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Bank of Japan

Recent Economic and Financial Developments and the Conduct of Monetary Policy

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Introduction

I am privileged to have an opportunity to speak before such a large audience.

I addressed you the last time in the beginning of November 2008, which was about a month and a half after the failure of Lehman Brothers, and the financial crisis was growing serious. As you remember vividly, the global economy deteriorated rapidly and simultaneously as if falling off a cliff due to the turmoil in the financial markets. The policy responses by the governments and central banks around the world to cope with such a situation were also unprecdentedly bold and massive. Thanks mainly to the effects of those measures, the global financial markets have increasingly been showing signs of improvement since around this spring, and economic activity has also been heading for improvement at home and abroad. At the same time, there are still many challenges to meet. While it is too early to summarize the current crisis, what countries around the world experienced in the past year undoubtedly will become an important event in the history of finance and economics, like the Great Depression in the 1930s. In my speech today, based on the developments in the past year, I will discuss the financial and economic developments at home and abroad, as well as the thinking of the Bank of Japan's conduct of monetary policy.

I. Developments in the Global Economy

Background of economic downturn

I will begin by discussing the developments in the global economy.

There are two important points to note. The first point is how to understand the background of the current global economic downturn. And the second point is how to understand the differences in the pace of recovery between advanced economies and emerging economies, which has recently become marked.

I will start with the first point. While the global economy was growing at a high rate of around 5 percent for four consecutive years up to the mid-2000s, in retrospect, the nature of the growth was largely an economic boom against a backdrop of the massive credit bubble mainly in the United States and Europe. In that situation, households and firms substantially increased their debts to make excessive spending. The essence of the current global economic downturn is, put simply, balance-sheet adjustments in the course of unwinding of such excessive financial and economic activity. Inevitably, firms and households have to restrain investment and consumption in order to repay the debts. Such compression of debts, namely, a move referred to as de-leveraging, leads to the contraction of aggregate demand and a decline in asset prices. Financial institutions are also forced to tackle the restoration of balance between overly increased assets, overly shouldered risks, and the capital. In that process, a forward-looking risk-taking activity such as making new lending will simply need to be deferred. While such balance-sheet adjustments are an unavoidable process for the global economy to return to a sustainable growth path, it should be noted that downward pressure on the economy will be imposed as long as the adjustments continue.

Another point in understanding the background of the economic downturn is the panicked contraction of financial and economic activity stemming from the liquidity crisis since the autumn of 2008. Triggered by the failure of Lehman Brothers in September 2008, fund providers such as financial institutions and institutional investors became extremely cautious about the creditworthiness of their counterparties. Nagging suspicions spread in many markets, and transactions became extremely inactive. Consequently, the funds necessary for economic activity did not circulate easily, and this, together with heightened anxiety among firms and households, reduced rapidly the global demand. If the balance-sheet adjustment is one cause of protracted "chronic illness," the liquidity crisis since the autumn of 2008 additionally brought a strong "acute pain" to the global economy.

The global economy has been picking up recently, and that is because the acute pain has been dissipating for the following three reasons. First, thanks to the ample liquidity provision by central banks around the world, financial markets have gradually restored stability. Policies implemented in the United States and Europe such as government guarantee of financial institutions' debts as well as expansion of deposits to be protected have also staved off further turmoil in the financial markets. Second, in response to the plunge in demand, prompt economic stimulus measures also from the fiscal front have been carried out. A typical example was the policy to enhance purchases of new automobiles implemented in many countries. And third, as a result of the private firms' significant cutbacks in production, inventory adjustments have progressed at a rapid pace.

However, the level of economic activity in the advanced economies is substantially low compared with that prior to the failure of Lehman Brothers. In addition, the effects of demand-boosting public measures and inventory restocking will not last forever. For the economic growth to gain momentum, the key is whether a self-sustained recovery of private demand will successfully takeover these effects before they wane. What we should not forget here is the effects of the balance-sheet adjustments that I have mentioned earlier.

For the recovery of private demand to gain momentum in the future, balance-sheet adjustments should progress smoothly and the drag on the economy should be removed. However, given the magnitude of the economic bubble in the mid-2000s, the size of the adjustments also appears to be extremely large. According to an estimate by the *Global Financial Stability Report* of the International Monetary Fund (IMF) released at the end of September, banks' losses stemming from the current crisis have only been provisioned or written-off for 60 percent in the United States and 40 percent in Europe, and thus the adjustment of balance sheets is only half way through. Based on those observations, the pace of growth in the global economy as a whole is likely to remain moderate for some time.

Advanced economies and emerging economies

The balance-sheet adjustments I have explained are mainly a problem of advanced economies in the United States and Europe. It can be said that emerging and commodity-exporting economies basically do not face such a problem this time. As the second point in understanding the global economy, let me touch on the difference in the pace of economic recovery between the advanced economies and the emerging economies and the relationship between the two.

The global liquidity crisis since the autumn of 2008 not only affected gravely the advanced economies but also the emerging and commodity-exporting economies. With the turmoil in global financial markets, capital inflows to the emerging economies rapidly contracted, and the world-wide decline in demand hit the emerging economies through the decline in exports. However, with such acute pain receding, the emerging and commodity-exporting economies are recovering faster than envisaged around early spring. The real GDP growth rate for the April-June quarter of 2009 was high in many countries including South Korea, Taiwan, and Brazil. China and India have also been regaining high growths. Going forward, those countries are expected to maintain relatively high growth rates. According to the *World Economic Outlook* of the IMF released in early October 2009, the year-on-year growth rate of the advanced economies for 2010 remained at 1.3 percent, while that of the emerging economies was at 5.1 percent, and that of Asian emerging economies was particularly high at 7.3 percent. The commodity-exporting countries have also been experiencing a rapid recovery in economic activity and a substantial rise in housing prices, and Australia, followed by Norway, decided last month to raise the policy interest rate.

There are several reasons for the economic recovery in the emerging economies. First, the underlying trend in domestic demand in the emerging economies is strong to start with, supported mainly by boosted consumption owing to an improvement in the standard of living as well as need to improve social infrastructure. Those countries, typically China, are likely to potentially have strength to achieve high economic growth. Second, the emerging countries themselves have also implemented aggressive stimulative measures in response to the current crisis. Unlike the advanced countries, the emerging economies were not facing the problem of balance-sheet adjustment and potential demand was strong to start with, thus the multiplier effects of fiscal stimulus might have been significant. Third, the effects of accommodative monetary policy in the advanced economies have spread to the emerging economies. Market participants often use the term "dollar carry trade." There was a period when "the yen carry trade" was talked about, and this time, as many advanced economies are adopting low interest rate policy, funds obtained in the most deep U.S. dollar-fund market are flowing into emerging economies again, and investors are starting to take risk. In addition, since many emerging economies are adopting a fixed foreign exchange policy pegging own currency to the U.S. dollar, that also seems to have brought about monetary easing effects. Those developments have improved significantly the financial environment in the emerging economies mainly through an increase in credit provisioning and a rise in asset prices, thereby underpinning their economic recovery.

As such, there are at present two groups of economies in the world, namely the advanced economies that are strongly affected by the balance-sheet adjustments, and the emerging and commodity-exporting economies that are not facing such a problem and are gradually becoming a growth engine for the global economy. As explained earlier, the difference in the pace of recovery between the two groups has enhanced the capital inflows from the advanced economies into the emerging economies, and those capital inflows are likely to contribute to boosting economic activity in the emerging economies for some time. However, if such a situation continues too long, it could lead to overheating of the economy or turmoil in the financial markets, which could lead to an ensuing economic downturn. That is not desirable for the advanced economies either. As economic globalization progresses and economies further strengthen their interconnectedness, there will neither be a de-coupling between the emerging economies and the advanced economies nor a complete coupling of. While it is a common-sense answer, the conclusion lies somewhere in between. What would be important for the global economy is that both the advanced economies and the emerging economies grow together in a well-balanced and sustainable manner without relying too much on each other.

II. Developments in Japan's Economic Activity and Prices

Economic Activity

Based on those developments in the global economy, let me turn to Japan's economy.

Japan's economy was affected by the effects of global acute pain since the autumn of 2008 and significantly deteriorated. One characteristic of Japan is that the industries related to durable consumer goods and capital goods, such as automobiles, electronic machinery, and general machinery, have a significant share in the economy. Not a few goods of those industries are exported to the advanced economies in the United States and Europe directly or through assembly bases in Asian countries. However, due to the rapid plunge in the global economy since the autumn of 2008 and heightened uncertainty for the future, households and firms around the world rushed to display defensive behavior of curtailing their spending on expensive durable goods consumption as well as machinery and equipment. In addition, the decline in the functioning of global credit markets contracted consumer credits and further reduced the appetite for purchasing mainly durable consumer goods. That is one of the major reasons Japan's exports rapidly declined and production plunged.

This suggests that the recovery in Japan's exports should start once the effects of acute pain wane in the United States and Europe. In addition, a faster-than-expected recovery in the emerging economies including China has contributed significantly to the increase in Japan's exports. As a result, exports and production turned upward around this early spring and have been increasing. Against such a backdrop, business sentiment especially at large manufacturing firms has also been improving. As such, although Japan's economy experienced a sharp downturn, it has been improving at a faster pace than other advanced economies. However, we should bear firmly in mind that the level of economic activity is still low, with the GDP remaining at slightly above 90 percent, according to the latest available figure of the April-June quarter, and the level of September industrial production remaining at slightly above 80 percent of that immediately before the failure of Lehman Brothers, respectively. The Bank of Japan uses a somewhat cautious phrase that "Japan's economy has started to pick up" in expressing the current state of Japan's economy, and that reflects also the judgment with respect to the levels I have just mentioned.

Let me turn to the outlook for the economy. The Bank issued last week the *Outlook for Economic Activity and Prices* (the Outlook Report) and presented the outlook for Japan's economy through fiscal 2011. The baseline scenario is that, in the second half of fiscal

2009, the economy is likely to improve gradually on the back of improvements in overseas economies as well as the effects of economic policy measures. Going forward, such tendency is expected to be maintained in fiscal 2010. However, since the pace of recovery in the global economy is likely to remain moderate and also, in Japan, pressure for adjusting employment and wages is likely to remain while the effects of demand-boosting policy measures wane, the pace of improvement in Japan's economy is likely to be moderate until around the middle of fiscal 2010. Thereafter, as balance-sheet adjustments in the United States and Europe make fair progress, the improvements in the corporate sector originating from exports are likely to spill over to the household sector. Therefore, in fiscal 2011, Japan's economic growth rate is likely to clearly increase.

However, the outlook is accompanied by various uncertainties. What worries me the most is the possible consequences of balance-sheet adjustments in the United States and Europe, as well as developments in the emerging and commodity-exporting economies. Besides, there are downside risks to the economy such as developments in firms' medium- to long-term expectations of future economic growth. However, given that the emerging and commodity-exporting economies are likely to continue growing at high rates, risks have been becoming balanced, compared with a situation in early spring when risks were generally tilted downside.

Prices

Based on the developments in the economy I have explained, I will now turn to the price developments in Japan.

Since 2008, the consumer price index (CPI) in Japan has been subject to a large swing due mainly to the changes in the prices of petroleum products. The year-on-year growth rate of the CPI (excluding fresh food) was on a declining trend following its peak at 2.4 percent in the summer of 2008 and became negative after March 2009. The pace of decline accelerated thereafter due mainly to the base effect from last year's high petroleum product prices, and the CPI (excluding fresh food) marked a record decline of 2.4 percent in August, year-on-year, and declined by 2.3 percent in September.

The Bank views the outlook for prices as follows. The pace of year-on-year rate of decline in the CPI (excluding fresh food) is expected to slow down significantly in the second half of fiscal 2009. That is because the base effect from last year's high petroleum product prices will dissipate. Thereafter, the CPI (excluding fresh food) is expected to be basically subject to the development in the aggregate supply and demand balance. From fiscal 2010 onward, the rate of decline in the CPI (excluding fresh food) is likely to continue to moderate, as the economy picks up as well as the aggregate supply and demand balance improves gradually. However, downward pressure on prices is likely to remain for a relatively long period, given that the negative output gap, which underlies this projection, is larger than ever and that the pace of economic recovery is likely to be moderate. Since the current plunge in demand was as sharp as no country experienced for a long period, it is commonly considered also in the United States and Europe that it will take a considerable period for inflation rates to recover to the past levels.

In those circumstances, what is important is whether, as a future baseline scenario, Japan's economy returning to a sustainable growth path with price stability is in sight. It is an issue for those who worry about the effects of price decline, whether the continued decline in prices, albeit modestly, will postpone spending, leading to further acceleration in price declines.

What might serve as a reference here is Japan's experience in the first half of the 2000s. While there were many arguments about deflation at that time, eventually Japan's economy started to recover amid the continued modest decline in prices. The year-on-year growth of the CPI had been slightly negative, at around just under minus 3 percent on a cumulative basis, for seven years from fiscal 1998 to 2004. Meanwhile, despite the price decline, the economy continued to recover from fiscal 2002 to 2007. While that has been a puzzle to one who worries about deflation, such a situation has been drawing interest from the overseas policy authorities and economists. In this regard, a difference from the global economy in the 1930s, when deflation was a grave problem, might give us a clue. Unlike Japan in the early 2000s, prices plunged by more than 20 percent on a cumulative basis, or more than 30 percent in some countries, in the global economy in the 1930s. Moreover, in the 1930s, the authorities could not come up with effective policy measures in response to successive bank failures and the financial system became extremely unstable, leading to a situation in which firms facing funding difficulties rushed to sell off their own products. In contrast, although Japan did face difficult problems, it succeeded in managing to avoid financial system instability due to such measures as ample liquidity provision by the Bank of Japan.

Looking at the current phase while bearing those episodes in mind, Japan's financial system has been generally stable, and, in terms of cumulative decline in prices, the level of the CPI as of September returned to the level of August 2007, just before the surge in petroleum products started. Firms' and households' medium- to long-term inflation expectations are considered to be stable so far, according to various surveys and developments in long-term interest rates. Based on those observations, the Bank judges that, at present, it is unlikely that the decline in prices will induce downward pressure on economic activity.

Of course, like the outlook for economic activity, the outlook for prices is also accompanied by uncertainty. As explained earlier, year-on-year changes in prices in Japan rose to around 2.5 percent in the summer of 2008 due mainly to the surge in prices of petroleum products, and this year, because of the base effect, prices have been declining by more than 2 percent, year-on-year. Several years ago, there were not many people who could forecast that such changes in prices would take place, including those in the Bank and international institutions, as well as economists. As such, it is the reality that the accuracy in predicting price changes during a phase of a large economic swing is not high. Therefore, we believe that it is important to maintain a stance of examining all available data, without having any prejudgment about the outlook.

The financial environment

So far I have explained the developments in economic activity and prices. I will now turn to Japan's financial environment.

The turmoil in global financial markets since autumn 2008 spread over to Japan's financial markets, especially CP and corporate bond markets where large firms raise funds. The issuance rates of CP and corporate bond soared, and the corporate bond market was in an abnormal situation that issuance virtually stopped. Together with a deterioration in economic activity, funding conditions of large firms became increasingly tight. The worsening financial environment for large firms affected funding conditions at small firms mainly through two channels. First, since large firms that faced malfunctioning of CP and corporate bond markets had shifted their funding sources to borrowing from banks, banks responded by using much of their remaining lending capacity. And second, the worsening of funding conditions at large firms had contracted business-to-business credit for trading partners and affiliated firms. As a result, in the March 2009 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the diffusion index of funding conditions plunged to the lowest level in about 10 years since 1998, regardless of firm size.

Subsequently, thanks to the regained stability in global financial markets and the effects of various policy measures in Japan, Japan's financial environment has been showing signs of improvement. In particular, the issuing conditions of CP and corporate bonds have improved markedly. In the CP market, issuance spreads for even low-rated firms have declined to a level below those before the failure of Lehman Brothers and the Bank judges that the market has already come back to a normal state. In addition, the corporate bond market has also restored favorable issuing conditions as a whole, as seen in the fact that credit spreads have declined and the total value of issuance in the first half of fiscal 2009 marked a record high.

Nevertheless, we should not forget that there is still lingering severity in Japan's financial environment. In particular, the improvement in funding conditions at small firms has been limited, compared with that of large firms. That would basically be attributable to the severe profit environment for small firms, as shown in the moderate pace of improvement in their business sentiment, albeit underpinned to some extent by the emergency guarantee program. The Bank will continue to examine corporate financing as a whole including that of small firms, through various surveys such as the *Tankan* as well as interviews through the Bank's branch network.

III. Conduct of Monetary Policy

I have explained the developments in the economies at home and abroad as well as the developments in prices. Based on those developments, I will finally explain the Bank's thinking behind the conduct of monetary policy.

The Bank reduced the policy rate to 0.3 percent in October 2008 and to 0.1 percent in December 2008 and has been maintaining the level unchanged since then. To address the rapid contraction of financial markets triggered by the failure of Lehman Brothers, the Bank implemented various temporary measures, including extraordinary ones for a central bank such as outright purchases of CP and corporate bonds. At the Monetary Policy Meeting (MPM) held on October 30, the Bank made a decision on the policy rate and those various measures.

The policy rate was decided to be maintained at the extremely low level of 0.1 percent. As mentioned earlier, the recovery in Japan's economy has just started, and it is likely to take some time for the economy to fully return to a growth path. The Bank will maintain the extremely accommodative financial environment and thereby provide steady support for Japan's economy to return to a sustainable growth path with price stability.

Next I will explain the management of various temporary measures. At the MPM, we decided on specific handling of measures from a perspective of what might be the most effective method that conforms to the degree of improvement in the acute pain, and will ensure financial market stability and thereby facilitate corporate financing.

It was decided that special funds-supplying operations to facilitate corporate financing will remain in effect until the end of March 2010 and will expire. This is a measure to supply funds at a fixed interest rate of 0.1 percent with a term of three months, for an unlimited amount against the value of private corporate debt pledged as collateral. While the operations contributed to stabilizing financial markets, the similar effects could be mostly achieved by the existing money market operations since the stability of financial markets has been restored. Nevertheless, we decided that the operations would remain in effect until March 2010 to further ensure financial market stability toward the end of the fiscal year. From April 2010 onward, the Bank will be prepared to provide ample liquidity by further utilizing the existing money market operation measures, which accept a wider range of collateral and have more flexibility in setting terms. We have clarified our intention after April at this point since we thought giving market participants a certain preparation period before the transition to a new system would facilitate smooth transition without any confusion.

The Bank's outright purchases of CP and corporate bonds will expire at the end of 2009 as scheduled. As issuing conditions in the CP and corporate bond markets improve, actual bids in the auction of outright purchase of CP has been zero for four consecutive auctions since mid-September. The bids for the outright purchase of corporate bonds have also been declining. As seen in those improvements, the Bank considers that the purpose of the purchases to restore market functioning in the impaired CP and corporate bond markets has fully been achieved. Meanwhile, a distortion of market functioning has recently been becoming prominent, as witnessed by the issuance rates of CP becoming lower than yields on government bills and, as a result, investors are increasingly becoming fewer. The Bank thus made the decision that the termination of the purchases would be useful in achieving the smooth flow of funds.

In addition, the Bank decided that the complementary deposit facility introduced in the autumn of 2008, to which interest is paid on part of financial institutions' deposits at the Bank, would remain in effect for the time being. While I will not go into technical details, the facility is a mechanism for avoiding substantial changes in market interest rates under ample liquidity provision by the Bank and thereby ensure stable interest rate formation. Upon this extension, an important infrastructure for the smooth conduct of money market operations while providing ample funds will continue to be secured.

As central banks around the world have been striving to ensure the stability of financial markets and financial systems through ample liquidity provision, demand for central bank funds is expected to recede as each country's financial environment further stabilizes with the dissipation of the acute pain. As a result, funds supply by central banks might decline. Looking at the size of major central banks' balance sheets and reserves since the autumn of 2008, they have been changing, reflecting the extent of impairment of financial market and financial system of each individual country. For example, since Japan's financial markets and financial system have been stable, compared with those in the United States and Europe, the balance sheet of the Bank has not been expanding that much. In contrast, in the United States where the current financial crisis was originated, the amount of excess reserves at the Federal Reserve rose to above 6 percent of nominal GDP, which is a level slightly above the peak of the Bank of Japan's excess reserves of 5.8 percent at the time of quantitative easing policy. When balance-sheet adjustments have been progressing, massive liquidity provision by central banks has not been affecting the rate of inflation, but has contributed substantially to restoring stability in the financial system. Going forward, the Federal Reserve's balance sheet is likely to shrink as the financial environment further improves, and even in that case, it is an evidence that financial markets have further stabilized, rather than signaling a change in central banks' accommodative monetary policy stance.

I reiterate that, in the conduct of monetary policy, the Bank will provide steady support for Japan's economy to return to a sustainable growth path with price stability, by maintaining the extremely accommodative financial environment. That means that the Bank will underpin Japan's economy so that it will be able to exert its potential strength. A more critical challenge for Japan is to raise "the potential strength," or put it differently, the long-term growth path itself. On this point, I will add that the key will be to improve profitability in investment and productivity of the economy as a whole through active efforts of private firms.

Closing Remarks

In closing, I will share with you what I have in my mind based on the experience of the past year.

Those thoughts all relate to the role of a central bank. First, the importance of decisively taking action upon accurately recognizing the role expected of a central bank. In any country, a central bank is an organization to carry out policies and business operations by highly valuing a self-sustained market mechanism. Nevertheless, when being confronted with a crisis that the financial system might collapse, a central bank will do its utmost to prevent the collapse of the financial system by using all central bank functions, including outright purchases of CP and corporate bonds, or sometimes creating new measures. While those actions will be carried out to protect the markets, it will indeed be a significant intervention against the market mechanism. Therefore, it sometimes becomes quite difficult for a central bank to draw the clear line between what it "should do" and "should not do." A central bank will be required to implement decisively even extraordinary measures if necessary, within a range allowed by law, to achieve the objective of a central bank to ensure economic and financial stability. At the same time, however, because a central bank is the sole organization that has a privilege of issuing interest-free debt, there will be considerable adverse effects of continuing the extraordinary measures to intervene in the markets after they have become unnecessary. In that regard, I am of the view that a central bank's proper actions are critical both during and after a crisis, and keeping this in mind, I believe that the Bank will fulfill the missions of a central bank.

And the second point concerns the prevention of a crisis. While the current crisis is not over yet, various efforts have been made to prevent the recurrence of a crisis, based on the lessons learned. For example, as a framework for preempting crisis, discussions are underway on the capital adequacy ratio and review of financial regulations and supervisory system. Moreover, a perspective of macroprudence, through which the existence of risks are checked and assessed upon reviewing the financial system as a whole, has been widely recognized.

However, the cause of a bubble will eventually boil down to the human nature such as bullish expectations in a benign financial and economic environment or a decline in self-discipline against risks. That itself raises a difficult issue of how a central bank should deal with such an elusive problem. I have discussed earlier the dollar carry trade, and the fact that people are able to easily take risk without geographical and time constraints, thanks to the recent financial and economic globalization and progress in information technology, has made the responses of a central bank all the more difficult. What is obvious is that a crisis will always come in a new form. By exchanging views with the policy authorities at home and abroad, market participants, and academics, and continuing to learn humbly, the Bank of Japan will meet such new challenges.

Thank you.