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Bank of Japan

Economic Activity and Prices in Japan and Monetary Policy

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I. The Global Economy

Economic activity in Japan is closely linked to global economic developments. Therefore, before discussing the Japanese economy, I will first take a look at trends in the world economy. From around 2005, the world economy grew at a rapid pace of around 5 percent annually, with China and other emerging economies gaining in prominence. The failure of Lehman Brothers in September 2008, however, brought this growth to a sudden halt, and the world economy marked negative growth in 2009 due to the severe contraction in the first half of the year. Causes of the sharp decline include the rapid deceleration in economic and financial activity due to the financial crisis triggered by the Lehman shock, and the corrections to the various excesses that had built up in the world economy since the mid-2000s. By "excesses," I am referring to overborrowing by households, excess production capacity in the corporate sector, and the large amount of nonperforming loans held by financial institutions.

Measures to address the financial crisis implemented by governments and central banks around the world started to show effects from the second half of 2009. With the contraction in economic and financial activity having come to a halt, policy measures to stimulate demand provided a further boost. It should be noted, however, that the pace of economic growth has been slowing somewhat since summer 2010, as restocking of inventories that took place during the recovery phase came to an end and the effects of demand-boosting measures in the United States and other countries waned. The slowdown is also due in part to the unwinding of accommodative policies in emerging countries in order to keep economies from overheating.

A. Advanced Economies

Let us look at advanced economies in more detail. The U.S. economy remains on a moderate uptrend. Although the effects of fiscal stimulus measures have been waning, exports to emerging and commodity-exporting economies have continued to increase and private consumption and business fixed investment have been rising moderately. Housing starts have remained at a depressed level after dropping sharply due to the expiry of tax credits for homebuyers, but are unlikely to fall further.

As for the outlook, the U.S. economy is likely to continue recovering on the back of increasing exports and accommodative monetary policy. It must be added, however, that in the labor market employment conditions have not improved greatly, with unemployment, for example, remaining at a high level. Consequently, balance-sheet adjustments in the household sector -- that is, the restoration of financial health, including the repayment of household debt -- are unlikely to gather pace, so that the pace of recovery is likely to remain moderate.

Economic activity in the euro area as a whole has been recovering moderately, with some differences in growth by country: Germany has performed strongly while other countries have lagged behind. Although the pace has been slowing, exports and production have continued to increase, while domestic demand components, such as private consumption, have been rising from the previous quarter. For the present, the euro area is likely to continue recovering moderately. However, attention needs to be paid to the effects of fiscal consolidation, which from next year will start in earnest also in the major economies, and to volatility in financial markets due to concerns over the public and private debt problems in some of the peripheral countries.

B. Emerging and Commodity-Exporting Economies

Although emerging and commodity-exporting economies are often grouped together, they are a diverse group. Here, I will focus on the major East Asian economies, since they are most relevant to Japan. First, the Chinese economy has continued to show high growth of around 10 percent. Although the pace of increase in exports has been slowing due to a deceleration in overseas economies such as the United States, domestic demand, as indicated by retail sales and investment in fixed assets, has continued to show high growth. Like China, South Korea, Taiwan, Thailand, and other NIEs and ASEAN countries also experienced continued economic growth driven by domestic demand, although inventory adjustments in IT-related goods are casting a shadow on the outlook for exports.

Overall, it is very likely that emerging and commodity-exporting economies will continue to show relatively high growth due to robust domestic demand and capital inflows from overseas. The pace of growth of the Chinese economy is likely to decelerate somewhat due, among other things, to government measures to restrain the increase in real estate transactions. However, given the continuing increase in private consumption, growth is nevertheless likely to remain relatively high. Economic conditions in the NIEs and ASEAN countries are expected to follow a recovery trend due to the inflow of overseas capital and increases in private consumption and business fixed investment.

II. The Japanese Economy

Based on the above assessment of the world economy, I will now talk about economic activity and prices in Japan. Semiannually, in April and October, the Bank of Japan releases the *Outlook for Economic Activity and Prices*, known as the Outlook Report, in which it makes public its forecasts for economic activity and prices for the next two to three years, the background for its forecasts, and the associated risk factors. My speech today will from time to time refer to this report, in particular the October 2010 Outlook Report.

A. Economic Activity

Real GDP growth for the July-September quarter of 2010 was relatively strong. Recent developments in production, however, indicate that the economic recovery seems to be pausing. The pause in the recovery can be attributed to various factors, including a decrease in demand following the last-minute rise in demand ahead of the expiration of subsidies for purchasers of environmentally friendly cars and the boost from the extremely hot weather, the deceleration in overseas economies, and inventory adjustments in IT-related goods.

Looking at the situation for each demand component, real exports as a whole have recently been more or less flat, reflecting the following factors: (1) the effects of inventory adjustments in IT-related goods such as semiconductors in South Korea and Taiwan; (2) the deceleration in the U.S. economy; (3) the unwinding of accommodative monetary policies in emerging economies; and (4) the effects of the strong yen on exports of cars and other goods. However, given the strong domestic demand in emerging economies, Japan's exports are unlikely to fall precipitously and are likely to recover in the longer term, providing support to the economy overall. Furthermore, production, which is likely to remain lackluster for a while due to the reasons mentioned above, is expected to gradually return to a moderate upward trend along with the recovery in exports.

The Bank maintained its assessment of business fixed investment as "showing signs of picking up." This rather cautious assessment, despite the fact that business fixed investment this fiscal year is likely to turn out to be higher than in the previous year, reflects the following: (1) the fact that firms continue to feel that their capital stock is still excessive; (2) the shift of production to overseas locations; (3) the deceleration in overseas economies; and (4) the appreciation of the yen. Yet, I frequently hear that there is considerable pent-up need for replacement investment and investment in environmentally friendly equipment, given that firms have held back on such investment since the collapse of Lehman Brothers. Barring any extreme external shocks, the pick-up in business fixed investment is therefore expected to gradually become more pronounced as a result of the improvement in corporate profits.

Turning to the household sector, private consumption in the July-September quarter of 2010 was supported by the last-minute rise in demand ahead of the expiration of subsidies for purchases of environmentally friendly cars and the increase in the tobacco tax, in addition to the boost from the extremely hot weather. There was a clear decrease in sales of cars, with the exception of small cars with engine sizes of 660 cc or less, which in October and November were sharply down, by approximately 30 percent, from the same period a year earlier. I earlier mentioned some factors behind the current "pause" in the economic recovery. Among them, I have been most concerned about the drop in car sales because of the wide range of firms and industries encompassed by the automotive sector. With the drop in car sales having become a reality, the question now is the depth and length of the decline. Demand for cars has been brought forward for a year and half since the introduction of subsidies in April 2009, so the decline in car sales is likely to continue. That being said, though, one would expect the negative impact on the economy to be greatest immediately after the expiration of subsidies and to subsequently ease gradually. Therefore, private consumption is expected to gradually recover. Obviously, the timing of a full-fledged recovery of private consumption is not clear, since the employment and income situation is expected to remain severe. Developments in this area, together with housing investment, which has been recovering gradually, warrant a close watch.

Against this background, if overseas economies, led by emerging and commodity-exporting economies, were to register higher growth, this would increase the likelihood of Japan's economy returning to a recovery path fueled by an increase in exports. The October 2010 Outlook Report paints such a scenario for fiscal 2011 onward. The report also said that in "fiscal 2012, Japan's economy is expected to continue growing at a pace above its potential, as the transmission mechanism by which the strength in exports and production feeds through into income and spending will likely operate more effectively amid the continued relatively high growth in overseas economies, especially emerging and commodity-exporting economies." Although this is subject to a considerable margin of error, the Bank estimates that Japan's potential growth rate during the projection period is around 0.5 percent.

B. Prices

Domestic corporate goods prices are expected to remain on a moderate uptrend for the time being, mainly due to the uptick in international commodity prices. The decline in the consumer price index (CPI; excluding fresh food) on a year-on-year basis is decelerating and is expected to continue decelerating as a trend as the aggregate supply and demand balance gradually improves.

As stated in the projection in the Outlook Report for the period ending in fiscal 2012, it will take considerable time for the supply and demand balance to improve because the drop in demand after the financial crisis was considerable and the pace of economic recovery has been moderate. Therefore, the deceleration in the decline in the CPI on a year-on-year basis is likely to remain moderate and it will likely take until sometime in fiscal 2011 for the year-on-year rate of change in the CPI to enter positive territory. Thereafter, the rate of increase is expected to start rising through fiscal 2012.

III. Risks to the Outlook

The above outlook for economic activity and prices suggests that the Japanese economy will be able to overcome deflation and return to a sustainable growth path with price stability, although it will take time. However, there are various upside and downside risks to economic activity and prices.

A. Risks to Economic Activity

In the October 2010 Outlook Report, the Bank listed the following as risk factors concerning the outlook for economic activity: (1) developments in advanced economies; (2) developments in emerging and commodity-exporting countries; (3) developments in business and household sentiment; and (4) firms' medium- to long-term growth expectations.

Regarding the first risk, economies burdened with balance-sheet adjustments, such as the United States, are unlikely to achieve strong growth and will remain prone to weakness until the adjustments are completed. U.S. household debt relative to income remains high. In Europe, financial markets remain volatile, as indicated by the recent surge in yields on Irish government bonds. Furthermore, the amount outstanding of public debt has increased considerably due to the implementation of vigorous fiscal policies. The implementation of fiscal consolidation measures, which will proceed further, might exert greater-than-expected downward pressure on individual economies and the global economy.

Emerging and commodity-exporting economies are likely to maintain relatively high growth led by domestic demand, and in this situation the continued large-scale monetary easing in advanced economies might accelerate capital inflows to emerging and commodity-exporting economies. Stock and housing prices in these economies have been rising already. If economic conditions in these economies are boosted further, Japan's economy could realize stronger-than-expected growth through the increase in exports to these economies. On the other hand, if economic and financial activity in these economies becomes excessive, there is a risk that this could, in the longer term, lead to a sharp reversal. Therefore, whether emerging and commodity-exporting economies will be able to achieve a soft landing and return to a sustainable growth path is an issue that warrants careful attention.

A domestic issue that warrants attention is the possibility that fluctuations in business and household sentiment might affect economic activity. For example, the appreciation of the yen may on the one hand encourage mergers and acquisitions abroad -- a positive development -- but on the other it is also likely to exert downward pressure on the profits of exporters and might damage economic activity if this were to hurt business confidence and lead firms to change their behavior.

A final point concerns firms' medium- to long-term growth expectations. If firms are able to capture infrastructure and consumption demand in emerging and commodity-exporting economies, this would increase the possibility that economic activity will be stronger than projected. On the other hand, if firms' growth expectations continue to shift downward, there is a risk that business fixed investment and private consumption could decrease more than expected.

I believe that the risks to either side are equally important and that at present the upside and downside risks are broadly balanced. However, I will continue to carefully monitor developments concerning these risks.

B. Risks to Prices

Risks to prices, in addition to the above four risk factors affecting economic activity, include a possible decline in firms' and households' medium- to long-term inflation expectations. If the pace of recovery in resource utilization of labor and production capacity remains moderate, firms and households might expect prices to fall, which in turn could affect actual prices. Other risks to prices that require careful observation include the high uncertainty in gauging the aggregate supply and demand balance and its impact on prices, as well as price changes due to fluctuations in international commodity prices and foreign exchange rates.

IV. Monetary Policy

Let me now turn to the Bank's conduct of monetary policy. The Bank recognizes that Japan's economy is faced with the extremely important challenge of emerging from deflation and returning to a sustainable growth path with price stability. Based on this recognition, the Bank has been doing its utmost as the central bank, using a three-pronged approach consisting of (1) strong monetary easing, (2) ensuring stability in financial markets, and (3) providing support to strengthen the foundations for economic growth. Today, I would like to explain the Bank's pursuit of strong easing through comprehensive monetary easing and the support for strengthening the foundations for economic growth to address the medium- to long-term issues faced by the Japanese economy.

A. Pursuing Strong Monetary Easing: The Comprehensive Monetary Easing Policy

With regard to its pursuit of strong monetary easing, the Bank has reduced its policy interest rate twice since the Lehman shock and, by increasing longer-term funds provision to financial institutions through new funds-supplying operations, the Bank has been influencing directly longer-term interest rates such as 3-month and 6-month rates. As a result, market interest rates have been stable at extremely low levels and firms' funding costs have been declining. However, at the Monetary Policy Meeting held on October 4 and 5, 2010, it was judged that the economic growth rate was likely to be somewhat lower than the projection presented in the July 2010 interim assessment, reflecting the slowdown in the U.S. economy since summer 2010 and the effect of the appreciation of the yen on business sentiment. It was also agreed at the meeting that, in view of the downside risks to the economic outlook, it had become more likely that the return of Japan's economy to a sustainable growth path would be delayed compared to what had been projected earlier. In this context, what particularly caught my attention was the results of the September 2010 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) released by the Bank. Although I had anticipated that firms' view of future business conditions had deteriorated to some extent due partly to the decrease in demand following the expiry of government measures to boost demand, the extent to which it had deteriorated was larger than I had expected.

The Bank has repeatedly stated that it will continue to consistently make contributions as the central bank so that Japan's economy will overcome deflation and return to a sustainable growth path with price stability. Therefore, the members of the Policy Board, myself included, thought that the time had come for the Bank to express this stance more clearly, examine concrete measures, and take drastic measures. Moreover, it was important to announce these measures as a package rather than piecemeal policies. The purpose of this package is to further enhance monetary easing, and I personally felt that first of all it was important for the Bank to announce a change in the guideline for money market operations and clarify the Bank's commitment regarding the time horizon based on the "understanding of medium- to long-term price stability" (hereafter the "understanding").

Regarding the change in the guideline for money market operations, the Bank lowered the target for the uncollateralized overnight call rate -- the shortest interbank rate -- from "at around 0.1 percent" to "at around 0 to 0.1 percent," thereby clearly indicating that it was pursuing a virtually zero interest rate policy. As for the clarification of its commitment regarding the time horizon based on the "understanding," Policy Board members agreed that (1) the Bank would maintain the virtually zero interest rate policy until it judged that price stability was in sight, and (2) the "understanding" would be appropriate as the basis for that judgment. The "understanding" is the level of inflation that each of the nine Policy Board members understands as being consistent with price stability over the medium to long term. The "understanding" at present falls in a positive range of 2 percent or lower, and the midpoints of most Policy Board members' understanding are around 1 percent.

In considering policy options the Bank could take, the Bank's options within the conventional monetary policy framework were limited, given that short-term interest rates -- ranging from overnight to longer-term rates -- were already at levels that left little room for a further decline. In these circumstances, the Bank decided on the establishment of the Asset Purchase Program (hereafter the Program) as the third measure in the comprehensive monetary easing package. Like other Policy Board members, I felt that the Bank should consider a variety of policy options without precluding measures that are temporary or extraordinary for a central bank, such as directly influencing longer-term rates and expanding the type of financial assets eligible for the Bank's purchases.

The details of the Program are as follows. The Bank established a program on its balance sheet to conduct outright purchases of various financial assets, such as Japanese government bonds (JGBs), CP, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs), and the fixed-rate funds-supplying operation against pooled collateral. The total amount of the Program will be about 35 trillion yen, consisting of about 5 trillion yen for purchases of financial assets and about 30 trillion yen for the fixed-rate funds-supplying operation against pooled collateral. The Bank has already begun purchasing JGBs and corporate bonds, and the first auction for the purchase of CP is scheduled for tomorrow, December 10, 2010. The Bank also decided to start purchasing ETFs and J-REITs in the near future. As the Bank has been explaining, this is a temporary and extraordinary measure for a central bank. Moreover, the Bank did not adopt this measure lightly, since it entails the critical issue of making sure that the risks involved in holding various risk assets are properly managed in order to ensure the financial health of the central bank of Japan.

B. The Bank's Measure to Support Strengthening the Foundations for Economic Growth

Lastly, I will move on to talk about the fund-provisioning measure to support strengthening the foundations for economic growth, which the Bank decided to introduce at the Monetary Policy Meeting held on June 14 and 15, 2010. The measure supplies long-term funds at a low interest rate against eligible collateral to financial institutions in accordance with their efforts in terms of lending and investment toward strengthening the foundations for economic growth.

Japan's economy faces the critical challenge of overcoming deflation and returning to a sustainable growth path with price stability. To achieve this, the key, in my view, is to tap potential demand, and both economic entities in the private sector and the authorities need to continue to make steady efforts to this end. The main cause of the current deflation is the negative output gap, which largely reflects a long-term downtrend in the economic growth rate since the 1990s. However, looking again at major trends such as demographic developments and globalization, can we really say that Japan has nothing to gain from these trends? I do not think so. It all depends on one's perspective. For example, demographic trends can be seen as a shrinking of the total and the working-age population, or they can be seen as an increase in the importance of the elderly. Similarly, global warming is an issue that requires an immediate response, but even more important is a medium- to long-term strategy covering the next 10 or 20 years.

Regarding the fund-provisioning measure to support strengthening the foundations for economic growth, Bank of Japan Governor Masaaki Shirakawa has commented that, in addition to providing practical support through the provision of funds, he felt that it was more important to raise awareness of the challenges the economy faces. Having worked in the business world, I feel exactly the same. I believe what is needed is to identify the root cause of the challenges Japan's economy faces and take the most appropriate action to address them, no matter how long this may take.

On December 7, 2010, the Bank carried out the second new loan disbursement under the fund-provisioning measure to support strengthening the foundations for economic growth, so that the amount of loans disbursed now totals about 1.5 trillion yen. Individual investments and loans under the measure cover a broad range of fields, with financial institutions making a variety of efforts reflecting the particular customer base and/or region they serve. I feel these are extremely encouraging signs and that such efforts are a vital step toward overcoming the challenges the economy faces. The Bank, as the central bank, is determined to offer support as broadly as possible for the efforts that private financial institutions are making on their own initiative toward strengthening the foundations for economic growth.