



June 26, 2008

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 Asahikawa*

**Seiji Nakamura**

*Member of the Policy Board*

## **I. Developments in Overseas Economies**

Before discussing economic and price developments in Japan, let me first begin with developments in overseas economies.

The global economy, which achieved stable growth led by both advanced and emerging economies from 2004 through the summer of 2007, has recently been slowing mainly due to the deceleration in the U.S. economy. Concerns about inflation have been heightening worldwide as the rise in prices of energy and materials, as well as food, has been accelerating since the beginning of 2008. At the same time, instability in global financial markets stemming from the U.S. subprime mortgage problem has yet to reach an end.

These risk factors, which have affected each other, have increased downside risks to overseas economies, making future developments extremely difficult to project. However, developments in overseas economies have so far been in line with the Bank of Japan's assessment in the most recent issue of its *Outlook for Economic Activity and Prices*,<sup>1</sup> or the Outlook Report, released at the end of April 2008, that overseas economies, especially emerging economies, were likely to grow moderately as a whole, albeit with some deceleration, without entering a serious adjustment phase.

### **A. Economic Developments**

In the United States, the real GDP growth rate for the January-March quarter of 2008 was at a low level of 0.9 percent on an annualized quarter-on-quarter basis. This reflects the ongoing correction in the housing market as well as the substantial deceleration in private consumption and business fixed investment mainly due to the deterioration in the financial environment. Although the adjustment process in the U.S. housing market has already been going on for over two years, home sales are still sluggish and inventories have remained at a high level for more than 10 months. In addition, home prices have continued to fall substantially. The S&P/Case-Shiller Home Price Index, which measures home prices in 20 metropolitan regions across the

---

<sup>1</sup> This semiannual report, which is released every April and October, makes public the Bank's outlook for economic activity and prices through the next fiscal year.

United States, rose substantially until peaking in July 2006, when it was 36 percent higher than at the beginning of 2004, but in April 2008 was down 15 percent from a year earlier. Although the reading for April was 18 percent off the peak, there are still no signs of a bottoming out in home prices. The adjustment in the housing market may be prolonged, as suggested by U.S. Treasury Secretary Henry M. Paulson, who observed that adjustments in the housing market might continue until next year.

In this situation, U.S. consumer sentiment has been deteriorating, partly due to the substantial rise in gasoline prices, which have roughly doubled over the past three years. The negative effect of the surge in crude oil prices on household spending can be seen in the sluggishness in sales of automobiles and the decrease in average miles driven. Moreover, looking at the volume of container shipping from Asia to North America -- the major channel of U.S. imports of consumer goods -- this has continued to be below the previous year's level since the second half of 2007, and the decline has accelerated since the beginning of 2008. As we have seen, growth in private consumption has been decelerating substantially. Against the background of a deteriorating employment situation, the decrease in real income due to inflation and tight consumer credit conditions are increasingly likely to weigh on consumer spending, thereby leading to a further slowdown in the U.S. economy.

European economies as a whole continued to grow, although at a slower pace, led mainly by firm growth in business fixed investment. Private consumption, however, has been relatively weak due to the rise in energy and food prices.

In China, exports have continued to increase significantly, particularly those to economies other than the United States, and growth in fixed asset investment has remained high. As for the outlook, developments in the economy and prices warrant careful attention as there are both upside and downside risks. Economic growth could be slower than expected if the effect of tightening policy to contain inflation turns out stronger than expected or if growth in exports becomes slower than expected. On the other hand, it could be faster than expected as a result of developments in domestic demand such as fixed asset investment.

The NIEs and ASEAN economies continued to expand at a moderate pace, but external demand has been on a decelerating trend and there have recently been signs of a slowdown in domestic demand due to the rise in energy and food prices. Countries that export natural resources, such as those in the Middle East, have been exhibiting strong growth.

## **B. Heightening Concerns over Inflation**

The rise in prices of energy and materials, as well as food, has been accelerating since the beginning of 2008 due to the increase in demand from emerging economies, the increase in the speculative inflow of funds and the inflow of fund money to commodity markets, and the current limit of suppliers' capacity to meet the increasing demand. As a result, concerns about inflation have been heightening worldwide and long-term interest rates have consequently been rising. Looking at the latest levels of inflation in individual countries, the year-on-year rate of increase in the consumer price index (CPI) has been elevated in many countries: 0.8 percent in Japan and 10.5 percent in Saudi Arabia in April 2008; and 4.2 percent in the United States, 3.9 percent in the European Union (EU), 7.7 percent in China, 10.4 percent in Indonesia, and 15.1 percent in Russia in May 2008. Emerging economies with low energy efficiency in particular have been affected significantly by the surge in energy prices. A rise in prices of petroleum products has started to be widely observed in China, India, and Indonesia due to reductions in energy subsidies and the easing of price controls. Against this background, many emerging economies have started to tighten monetary policy to contain inflation. Price developments are also being closely watched in the advanced economies, with U.S. Federal Reserve Chairman Ben S. Bernanke expressing growing concern about inflation pressures and European Central Bank (ECB) President Jean-Claude Trichet making it clear that the ECB would work to contain inflation.

## **C. Turbulence in Global Financial Markets**

The turbulence in global financial markets stemmed from subprime mortgage loans, which were provided on the assumption that home prices would continue to rise. Since 2004, the world economy experienced a period of stable and high growth of

around 5 percent, and inflation remained low. In this situation, investors were relatively lax about taking risks and were less risk sensitive not only in the mortgage loan market but also in a wide range of financial markets.

Leveraging -- the investing of funds beyond the amount in hand to search for higher yields through borrowing, margin transactions, and derivatives -- increased, and the level of leverage in some cases reached a factor of around 30. Once adjustments in global markets began, however, it became necessary for market participants to rapidly deleverage, which was one factor amplifying the market turbulence. Furthermore, some securitized products were sold at fire-sale prices far below their theoretical values, which then became their mark-to-market values, increasing financial institutions' losses on asset holdings and forcing them to make provisions for these losses. Financial institutions holding large amounts of such securitized products saw their capital bases damaged as a result. According to data compiled by Bloomberg, the total amount of losses incurred by financial institutions worldwide has reached about 400 billion U.S. dollars, and so far, 300 billion U.S. dollars in total have been raised to make up these losses. In such a severe situation, financial institutions worldwide, especially those of the United States and Europe, have become extremely cautious about taking on new credit risks, and this has resulted in a tightening of global financial conditions.

Since summer 2007, there have been times when market participants thought that the worst in global financial markets was over. However, global financial markets seem far from stable given that the turbulence has spread to financial products other than those related to subprime mortgage loans; market participants' concerns about further losses at financial institutions increase every time financial institutions' financial results are released, and credit risk premiums, which had narrowed, have started to widen again. The turbulence in global financial markets is likely to continue as long as the adjustments in the housing market, which triggered the market turbulence, and uncertainties regarding financial institutions' business outlook continue.

## **II. Japan's Economy and Prices**

Let me now discuss the recent economic and price situation in Japan, taking into account the current situation of overseas economies, which I just mentioned.

Japan's economic growth has been slowing recently, mainly due to the effects of soaring prices of energy, materials, and food. As for the outlook, Japan's economy is likely to grow at a slower pace for the time being and follow a moderate growth path thereafter.

A deterioration in the terms of trade that results from rises in energy and materials prices leads to an outflow of real income, as Japan depends heavily on imported resources. Relatively stable export prices and rising import prices have led to only modest growth in income from abroad and an increase in spending on imports. As a result, the nominal trade balance has been deteriorating and corporate profits have been leveling off. Although business fixed investment and private consumption remain firm, due attention should be paid to the possibility that the weakening of the economy's capacity to generate income will result in weaker domestic private demand.

### **A. Developments in the Corporate Sector**

Looking at the economic developments in Japan in further detail, the current upward trend in exports is unlikely to change significantly -- even though exports to the United States have been falling for some time -- as exports have been on an increasing trend to a broad range of destinations, particularly emerging economies and countries that export natural resources. Although the profit environment has been deteriorating as firms have found it difficult to fully pass on rising materials prices, corporate profits, particularly those of large firms, have remained at a relatively high level. Moreover, firms currently face no excess in production capacity, inventory, or employment. Given this situation, it seems that Japan's economy has become more resilient against negative shocks than in the past. The accommodative financial conditions are likely to continue to support private demand. In addition, firms' liquidity positions and funding conditions have continued to be favorable on the whole, although the liquidity positions of small firms and some nonmanufacturing firms are increasingly unfavorable and therefore developments need to be closely monitored.

## **B. Developments in the Household Sector**

With regard to the household sector, private consumption seems to be generally firm, although its growth lacks strong momentum. Sales of electrical appliances have been steady, and sales at commercial facilities such as shopping and outlet malls have been favorable. However, the Consumer Confidence Index for May suggests that consumer sentiment has been weak as a result of widespread rises in prices of petroleum products and food products, and business managers in the retail sector have expressed the view that consumers are cutting back on their spending. Consumers are trying to spend as little as possible, while at the same time seeking high-quality goods. Close attention should be paid to how the behavior of consumers will change if the rise in the prices of daily necessities depresses real income.

As for housing investment in Japan, there are growing concerns in the housing industry about its future developments. Sales of newly built condominiums in the Tokyo metropolitan area continue to be on a downward trend, and inventories of unsold condominiums continue to accumulate. The rise in prices of building materials such as cement and structural steel has worsened the profitability of real estate firms, and some firms, especially those outside the Tokyo metropolitan area, have commented that their business will face severe difficulties if this situation continues.

## **C. Developments in Prices**

Turning to prices, the year-on-year rate of increase in the domestic corporate goods price index (CGPI) has been rising mainly due to the rise in international commodity prices, and was 4.7 percent in May 2008. The year-on-year rate of increase in the CPI (excluding fresh food) has been rising since around the end of last year, and it has been around 1 percent lately. It is likely to stay around 1.5 percent for the time being, due to the rise in prices of petroleum products and food products in a situation where overall supply and demand in the economy are more or less balanced. Given that the current increase in the CPI is the highest in 15 years -- if we disregard fiscal 1997, when retail prices rose due to the rise in the consumption tax -- and that the prices of daily necessities that are purchased frequently are rising markedly, close attention should be

paid to the effects of price developments on consumers' inflation expectations and the price-setting behavior of firms as well as to the effects of increasing inflation pressure worldwide on price developments in Japan.

### **III. Future Conduct of Monetary Policy**

I said earlier that Japan's economy is likely to grow at a slower pace for the time being and thereafter follow a path of moderate growth at a pace around the potential growth rate, that is, at a pace of about 1.5 percent. However, uncertainties regarding the three risk factors described earlier -- developments in overseas economies, inflation pressure stemming from the surge in energy and materials prices, and the turbulence in global financial markets -- have been growing further. In view of this situation, the Bank at the Monetary Policy Meeting held on June 12 and 13, 2008, decided to further closely examine developments in economic activity and prices and leave the policy interest rate unchanged at around 0.5 percent. The real short-term interest rate calculated by subtracting the rate of increase in the CPI from the policy interest rate has been negative and is extremely low relative to the current level of the potential growth rate. These continuing accommodative financial conditions provided by the current interest rate level should support private demand.

As for the future conduct of monetary policy, this depends on the situation of the economy and prices, and given the current situation, where the outlook for economic activity and prices is highly uncertain, it is not appropriate to predetermine the direction of future monetary policy. Rather, close attention needs to be paid to future developments in economic activity and prices to make an accurate assessment without any predetermined view: whether downside risks to the economy will decrease, thereby increasing the likelihood of the economy realizing sustainable growth with price stability; or whether the probability of such risks materializing will rise. Furthermore, in view of the assessment of economic activity and prices, it is important that the Bank implement its policies in a flexible manner.



#### **IV. The Importance of Capturing Global Demand**

Lastly, I would like to talk about the importance of capturing global demand. The current major driving force of Japan's economic growth is exports, as can be seen by the fact that growth in net exports has recently accounted for half of the real GDP growth rate. Japan has also enjoyed a surplus in the income balance exceeding the trade surplus. In this situation, capturing global demand is essential for Japan's economy to grow.

Since the aging and decline of Japan's population is certain to diminish domestic demand, Japan's economy cannot grow in the medium to long term unless it captures growing global demand, especially demand from emerging economies. According to the United Nations Population Fund's *State of World Population 2007*, Japan's population is expected to decline by 20 million, from 130 million in 2007 to 110 million in 2050, whereas the world population is expected to increase, especially in emerging economies, by 2.5 billion or 37 percent, from 6.6 billion in 2007 to 9.1 billion in 2050. According to the latest projection by the International Monetary Fund (IMF), the real GDP growth rate for 2009 of Japan's economy is likely to be only 1.5 percent, while the rates of the global economy and of emerging economies are likely to be high, 3.8 percent and 6.6 percent, respectively. In fact, regions in Japan in which economic performance is relatively favorable tend to be those in which there are many active exporters. For this reason, attempts by firms throughout Japan to capture global demand are gradually spreading from large manufacturers to small ones and to nonmanufacturing firms.

Looking at the activities of small and medium-sized Japanese manufacturers in overseas markets, not only have such firms been taking an increasing number of orders as subcontractors from large Japanese firms, they also have been making efforts to directly capture local demand overseas and some have expanded the market for their products in environment and infrastructure-related fields. Moreover, a number of Japanese nonmanufacturing firms have started to establish overseas outlets, particularly in China, in the areas of retail, restaurants, and services, or have been directly involved in local projects in the area of construction. This shows that Japanese firms' overseas activities

have been spreading to a wider range of industries. Japanese environment-related technologies, such as those for energy saving and water treatment, rank high in the world, and Japanese firms are expected to grow further in these areas given the recent surge in energy prices.

With regard to capturing global demand in the market at home, activities taking full advantage of distinctive local tourist attractions to increase the number of foreign visitors are being carried out in connection with, for example, the "Visit Japan Campaign," which is promoted jointly by the government and the private sector, and activities to satisfy the various needs of foreign visitors have also sprung up. The favorable outcome of these efforts can be seen in the outlays for travel of major travel agencies for April this year: the figure for outlays by foreign tourists showed a steady increase of 22.4 percent, while the figure for Japanese tourists was more or less unchanged.

Recently at department stores in Tokyo, foreign languages such as Chinese and Korean can often be heard, suggesting that such retailers are actively attracting foreign tourists who are willing to spend money. It is said that the number of tourists in Hakone has been on the rise and the majority of the additional tourists there are foreigners.

According to the National Institute of Population and Social Security Research, the population of Hokkaido is expected to decline by 22 percent from 2005 to 2035 -- a faster pace of decline than the nationwide average of 13 percent -- while the aging of society is also expected to progress. Meanwhile, in Hokkaido the proportion of export-related firms is small and exports account for only 2 percent of Hokkaido's GDP, so that the proportion of firms in Hokkaido that enjoy the benefits of global economic growth is smaller than in other regions of Japan.

Recently, however, based on the "brand power" of Hokkaido, firms have gradually become active in exporting foodstuffs to the rest of Asia, such as China, South Korea, Taiwan, and Hong Kong, as well as used automobiles to Russia, and in 2007 the amount of exports from Hokkaido increased by about 20 percent. Other activities include the

opening of restaurants in China and the United States targeting Japanese people living there and affluent locals, the securing of interpreters in various languages and the installation of directional signs in foreign languages to expand demand through an increase in the number of foreign tourists, the installation of devices that accept foreign debit cards at shops, and the provision of special services intended only for foreigners at restaurants and the like. In fact, in addition to tourists from Taiwan and Hong Kong, the number of visitors from South Korea, Singapore, and Australia has recently also been on an uptrend. Meanwhile, some voices can be heard saying that there is more room for improvement in dealing with foreign tourists, citing the need to increase the number of staff who can speak foreign languages, improve accommodation facilities as well as expand the number of directional signs in foreign languages, and solve problems between foreign and Japanese tourists caused by differing customs. Although it will not be easy, making efforts to resolve these issues will become ever more important to fully take advantage of the benefits of globalization.