June 24, 2009

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 Niigata

Seiji Nakamura

Member of the Policy Board

Introduction

Today, I would like to start by outlining the business operations of the Bank of Japan. I will then discuss recent economic and financial situations at home and abroad and present the Bank's basic thinking concerning the conduct of monetary policy.

I. The Bank's Business Operations

I will first briefly touch upon the Bank's functions and operations. The Bank's quarterly *Opinion Survey on the General Public's Views and Behavior* released in April revealed that about 70 percent of respondents view the Bank as related to their lives. Still, most respondents admitted that they knew little about the Bank. Many people do not seem familiar with the Bank's business operations, although they know through media coverage that the Bank decides monetary policy as the central bank of Japan. In addition to conducting monetary policy, the Bank's business operations include ensuring the smooth circulation of clean banknotes. At the end of March 2009, about 12.8 billion banknotes were in circulation, with a total value of around 76 trillion yen. Other roles are to settle funds as the bank of banks, pay and receive treasury funds as the bank of the government, monitor financial institutions' business conditions to maintain financial system stability, and research and analyze economic and financial developments. I would also like to note that such business operations behind the scenes for the Japanese economy are carried out with the efforts of the Bank's roughly 5,000 employees at the Head Office, 32 branches, including the Niigata Branch, and 12 local offices in Japan. The Bank will continue to ensure the continuity of its core business operations even during earthquakes and other natural disasters, system disruptions, and influenza outbreaks.

II. The Bank's Financial Statements

The Bank is a juridical person established based on the Bank of Japan Act, and is capitalized at 100 million yen, 55 percent of which is subscribed by the government. The Bank's subscription certificates are traded through the Jasdaq Securities Exchange. As with any firms, the Bank's financial statements contain information about its operations, and with that in mind I will overview the Bank's settlement of accounts for fiscal 2008, ended

March 31, 2009, and its basic balance-sheet policies.[1]

With regard to the Bank's statement of income for fiscal 2008, operating income was around 1.3 trillion yen, down 21 percent from a year earlier. Operating income consists primarily of interest on financial instruments held by the Bank, such as Japanese government securities (JGSs), and interest on loans. Operating expenses include foreign exchange losses and general and administrative expenses and costs, such as the cost of production of banknotes and personnel expenses. After subtracting taxes, net income for the term declined by 53 percent from the previous year, to 300.3 billion yen. After transferring 15 percent of net income for the fiscal year to the legal reserve and paying dividends representing 5 percent of the face value of shares, the Bank paid the balance of 255.2 billion yen to the government.

Turning to the balance sheet of the Bank at the end of fiscal 2008, total assets were 124 trillion yen, up 9 percent from a year earlier. The major assets were 43 trillion yen in Japanese government bonds (JGBs), 13 trillion yen in treasury discount bills underwritten, and 54 trillion yen in various financial assets from short-term funds-supplying operations. Key liabilities were 77 trillion yen in banknotes, 22 trillion yen in current account deposits at the Bank, excluding those of the government, and 11 trillion yen in government deposits and other debts.

The Bank projects the intra-day supply and demand for funds to ensure that the uncollateralized overnight call rate, the policy interest rate, remains at the target level and conducts money market operations to adjust changes in the amount outstanding of current account deposits at the Bank, which is on the liability side of the balance sheet. Specifically, if it projects a funds shortage, the Bank supplies funds to financial institutions by purchasing money market instruments from them or by extending loans to them. In the reverse case, the Bank absorbs funds by selling money market instruments to financial institutions. These operations are conducted on a daily basis. Treasury funds outstanding

---

[1] For more details on the relationship between money market operations and the Bank's balance sheets, see "Box 2: Money Market Operations and the Bank's Balance Sheets" in *Money Market Operations in Fiscal 2008*, published in Japanese in June 2009. The English text will be made available on the Bank's web site.

fluctuate widely in Japan and shortages can approach 10 trillion yen because of such factors as the issuance of JGSs, pension payments, and tax payments. To conduct money market operations in a timely manner, it is important to adjust financial asset holdings in line with changes in liabilities. Therefore, the Bank ensures smooth money market operations based on the following thinking: government deposits and other debts that fluctuate widely in the short term, as well as current account deposits that require timely control over the amount outstanding, should be backed by short-term financial assets obtained by the Bank through its funds-supplying operations; and similarly, banknotes, which are long-term liabilities of the Bank, should be backed by JGBs, which are long-term assets. This is similar to firms' accounting practice of managing asset and liability positions to stabilize their balance sheets.

The Bank therefore follows a principle of limiting its holdings of JGBs to the amount of banknotes in circulation. If such holdings exceed the value of circulating banknotes when the Bank needs to conduct large-scale funds-absorbing operations, the Bank may have to sell JGBs on the market, as sales of short-term financial assets obtained through its funds-supplying operations are insufficient. Such actions would significantly reduce the flexibility of money market operations and hamper the Bank's appropriate conduct of monetary policy while disturbing the bond and other financial markets, undermining public confidence in the Bank's monetary policy. To avoid such an outcome, the Bank discloses its basic stance on the amount of the Bank's JGB holdings, taking its unique balance sheet into account and limiting such holdings under its banknote principle.

Article 5 of the Fiscal Act prohibits the Bank from underwriting JGSs except under special circumstances with the Diet's approval. Therefore, the banknote principle demonstrates that the Bank's outright purchases of JGBs are not to support JGB prices or government financing. Since March 2009, the Bank has been purchasing JGBs at the pace of 21.6 trillion yen annually to supply long-term funds to the market. For the time being, I do not think that such purchases would be in conflict with the banknote principle.

III. Overseas Economies

Next, I will talk about recent economic and price developments, starting overseas and then turning to the Japanese economy.

The world economy grew at a steady, fast pace of around 5 percent, but a slowdown began from summer 2007 as the subprime mortgage problem triggered the global financial market turmoil and its effect spread into the global economy. After Lehman Brothers failed in September 2008, market participants' concern about the soundness of financial institutions mounted, causing financial markets worldwide to malfunction and exacerbate the economic deterioration. The deterioration in economic activity further worsened the business conditions of financial institutions by turning housing and corporate loans into impaired assets. It then caused financial institutions to tighten their lending attitudes, and thereby constrain corporate activity and consumer spending. This adverse feedback loop intensified, causing a global economic crisis sometimes described as "the most severe since World War II" or a "once-in-a-century event."

An analogy with the human body would aid understanding of this rapid global economic downturn. Funds flow like blood through the body; interruptions paralyze the economy just as clogging or cutting a vein or artery produces bodily paralysis. Financial systems and markets around the world malfunctioned after the failure of Lehman Brothers in September 2008, as globalization had made them reliant on close linkages. The economic lifeblood slowed significantly and even flowed backward in some areas. The effects rapidly spread worldwide, causing an abrupt contraction of economic activity.

In its *World Economic Outlook*, published in April 2009, the International Monetary Fund projected that the world economy would shrink by 1.3 percent in 2009, the first contraction since World War II, but it also forecasted a slight 1.9 percent increase for 2010. Inventory adjustments are helping to brake the overall deterioration in the world economy. Global financial markets have responded to these favorable developments by slightly increasing their risk tolerance. Stock prices worldwide have bottomed out, and the impact of the failure of Lehman Brothers seems to be diminishing. On the other hand, economic conditions and corporate activity remain very weak because adjustments continue for various distortions accumulated in recent years, such as excessive loan-financed consumption and debt. To sum things up, the worst of the storm may have passed, but the world economic outlook remains very uncertain.

Let us turn to developments by country. In the United States, there are increasing signs that suggest the economic activity is leveling out, such as improved confidence of firms and households and slower unemployment growth. Financial conditions remain tight, however, and the U.S. economy as a whole continues to contract. Private consumption indicators remain weak. In May, for example, retail sales (excluding automobiles, gasoline, and building materials) were more or less unchanged from April after declining for two consecutive months. New car sales were down about 40 percent from two years earlier. Households are likely to constrain spending for the time being, as the employment situation remains severe with the unemployment rate rising as high as 9.4 percent, and consumer credit conditions have failed to improve significantly. U.S. imports and domestic freight movements continue to fall, indicating that the pace of improvement in private consumption would be slow.

In the housing market, which triggered the global recession, home sales remain more or less flat, albeit at a low level. Sales may be picking up slightly as price adjustments progress, but there are few signs that home prices are bottoming out. A supply in the secondary markets from foreclosures has kept housing inventories high, and any recovery will probably be slow in coming even when housing investment starts to recover.

In Europe, exports continue to decline, but the pace is slowing. The pace of deterioration in economic conditions is therefore moderating gradually. In April, however, industrial production of the euro area, excluding construction, dropped 1.9 percent from a month earlier, suggesting that progress in inventory adjustments may be slower than in other parts of the world. It will probably take time for production to level out and stabilize. Central and Eastern European countries remain vulnerable to even minor financial and economic shocks, an example being mounting concerns over a possible currency devaluation in Latvia. Considerable uncertainty remains regarding the degree to which further economic deterioration in the region will add downward pressure on the economy of the euro area as a whole.

Downturns in the United States and Europe have caused emerging and commodity-exporting economies to experience lower exports and severe financial conditions. Recently, however, there have been signs of recovery in countries such as China. Its exports continue to fall because of stagnant external demand, but fixed-asset investment has surged owing to fiscal stimulus measures, while the decline in industrial production is slowing. There are a wide range of opinions regarding the 4 trillion yuan economic stimulus package announced in November 2008: some think that the package has been more effective than expected, while others are more cautious about its future effect, warning that government-led investment has not stimulated sufficient private-sector investment. The Chinese government is still determined to maintain high growth, but given a sluggish global economic recovery China faces difficulties because it has depended heavily on exports.

IV. The Japanese Economy

A. Significant Deterioration in the Economy

I will now talk about developments in the Japanese economy. Since fall 2008, firms have cut production significantly, with drastic inventory adjustments in response to plunging domestic and overseas demand and deteriorating funding conditions. Production and exports for the January-March quarter of 2009 declined by 30 percent and 40 percent, respectively, compared with the April-June quarter of 2008. Real GDP dropped by 8 percent, or 44 trillion yen. These declines were unprecedented.

Here, Japan's industrial structure has proved to be vulnerable to a downturn in the global economy.[2] The transport equipment, electrical machinery, and general machinery industries fueled the Japanese economy by significantly expanding their exports for several years before the financial crisis. The main drivers were buoyant private consumption in the United States, Europe, and other advanced economies, robust growth in emerging economies, and the yen's depreciation. However, plunging global demand and the yen's appreciation caused exports in these three industries to plummet, triggering drastic production and inventory adjustments. The global demand shock spread across a wide

[2] For more details, refer to "Box: Recent Substantial Decrease in Industrial Production" in *Monthly Report of Recent Economic and Financial Developments*, released in February 2009.

range of manufacturing industries in Japan and dampened the economy, because these three export-led industries hold a large share in the nation's total industrial production and maintain large and diverse domestic networks of parts and equipment suppliers: these industries mentioned account for about 50 percent of the nation's total industrial production, compared with about 20 percent for their U.S. counterparts; and they are heavily dependent on exports as shown in data from the Japan Automobile Manufacturers Association, Inc. that 58 percent of motor vehicles produced in Japan in 2008 were exported, a rise of about 10 percent in four years. A breakdown of industrial shipments shows that during the October-December quarter of 2008 export shipments caused a greater negative impact, while during January to March 2009 domestic shipments exerted a greater negative impact. This sequence occurred because plunging demand first affected exports and then spread to business fixed investment and other aspects of domestic demand. South Korea and Taiwan have similar industrial structures, which would explain the substantial drop in their production and exports, as in the case of Japan.

B. Projections in the Bank's April 2009 Outlook Report

The Bank discusses economic activity and prices at the Monetary Policy Meetings. In April and October, it releases the *Outlook for Economic Activity and Prices*, also known as the Outlook Report, which discloses the Bank's forecasts for economic activity and prices for the next two or three years. In the April 2009 Outlook Report, the forecast considered most likely by Policy Board members was that on a fiscal-year basis the real GDP growth rate would likely fall substantially to minus 3 to 4 percent in fiscal 2009, but would recover to around 1 percent in fiscal 2010. In other words, in the first half of fiscal 2009, the pace of deterioration in economic condition should moderate gradually and start to level out as inventory adjustments made progress both at home and abroad. From the latter half of fiscal 2009, global financial markets should regain stability, with overseas economies starting to recover on the strength of policy actions taken in various countries and the gradual adjustment of various excesses in financial and economic activity. Japan's economy should also recover gradually, and return to a growth rate above its potential in fiscal 2010. Drivers would include the positive effects of policy measures, in addition to an overseas economic recovery, and improved global financial markets. Still, the outlook for economic activity and prices remains extremely uncertain.

C. The Current Situation

The Japanese economy has moved in line with the scenario I described, and has recently begun to stop worsening. Data for the April-June quarter should show positive growth from the previous quarter, ending the economic free fall. The progress in inventory adjustments both at home and abroad has enabled automobile and electrical machinery makers to increase production from May, while exports mainly to Europe and East Asia have recovered since April. The Government's policy package to address the economic crisis should also boost the economy. Unfortunately, the level of economic activity has declined so much over the past six months that anticipated export and production gains may not be sufficient for the public to feel the recovery for the time being.

Employee income and corporate profits, which drive consumption and capital investment, are the keys to raising domestic private demand. Slack in supply and demand in the aftermath of the significant drop in economic activity increasingly suggests a stronger sense of excessive employment and capital stock among firms at present. To illustrate my point, the unemployment rate has risen to 5 percent, and household income has decreased substantially in response to sharp falls in wages and overtime payments, as well as because of dwindling bonus payments owing to worsening business performances. In this environment, private consumption should benefit from declining prices, and reduced automobile taxes and other measures included in the Government's policy package to address the economic crisis. However, further job and wage cuts may weigh on the consumer sentiment recovery, keeping overall consumption weak. Business fixed investment is not likely to increase much, as firms are likely to remain cautious about making new investments in view of the extent to which demand might recover.

As for prices, the year-on-year rate of increase in the consumer price index has declined to around 0 percent. Falls in consumer prices are likely to expand toward the middle of this fiscal year in the absence of the surge in petroleum product and food prices around this time last year and because of increasing slackness in supply and demand conditions in the overall economy. However, subsequent falls may taper off, as the impact of declining petroleum product prices should ebb as medium- to long-term inflation expectations remain stable.

We need to note that crude oil prices have again been rising recently. Some say that this is because China has boosted imports of crude oil and other resources, such as iron ore and copper, and because a growing risk tolerance of investment funds has fueled an inflow of speculative money. An ongoing hike in crude oil prices might dampen an economic recovery by raising overall price levels and further burdening households, which already suffer from lower incomes.

V. Risk Factors and the Future Conduct of Monetary Policy

Given Japan's industrial structure and demographic changes, a significant domestic demand-led economic recovery seems unlikely. The Japanese economy will probably continue to depend on external demand. Recovery in overseas economies is likely to be moderate, as considerable time may be required to adjust various distortions in the global economy. In this situation, it will take some time for the Japanese economy to achieve a full-fledged recovery.

There are three prime risk factors for the outlook. The first is the spillover effect on the Japanese economy of either a possible deterioration in overseas economic and financial conditions or an overseas recovery. The second is firms' revision of their medium- to long-term business strategies or growth expectations. The third is unfavorable price developments at home and abroad.

The outlook for overseas economies, particularly the United States, is quite uncertain. U.S. private consumption and housing investment are unlikely to recover noticeably. Even after a full-fledged recovery, final consumption may still fall short of previous peaks. Hopes are increasing that consumption and infrastructure investment in China and other emerging economies will stimulate global growth, but such levels would not be comparable with those of advanced economies. For example, Chinese private consumption in 2007 was 1.2 U.S. trillion dollars, against 9.7 trillion dollars in the United States, 6.9 trillion dollars in the euro area, and 2.5 trillion dollars in Japan. Therefore, it will take some time for consumption in emerging economies to offset declines in advanced economies.

Firms have responded variously to the current global economic crisis, which features an adverse feedback loop between financial and economic activity. Many corporate managers are innovating business models that differ from their previous thinking and enable a paradigm shift. The changes include withdrawal from unprofitable areas of business, mergers of loss-making sections with other companies, exploration of new business areas, and a review of supply and production as well as research and development capabilities for each overseas market. All such steps are being considered from strategic viewpoints that encompass multilateral risk management. For this reason, firms might scrap existing domestic production facilities and transfer them overseas. Even if overseas economies fully recover, domestic business fixed investment would be restrained and a recovery in the employment situation would be limited. We should also note that business fixed investment and other economic activities might decline further if firms lower further their medium- to long-term growth expectations in light of a prolonged economic downturn.

Regarding the outlook for prices, inflation may fall more than expected if the downside risks to the economy materialize or medium- to long-term inflation expectations decline. Alternatively, over the medium to long terms, if the current strong economic stimulus measures and an accommodative monetary policy are maintained amid a global economic recovery, the rate of inflation in Japan might rise more than projected due, for example, to a further rise in commodity prices.

Given the above assessment of economic activity and prices, the Bank will continue to carefully assess the outlook for economic activity and prices, considering the likelihood of its projections materializing and factors posing upside or downside risks, and will conduct monetary policy appropriately. While considering for the time being the downside risks to economic activity and prices, the Bank will continue to do its utmost as a central bank to help Japan's economy return to a sustainable growth path with price stability.

VI. The Bank's Policy Responses since Fall 2008

Let us turn to the environment for corporate finance in Japan. Before the Lehman Brothers failure, few firms except those with poor business performances worried about their prospective financial positions under accommodative financial conditions. After fall

2008, however, the Japanese economy found itself uncommonly trapped, as the risk-taking capacity of investors and financial institutions plummeted, and the functioning of CP and corporate bond markets deteriorated significantly. Even firms with strong credit ratings had to raise funds at high interest rates, while some industries and firms were unable to raise funds even at higher issuance rates. In the meantime, firms moved to secure ample on-hand liquidity, reflecting concerns that corporate profits might deteriorate and that market liquidity might tighten. Firms came to depend more on indirect financing, rushing to obtain bank loans ahead of schedule and extending financing terms. Financial institutions could respond only partially to surging corporate demand for liquidity, because they were worried about capital constraints caused by sluggish stock prices and their own deteriorating profits. As a result, more firms -- both small and large -- reported weak financial positions and tight lending attitudes of financial institutions, greatly raising tensions in financial markets.

Confronted with drastically changing economic and financial conditions, the Bank has taken a range of monetary policy measures to support the Japanese economy. Specifically, the Bank lowered the target rate in October and December 2008 to 0.1 percent. By providing unlimited U.S. dollar funding through swap transactions with the Federal Reserve and expanding daily money market operations, the Bank has provided substantial liquidity to the markets and worked to ensure market stability. The Bank has also taken exceptional measures, one of which is outright purchases of CP and corporate bonds through banks to support a recovery in market function. Another measure is special funds-supplying operations to facilitate corporate financing, providing funds at low interest rates against corporate debt submitted as collateral. Through these and other efforts, the Bank has helped firms to deal with financing difficulties by facilitating smooth extension of bank credit.

In addition to the measures in three main areas, namely, reducing the policy interest rate, ensuring stability in financial markets by providing ample liquidity, and facilitating corporate financing, the Bank resumed purchasing stocks held by banks to secure stability in the financial system and has provided subordinated loans to banks. These measures aim to improve banks' capital adequacy ratios, ensure the smooth functioning of financial intermediation, and provide a safety net if emergencies arise.

The Bank's policy measures seem to have contributed to financial market stability to some degree. Issuing conditions for CP and corporate bonds have improved significantly compared to the end of 2008. Issuance rates on CP have declined, and some firms have issued more corporate bonds than originally planned. Among firms with single-A ratings, there has also been a rise in corporate bond issuance, which had been difficult at the end of 2008. Overall, corporate funding costs of firms seem to have declined compared to some time ago, mainly because of lower issuance rates for CP and corporate bonds. Meanwhile, there were no bids for outright purchases of CP offered at auction on June 5, 2009, which could indicate improvements in the functioning of the CP market.

Given the strong uncertainty about prospects for a world economic recovery, the environment for corporate finance should remain generally severe. This is because firms' cash flow is likely to decline due to deterioration in their corporate profits, while liquidity demand should continue increasing, owing mainly to corporate restructuring. Although financial markets are improving, they have not yet returned to normal. As some policy measures conducted so far have been unprecedented for a central bank, it is important for the Bank to conduct them within a necessary time frame and scale. The Bank thus needs to examine the future conduct of monetary policy measures offered through the end of September 2009 without any preconceived ideas while carefully assessing economic and financial developments. For each monetary policy decision, the Bank needs to take careful responses in accurately communicating its policy intentions with the public and market participants.