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# Overseas Economies under Persistent Stress, and the Current Situation and Challenges for Japan's Economy

*Speech at a Meeting with Business Leaders in Kyoto*

**Kiyohiko G. Nishimura**
*Deputy Governor of the Bank of Japan*

## Introduction

I am privileged to be here today to exchange views with business leaders in Kyoto. Also I would like to express my sincere gratitude for your cooperation in interviews and surveys conducted by the Kyoto branch of the Bank of Japan. Information from these interviews and surveys is invaluable and utilized fully in assessing economic and financial developments and conducting monetary policy.

Before we start to exchange views, let me talk about economic and financial developments both in Japan and abroad and about the Bank's thinking on the conduct of monetary policy. I will then speak briefly about financial institutions' efforts to strengthen the medium- to long-term growth potential of Japan's economy.

## I. Overseas Economies under Persistent Stress

Let me start with overseas economic and financial developments that could affect Japan's economy.

Since this summer, an extremely nervous situation has continued in global financial markets due to developments in the sovereign debt problem in Europe -- namely, investors have been busily shifting back and forth between optimism ("risk on" mode) and pessimism ("risk off" mode) within a short period of time. In Europe, government bond yields have risen considerably in countries experiencing serious fiscal concern, especially Greece, and this development has recently spread to major European countries such as Spain and Italy. As a result, European banks with significant exposure to such government bonds have faced difficulty in liquidity funding in markets due to a rising concern for creditworthiness, and they have been forced to restrain their lending to ensure their on-hand liquidity. As such, in Europe a feedback loop among fiscal balances, the financial system, and the real economy is now operating in an undesirable way: that is, a decline in confidence in public finances has caused a high degree of concern over stability in the financial system, and this has adversely affected economic activity, including sentiment.

The increasingly critical sovereign debt problem in Europe is basically caused by the fact that having already enjoyed most of the benefits arising from European monetary unification, euro area countries are now being asked to pay the price. For some peripheral European countries such as Greece, the main benefit of unification was a dramatic decline in funding costs such as government bond yields. In exchange for the decline in funding costs, these countries were expected to enhance their growth potential and solvency through the conduct of reforms in the labor markets, as well as tax and administration systems. In other words, the euro area was supposed to become a sustainable system only after going through such a process. These peripheral countries, however, expanded government spending excessively relying on low funding costs, and as a result public debt increased considerably, going far beyond their capacity to repay. On the other hand, Germany has continued to steadily record current account surpluses by increasing exports to these peripheral European countries and to increase credit to such countries. Thus, the essence of the problem is imbalances between euro area countries that have developed since monetary unification. Therefore, it is necessary to fully understand that there is no immediate remedy to solve the sovereign debt problem and postponing the resolution of the problem will never bring back the pre-crisis situation. In short, some peripheral European countries need to seriously consider long-lasting policy responses that would strengthen their medium-to long-term growth potential.

How will the sovereign debt problem develop for the time being? Given the extremely high degree of uncertainty it is difficult to predict future developments. Many market participants seemingly hold the view that euro area countries will buy time and contain overreaction of the financial markets, which currently tend to be ruled by extreme pessimism, by gradually presenting a roadmap for fiscal transfer and fiscal integration and finding some way to compromise with one another to deal with individual domestic political problems. If the situation develops in accordance with this view, it is necessary to acknowledge that the high stress in global financial markets caused by the sovereign debt problem in Europe will persist for a long time. The risk of some kind of shock triggering the spread of credit contraction also warrants attention.

Turning to the United States, an increasing number of recently released economic indicators have turned out to be better than market expectations and concern about a possible double dip or a negative spiral has receded compared with early spring and summer. However, improvement in the employment situation has remained slow and the pace of economic recovery has remained extremely moderate. In such a situation where the average growth rate has declined, various economic indicators have shown large fluctuations and differences among industries and firm size. Therefore, it has become difficult to capture the underlying trend. This difficulty has heightened uncertainty regarding the U.S. economy, and is one reason for the increasing short-term fluctuations of sentiment. In any case, the pace of growth in the U.S. economy is likely to remain modest reflecting the limited room for further fiscal and monetary stimulus and the lingering adjustment pressure on households' and financial institutions' excessive debts. It is important to bear in mind that, despite the deteriorating situation in Europe, the market's view on the outlook for overseas economies has not yet become too pessimistic, reflecting the improved outlook for the U.S economy. Therefore, attention should be paid to the possibility that if the outlook for the U.S. economy becomes cautious again, disruptions in global financial markets could spread rapidly.

As for emerging economies, the pace of growth has decelerated somewhat due to the effects of monetary tightening and the decline in exports reflecting the slowdown in advanced economies. In fact, in China, the driving force of the global economy, tax revenues, the amount of electric power, and imports -- indicators that are considered to be fairly reliable -- have continued to be weak from around the middle of this year compared with the previous trend of high growth. If European financial institutions reduce their assets more as the sovereign debt problem deteriorates further, lending to emerging countries could be restrained and trade financing affected. On the other hand, it is encouraging that the room left for monetary easing in emerging countries including China has increased, reflecting the recent pause in the rise in consumer prices, particularly food prices. As I have stated, there are both positive and negative factors for emerging economies. Attention should continue to be paid to whether the economies can make a soft-landing by realizing price stability and growth at the same time.

Before I turn to the next topic, let me point out that recently two significant changes are proceeding, albeit gradually, in the global economy.

The first change includes the aging of the population profile and a decrease in working population in advanced countries, and an increasing mismatch between job seekers and job offers. This increasing mismatch reflects not only the change in the skills required of workers due to the rising importance of information technology in economic activity. It also reflects the fact that inter-regional labor mobility has become less smooth than before as workers experience increasing difficulty in buying and selling their homes due to the sharp decline in housing prices after the collapse of the housing bubble. These changes in the labor markets could exert downward pressure on the growth potential of advanced countries, and therefore delay adjustments in the excessive debts of U.S. households and European governments. If the structural unemployment rate rises due to the increase in this mismatch, wages and prices become less likely to decline even if a high unemployment rate continues. In fact, I think that such trend has recently appeared in the United States and Europe.

The second change is that emerging economies with currencies that are *de facto* pegged to the U.S. dollar have an increasing presence in the global economy, and such countries, the so-called "U.S. dollar-pegged bloc," play a major role in the dynamics of the global economy. In such a situation, the effects of monetary easing in the United States have spread to the U.S. dollar-pegged bloc as a whole through fixed foreign exchange rates. As a result, prices of commodities such as crude oil tend to trend upward since commodities are traded in U.S. dollars and underlying demand from emerging economies tends to be strong.

It is uncertain how long these two changes will persist. The mismatch in the labor markets is expected to ease as proper employment policy measures are implemented and post-bubble adjustments in excessive debts proceed. Some emerging countries are apparently making adjustments to their exchange rates, albeit slowly, in the awareness that importing easy monetary conditions from the United Sates by pegging to the U.S. dollar will further exacerbate inflationary pressure. If the situation does not change dramatically and promptly, however, it is highly likely that in advanced economies, where growth potential is declining and inflationary pressures are tending to rise, the pace of recovery will continue to be restrained even under expansionary policies to stimulate aggregate demand.

## II. Moderate Pace of Recovery in Japan's Economic Activity and Price Developments

Now I will talk about recent developments in Japan's economic activity and prices.

Japan's economic activity plunged after the Great East Japan Earthquake in March, mainly on the production and export sides. As constraints on the supply side were resolved, economic activity recovered in the summer at a faster pace than originally anticipated. As the supply-side constraints are now almost fully resolved, demand-side developments are once more becoming increasingly important for Japan's economic prospects. In these circumstances, Japan's economic activity has continued picking up but at a more moderate pace, mainly due to the effects of a slowdown in overseas economies.

As for domestic demand, business fixed investment has been increasing moderately as demand related to reconstruction after the earthquake disaster has been gradually materializing. In particular, orders for construction machinery have recently marked a large increase due to demand for restoration of disaster-stricken buildings. Private consumption has been firm. Although services consumption took somewhat longer to recover from the earthquake disaster, it is now picking up as evidenced by the fact that sales in the food service industry and outlays for travel have more or less returned to their pre-quake levels. Exports and production continue to increase partly due to the restoration of the level of overseas inventories, which declined after the earthquake. However, the pace of their increase has become moderate due to effects of the slowdown in overseas economies. The effects of the slowdown in overseas economies are particularly apparent in exports of IT-related goods such as semiconductor manufacturing equipment.

As for the outlook, for the time being, Japan's economy will face an adverse effect from the slowdown in overseas economies and the appreciation of the yen, as well as from the flooding in Thailand. After that, the economy is expected to return to a moderate recovery path as the pace of recovery in overseas economies picks up, led by emerging and commodity-exporting economies that basically maintain their growth mechanism of domestic demand, and as reconstruction-related demand after the earthquake disaster gradually materializes.

The year-on-year rate of change in the CPI (all items less fresh food) has recently been at around 0 percent. It will remain at around 0 percent for the time being but will gradually rise to around 0.5 percent toward fiscal 2013, along with an improvement in the aggregate supply and demand balance.

The baseline scenario for Japan's economy is that it will eventually return to a sustainable growth path with price stability in the longer run. There are, however, various risk factors to such a baseline scenario. Needless to say, the risk factor that should cause most concern is future developments in the sovereign debt problem in Europe and their effects on global financial markets and the global economy. As I have stated earlier, the debt problem has largely affected the global economy already, but it could result in weaker growth, not only in the European economy but also in the global economy, particularly through its effects on global financial markets.

As global financial markets continue to be under stress, global investors have tended to be increasingly risk averse, and to purchase the yen, which is considered a relatively safe currency. While the U.S. dollar-pegged bloc expands, the yen is one of the major free-floating currencies with high liquidity. There is a risk that if investors are attracted by such characteristics of the yen this will lead to a sharp appreciation of the yen that diverges considerably from economic fundamentals. This may cause a sharp increase in the shift of production overseas by Japanese firms beyond a critical level. If not just a shift of a factory to abroad, but a shift of the entire manufacturing, or *monozukuri*, system -- including suppliers -- occurs, Japan's manufacturing would find it hard to recover even if the yen depreciated in the future. The essence of *monozukuri* is not efficiently producing goods at the lowest cost. Rather, it is the repeatedly occurring innovation that generates value-added in various ways, in which all the parties concerned cooperate but compete with one another at the same time. Innovation can sometimes be the identification and avoidance of unnecessary procedures in production, or it can be an effort to adapt goods to customers' changing needs. In order to continue to innovate in the *monozukuri* system, it is vital to maintain a system that can respond immediately and flexibly to changes in the situation. That said, we should continue to carefully monitor developments in foreign exchange and global financial markets from the standpoint of whether they will cause irreversible shifting of the *monozukuri* system to overseas locations.

## III. Bank's Conduct of Monetary Policy

I would now like to talk about the Bank's conduct of monetary policy, taking into account the financial and economic situation in Japan and abroad.

The Bank has been pursuing powerful monetary easing under the new monetary policy framework introduced in October 2010 -- "Comprehensive Monetary Easing." This framework is composed of three measures.

First, the Bank sets the policy rate at 0 to 0.1 percent, which can be deemed a virtually zero interest rate. Second, the Bank is publicly committed to continuing this virtually zero interest rate policy until it judges that price stability is in sight. And third, as an exceptional measure for a central bank, it purchases from the markets not only long- and short-term government bonds but also risk assets such as CP, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs). The aim of the Bank's purchases is to encourage a decline in longer-term interest rates and risk premiums.

A program for purchasing financial assets, called the Asset Purchase Program started at 35 trillion yen, but has been repeatedly expanded in size on a significant scale. Recently, on October 27, the Bank decided to increase the size by a further 5 trillion yen, to about 55 trillion yen, and to designate this increase for the purchase of Japanese government bonds (JGBs). This decision was based on the recognition that considering the slowdown in overseas economies and the appreciation of the yen, some more time will be needed to confirm that price stability is in sight and due attention should be paid to the risk that the economic and price outlook will further deteriorate depending on developments in global financial markets and overseas economies. The outstanding amount of the Asset Purchase

Program is slightly over 40 trillion yen, and the Bank will further accumulate another 15 trillion yen to reach the targeted amount of 55 trillion yen.

Over a year has passed since the Bank started to conduct comprehensive monetary easing in October 2010. Meanwhile, Japan's economy and financial conditions have continued to face strong headwinds, including the earthquake disaster and heightening uncertainty regarding the global economy triggered by the sovereign debt problem in Europe. In such a severe situation, the comprehensive monetary easing has encouraged a decline in firms' funding costs and eased investors' risk aversion. And therefore, I believe that the easing has been effective in realizing an accommodative financial environment. Now I will explain about the positive effects by referring to some indicators.

First, interbank rates have been declining moderately in Japan, although they have been rising considerably in the United States and the euro area since this summer when tension regarding the sovereign debt problem in Europe heightened. Yields on treasury discount bills, including those with a one-year maturity, have remained at 0.1 percent, and those on longer-term government bonds, up to those with a two-year maturity, have been at an extremely low level of around 0.1 percent. Against the background of such developments in market rates, firms' funding costs have shown a steady, though moderate, decline. The average contracted interest rates on new loans and discounts are on a declining trend. Various surveys show that firms consider financial institutions' lending attitudes as being on an improving trend and that the financial positions of firms are on an improving trend.

As for risk assets, credit spreads on CP and corporate bonds widened somewhat soon after the earthquake. However, they declined rather quickly encouraged by the Bank's outright purchases. Issuing conditions for corporate bonds have remained favorable: credit spreads on corporate bonds have remained stable at low levels and the variety of corporate bond issuers has increased. New issuance of corporate bonds has recently been steady except for industries related to electric power, which have faced difficulties with new issuance due to uncertainty concerning their business environment. Japan's situation is quite different from that in the United States and Europe where credit spreads have widened remarkably and new issuance has decreased sharply since summer.

Although comprehensive monetary easing was introduced last fall, stock prices and J-REITs have not risen, partly due to a deterioration in the external environment. However, some market participants have observed that the Bank's purchases of ETFs and J-REITs helped markets to support some confidence right after the earthquake and also during the period of high uncertainty since this summer. As I have stated, comprehensive monetary easing has been effective in that it has encouraged a decline in longer-term interest rates and helped market participants from becoming too pessimistic. I believe that this is one reason why Japan's financial conditions have been stable compared to those in the United States and Europe.

## IV. Financial Institutions' Efforts to Strengthen the Medium- to Long-Term Growth Potential of Japan's Economy

Let me use the remaining time to talk about efforts made by financial institutions to strengthen the medium- to long-term growth potential of Japan's economy. I will share with you some examples of regional financial institutions supporting firms' movement toward renewed growth with the cooperation of research institutions.

I brought up this topic because I think that firms' positive efforts in high-growth business areas are necessary in order to strengthen the medium- to long-term growth potential of Japan's economy. The decline in the medium- to long-term growth potential of Japan's economy is also part of the background to a protracted period of stagnant demand and ensuing prolonged deflation, notwithstanding an extremely accommodative financial environment. Based on this recognition, since last summer, the Bank has been supporting the private sector's efforts to strengthen the medium- to long-term growth potential of Japan's economy through the provision of long-term funds at a low interest rate to financial institutions under the new framework of the Growth Foundation Strengthening Facility (Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth). Financial institutions are now requested not only to meet demand for funds from existing mature firms, but also to actively identify efforts made by newer, growth-oriented firms, making use of the Bank's framework.

Let me share with you one example in which a new business in the lumber industry was established using a lending method called asset-based lending (ABL). It has been pointed out for a long time that one of the structural problems of the lumber industry was a shortage of funds. There seem to be many firms that have abundant inventories of lumber but have a limitation in the amount of lumber that they can process and the amount that they can ship due to cash flow constraints. To deal with this problem, a project team, consisting of a regional financial institution, a furniture manufacturing firm, and a university's laboratory, came up with an idea to use ABL for establishing a new business. Under ABL, a financial institution will take receivables and movable properties that are closely tied to the firm's business cash flow, such as accounts receivable and goods in stock, as collateral for a loan. This lending method, which finds value in corporate activities on their own terms, enables firms that do not own enough real or personal assets to raise the financial resources necessary to run their business.

In order to raise funds through ABL, there is a hurdle to clear. Specifically, the financial institution that adopts this measure, in addition to making collateral assessment of say, accounts receivable and goods in stock upon extension of credit, needs to keep track of subsequent changes in their value in order to manage credit risk. The firm is required to provide this information regularly to the financial institution. In this way, both the financial institution and the firm incur costs in monitoring and providing information, and this is considered to be the crux of ABL. But in this example, the project team treated the cherry wood used for furniture manufacturing as movable property and reduced such costs by attaching an IC tag to the wood to ensure traceability.

This attempt has just started but it deserves attention in that a structural problem of an industry was solved by financial efforts. So far ABL has tended to be perceived with a negative image as a lending facility for small firms with little real estate collateral and insufficient financial resources. As I have stated, however, ABL is a lending facility that can be used for starting up a new business and project financing. If such understanding is more widely shared, ABL has large potential to become a more popular facility without any negative image. The outstanding balance in the Japanese ABL market is still very limited compared to the total size of accounts receivable and goods in stocks of small firms in

Japan and also small relative to the outstanding balance in other advanced countries such as the United States. Going forward, I expect this method to be utilized widely through active cooperation between financial institutions and firms.

Next I would like to introduce an attempt made mainly by regional financial institutions to send *monozukuri* or manufacturing instructors to small firms. "Competitiveness at worksites," or *genbaryoku*, of *monozukuri* proved effective in the process of rebuilding from the earthquake disaster. In order to boost the growth potential of Japan's economy by utilizing this strength, it is necessary to spread to other worksites the know-how of people who worked in the front-runner firms that lead the industry. Also, it is important to pass on the advantages of *genbaryoku* to the next generation. With that in mind, some local governments and universities have been training as *monozukuri* instructors people in their 50's and 60's who have retired from manufacturing firms and sending those instructors to small firms to spread and pass on special techniques to others. In such a process, regional financial institutions play a major role. From the standpoint of small firms, some of them feel reluctant to accept instructors who have built up a long-term career in another firm. However, in cases where regional financial institutions match the right instructor and the right workplace using the trust between institutions and firms that they have been fostering every day, small firms tend to accept instructors much more easily. An example such as this has also been seen in Shiga, Kyoto’s neighboring prefecture.

Due to limited time, I have only touched upon two examples today. But I want to emphasize that, in either of the examples, not only industry, government, and academia but also financial institutions are collaborating and making efforts in their respective roles to boost the productivity and competitiveness of the region. I hope that such steady efforts, together with the accommodative financial environment, will support the enhancement of regions and industries, and consequently spread to Japan's economy as a whole.

**Concluding Remarks**

Kyoto is a special place for me. I was born in Tokyo, but during my childhood I often visited my uncle's house in Kamigamo, Kyoto. He was chief librarian of the Kyoto Prefectural Library at that time. The history and the culture that I saw and experienced at my visits have formed the basis of the way I look at things. Also, when I was in graduate school, I was able to study on the east coast of the United States thanks to a scholarship that had been newly established by a benevolent entrepreneur in Kyoto. It is not too much to say that I am now here today because I have been supported by the culture in Kyoto and the industries that developed in Kyoto.

Culture, or the vernacular wisdom, and industry, or making one's living assiduously, are actually the two most important factors in solving the problems Japan's economy faces. To solve the pressing problem of enhancing Japan's growth potential, which I have been talking about in this speech, it is important that research institutions, private firms, and governments, together with financial institutions, use the wisdom that they have developed from their daily work and make steady progress. In Kyoto, active collaboration between industry, academia, and government is fostered and firms, universities, and the government are closely tied together since firms with advanced techniques and leading universities are based in Kyoto. Financial institutions have also made various efforts to support firms' activities.

Kyoto Chamber of Commerce and Industry is proposing to create a "Wisdom Industry" so as to expand domestic demand by using Kyoto's unique characteristics and strength. Kyoto Prefecture has been promoting the plan to make Kyoto a capital of the Wisdom Industry. The City of Kyoto has established the Center for Integrated Sensible Industry. Kyoto as a whole is promoting "City of Wisdom Industry -- Kyoto."

Kyoto's economic environment is not particularly favorable due to the appreciating yen and aging population profile. However, Kyoto is an attractive city with one of the highest potential abilities in the world as shown by the cutting-edge mentality that produced many venture firms in Kyoto, fine traditions and tourism resources, as well as advanced research institutions. I hope that the latent strengths of the Kyoto economy will become further activated as a center of the Wisdom Industry through the efforts of the people of Kyoto.

Thank you for your kind attention.