August 24, 2012
Bank of Japan

Japan's Economy and Monetary Policy

Speech at a Meeting with Business Leaders in Osaka

Masaaki Shirakawa
Governor of the Bank of Japan

Introduction

It is a great honor to have this opportunity to address such a distinguished gathering of business leaders in Osaka today. I would like to start by expressing my deep gratitude to you for your cooperation with our branches in Osaka, Kobe, and Kyoto.

The last time I spoke here was in late October 2011. At that time, we were right in the middle of a period of intensifying strains caused by the European debt problem, and I pointed out that we had to pay close attention to future developments. Looking back at developments since then, unfortunately these concerns came to pass. Overseas economies started to decelerate, mainly due to the direct and indirect effects of the European debt problem. Even today they have not yet emerged from this deceleration phase. Against this backdrop, today I will first discuss developments in global financial markets and overseas economies, focusing on the European debt problem. I will then explain recent developments in Japan's economy and the Bank's conduct of monetary policy.

I. European Debt Problem and Developments in Global Financial Markets and Overseas Economies

Let me start with the European debt problem. Looking back on last autumn, it was a time of rising tension in global financial markets. People were concerned that the fiscal problems in Europe would not be contained within the countries that had already received support from the EU and IMF, namely, Greece, Portugal, and Ireland, but instead would spread to the larger southern European economies of Spain and Italy. Yields on government bonds rose sharply in those economies, or in other words, bond prices fell substantially. The assets of financial institutions with large holdings of European government bonds deteriorated (Chart 1). As market confidence in these institutions had declined, they were exposed to rising funding costs and also began to find it difficult to procure funds (Chart 2). As a result, European financial institutions became more cautious about providing loans to firms, which exerted downward pressure on the real economy. The slowdown in the real economy created an adverse feedback loop by further worsening fiscal conditions, which in turn adversely affected financial institutions' business through rises in government bond yields (Chart 3).

Global financial markets appeared to regain some stability from the turn of this year through to spring, thanks to a number of policy measures including the European Central Bank (ECB)'s conduct of two longer-term refinancing operations (LTROs) with a maturity of 36 months, which provided virtually unlimited liquidity in the euro area. After that, however, nervousness returned to global financial markets, caused by uncertainties about the Greek re-election as well as concerns about Spain's financial system. While Spanish government bond yields, the most-watched indicator in financial markets lately, declined from their peak of more than 7 percent, they are still around 6.0-6.5 percent, far above the average growth rate of nominal GDP since 2010, which is around 1.0 percent. Since the debt problem in Europe first emerged in spring 2010, we have been on a merry-go-round in which deteriorating market sentiment is followed by temporary measures by authorities to alleviate market strains and a subsequent recovery in market sentiment, before the cycle repeats itself again. To resolve this problem, a comprehensive approach must be taken in which each country makes an effort to achieve fiscal consolidation, structural reform, and financial system stabilization and reinforcement. At the same time, Europe as a whole must proceed with fiscal union and financial integration commensurate with its existing monetary union. European authorities share a broad sense that it is important to proceed steadily with these initiatives, but these are such essential and difficult tasks that will define the future of Europe's economy, society, and politics. For that very reason, resolving these issues will surely take a long time. We need to face the reality that the global economy has no choice but to live with the risks inherent to the European debt problem for some time to come.

Despite these difficulties in Europe, extreme risk scenarios have not come to pass. This is because the money markets -- core markets for the financial system in which financial institutions lend to and borrow from one another -- have remained broadly stable. The sense of security created by the existence of central banks' frameworks for enhancing liquidity provision -- such as the ECB's provision of ample euro liquidity and the coordinated U.S. dollar fund-supplying action by six central banks including the Bank of Japan -- has played a pivotal role in maintaining stability in the money markets.

At the same time, we must dispassionately realize that the liquidity provision by central banks can only provide a temporary reprieve -- a measure to "buy time" or "mitigate the pain" so to speak. Ultimately, the most important thing is that policy authorities in Europe make steady progress in furthering fiscal and economic structural reforms as well as maintaining and strengthening the soundness of financial systems. Through a number of international fora, the Bank of Japan has been urging these authorities to make such progress. This is because the European debt problem has already had an impact on economies outside the euro zone, including Japan, in a number of ways, and depending on future developments, it might have an even bigger impact. Let me elaborate on the various ways that the problem is affecting other economies.

The first and foremost is the effect on trade. The slowdown of the European economy has had the direct effect on economies outside the euro zone of reducing exports to Europe. At the same time, it has also had an indirect effect on them. More specifically, as economies with close trade ties with Europe have slowed due to the European debt problem, this has had a knock-on effect on countries exporting to these economies, because their exports have declined as a result. In this regard, the Chinese economy, which became an engine for global economic recovery after the Lehman shock in 2008, has been slowing down since last autumn as a result of monetary tightening and a decline in exports to Europe, which account for almost 20 percent of China's total exports. While Europe accounts for only 10 percent of total exports for Japan, the knock-on effect of the slowdown in China is significant (Charts 4 and 5).

The second is the effect on business sentiment. If companies think that economic sluggishness in Europe will be prolonged, or if they have strong concerns about a worst-case scenario regarding the European debt problem coming to pass, they could postpone making capital investments and so forth, even if the actual risks do not materialize. Lately, manufacturing firms around the globe have become somewhat cautious, which may be an example of how the problems in Europe are affecting business sentiment.

The third is the effect on financial markets. Amid continued nervousness in global financial markets, global investors have become increasingly risk averse, which consequently creates more demand for relatively safe assets such as U.S. Treasury bonds, German government bonds, and Japanese government bonds. In terms of currencies, it also creates more demand for the U.S. dollar and the yen. While declines in long-term yields in advanced economies are reinforcing monetary accommodation, on the foreign exchange front, the chronic upward pressure on the yen is placing downward pressure on Japan's economy (Charts 6 and 7).

Last but not least is the effect on the financial system, which has been well-contained so far. Japan's financial system has been the most stable of the advanced economies, reflecting powerful monetary easing by the Bank of Japan (Chart 2). Nonetheless, as we saw following the Lehman shock, financial markets in respective countries are increasingly interconnected and we cannot rule out the possibility of negative effects from one financial system spilling over to another through a number of different channels. The Bank of Japan continues to give particular attention to developments in global financial markets, and will do its utmost to ensure the stability of Japan's financial system while cooperating closely with other central banks.

II. Recent Developments and Outlook for Japan's Economy

I would now like to outline the state of Japan's economy and prices, based on this discussion of the effects of the European debt problem.

Following a sharp downturn after the Great East Japan Earthquake in March 2011, Japan's economy recovered at a pace much faster than anticipated, thanks to the strenuous efforts of all involved. However, after autumn 2011, when the debt situation in Europe deteriorated, economic activity in Japan became broadly flat, partly due to the impact of the slowdown in overseas economies and appreciation of the yen. Overseas economies have not yet emerged from a deceleration phase, and overseas demand is somewhat weak. Domestic demand, by contrast, has been firmer than expected, mainly supported by reconstruction-related demand, and our assessment is that Japan's overall economic activity has started picking up moderately (Chart 8).

Looking at each demand component separately, in terms of domestic demand, public investment has clearly continued to increase. Business fixed investment has been on a moderate increasing trend with improvement in corporate profits, as evidenced by recent surveys. Private consumption has continued to increase moderately, supported partly by the effects of measures to stimulate demand for automobiles. Housing investment has generally been picking up. The recent firmness in Japan's domestic demand stands out among the advanced economies (Chart 9). On the other hand, the pick-up in exports has moderated, due to a decline in exports to Europe, and the recent reading on industrial production, which is heavily influenced by export activities, has been relatively weak.

As for the outlook of Japan's economy, it is expected to return to a moderate recovery path as domestic demand remains firm and overseas economies emerge from the deceleration phase. The Bank's growth rate projections for fiscal 2012 and 2013 are 2.2 percent and 1.7 percent, respectively. Under such circumstances, the negative output gap is expected to narrow gradually, exerting upward pressure on prices. The year-on-year rate of change in the consumer price index (CPI) is expected to remain at around 0 percent for the time being mainly due to the fall back in crude oil prices. Looking somewhat further ahead, the rate is expected to gradually rise to a range of above 0.5 percent and less than 1 percent toward fiscal 2013 as the aggregate supply and demand balance improves. Thereafter, it will likely be not too long before it reaches the Bank's "price stability goal in the medium to long term" of 1 percent for the time being (Chart 10). In terms of the price environment, it is worth noting that supply and demand conditions in the labor market have improved moderately and wages have stopped declining. Furthermore, the inflow of low-priced imported goods is not as prevalent as before, partly reflecting a pick-up in wages in China (Chart 11).

The key factor when considering the outlook for Japan's economy is whether overseas economies emerge from the deceleration phase and overseas demand starts to recover while domestic demand remains firm, thus maintaining momentum in economic activity.

On this point, let me summarize the forces that are sustaining the firmness in domestic demand. The first is the effects of policy measures such as subsidies for purchasing environmentally-friendly cars. The second is reconstruction-related demand in a broad sense. This includes not only public investment but also demand for replacement of automobiles, and demand for reconstruction or repair of facilities and housing damaged by the earthquake or tsunami. All such demand is gradually gaining momentum. Furthermore, firms are now building disaster prevention centers or business continuity centers as backup sites following their experiences of the earthquake. They are also shifting business resources onto energy and environment-related businesses, including launching projects to build mega solar power plants. The third force sustaining the firmness in domestic demand is an improvement in business sentiment as corporate profits have improved and wages and income have subsequently stopped declining. The fourth relates to how firms are increasingly succeeding in discovering potential demand, such as by creating new business to meet demand associated with population aging. Fifth, although the yen's appreciation puts downward pressure on exports, it also raises real purchasing power. As for the outlook for domestic demand, while we should be mindful of the negative effects from the ending of subsidies for the purchase of environmentally-friendly cars, underlying factors, such as broadening reconstruction-related demand, improving corporate profits and employee income, and firmer consumption by the elderly will continue, to some extent, to underpin the sustainable recovery of the domestic economy.

As for overseas demand -- an area of concern --, a wide range of uncertainty remains, including with respect to when such demand will recover. As I mentioned earlier, the European debt problem has already had a significant impact on overseas economies including Japan. While such an impact has been taken into account in our outlook for economic activity and prices, we must remain highly vigilant to the risk of the European debt problem possibly deteriorating further and leading to turmoil in global financial markets, triggering an even graver deterioration of the global economy. Regarding the Chinese economy, there are some signs of improvement in domestic demand, such as increased investment in infrastructure and a pick-up in sales of real estate. Nevertheless, amid sluggishness in exports to Europe, particular attention should be paid to whether China's deceleration will continue for longer than expected. As for the U.S. economy, we expect that it will continue its moderate recovery, supported by accommodative financial conditions. However, the momentum for recovery needs to be monitored carefully, as balance sheet adjustment, although making gradual progress, still weighs on the economy and a high degree of uncertainty remains with respect to future fiscal policy.

III. The Bank's Conduct of Monetary Policy

Finally, let me talk about the Bank's conduct of monetary policy, based on the above assessment of economic activity and prices.

The Bank recognizes that Japan's economy faces the critical challenge of overcoming deflation and returning to a sustainable growth path with price stability. Based on that recognition, the Bank clearly stated that it will proceed with powerful monetary easing in a continuous manner with the aim of achieving the goal of 1 percent inflation -- in terms of the year-on-year rate of increase in the CPI -- until it judges the 1 percent goal to be in sight.

In pursuing monetary easing, the Bank has been purchasing financial assets under the "Asset Purchase Program" (hereafter the Program). This program is aimed at encouraging a decline in longer-term market interest rates and a reduction in risk premiums through the purchase of a wide range of financial assets, including Japanese government bonds. The Bank expanded the total amount of the Program in February and April 2012, so that by the end of June 2013, the total size of the Program will reach about 70 trillion yen. The current size of the Program is about 57.8 trillion yen (Chart 12).

At every Monetary Policy Meeting, attention tends to focus on whether the total size of the Program will be increased. At present, however, the Bank is in the process of increasing the size of the Program by another 12 trillion yen. Put differently, the effects of monetary easing will strengthen in a continuous manner with every passing day as this process continues. In terms of transmission of its powerful monetary easing, lending rates of financial institutions have been falling to fresh new lows. Interest rates paid by firms remain at considerably low levels compared to their profitability (Chart 13). Firms' judgments on financial institutions' lending attitudes and financial positions have improved to levels higher than the average from the year 2000 onward (Chart 14). This is true for small enterprises as well.

The effects of monetary easing will be realized through accommodative financial conditions leading to increases in investments and outlays by firms. A rise in inflation expectations, which is often discussed as one aim of monetary easing, can only be realized once an increase in spending has generated higher prices. The transmission of monetary easing always starts from the reduction of interest rates in general. As such, accommodative financial conditions provide a strong supporting base for Japan's economy to overcome deflation and achieve sustainable growth with price stability. The major problem facing Japan's economy is, however, that firms do not see investment in the domestic economy as a profitable option. In fact, among Japanese listed companies, the proportion of firms without net external borrowings -- firms whose cash, deposits, and cash equivalents exceed their interest-bearing debt -- has risen from the 25 to 30 percent range in the early 2000s to more than 40 percent recently (Chart 15). What is necessary at this juncture is to formulate a two-pronged strategy of capturing overseas demand and cultivating domestic demand, as I explained in detail at this gathering last year.[1] In order to do so, we need two things: drastic deregulation at the macro level and the creation of business models based on differentiated strategies at the level of individual firms.

Looking at the situation in Switzerland, while the Swiss franc has appreciated more than the yen over the last 10 years, Switzerland's exports have outperformed Japan's (Chart 16). In other words, the real challenge for Japan's economy is to raise its growth potential, and the challenge of overcoming deflation can only be achieved through a combination of forces: first, having a wide range of economic agents exert efforts to strengthen the economy's growth potential; and second, providing support from the financial side. Based on this recognition, the Bank has embarked on an unprecedented measure for a central bank: that is, the establishment of the "Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth."[2]

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[1] Please see Masaaki Shirakawa, "The Outlook and Challenges for Japan's Economy" (Speech at a Meeting with Business Leaders in Osaka), October 31, 2011.
http://www.boj.or.jp/en/announcements/press/koen_2011/ko111031a.htm/

[2] Under this measure, the Bank provides long-term funds at low rates to financial institutions carrying out lending or investment in support of strengthening the foundations for Japan's economic growth. In June 2011, the Bank introduced a special scheme, as part of its overall support measures, which established a new line of credit for equity investments and asset-based lending (ABL), which,

The Bank of Japan will do its utmost to ensure the stability of Japan's financial system, while giving particular attention to developments in global financial markets. At the same time, the Bank, while examining carefully risk factors concerning domestic and overseas demand, continues to conduct monetary policy in an appropriate manner with the aim of overcoming deflation and achieving sustainable growth with price stability.

Thank you very much.

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unlike traditional lending, uses assets that are closely tied to firms' businesses -- such as their inventories, equipment, and machines, as well as accounts receivables -- as collateral. The most significant advantage of ABL is that it creates ways for firms without real estate collateral and personal assets to gain access to loans. For example, start-up firms tend to have a high ratio of accounts receivables to total assets. They will be able to raise funds for business expansion and exploration of new business opportunities more smoothly if they can make use of their accounts receivables as collateral. In addition, the Bank established special rules for small-lot investments and loans -- those less than 10 million yen -- as well as special rules for U.S. dollar lending arrangements. At present, the total size of the measure stands at 5.5 trillion yen. The Bank anticipates that the private sector's efforts to strengthen growth potential will make progress steadily, with such measures serving as a catalyst.

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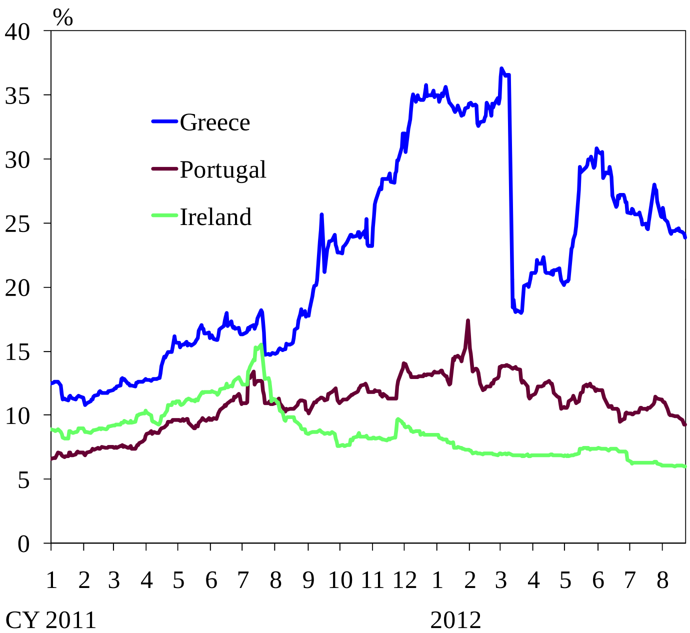
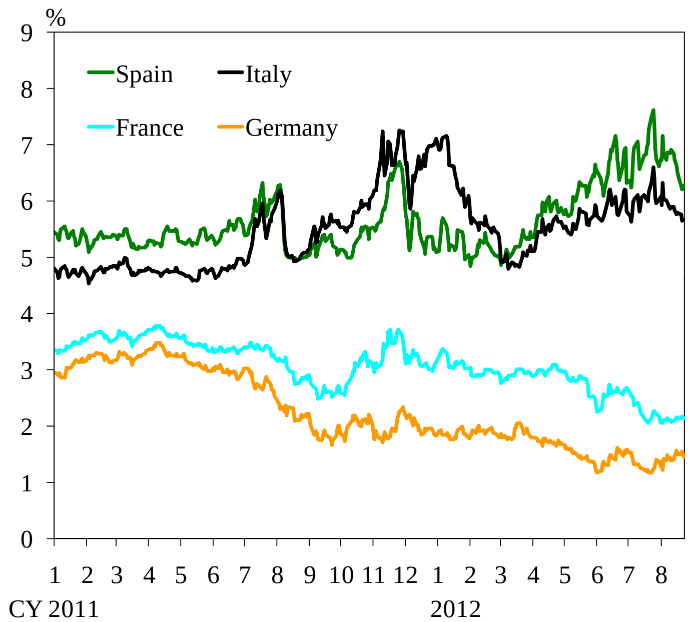
Chart 1

Long-Term Government Bond Yields in Europe





Note: Yields shown are on 10-year government bonds, except for Ireland, for which 9-year government bond yields are used.
Source: Bloomberg.

Chart 2

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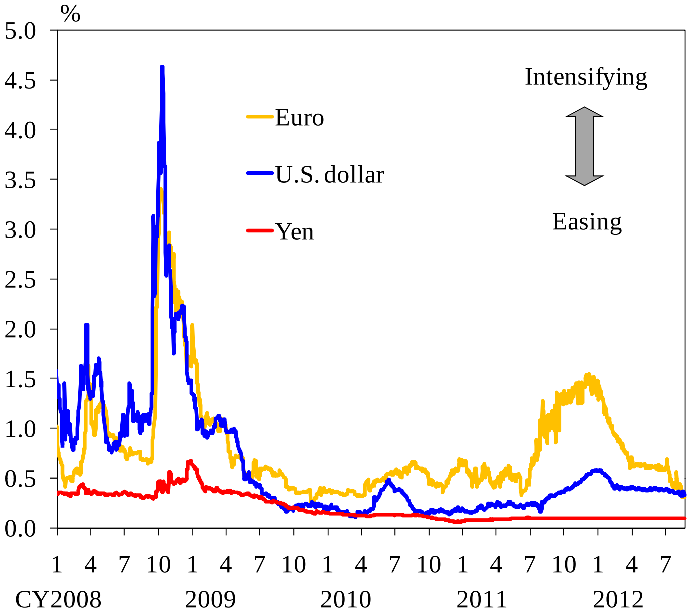
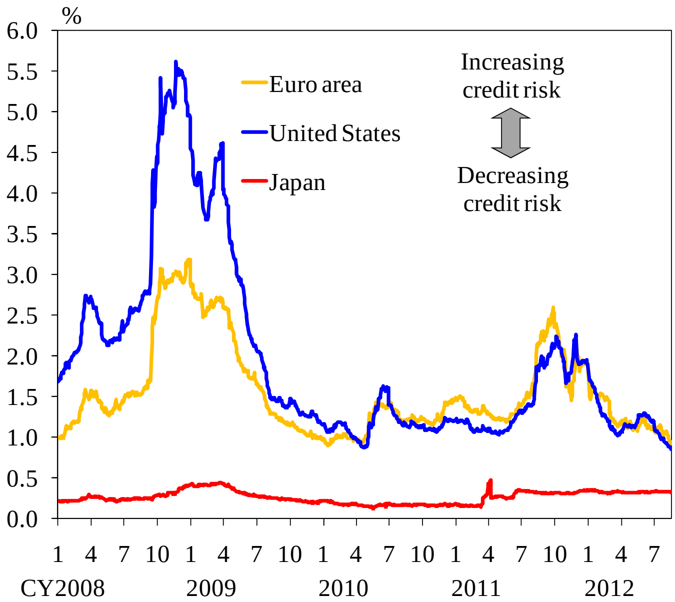
Financial Conditions in Major Countries

Degree of Strain in Funding Markets[1]



Credit Spreads for Corporate Bonds[2]



Notes: 1. The degree of strain in funding markets is 3-month Libor minus 3-month overnight index swap (OIS) rates. Government bonds for the euro area are those issued by Germany.
2. The spreads for corporate bonds (rated AA) are the yields for corporate bonds minus those for government bonds.
Source: Bloomberg.

Chart 3

BANK OF JAPAN

Adverse Feedback Loop among Fiscal Conditions, the Financial System, and the Real Economy

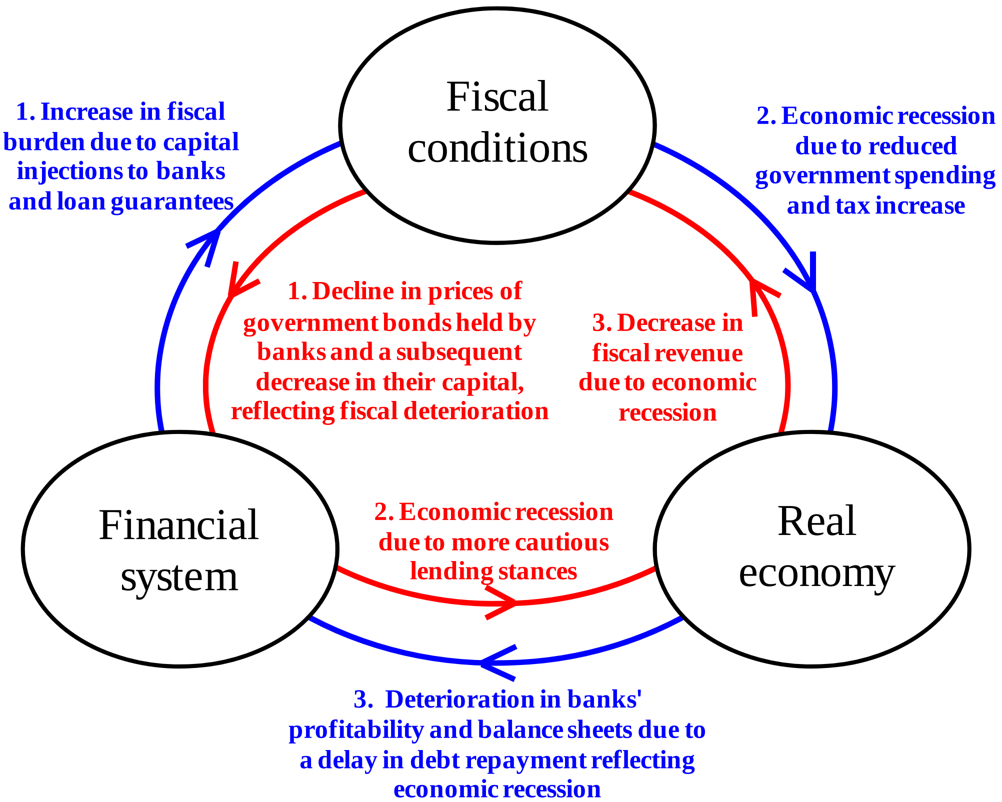
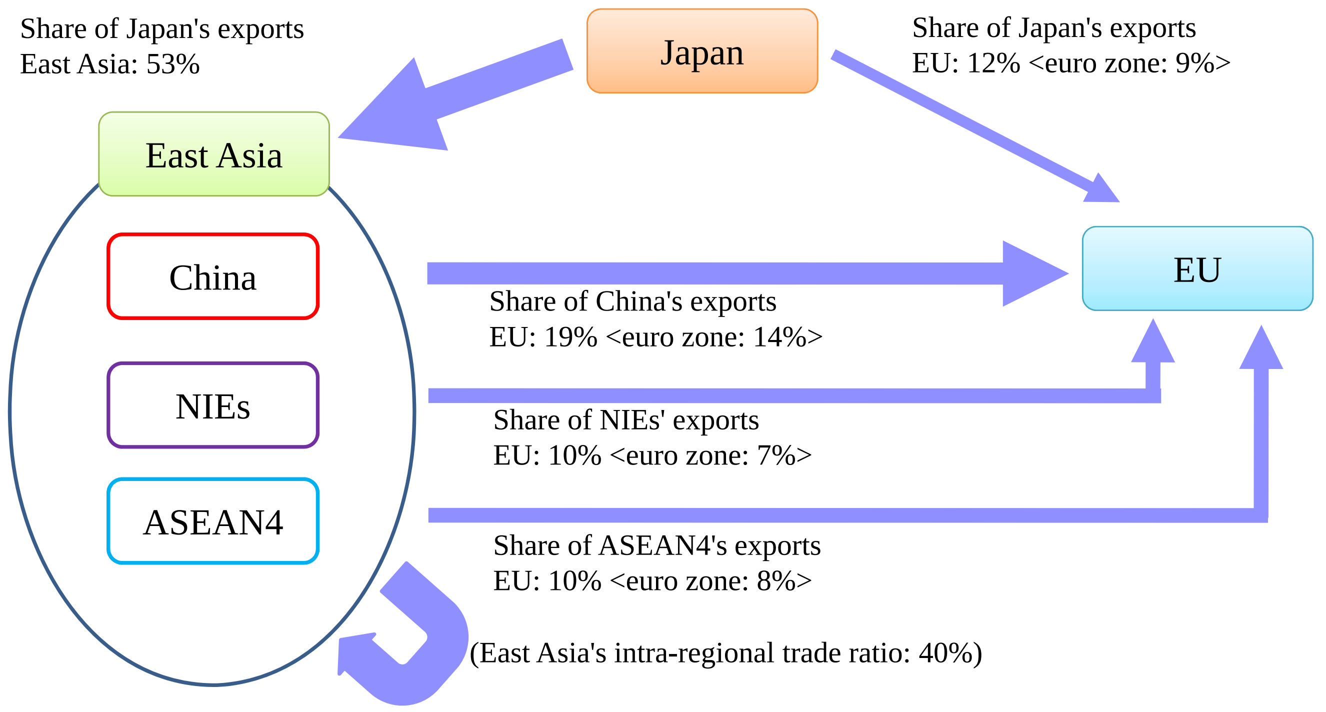


Chart 4

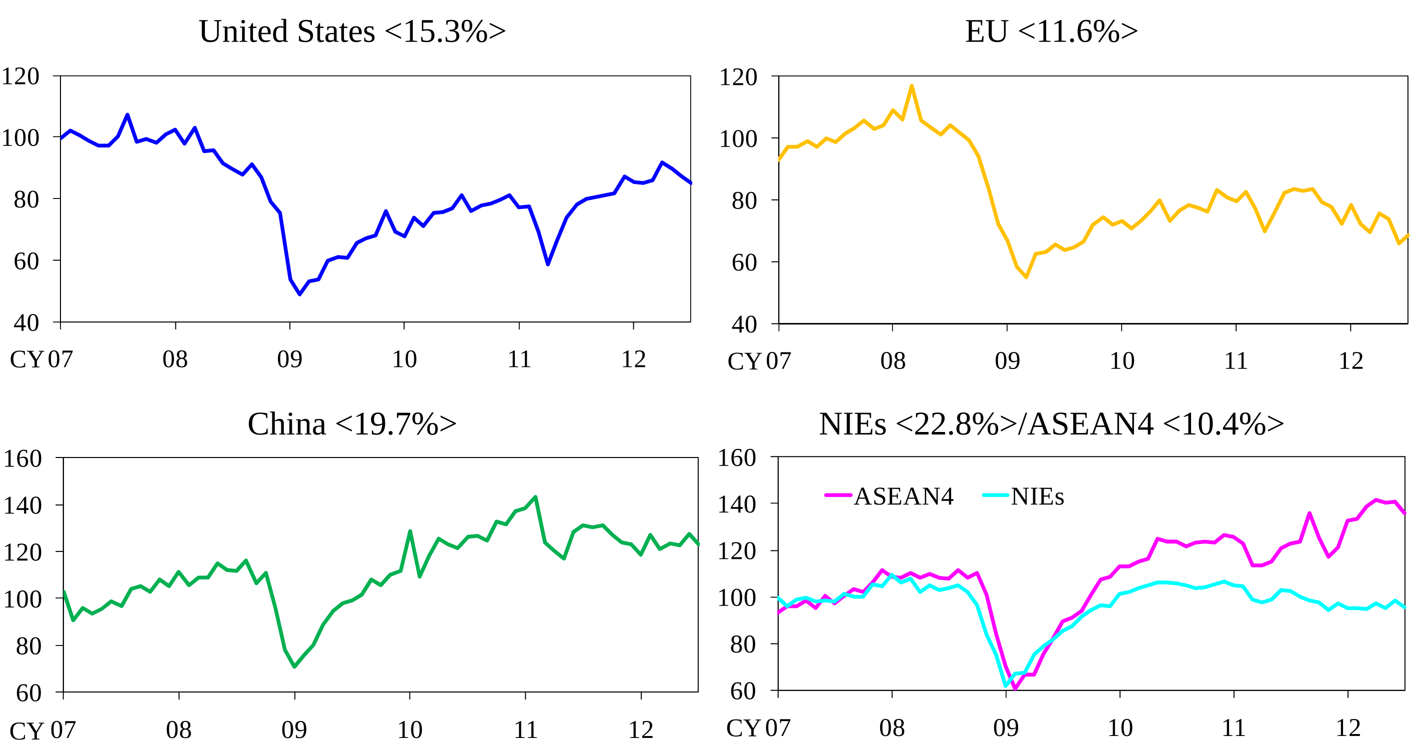
Trade Relations among Japan, Europe, and East Asia



Note: Figures are for 2011. The NIEs consist of Korea, Taiwan, Hong Kong, and Singapore. ASEAN4 refers to Thailand, Indonesia, Malaysia, and the Philippines.
Sources: Ministry of Finance; IMF; HAVER.

Chart 5

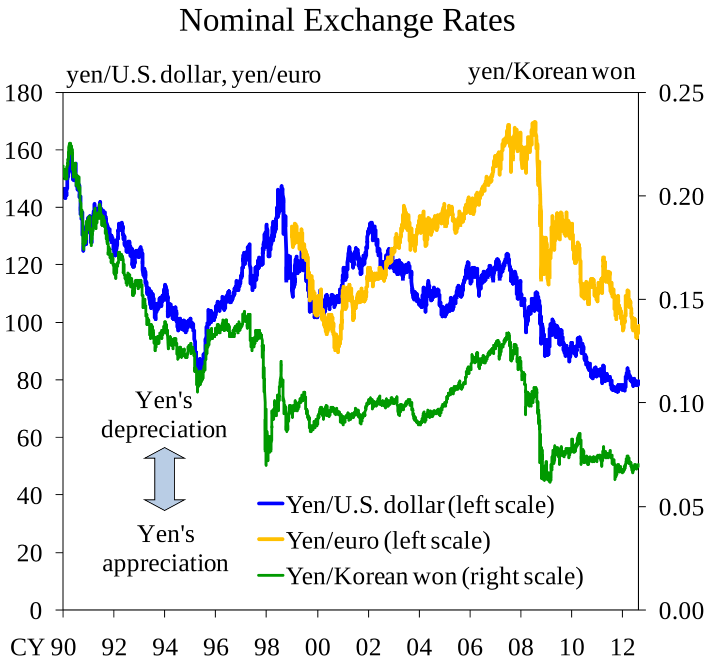
Japan's Real Exports by Region

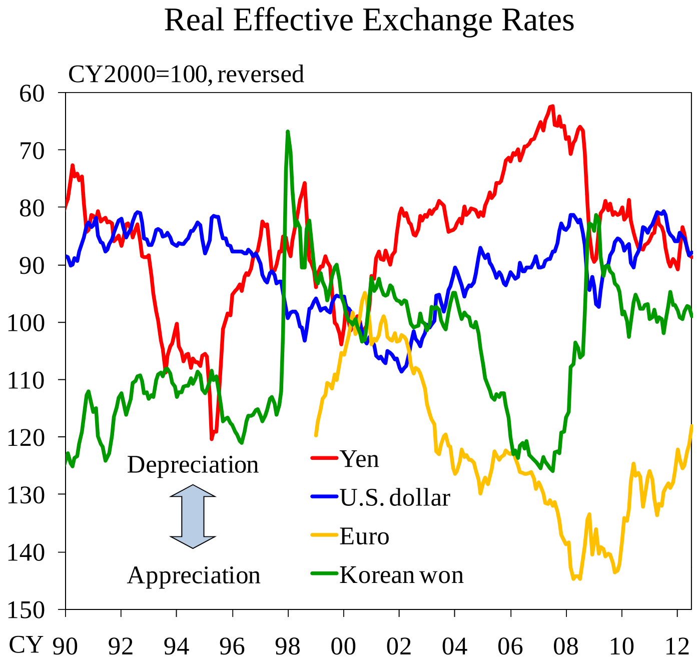


Note: Figures are seasonally adjusted and CY2007=100. Figures in angular brackets indicate the share of exports from Japan to each destination in 2011.
Source: Ministry of Finance; Bank of Japan.

Chart 6

Exchange Rates



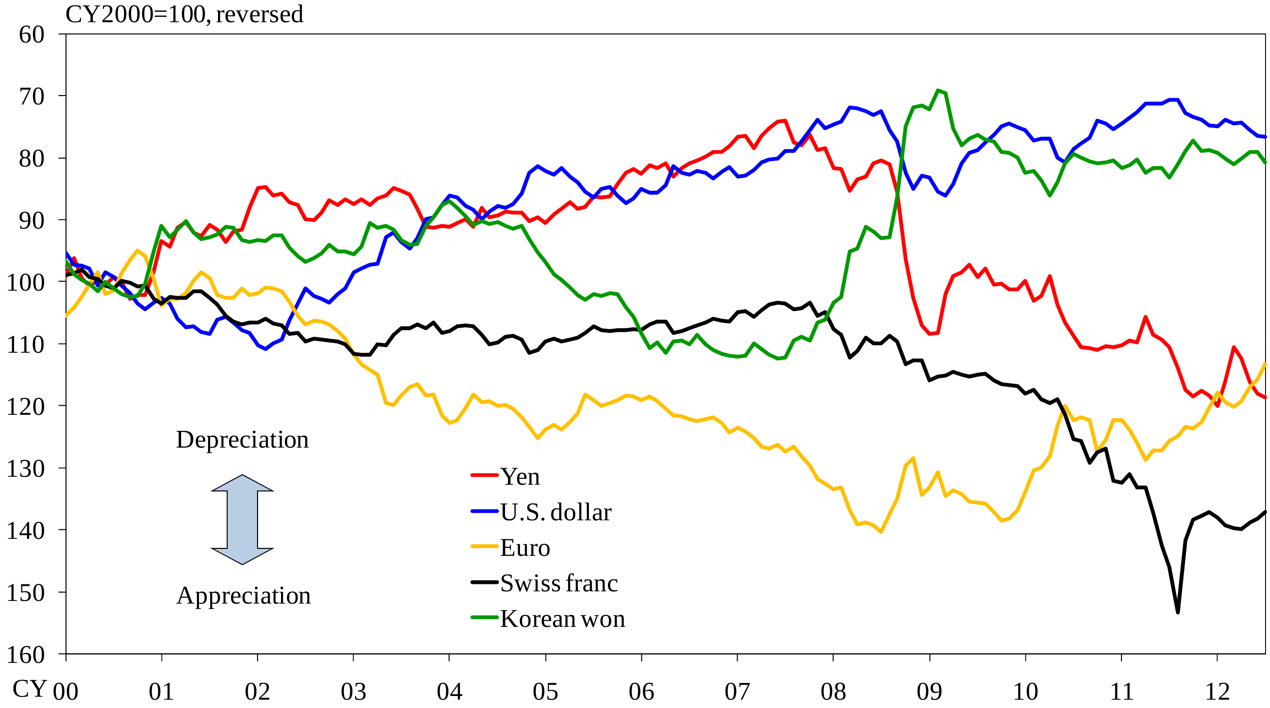


Note: The real effective exchange rate is an indicator of a country's overall international competitiveness, calculated as follows. First, each of the exchange rates of the country's currency against other currencies (i.e., nominal exchange rates) is deflated by the price indices of those countries to calculate the real exchange rate. Then, the weighted average of the real exchange rates is calculated using the annual value of the country's trade with its counterparties as its weights.

Sources: Bloomberg; BIS.

Chart 7

Nominal Effective Exchange Rates



Note: The nominal effective exchange rate is an indicator that measures the overall value of individual currencies. It is derived by calculating the weighted average of each currency's exchange rate against other currencies using the annual value of each country's trade with its counterparties as its weights.

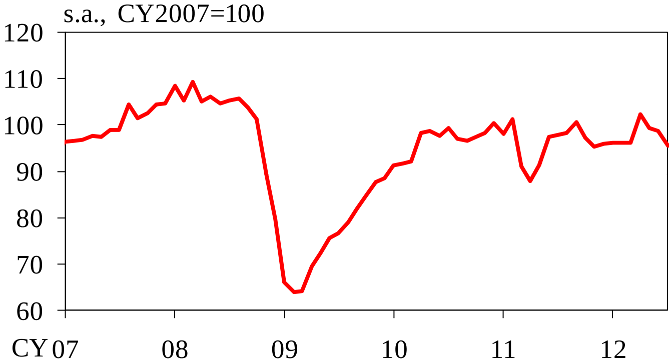
Source: BIS.

Chart 8

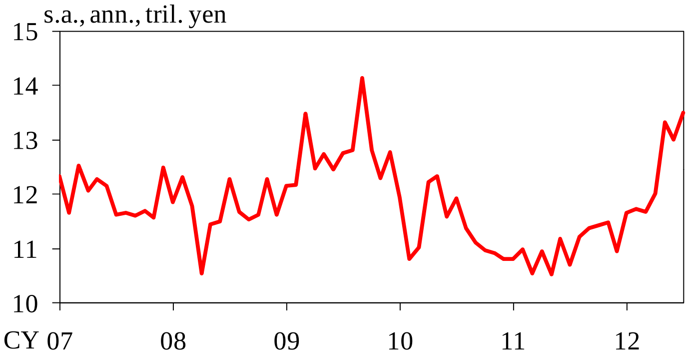
日本銀行 Bank of Japan

Recent Developments in Japan's Economy

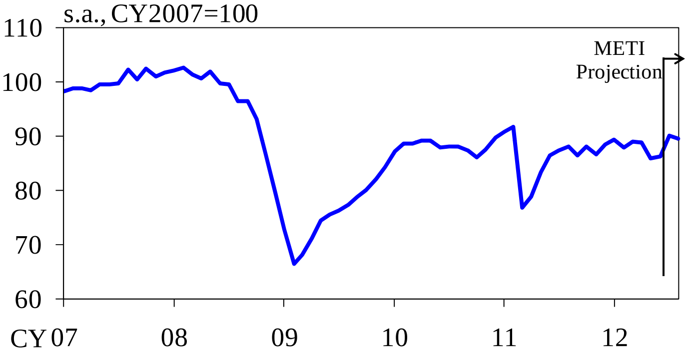
Real Exports



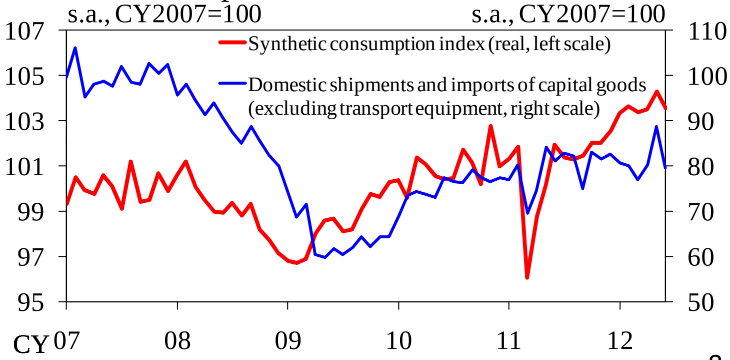
Value of Public Works Contracted



Industrial Production



Private Consumption and Business Fixed Investment



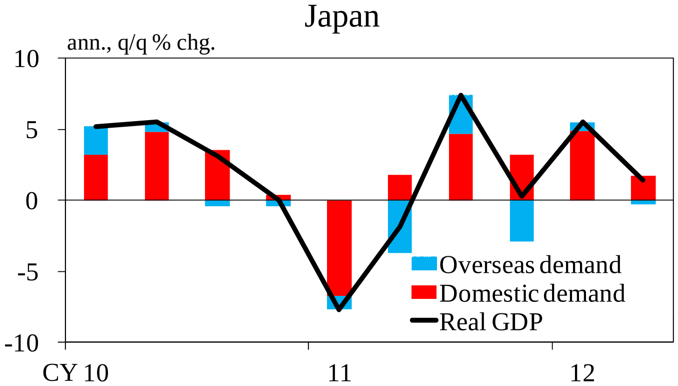
Sources: Ministry of Economy, Trade and Industry; East Japan Construction Surety, etc.; Cabinet Office; Bank of Japan.

Chart 9

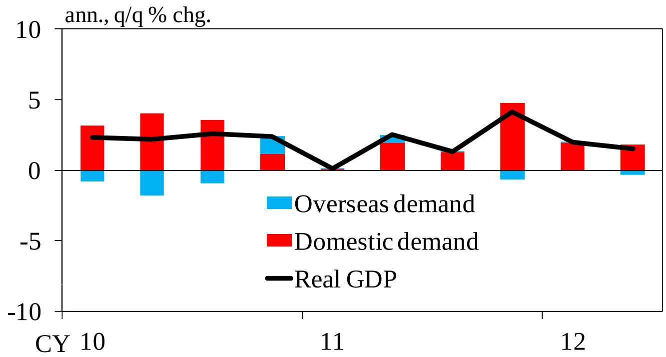
日本銀行 Bank of Japan

Contribution of Overseas and Domestic Demand to Growth Rate

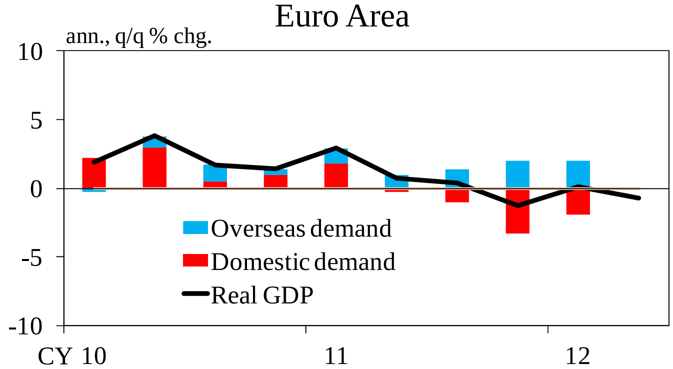
Japan



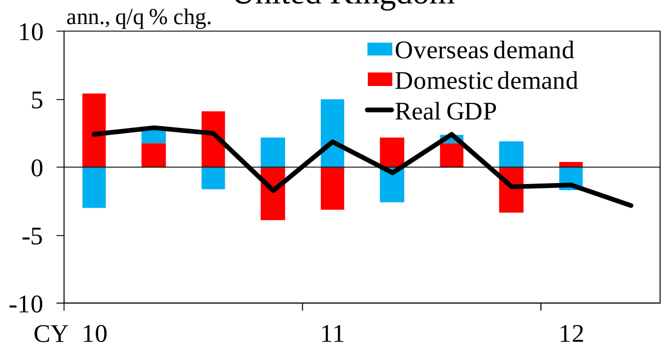
United States



Euro Area



United Kingdom



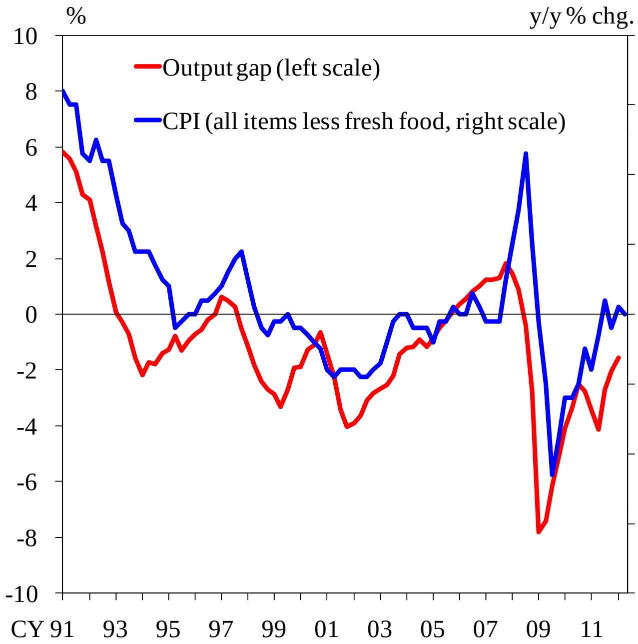
Sources: Cabinet Office; BEA; Eurostat; ONS.

Chart 10

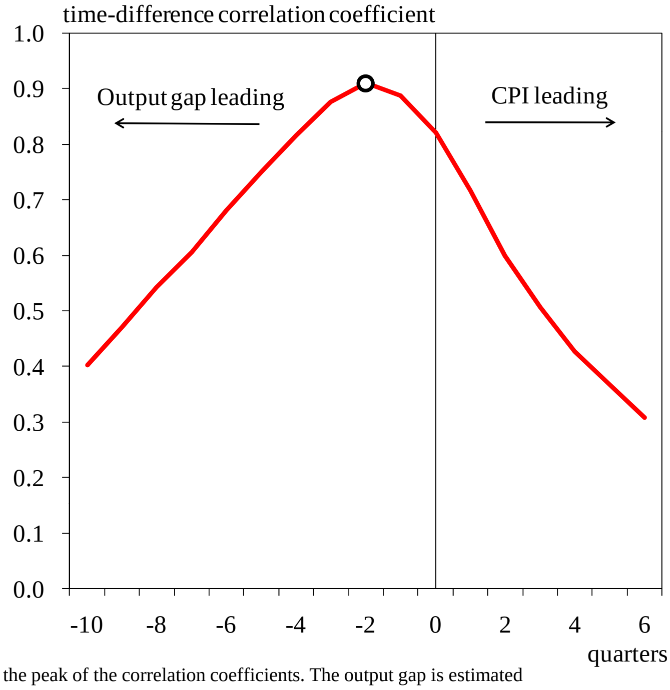
Output Gap and Consumer Price Index

The year-on-year rate of change in the CPI is correlated to the output gap which leads several quarters.

Output Gap and Consumer Price Index



Output Gap and Time-Difference Correlation of Consumer Price Index



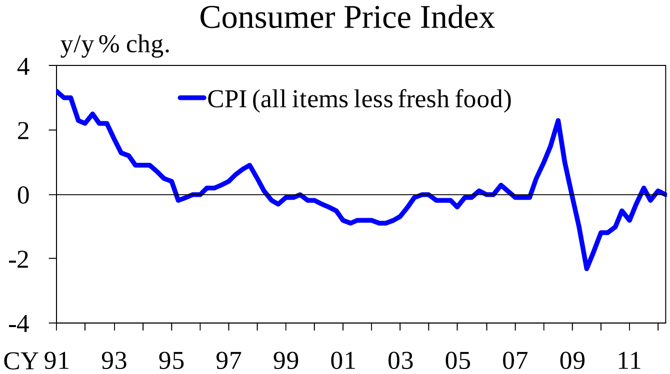
Note: Time difference is calculated using data since 1990/Q1. The white circle indicates the peak of the correlation coefficients. The output gap is estimated by the Research and Statistics Department, Bank of Japan.

Sources: Ministry of Internal Affairs and Communications; Cabinet Office, etc.

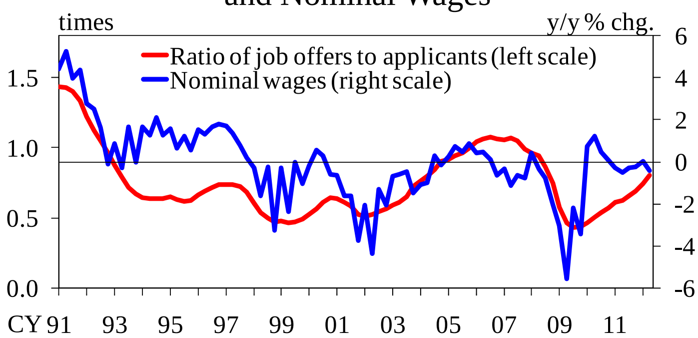
Chart 11

Environment Surrounding Prices

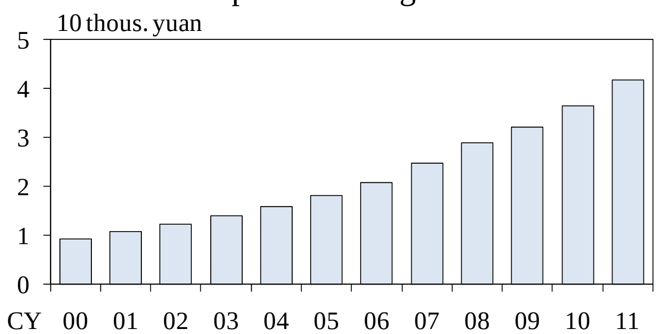
Consumer Price Index



Ratio of Job Offers to Applicants and Nominal Wages



Development in Wages in China

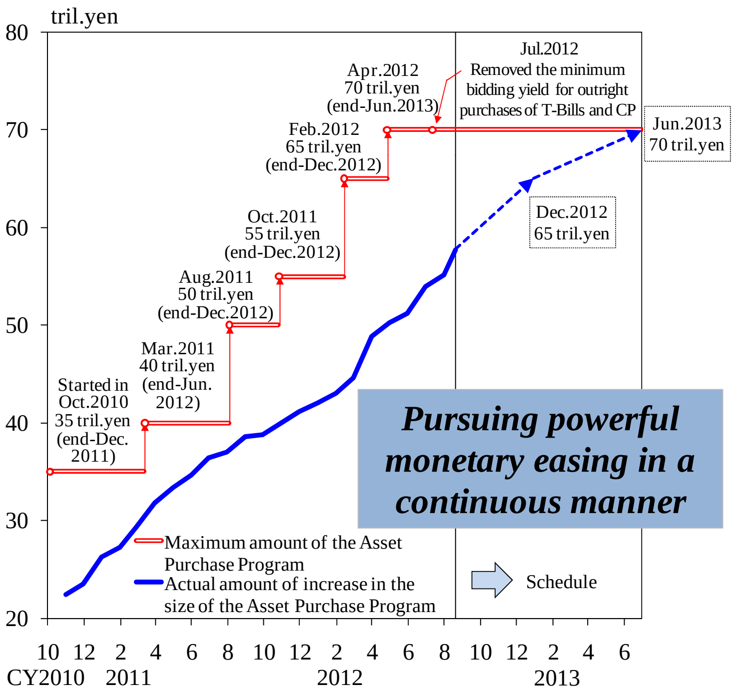


Import Price Index for Consumer Goods (Contractual Currency Basis)

Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labor and Welfare; Ministry of Economy, Trade and Industry; National Bureau of Statistics of China; Bank of Japan.

Monetary Policy

Maximum Amount and Actual Amount of Increase in the Size of the Asset Purchase Program



Notes: 1. Dates in parentheses indicate the intended timescale for completing the increase.
2. Latest figures of the amount outstanding are as of August 20, 2012.

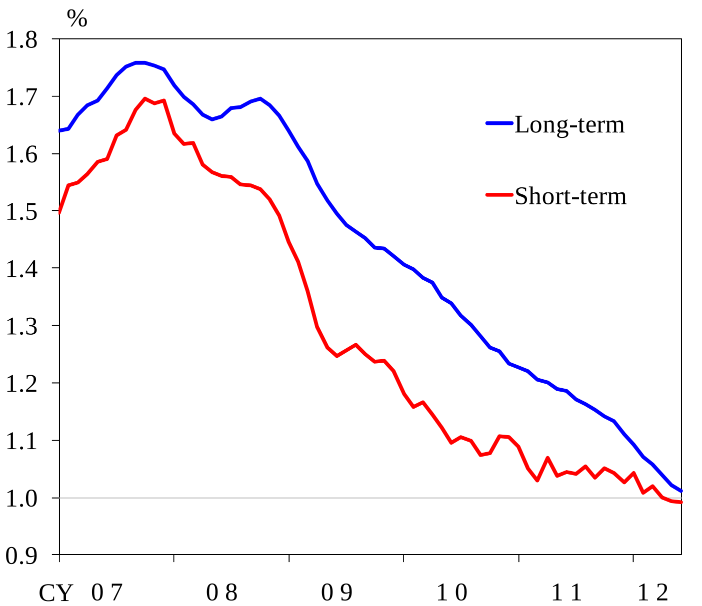
Breakdown of the Asset Purchase Program

tril. yen

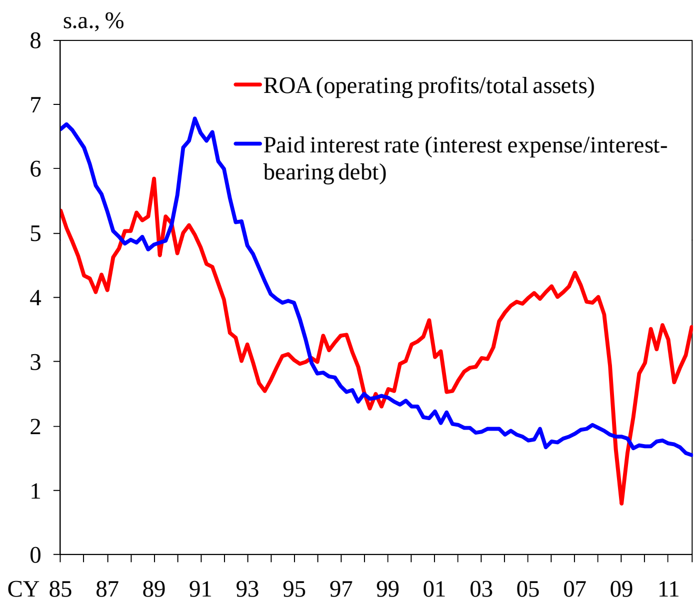
	Started in Oct. 2010	Mar. 2011	Aug. 2011	Oct. 2012	Feb. 2012	Apr. 2012	Jul. 2012	Latest amount
Total size	About 35	About 40	About 50	About 55	About 65	About 70	About 70	About 57.8
JGBs	1.5	2.0	4.0	9.0	19.0	29.0	29.0	15.0
T-Bills	2.0	3.0	4.5	4.5	4.5	4.5	9.5	5.3
CP	0.5	2.0	2.1	2.1	2.1	2.1	2.1	1.7
Corporate bonds	0.5	2.0	2.9	2.9	2.9	2.9	2.9	2.6
ETFs	0.45	0.9	1.4	1.4	1.4	1.6	1.6	1.3
J-REITs	0.05	0.1	0.11	0.11	0.11	0.12	0.12	0.09
Fixed-rate operation	30.0	30.0	35.0	35.0	35.0	30.0	25.0	31.7
Intended time of completion	End-Dec. 2011	End-Jun. 2012	End-Dec. 2012	End-Dec. 2012	End-Dec. 2012	End-Jun. 2013	End-Jun. 2013	

Corporate Financial Conditions

Domestic Banks' Average Contracted Interest Rates



ROA and Paid Interest Rate of Japanese Firms



Note: Average contracted interest rates are the six-month backward moving averages on new loans.
Sources: Ministry of Finance; Bank of Japan.

Financial Positions of Firms and Lending Attitudes of Financial Institutions

Financial Positions of Firms

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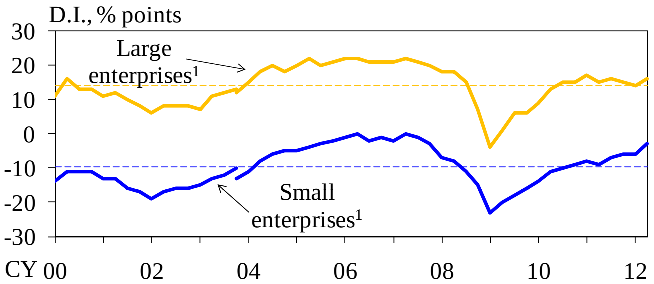
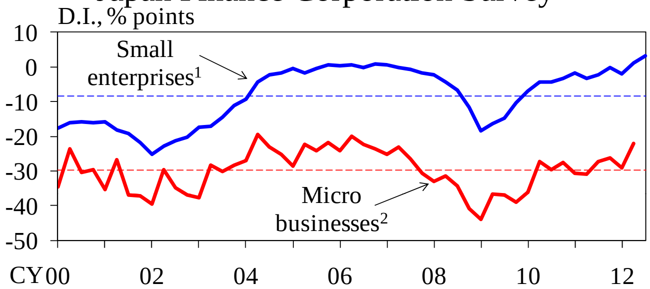


<Japan Finance Corporation Survey>



Notes: 1. The D.I. for the left-hand chart represents the proportion of responding enterprises that answered "easy" minus the proportion of those that answered "tight." The D.I. for the right-hand chart indicates the proportion of responding small enterprises that answered "easy" minus the proportion of those that answered "tight," and the proportion of micro businesses that answered "easier" minus the proportion of those that answered "tighter."
2. Dotted lines indicate averages for 2000 onward.

Lending Attitudes of Financial Institutions as Perceived by Firms

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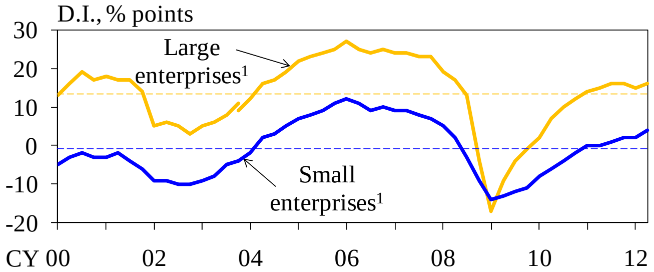

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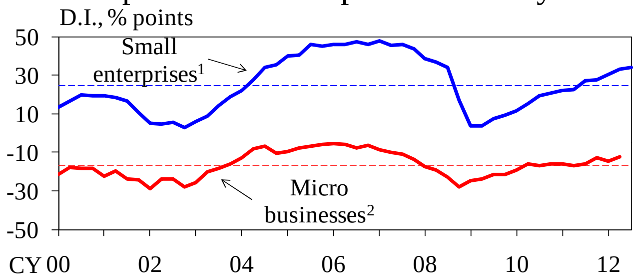
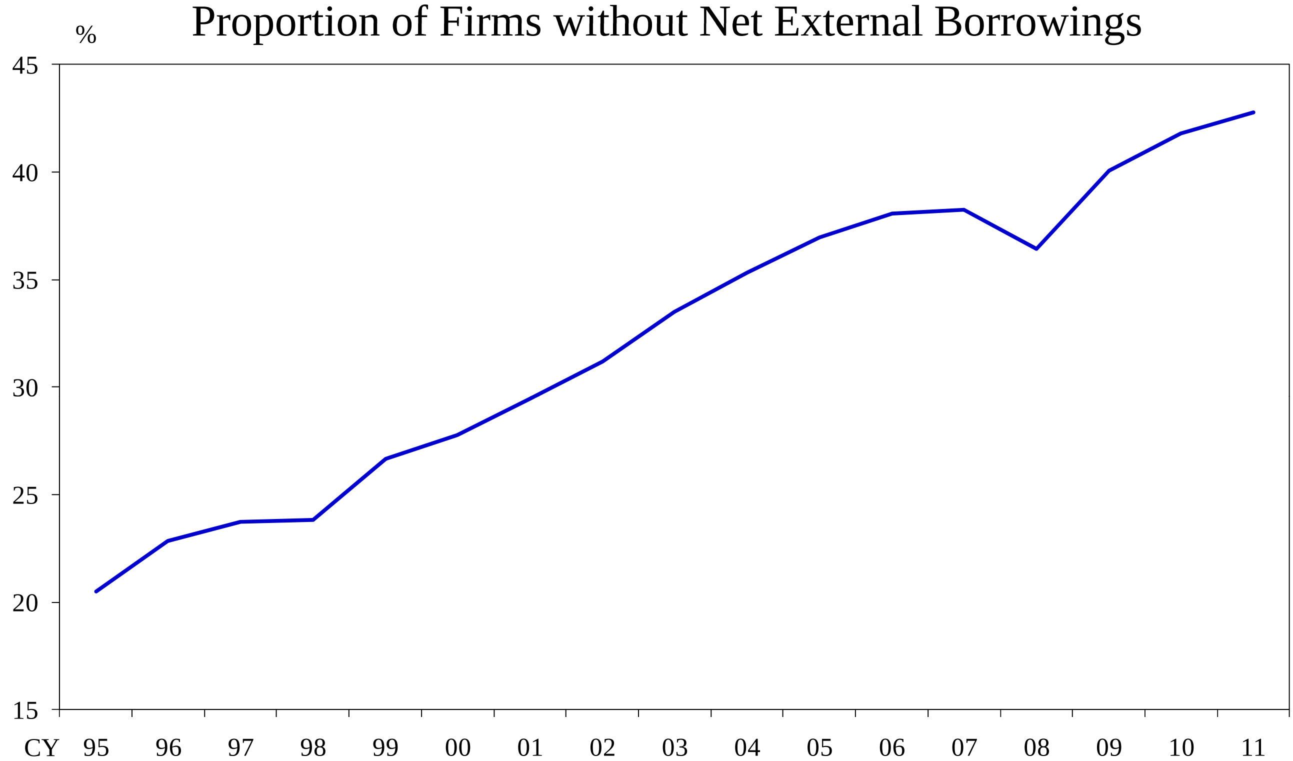


Notes: 1. The D.I. for the left-hand chart represents the proportion of responding enterprises that answered "accommodative" minus the proportion of those that answered "severe." The D.I. for the right-hand chart indicates the proportion of responding small enterprises that answered "accommodative" minus the proportion of those that answered "severe," and the proportion of micro businesses that answered "more accommodative" minus the proportion of those that answered "more severe."
2. Dotted lines indicate averages for 2000 onward.
Sources: Japan Finance Corporation; Bank of Japan.

Proportion of Firms without Net External Borrowings

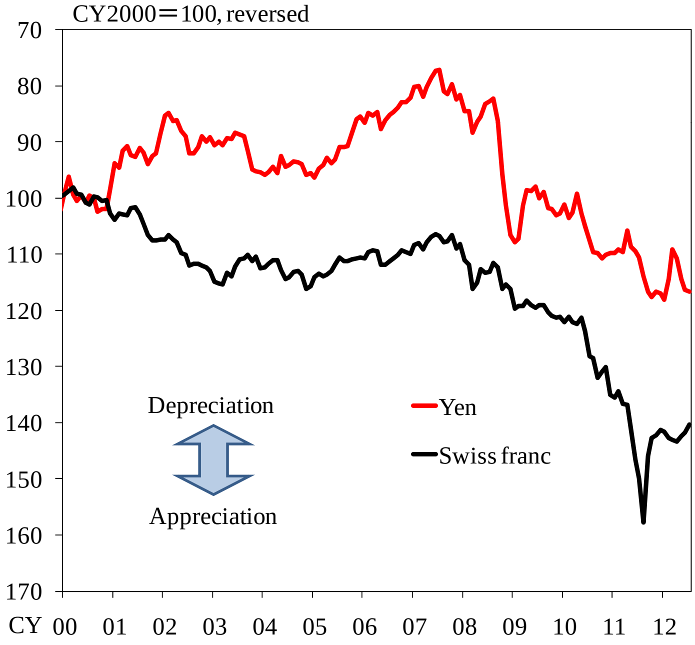


Notes: 1. Firms without net external borrowings are ones whose cash, deposits, and cash equivalents exceed their interest-bearing debt. Cash equivalents are short-term assets such as CP, CD, and bond investment trusts.
2. The 1,260 sample firms (excluding financial institutions) are those listed on the First or Second Section of the Tokyo Stock Exchange, with March year-ends, and whose data can be obtained consecutively from fiscal 1995 onward.
Source: Nikkei Financial QUEST.

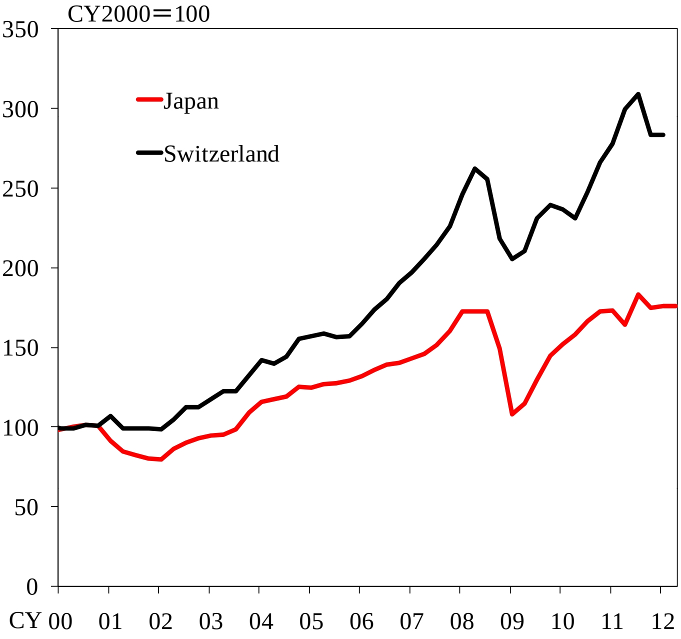
Chart 16

Exchange Rates and Exports of Switzerland and Japan

Nominal Effective Exchange Rate



Value of Exports



Note: Value of Exports is calculated on a U.S. dollar basis.
Sources: Cabinet Office; Eurostat; Bloomberg; BIS.