gloomy topics in Japan. However, worrying does no good for either physical health or the economy, and thus it is important to keep hope alive for the future. When I was working for a trading house, that company did not just sit and wait during times of economic downturns for the economy to start recovering, but took an aggressive and proactive stance. For example, managerial resources were shifted to businesses with higher potential or a greater relative advantage, and new business models were built on such prospects. In fact, in the current economic situation, many firms are developing new technologies, expanding business through M&A, or implementing new strategies to appeal to a wider range of customers. Although these are all microeconomic examples of initiatives taken by individual firms, similar efforts are required of policy makers who are responsible for macroeconomic management.

In order to enjoy a measure of success in the fierce global competition in which Japan finds itself, it is important for the country to draw up a blueprint for the future of its economy, or the ideal state of the economy, over a period of five to ten years. To attain this objective, it is vital that the government, firms, and general public are united in their endeavors to reach a common vision. Assuming that globalization makes further progress, it is essential for Japan to strengthen its competitive edge, which currently lies largely in the manufacturing sector and thus includes automobiles, electrical machinery, and general machinery. At the same time, one of the lessons to be learned from the current economic downturn is the limit to economic growth dependent largely on exports. Therefore, although the reinforcement of sectors related to exports remains important, Japan also will need to nurture domestic

demand-oriented sectors; namely, businesses related to foods, an aging population with fewer children, and environmental protection. These areas, in my view, offer great potential for domestic demand growth, which would provide an economic infrastructure that is relatively immune to fluctuations in overseas economies. Moreover, they are among the areas in which the situation is deteriorating rapidly and in need of immediate attention.

#### **A. Sectors Related to Foods**

Against the background of rising concerns over the safety of imported foods, demand has been strong for domestically produced foods. Such foods generally are considered to be safe, of high quality, and to meet the tastes of Japanese consumers; thus, they have considerable potential as a driving force for the development of a domestic demand-oriented industry.

Japan's farming industry, however, is in a serious condition confronting a number of problems. These problems include low labor productivity, small-scale holdings, and a lack of diversity in terms of farm management and distribution channels, all of which compare unfavorably with other sectors. Moreover, given the aging of the farming population, the farming industry's condition affords little hope for the future. In order to survive and achieve growth, the industry must overcome the problems and transform itself into a profitable industry independent of government subsidies. Needless to say, this revitalization would not only foster domestic industry but also offer many other merits, such as raising the nation's self-sufficiency with respect to the food supply, boosting employment, and helping conserve water resources and scenic rural land.

#### **B. Sectors Related to the Aging Population with Fewer Children**

With Japan's population aging at a rapid pace, domestic demand-oriented sectors related to this demographic trend offer a promising outlook. The development of new businesses in these sectors, and therefore a greater variety of services addressing the needs of senior citizens, will boost the sense of security and comfort in their daily lives. Improved services in these sectors are likely to meet considerable demand, since they also satisfy the needs of the younger generations that take care of the elderly.

At present, however, the supply of medical- and nursing care-related services falls well short of the growing demand. There are long waiting lists for admission to nursing care facilities, while rural areas generally suffer from a shortage of doctors and nursing staff. These are just a few of the many problems the sectors need to overcome. The root cause of such problems lies in the poor profitability of the businesses and low remuneration in return for hard work and heavy responsibilities, and this suggests that proper functioning of the basic economic principles of supply and demand is being hindered. If compensation for jobs in these sectors is raised to a sufficient level, excess labor in other sectors would be expected to flow in to fill job openings and thereby create substantial growth in this area, and the mismatch in the labor market consequently would be expected to achieve some resolution.

I would also like to emphasize the importance of implementing measures to counter the declining birth rate and putting a brake on the pace of aging in Japan. A downturn in the birth rate is a serious problem because it leads to declines in the workforce and domestic demand, which would restrain the country's economic growth. An estimate shows that, if the current situation continues, the Japanese population will decline to half its current level in 100 years' time; therefore, the government, firms, and local communities need to join forces to further support the birth and rearing of children. Such efforts would include promoting the development of child-care-related services -- for example, providing more facilities for childbirth and daycare centers, and increasing the number of babysitters -- regardless of whether such services are profitable.

An aging population with fewer children is of great concern, in that it adds to the burden on Japanese society as a whole. Efforts to improve the situation would contribute to creating greater sense of security among the public and potentially induce increased spending across all age groups. Thus, policies dealing with this issue should also take into consideration the effects from a macroeconomic perspective.

### **C. Sectors Related to Environmental Protection**

Environmental pollution and the depletion of natural resources loom large as pressing issues

threatening the future of mankind. These topics head the agenda of international conventions in view of the rapidly worsening situation. Against this background, there is heightened demand for technologies and products that are environmentally friendly and support efficient use of energy.

Japanese culture traditionally has valued cleanliness and the avoidance of wastefulness, as expressed by the word *mottainai*, and the Japanese people have long been aware of the value of the environment and natural resources. This attitude seems to have grown stronger recently, as evidenced by the rush of orders placed on new hybrid cars, even though car sales as a whole have been weak. The two oil shocks forced Japanese firms to develop advanced technologies for the protection of the environment, making such companies world leaders in this field, and they have continued with their efforts to develop leading-edge technologies in related areas. Examples are found among a wide range of fields including the construction of liquid crystal display factories that save vast amounts of industrial water, as well as the development and application of heat-resisting alloy metals for use in steam turbines that lead to greater efficiency in power generation, automotive carbon fibers that are lightweight and highly durable, resins produced from plant life, ships that can run on solar power, and automobiles and motorcycles powered solely by electricity. Firms in these fields now need to enhance their competitiveness by further refining their products, while contributing to the protection of the environment on a global scale.

Technologies and products related to environmental protection are needed on a worldwide basis, and thus demand is equally promising in both the domestic and overseas markets. Nevertheless, I consider it important to boost demand in the domestic market first. Japanese firms used to hold a dominant position in the market for solar cells. However, their market share overseas was overtaken by Germany, where government subsidies for the cells were introduced. The adoption of similar subsidies now scheduled in the United States and some European countries would expand their respective markets, and local firms are expected to grow as a result. Japan cannot afford to be left behind in developments aimed at the achievement of a low-carbon society, and a strong macroeconomic policy therefore needs to be set out to support and encourage corporate activity.