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Bank of Japan

Economic Policy Challenges Lying Ahead
--- Two Years after the Crisis ---

Speech at the 2010 IIF Annual Membership Meeting of the Institute of International Finance

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I. Introduction

I am honored to be invited today to address the Annual Membership Meeting of the Institute of International Finance.

I wondered how I would be able to contribute most to discussions at this meeting without overlapping other participants' presentations, and I decided to talk about economic policy challenges lying ahead, especially monetary policy challenges, with consideration of Japan's experience. In fact, there are increasing discussions in the United States recently as to whether the United States will fall into "deflation in the Japanese style" or the "lost decade like Japan."

In Japan, CPI inflation reached its peak of 3.3 percent in January 1991 soon after the burst of the bubble, started declining shortly thereafter, and turned negative in 1998 (Chart 1). When overlaying U.S. CPI inflation from 2007 on Japanese CPI inflation after the burst of the bubble, we find a striking similarity in the inflation developments between them. Looking at the growth in bank lending, the pace of the declines in the United States and European countries is much faster than that in Japan.

Of course, I do not have the answer to the tough question I raised shortly before. Nevertheless, concerning Japan's experience, I do not think that either way of thinking is appropriate: to fear a specter, nor to take Japan's experience just as unique. The United States and European countries obviously have an advantage of learning from Japan's experience.[1] Japan was a lonely forerunner.

II. Japan's Economy after the Burst of the Bubble

Let me begin by making a quick summary of Japan's experience.

First, it took fairly long to restore the full-fledged recovery path after the burst of the

[1] For a comparison between Japan's experience after the burst of the bubble and the U.S. and European experience in the recent financial crisis, see Shirakawa, Masaaki, "Uniqueness or Similarity? --- Japan's Post-Bubble Experience in Monetary Policy Studies ---," Keynote Address at Second IJCB Fall Conference hosted by the Institute for Monetary and Economic Studies, the Bank of Japan, September 16, 2010 (available at http://www.boj.or.jp/en/type/press/koen07/ko1009c.htm).

bubble (Chart 2). Japan started recovering in a full-fledged manner in 2003 long after the burst of the bubble in the early 1990s. Until then, Japan experienced two business cycle expansions and three contractions in the "lost decade." Whenever some signs of recovery were observed in Japan, expectations that the economy would finally escape from stagnant conditions and enter a full-fledged recovery were rising. Based on such Japan's experience, I attempted to draw public attention to the risk of falling into false optimism by using the phrase of a "false dawn," when we first saw some signs of economic recovery in advanced economies in the spring of 2009.[2]

Second, the sharp contraction of economic activity after the burst of the bubble in Japan occurred when interbank funding markets became destabilized. That decline, however, was much smaller than those in many countries, including Japan, after the failure of Lehman Brothers in the fall of 2008. Looking at real GDP data, Japan recorded the largest decline by 1.9 percent in the first quarter of 1998, but, in the recent global financial crisis, even the United States, which showed the smallest decline after the failure of Lehman Brothers, registered the huge decline by 3.0 percent during the period from the fourth quarter of 2008 to the first quarter of 2009 (Chart 3). The two cases have the common trigger of an interbank market participant default.

Third, Japan has experienced mild deflation, but has not experienced a deflationary spiral, by which I mean that a decline in prices induced a decline in economic activity, thereby leading to a further decline in prices. Consumer price inflation turned negative in 1998, and from 1997 to 2007, before the current crisis, it declined by 3.3 percent on a cumulative basis, and 0.3 percent on an annualized basis (Chart 4). Under mild deflation, however, Japan registered the longest recovery from 2002 to 2007, just in duration without considering its strength (Chart 5).

Fourth, labor practice significantly influenced inflation developments. For example, about 90 percent of the difference in consumer price inflation between Japan and the

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[2] See Shirakawa, Masaaki, "Way out of Economic and Financial Crisis: Lessons and Policy Actions," Speech at Japan Society in New York, April 23, 2009 (available at http://www.boj.or.jp/en/type/press/koen07/ko0904c.htm).

United States is attributed to services prices, which are strongly influenced by developments in the labor market (Chart 6).

Let me elaborate on the effects of labor practice on inflation developments in more detail. As inflation declined in Japan, wages tended to be set in a more flexible manner. Such flexibility in wage setting was attained not only through a reduction in bonus payments and an increase in the number of non-regular workers, but also the downward revision of fixed compensation for regular workers (Chart 7). Since the service sector is more labor-intensive than the manufacturing sector, flexible downward revisions of nominal wages caused declines in services prices, thereby inducing deflation. As you may be well aware, Japan experienced smaller increases in unemployment rates. Their flip side was mild deflation. Since the second half of the 1990s, management and labor in Japan have put priority on maintaining employment, and to do so, workers have accepted reductions in wages. By contrast, European countries had more rigidity in wage setting, and thus they were less likely to experience deflation at least in the short term, but needed to endure higher unemployment rates. Such differences in wage and employment developments in Japan and the European countries are the results of social choice after considering various costs, and do not necessarily imply whether one system is better than the other.

Turing to the fifth and last point on Japan’s experience, demographic changes affected the Japanese economy significantly. Japan delivered a weaker performance in real GDP growth. At the same time, in terms of labor productivity growth, Japan still showed a comparable performance to the US, although Japan had lost a superior performance in the 1980s (Chart 8). Obviously, the differences between real GDP growth and labor productivity growth reflect the declines in the workforce in Japan. In any event, in extracting implications from Japan’s “lost decade,” it is essential to analyze not only short-term aggregate demand movements but also changes in the potential growth trend, which is determined by productivity growth and demographic changes.

III. Major and Common Challenges for Advanced Countries

Then, what should we consider in mapping out near-term economic policies in each country? Of course, the answer to that question varies from country to country, depending on economic conditions. Based on Japan's experience, I will offer my thoughts on major economic policy challenges that are common to advanced countries despite the differences in economic conditions.

First, we definitely need to maintain financial system stability. Using the metaphor, the economy after the burst of a bubble can be divided into two phases: the phase of "acute pains" arising from the malfunctioning interbank money markets and the phase of "chronic illnesses" from balance-sheet adjustments after such acute pains recede. It is very important to stave off the acute pains, which are likely to trigger a sharp contraction of economic activity and potentially produce devastating effects on the economy. In May 2010, major central banks reintroduced dollar-fund supplying operations when dollar-funding markets showed signs of tension, again reflecting increased concern over sovereign debts problems in peripheral European countries. Such measure was implemented with consideration of the importance of maintaining the stability in interbank funding markets.

Second, we need to continue with the unprecedented easy monetary policy, given the current economic conditions. In fact, many advanced countries have maintained very accommodative monetary policy. The Bank of Japan (BOJ) also decided recently to implement a comprehensive monetary easing policy in order to further enhance monetary easing. That included three measures: (i) clarification of maintaining virtually zero interest rates; (ii) clarification of the time horizon to maintain the virtually zero interest rate policy; and (iii) establishment of an asset purchase program to purchase various financial assets, such as government securities, commercial paper (CP), corporate bonds, exchange-traded funds, and real estate investment trusts and to conduct the fixed-rate funds-supplying operation against the pooled collateral .

Third, we need to accept the fact that, once a country experienced a bubble, it will take fairly long to rise up from the bottom in the aftermath of the burst of a bubble, and restore the full-fledged recovery path, despite various unprecedented policy efforts. As Japan's experience shows, it is the hard fact that the economy will be unable to achieve a strong recovery without resolving "excesses" accumulated during a bubble period. The form of "excesses" varies from country to country. In Japan, they were "three excesses" in the business sector: employment, production capacity, and debt (Chart 9).

In that context, we sometimes hear an argument that "the delayed monetary policy responses caused the economic stagnation." It is true that the BOJ failed to fully recognize the significant magnitude of adverse effects soon after the burst of the bubble, like other central banks. But it is also true that the BOJ carried out innovative monetary policy measures on a large scale as a pioneering effort.

For example, the BOJ reduced the overnight interest rate to virtually zero in the second half of 1995, of which level corresponds to the current policy interest rates in the United States and European countries. The BOJ also expanded its balance sheet size considerably. From 1995 when the overnight interest rate fell down to virtually zero, the ratio of the BOJ's balance sheet size to nominal GDP increased by more than 20 percentage points at its peak (Chart 10). That increase in the ratio for the BOJ was twice as large as that in the U.S. Federal Reserve (Fed), the European Central Bank (ECB), and the Bank of England (BOE) in the recent crisis. In addition, the BOJ made a policy commitment to continuing the quantitative easing policy "until core CPI inflation becomes stably zero or above." The BOJ adopted "credit easing" in the current terminology, ahead of central banks in the world. The BOJ purchased asset-backed securities (ABSs), asset-backed commercial papers (ABCPs), and even stocks held by financial institutions to reduce market risk associated with stockholdings, which was one of the biggest risk factors in potentially destabilizing the financial system.

In retrospect, the BOJ introduced various unprecedented measures under the uncharted circumstances during the period from the late 1990s to the early 2000s. Such measures involved most of the elements in the unconventional policy measures taken in the recent global financial crisis. Nevertheless, it took a fairly long before the Japanese economy restored the full-fledged recovery path. And that fact suggests the severity of the balance sheet adjustments I have mentioned earlier.

In any event, without sufficient public understanding about the fact that we need a long time to complete balance sheet adjustments, the delay in the recovery in the macroeconomic performance is likely to provoke social discontent. That tends to create the social climate, which is prone to induce policy measures inconsistent with economic efficiency. That leads to the fourth point in economic policy challenges.

Fourth, we need to pay more attention to the importance of maintaining the flexibility of the economic structure. As I discussed earlier, Japan's "lost decade" was crucially attributed to the decline in population and productivity. In that sense, if foreign countries mistakenly draw the most crucial lesson from Japan's experience as the necessity of short-term stimulative policy measures, they will face a risk of writing the wrong policy prescription. I do not go into the details of economic policy in each country, but I think that it is crucial to maintain the flexibility of the economic structure to smoothly reallocate labor and capital from the lower productivity sector to the higher productivity sector. That is, however, not necessarily easy, given the social climate after the burst of bubble, just I mentioned.

Fifth, we cannot rule out the possibility that the current unprecedented easy monetary policy in many advanced countries, if continued for an extended period, will produce unintended consequences. Under the easy monetary condition, inefficient businesses tend to be preserved, and economic rejuvenation also tends to be delayed, thereby reducing the productivity growth. Although easy monetary policy is needed, it alone cannot solve the problem. Structural reform is indispensable. Also, it cannot be denied that such easy monetary condition is likely to contribute to the emergence of another bubble. In fact, the prolonged low interest rates in the early 2000s, in the aftermath of intensified deflationary concern stemming from the burst of the dot-com bubble, partly contributed to the global credit bubble.

A crisis comes to the surface with a different face every time. The current recovery in advanced countries is basically supported by strong growth in emerging countries. Thus, if the strong growth in emerging countries turns out to be the one entailing the bubble-like nature, advanced countries as well as emerging countries themselves will be affected significantly. As for equity price developments, advanced countries still stay far below the level before the failure of Lehman Brothers, while a few emerging countries are reaching an all-time high due partly to capital inflows from advance countries. In some sense, it can be said that monetary easing in advanced countries has exerted stimulative effects through capital outflows to emerging countries. That suggests a significant change in the transmission mechanism of monetary policy from the conventional mechanism we generally assume.

Sixth, we need to implement financial reform in a well-balanced manner. In light of the lessons from the recent crisis, it is a fairly appropriate direction of the reform to strengthen the existing capital requirement. At the same time, it is also necessary to avoid undermining the economic recovery in raising capital requirements. In that regard, I appreciate that the new capital standards, so called "Basel III" agreed at the meeting of the Group of Central Bank Governors and Heads of Supervision in September, ensures a good balance between the two requirements.

I do also want to emphasize that we need to find the right balance between stricter regulation and intensified supervision. Regulation alone, especially in the form of more regulatory capital, will not prevent the next crisis. The risk profiles of financial institutions vary across firms and countries, and they change over time. Thus, regulation needs to be effectively combined with rigorous supervision and close monitoring.

IV. Closing Remarks

I have discussed the points to be remembered in discussing near-term economic policies at this critical juncture. But I have stopped short of showing a specific direction of policy actions. Such policy actions should be mapped out by the policy authorities and people concerned with consideration of economic conditions. Given that a crisis comes to the surface with a different face every time, what I can say here is that central bankers as well as executives of private financial institutions, who are all at this meeting, need to be humble enough to pay attention to various possibilities with consideration of historical lessons.

Thank you for your attention.

Economic Policy Challenges Lying Ahead

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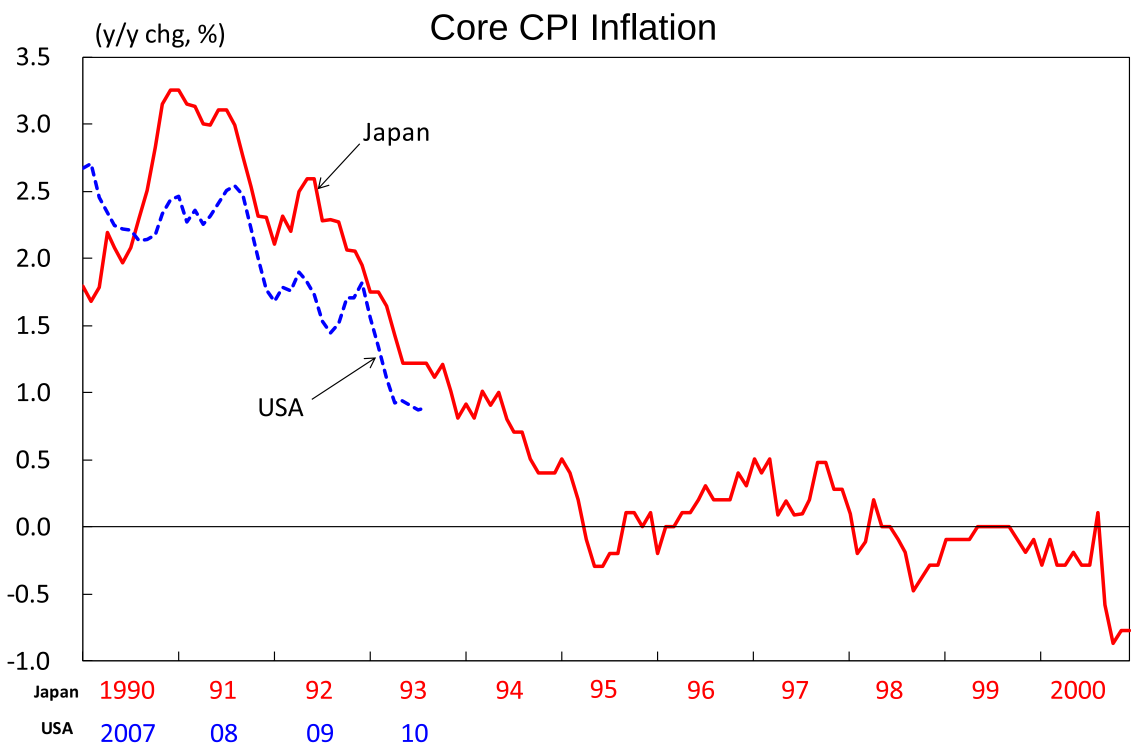
Chart 1

Inflation developments in both Japan and the US after the bubble burst look similar.



Notes: Core CPI in Japan is computed by excluding perishables from headline CPI. Figures for Japan are adjusted for the changes in the consumption tax rate from 3 to 5 percent in April 1997. US data start from January 2007.

Sources: Ministry of Internal Affairs and Communications, *Consumer Price Index*; Bureau of Labor Statistics, *Consumer Price Index*.

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Japan's Experience

1. Took long to restore the full-fledged recovery path, creating a sense of a "false dawn."
2. The severe contraction triggered by destabilizing interbank funding markets, while limited compared with the recent global crisis.
3. Experienced mild deflation, but not a deflationary spiral.
4. Labor practice affected inflation developments.
5. Demographic changes significantly affected economic performance.

Chart 2: Japan's Experience 1

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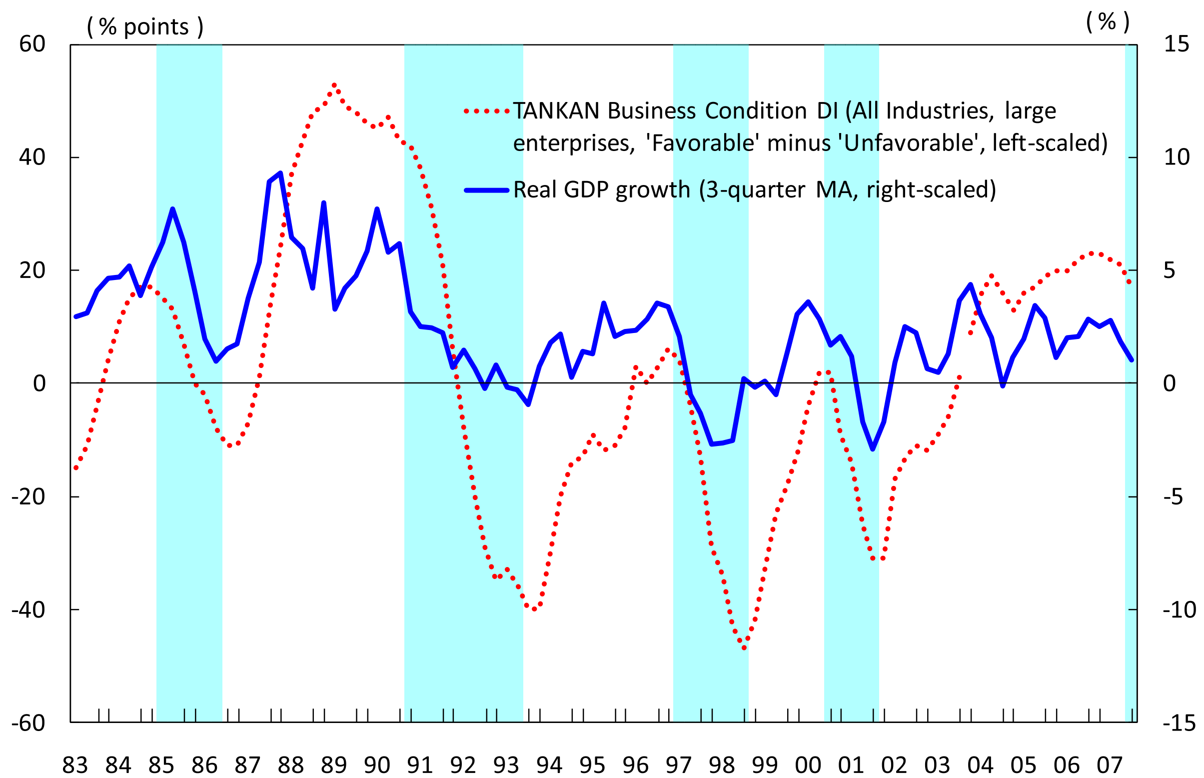
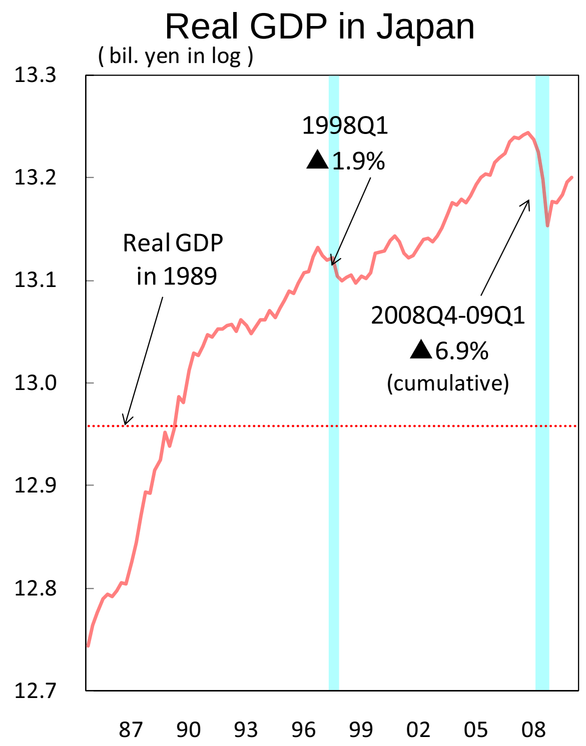
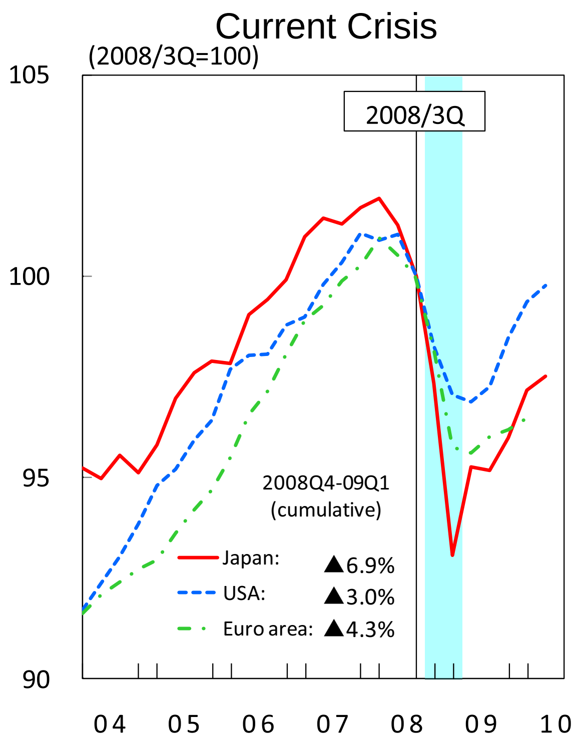
Took long to restore the full-fledged recovery path, creating a sense of a "false dawn."



Note: Shaded areas indicate business cycle contraction periods.
Sources: Cabinet Office, *Annual Report on National Accounts*; Bank of Japan, *TANKAN* (*Short-Term Economic Survey of Enterprises in Japan*).

The severe contraction triggered by destabilizing interbank funding markets, while limited compared with the recent global crisis.





Sources: Cabinet Office, *Annual Report on National Accounts*; US Bureau of Economic Analysis, *National Economic Accounts*; Eurostat, *National Accounts*.

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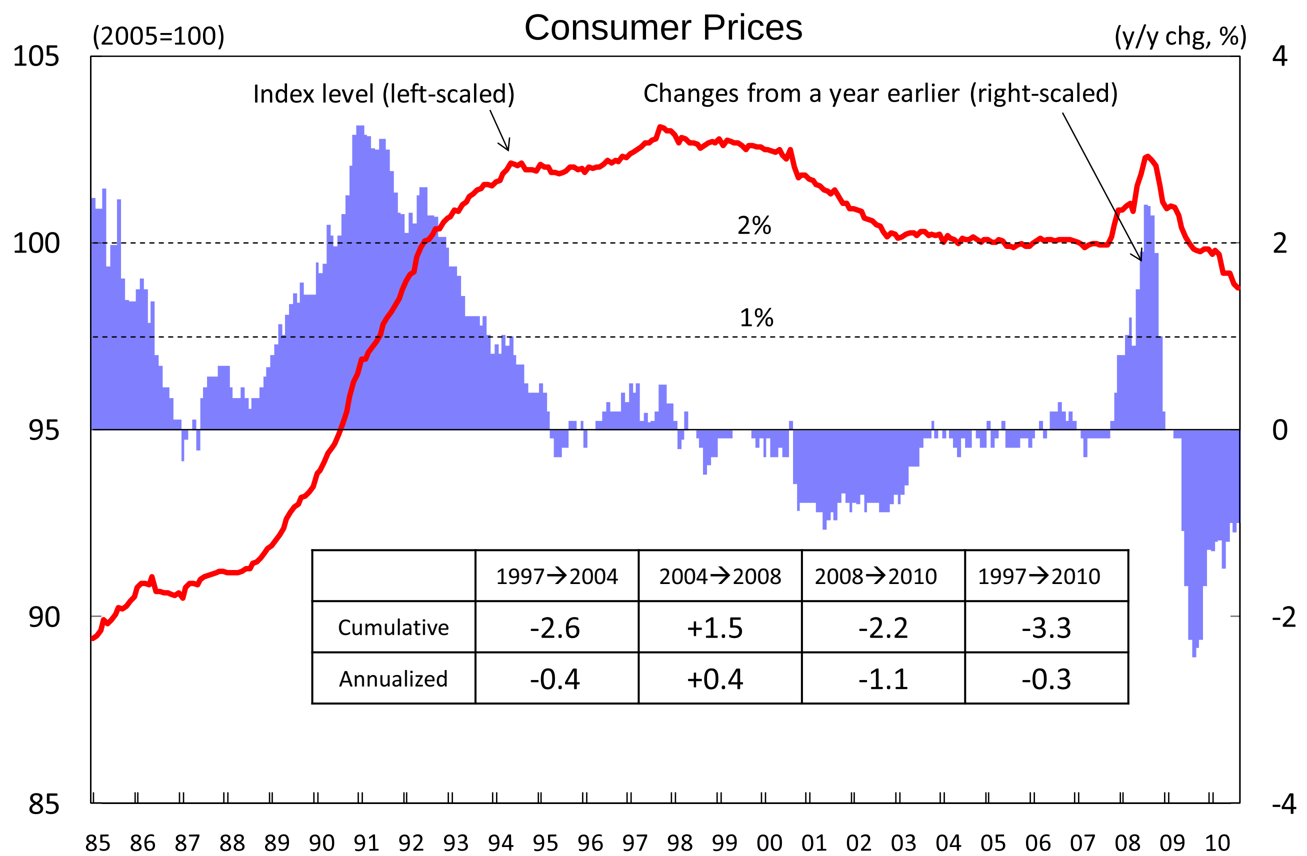
Japan experienced mild deflation from 1998.



	1997→2004	2004→2008	2008→2010	1997→2010
Cumulative	-2.6	+1.5	-2.2	-3.3
Annualized	-0.4	+0.4	-1.1	-0.3

Note: Figures are adjusted for the impact of consumption tax, which introduced at 3 percent in 1989, and raised to 5 percent in 1997.
Source: Ministry of Internal Affairs and Communications, *Consumer Price Index*.

Chart 5: Japan's Experience 3

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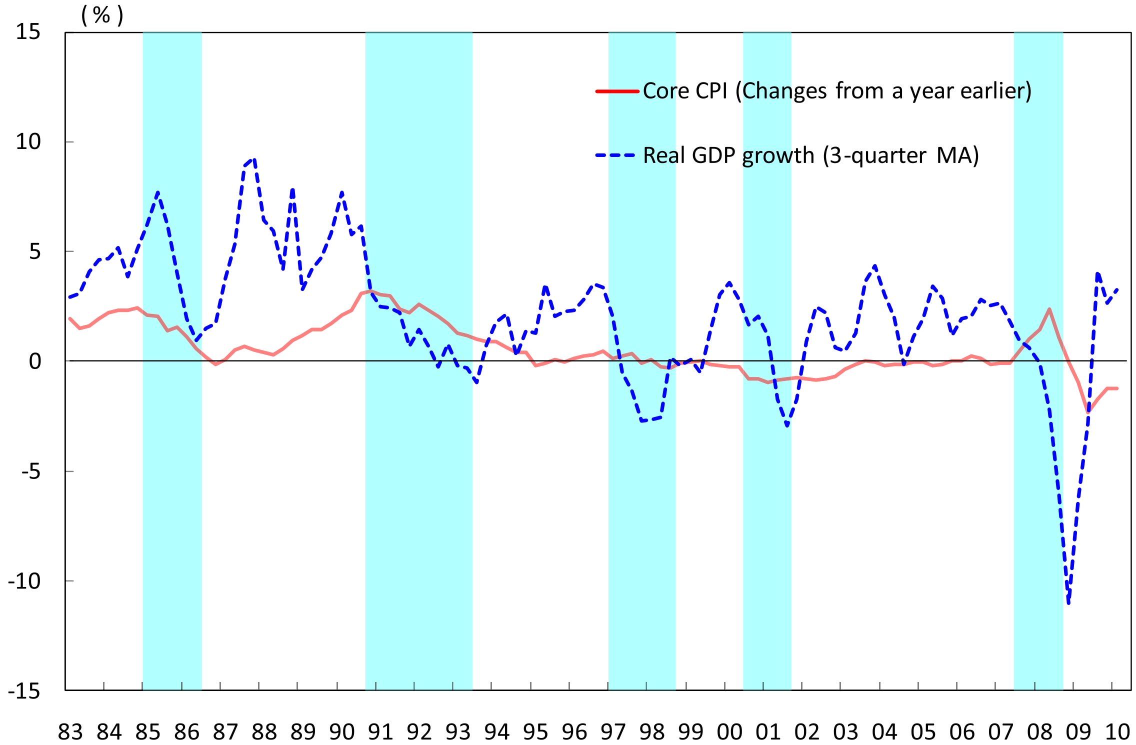
In spite of mild deflation, Japan registered the longest recovery from 2002 to 2007.



Note: Figures for CPI are adjusted for the impact of consumption tax, which introduced at 3 percent in 1989, and raised to 5 percent in 1997. Shaded areas indicate business cycle contraction periods.
Sources: Cabinet Office, *Annual Report on National Accounts*; Ministry of Internal Affairs and Communications, *Consumer Price Index*.

Chart 6 : Japan's Experience 4

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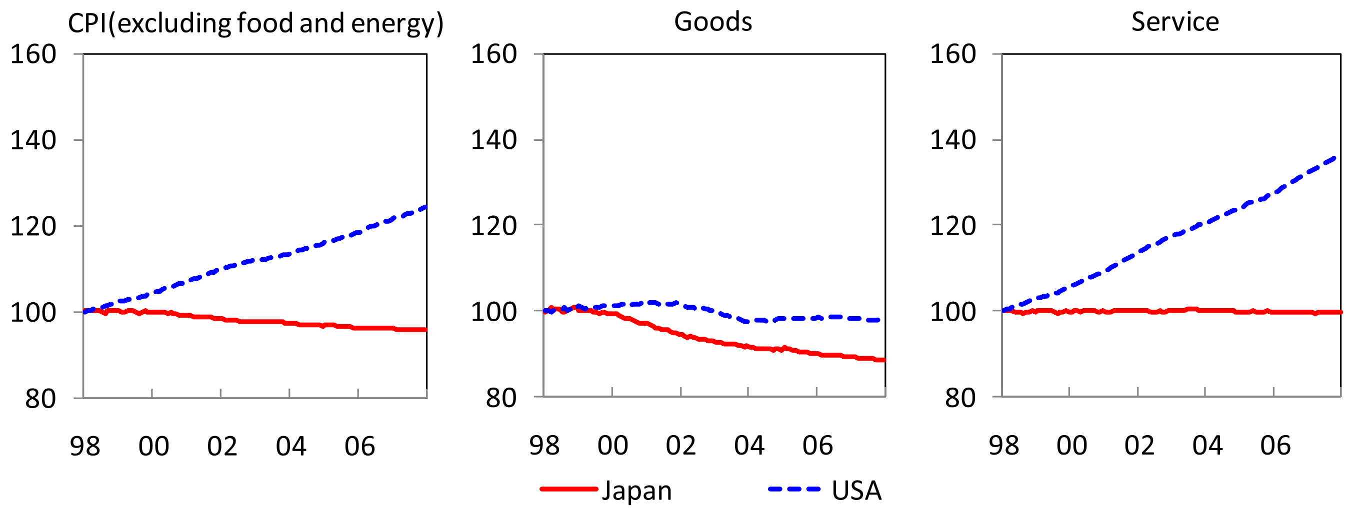
Labor practice affected inflation developments.

Cumulative changes from 1998 to 2007			
	Japan(a)	USA(b)	(a)-(b)
CPI	-4.2	+21.5	-25.7
Goods	-4.1	-0.7	-3.4
Services	-0.1	+22.2	**-22.3**

CPI inflation differential between Japan and USA is explained mostly by a decline in service prices in Japan.



Sources: Ministry of Internal Affairs and Communications, *Consumer Price Index*; Bureau of Labor Statistics, *Consumer Price Index*.

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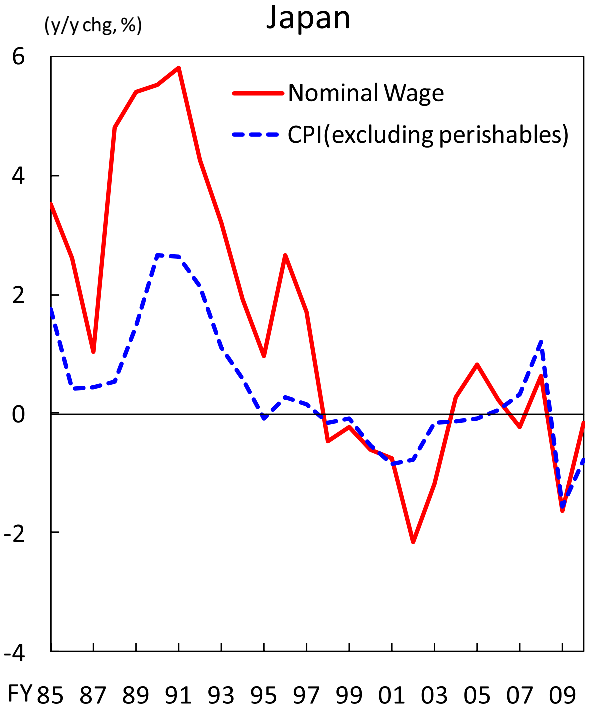
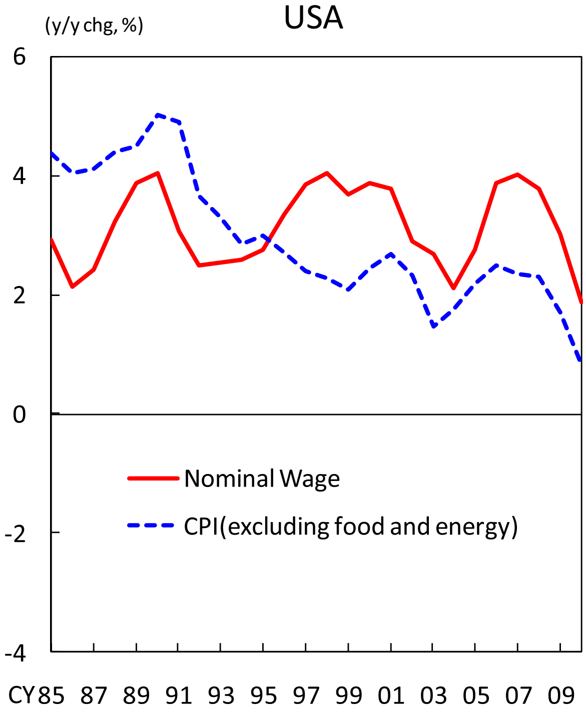
Downward rigidity in nominal wages disappeared in the late 1990s in Japan.





Notes: Figures of nominal wages are on a per hour basis. Figures for CPI in Japan are adjusted for the impact of consumption tax, introduced at 3 percent in 1989, and raised to 5 percent in 1997.
Sources: Ministry of Internal Affairs and Communications, *Consumer Price Index*; Ministry of Health, Labour and Welfare, *Monthly Labour Survey*; US Bureau of Labor Statistics, *Consumer Price Index*, and *Average Hourly Earnings*.

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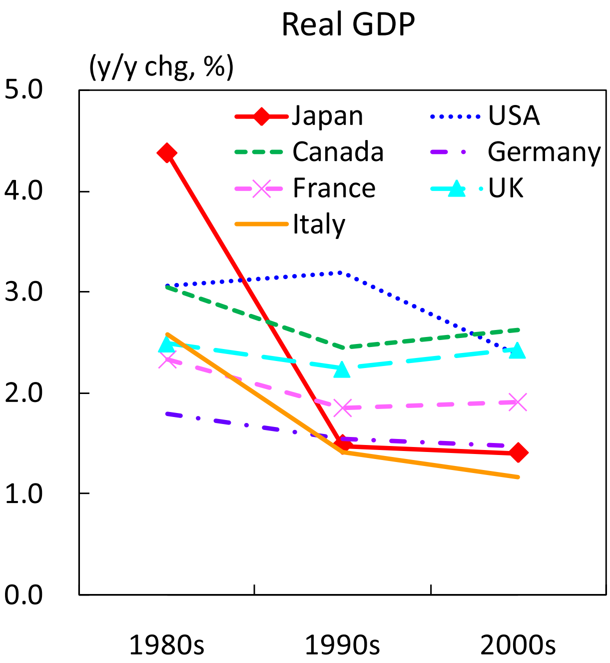
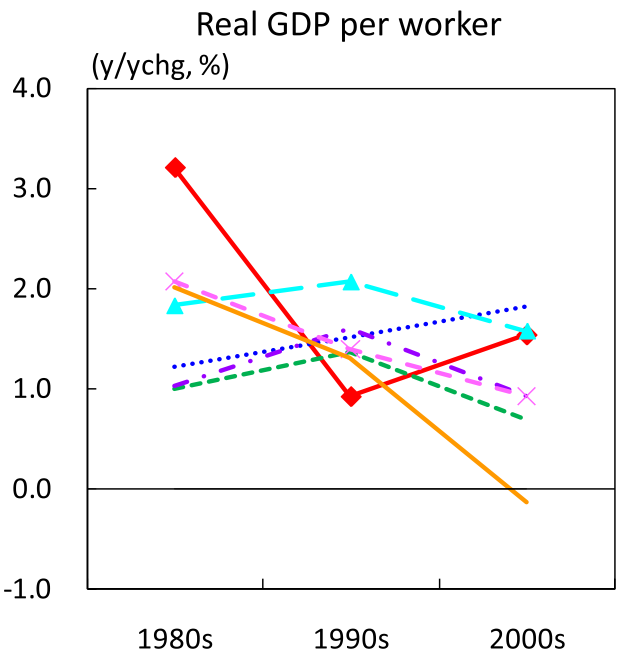
Demographic changes significantly affected economic performance.





Notes: 1. The figures for Germany for the 1980s are West Germany. The figures for Germany for the 1990s are the average from 1992 to 1999.
2. The figures for the period since 2000 are from 2000 through 2008.
Sources: Organisation for Economic Co-operation and Development, *OEDC.Stat* and other governmental sources.

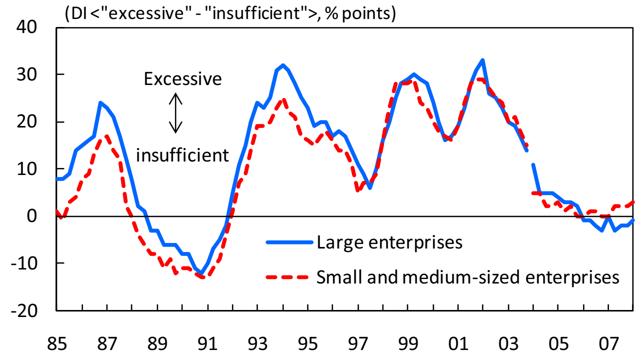
Economic Policy after the Burst of Bubble: Major and Common Challenges for Advanced Economies

1. Importance of financial system stability.
2. Monetary easing as a necessary action.
3. Need for clear recognition of long adjustment process before full-fledged recovery.
4. Importance of flexibility in economic structure.
5. Unintended consequences of prolonged unprecedented easy monetary policy.
6. Financial reform in a balanced manner.

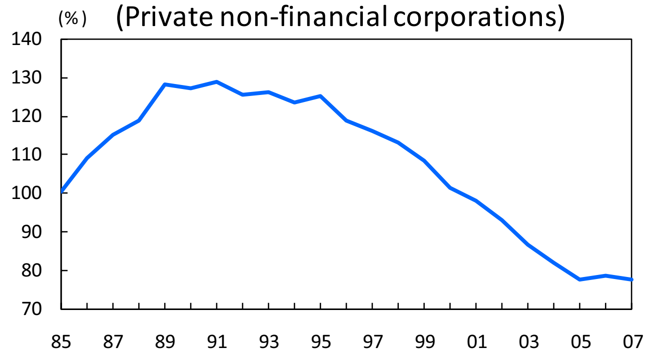
Chart 9

Resolution of Japan's "three excesses" came before the full-fledged recovery.

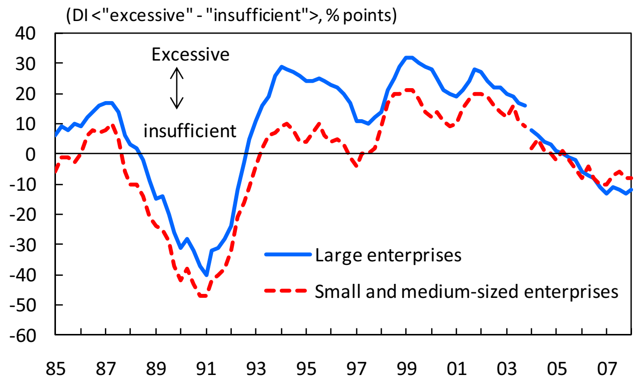
Production Capacity DI (manufacturing)



Ratio of debts to nominal GDP
(Private non-financial corporations)



Employment Condition DI (all industries)



Notes: 1. The Tankan has been revised from the March 2004 survey. Figures up to the December 2003 survey are based on the previous data sets. Figures from the December 2003 survey are on a new basis.
2. Debts is the sum of loans and securities (other than equities) in private non-financial corporations.

Sources: Cabinet Office, *Annual Report on National Accounts*; Bank of Japan, Bank of Japan, *Tankan* , *Short-Term Economic Survey of Enterprises in Japan*, *Flow of Funds*.

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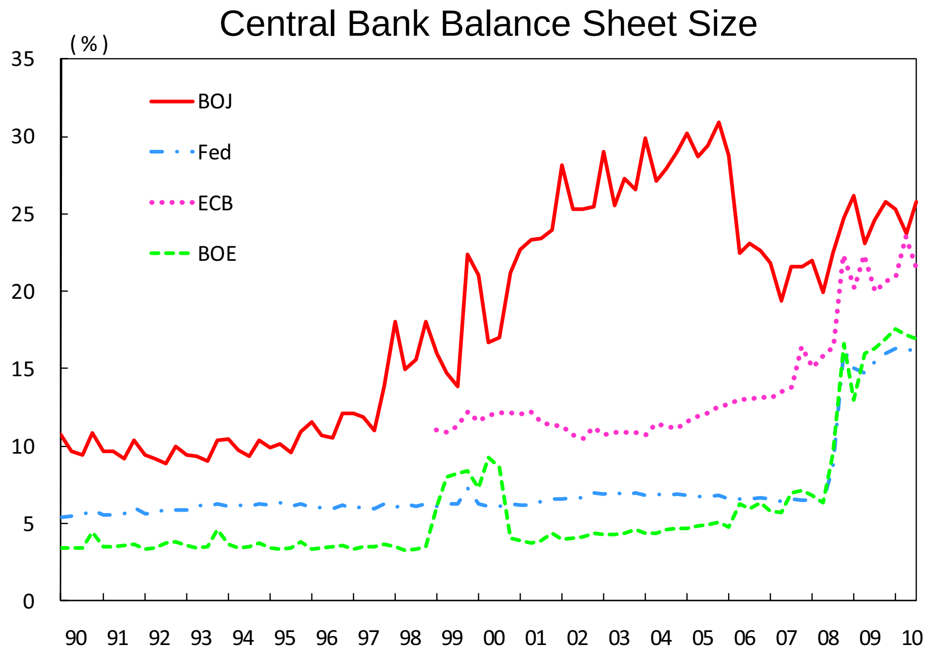
The ratio of the BOJ's B/S size to GDP increased by more than 20 percentage points at its peak, which were twice as large as that in the Fed, the ECB, and the BOE in the recent crisis.



Notes: 1. The latest figures are the ratio of balance sheet size at the end of August, 2010 to nominal GDP for the second quarter of 2010.
2. The BOE's balance sheet increased temporarily from 1999 to 2000 reflecting a technical factor associated with the BOE's participation to the TARGET system, the settlement and clearing system for euro.

Sources: Bank of Japan, Board of Governors of the Federal Reserve System, European Central Bank, Bank of England.