June 9, 2012
Bank of Japan

Europe's Economic and Financial Developments and Monetary Policy in Japan

Summary of a Speech at the 77th Meeting of the Society for the Economic Studies of Securities

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I. Introduction

Good afternoon, members of the Society for the Economic Studies of Securities. My name is Sayuri Shirai, and I am a Policy Board member of the Bank of Japan. It is indeed a great honor and a pleasure for me to give a talk at this esteemed society. Today, I would like to focus on Europe, which is the common theme of today's meeting, with the greater emphasis being on the euro area, where developments have shown considerable uncertainty over recent months.

First, let me briefly outline the content of this presentation, which will consist of four parts. I would like to begin by describing recent changes seen in the euro area. Next, I will summarize my view on the fundamental issues facing the euro area. Following that, I will review the region-wide responses to the European sovereign debt crisis. In the final part, I would like to summarize recent economic and price developments in Japan, the impact of the European sovereign debt crisis on the Japanese economy, and Japan's monetary policy and related developments[1]. I very much look forward to a lively discussion with you after my talk.

II. Changes in the Political Situation and Greater Emphasis on Growth—Two Recent Transformations in the Euro Area

As we are all aware, global financial markets have been nervous in recent months following a period of some easing of strains in the first quarter of 2012. I believe that two important changes have been associated with the recent enhanced sensitivity of global financial markets: one is changes in the political situation; the other is growing focus on growth, the interpretation of which appears to be somewhat different from what it was in the past.

Recent Changes in the Political Situation

With regard to political changes, I view the first event in the euro area as having been the collapse of the coalition government in the Netherlands on April 23, 2012. This occurred as a result of disagreement over budget cuts. That dispute emerged because then-Prime Minister Mark Rutte had stressed the need for additional budget cuts in order to meet the 3-percent fiscal deficit target—the common target set by the EU—by 2013. However, his minority coalition partner, the Freedom Party, rejected the proposal and demanded that the target year be postponed. As you are aware, the Netherlands is one of the "core" countries of the EU[2], which are known for having achieved favorable macroeconomic performance

1 The data used in this speech cover the period up to June 6, 2012.

2 Here, I refer to Germany, Austria, the Netherlands, and Finland as the core countries. All these countries enjoy current account surpluses and a very high-grade credit rating on their sovereign bonds.

over a long period. Prior to the global financial crisis of 2008–09, the fiscal balance of the Netherlands had recorded a surplus, and the ratio of sovereign debt to GDP had remained below the EU's 60-percent threshold. Since the crisis, the fiscal balance has shifted to a deficit, with a peak of 5.5 percent of GDP in 2009; however, the Netherlands managed to reduce that to 4.6 percent by 2011. Owing to the continued fiscal deficit, the sovereign debt to GDP ratio has risen to 65.2 percent, though this is well below the euro-area average of 88 percent. Moreover, the Netherlands is, like Japan, a net external creditor nation, thanks to its accumulated current account surpluses—a phenomenon that is in contrast with the "peripheral" countries of the EU. The unemployment rate in the Netherlands is also low at around 5 percent. Therefore, I was genuinely surprised by the news about the political turmoil. This event reminded me that fiscal austerity measures are painful even for the core countries, and the Dutch public felt frustrated about the recession that had continued over three consecutive quarters from July to September 2011 and the resultant rising unemployment rate. On April 26, nonetheless, the Dutch government managed to produce an agreement with some opposition parties on austerity measures worth around €12.4 billion in 2013 to meet the 3-percent target; however, the Dutch general election is scheduled to take place in September.

The next regime change took place in France—the second-largest economy in the euro area—and that event surprised the world. The first round of voting in the presidential election was held on April 22, 2012, in which Mr. François Hollande, the candidate for the Socialist Party, took a lead over Mr. Nicolas Sarkozy, the incumbent president and candidate for the Union for a Popular Movement. During the election campaign, Mr. Hollande promised to renegotiate the terms of the EU Fiscal Compact, which was signed by 25 of the 27 EU member countries in March 2012[3]. Like Mr. Sarkozy, he is also committed to meeting the 3-percent fiscal deficit target in 2013 and subsequently balancing the budget by 2017. Mr. Hollande's plan was to achieve this by, for example, imposing a tax on financial transactions, introducing a 75-percent income tax on earnings above €1 million euros, and raising the corporate tax on the biggest companies to 35 percent, while reducing taxes on small and medium-sized enterprises (SMEs) and scrapping a value-added tax (VAT)

[3] The Fiscal Compact is an intergovernmental treaty signed by all the EU members except the Czech Republic and the United Kingdom on March 2, 2012. The compact is expected to go into force on January 1, 2013 if 12 members of the euro area ratify it by that time. According to the compact, the structural fiscal deficit must not exceed 0.5 percent of GDP, and this fiscal rule has to be specified in each country's national legal system at least at the statutory level, although some deviation may be permitted under exceptional circumstance. The rule contains an automatic correction mechanism in the event of deviation, with a possible penalty equivalent of up to 0.1 percent of GDP. According to the enhanced Stability and Growth Pact, moreover, countries whose sovereign debt exceeds the 60-percent threshold level should reduce it at an average rate of 1/20 per year as a benchmark.

increase proposed by Mr. Sarkozy. Mr. Hollande has also promised to expand public spending by such efforts as raising state spending, reducing the retirement age to 60 years for those having worked more than 41.5 years, hiring 150,000 youths in state-subsidized jobs, and hiring more teachers and police officers. In the second round of presidential voting held on May 6, Mr. Hollande won the first vote and became the country's first socialist president in 17 years. The market now appears to have adopted a wait-and-see attitude before it judges the credibility of his fiscal consolidation plan as well as the fate of the Fiscal Compact.

The biggest political change occurred in Greece after the general election held on May 6, 2012, in which the Panhellenic Socialist Movement (PASOK) and New Democracy (ND)—who had joined in a grand coalition in November 2011 headed by Mr. Lucas Papademos, the former European Central Bank (ECB) vice-president—lost by wide margins. Since no political party won an absolute majority of seats, President Karolos Papoulias attempted to offer successive exploratory mandates to the leaders of the three main parties in accordance with the constitution. However, each party ended up failing to form a government and returning their mandates to the president. After the president had failed in his final attempt to form a government after meeting all party leaders, it was decided that Mr. Panagiotis Pikrammenos, head of the Council of State, would become the leader of a caretaker administration until a new election could take place on June 17. The result of the Greek election intensified the nervousness of markets amid fears that a new government other than PASOK and/or ND could reject the fiscal consolidation and economic reform programs already agreed with the troika—the European Commission, the International Monetary Fund (IMF), and the ECB. Greece would thus fail to receive its scheduled financial support, thereby leading to the collapse of the government administration and a possible exit from the euro area.

Increasing Attention on Growth

Against the background of these political changes, I noticed that a second type of change has occurred in recent months: a number of key policy players have begun to actively use the key word "growth," though in a different context from how it was used in the past. For example, ECB President Mario Draghi stressed the need of a Growth Compact in addition to the already-agreed Fiscal Compact on April 25, 2012. On May 3, he subsequently elaborated the idea of a Growth Compact by proposing the following: (1) an increase in the involvement of the European Investment Bank (EIB) and a redirection of EU structural funds toward the low-income areas; and (2) prioritizing an expenditure cut (especially a cut in current, rather than investment, expenditure) over a tax increase[4].

On May 5, European economics commissioner Olli Rehn made remarks somewhat similar to those of Mr. Draghi and stated that the EU needs to increase public investment to promote growth and jobs in the region. Mr. Rehn said it should do so by creating project bonds for infrastructure development (as proposed by the European Commission in October 2011), increasing the lending capacity of the EIB, and improving accessibility of EU structural funds for guaranteeing lending to SMEs. Mr. Rehn also stressed that, based on economic analysis, the Stability and Growth Pact contains considerable scope for judgment regarding public deficit and debt and also that its legal provisions applied to excessive deficit procedure; he encouraged countries with fiscal surpluses to boost public spending. On May 8, European Commission President Barroso announced a plan to expand infrastructure investment in the EU by, for example, issuing project bonds by June 2012. Regarding the feasibility of a renegotiation of the Fiscal Compact, Mr. Jean-Claude Juncker, head of the Eurogroup, has taken a balanced position between the demand by Mr. Hollande to renegotiate the compact and resistance to this by Ms. Angela Merkel. On May 7, Mr. Juncker declared that it would not be possible to renegotiate the Fiscal Compact, although it would be possible to add growth elements, but not necessarily in the form of a treaty. Reflecting these new moves, EU President Herman Van Rompuy called for an informal European Council (EU summit) to be held on May 23 to discuss the balance between growth and fiscal austerity measures.

EU's Approach to Growth Thus Far

The question emerges as to why the growth agenda has now suddenly become a focus of attention. Does it mean that previously the EU had barely paid attention to the issue? It is clear that the EU has been tackling the issue of promoting growth together with fiscal consolidation over the past few years. As you may recall, for example, the European Council in June 2010 adopted the growth strategy called “Europe 2020,” whereby each member country had to undertake structural reforms toward strong, sustainable recovery. The strategy also targeted EU needs to better focus on boosting Europe’s competitiveness, productivity, growth potential, and economic convergence to deliver more growth and jobs.

[4] This approach over fiscal consolidation has gained some support in recent years. For example, *World Economic Outlook* compiled by the IMF (2010) stresses that fiscal contraction that relies on spending cuts tends to have smaller contractionary effects than tax-based adjustments. This is partly because central banks usually provide substantially greater stimulus following a spending-based contraction than after a tax-based contraction. Monetary stimulus is particularly weak following indirect tax hikes (such as VAT), which raise prices.

Accordingly, five headline targets were agreed to as common objectives for guiding the action of member countries[5].

In line with this approach, the EU introduced a so-called “European Semester” in 2011, whereby each member country submitted a medium-term budgetary strategy and a National Reform Program to the European Commission for assessment. The commission then published a country-specific report on detailed policy recommendations, covering fiscal consolidation and structural reforms. Moreover, the EU introduced the “Macroeconomic Imbalance Procedure (MIP)” in December 2011, which, as the name suggests, is a surveillance mechanism that aims to prevent and correct macroeconomic imbalances within the EU. This alert system uses a “scoreboard” of 10 indicators as well as detailed country studies. Each indicator is given a threshold, so a large divergence in each country’s performance from the threshold functions as a warning signal[6]. As in the original “Excessive Deficit Procedure,” which was applied to the size of fiscal deficits, strict rules come into effect in the event of a large divergence in the form of a new “Excessive Macroeconomic Imbalance Procedure (EIP)”; this carries a possible financial penalty of up to 0.1 percent of GDP for euro-area member countries. The decision-making process in the new regulations will employ reverse qualified majority voting to make all the appropriate relevant judgments before a penalty is introduced. This semi-automatic procedure makes it difficult for member countries to form a blocking majority.

In February 2012, the European Commission disclosed the first Alert Mechanism Report. Of the 27 EU member countries, those that are already under enhanced economic surveillance—Greece, Ireland, Portugal, and Romania—were exempted from examination under the macroeconomic imbalances. The report indicated that 12 countries—Belgium,

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[5] The five targets were as follows: (1) an increase of the employment rate for women and men aged 20–64 to 75 percent; (2) achieving combined public and private R&D investment levels to 3 percent of GDP; (3) reducing greenhouse gas emissions by 20 percent compared with 1990 levels; (4) reducing school drop-out rates to 10 percent and increasing the proportion of the population aged 30–34 having completed tertiary or equivalent education to 40 percent; and (5) promoting social inclusion, particularly by reducing poverty and aiming to lift at least 20 million people out of the risk of poverty and exclusion.

[6] The 10 indicators are divided into two areas: external imbalances and competitiveness, and internal imbalances. The external imbalances and competitiveness comprise the following: (1) three-year average of current account balance as a percent of GDP (with an indicative threshold of between plus 6 percent and minus 4 percent); (2) net international investment position as a percent of GDP (minus 35-percent lower quartile); (3) three-year percentage change in real effective exchange rate (between plus and minus 5 percent); (4) five-year percentage change in export market shares (minus 6-percent lower quartile); and (5) three-year percentage change in export market shares. The internal imbalances comprise the following: (6) year-on-year change in deflated house prices (plus 6-percent upper quartile); (7) private sector credit flow as a percent of GDP (plus 15-percent upper quartile); (8) private-sector debt as a percent of GDP (160-percent upper quartile); (9) general government debt as a percent of GDP (60 percent); and (10) three-year average of the unemployment rate (10 percent).

Bulgaria, Denmark, Spain, France, Italy, Cyprus, Hungary, Slovenia, Finland, Sweden, and the United Kingdom—bore some potential risk related to macroeconomic imbalances and thus warranted further detailed analysis[7]. According to the report, Spain, for example, will take time to correct its external and internal imbalances despite the efforts being made to rectify its imbalances owing to the sheer size of the internal and external debt. It has also been pointed out that a fall in employment linked to downsizing in the construction sector and the economic recession has been aggravated by a sluggish adjustment of wages. At the end of May 2012, the commission confirmed that the 12 countries need to correct the large macroeconomic imbalances and that the adjustment process should be closely monitored.

Background to the Refocus on Growth

Thus, it could be said that greater efforts have been made over recent years at the EU level to boost growth and competitiveness. Why, then, has the question of growth been discussed so intensively over recent months? In general, boosting growth requires the implementation of various structural reforms (Chart 1). And some peripheral countries have only just launched some needed structural reforms and are thus far from being in a position of completing them. The answer to this question may be associated with public anxiety because some reforms may be accompanied by social transformation and short-term economic suffering, such as wage restraints, job losses, and profit losses in protected sectors. Moreover, the public may become frustrated by fiscal austerity measures that end up squeezing domestic absorption and promoting deleveraging of the banking sector in the short term; this is because it takes time to realize long-term gains, such as an improvement in credibility and a cut in long-term interest rates. Furthermore, sluggish growth in the rest of the world has not generated sufficient external demand for the euro area that could offset the shrinkage in domestic demand driven by the collective acts of fiscal consolidation. In addition, it is important to recognize that the context of growth has shifted from improving competitiveness, which could be achieved in the medium to long term, to moderating short-term pains caused by austerity measures implemented during the economic recession.

Various Interpretations Related to Growth

Despite the above reasoning, it is my impression that the word “growth” is interpreted differently from the way it was in the past and by the people employing the term. It appears that there are at least three types of interpretation[8]. According to the first interpretation, the

[7] The report concludes that the following countries do not require a further detailed review: the Czech Republic, Germany, Estonia, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Austria, Poland, and Slovakia.

[8] Other proposals include Eurobonds, which would be issued jointly by euro area member countries by pooling their

EU should expand its region-wide infrastructure investment by issuing project bonds and more actively utilizing EIB and EU structural funds to mitigate the adverse impact of fiscal austerity measures adopted by a number of member countries. The second interpretation holds that the current fiscal consolidation schedule could be slowed down—for example, by extending the target year for fulfilling the 3-percent fiscal deficit goal if the situation allows it[9]. With this interpretation, the better mix of revenue-generating and expenditure-reducing measures is also stressed. According to the third interpretation, structural reforms should be prioritized so as to effect an immediate positive impact on growth and employment. This latter option may help reduce the sense of exhaustion with austerity programs that some countries have experienced.

However, I believe that these interpretations do not rule out the structural reforms needed for boosting growth in each country. Some action has recently been associated with the first interpretation. On May 23, the informal European Council agreed that the board of the EIB would be invited to consider an increase of its capital by June for financing projects across the EU. The previous day, political agreement was also reached by the Council of the EU, European Commission, and Parliament with regard to the pilot phase of the project bonds. Based on the guarantee of €230 million from the EU budget, project bonds could possibly finance up to €4.6 billion of key infrastructure projects in the areas of transport, energy, and communications[10]. The second interpretation, or a moderation of the fiscal consolidation schedule, might be feasible if a country could present a credible medium-term plan. But this may not be possible for some peripheral countries owing to a lack of market confidence. On this issue, the European Commission made an initial move with Spain by suggesting a possible extension of one year on the schedule for meeting the 3-percent fiscal deficit target to 2014—on condition of improved expenditure control over local governments and the submission of a credible two-year budget plan for 2013–14.

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debt. This idea was rejected by Ms. Merkel in 2011, but it was brought up again by Mr. Hollande at the European Council on May 23, 2012. While Eurobonds could be a long-term strategy for integration, Ms. Merkel stressed that they would reduce incentives for countries to contain their fiscal deficits. Recently, the European Commission addressed an idea of a banking union, with integrated financial supervision and a single deposit guarantee scheme. The idea of a uniform deposit guarantee scheme was proposed and rejected by member countries a few years ago. It would appear to require quite some time before this proposal can be agreed upon.

[9] On May 2012, the European Commission suggested, for example, that Spain, France, the Netherlands (the impact of an additional deficit cut agreed at the end of April was not taken into account), Slovenia, and Slovakia might not meet the 3-percent fiscal deficit target unless additional measures were undertaken.

[10] The EIB will manage the project. If the EIB could guarantee the project bonds, more bonds could be issued on the market. Private sector participation would also be expected.

III. Three Fundamental Issues Related to the Euro Area

So far, I have discussed recent changes in the political situation and the increased focus on growth in the euro area. My observation is that those changes reflect deeper fundamental issues pertaining to the region: (1) issues arising from accumulated current account imbalances; (2) issues related to the savings-investment gaps that constitute the current account imbalances; and (3) issues arising from accumulated fiscal imbalances. These issues are of course interconnected, but the distinction may assist in understanding the fundamental problems that the region faces.

Accumulated Current Account Imbalances

Regarding the first fundamental issue, the current account imbalances have expanded in the euro area since the adoption of the euro (Chart 2). Thanks to an elimination of exchange-rate risk and a decline in inflation differentials, peripheral countries—such as Greece, Ireland, Portugal, and Spain—gained access to considerable financial resources from the region at substantially lower interest rates than before. In real terms, their interest rates were lower than those of the core countries. Cheap external finance enabled the peripheral countries to swell their net external debt (Chart 3)[11]. Major financiers to the peripheral countries were largely concentrated in the core countries (with current account surpluses) and France. Since capital inflows to the peripheral countries mostly took the form of bank loans and bond issues, the growing net external debt made those countries more prone to changes in investor sentiment. In retrospect, if those countries had allocated the external financial resources toward more productive investment and investment leading to a shift to higher-value-added economic structure, they could have improved their economic productivity and enhanced international competitiveness. Subsequently, this would have enabled those countries to repay their external debt by gradually shifting to current account surpluses.

Instead, the capital inflows largely financed domestic consumption and the real estate and construction sectors (although this comment does not necessarily fully apply in the case of Ireland, where a number of high-technology multinational firms have been operating). Thus, the foreign borrowing did not promote sustainable economic growth or contain external debt growth (Chart 2). To reduce net external debt, it is necessary to achieve a current account surplus. At this stage, only Ireland, whose current account deficit was initially small,

[11] Italy is not included in this analysis, because its current account to GDP ratio is small and its net external debt to GDP remains below the indicative threshold of 35 percent specified under the macroeconomic imbalance procedure. Its primary fiscal balance is in surplus, although its government debt to GDP ratio is large.

has succeeded in achieving a current account surplus. It is fair to say that the other countries have made efforts to reduce their current account deficits—at the scale of around 5 percentage points or more of GDP in the case of Greece and Spain and 4 percentage points in Portugal during the period of 2007–11. Nonetheless, it will be some time before these three countries could achieve current account surpluses, and so their net external debt is unlikely to decline soon. In other words, the external imbalance on a stock (debt) basis will remain for the time being. Meanwhile, among the core countries, Finland reduced its current account surplus to GDP ratio by 5 percentage points over the same period, though Germany, Austria, and the Netherlands barely reduced their current account surpluses. In particular, the current account surplus to GDP ratio remains high in Austria (around 2 percent), Germany (around 5 percent), and the Netherlands (over 7.5 percent). This enables these core countries to further accumulate their net external assets. In other words, the surplus countries have continued to accumulate net external assets, and the deficit countries net external debt—despite some emerging improvements over the current account imbalances in the euro area (Chart 3). I believe that this partly explains why the debtor peripheral countries currently find it difficult to resume adequate private-sector-based capital inflows despite their adjustment efforts.

Growing Savings-Investment Gaps

With respect to the second issue listed above—savings-investment gaps—the savings–GDP ratio (hereafter, saving rate) showed a declining trend in the four peripheral countries before the global financial crisis. The scale of the decrease was greatest in Greece followed by Portugal (Chart 4). It could be said that Greece and Portugal allocated a large part of their capital inflows to both private and public consumption (such as public pay, pensions, and medical care). Owing to the tendency for Germany to increase the saving rate, the current account imbalances between Greece and Portugal, on the one hand, and Germany, on the other, could be explained primarily by the difference in saving-rate patterns. However, the saving rates of Ireland and Spain were not very different from that of Germany: Ireland and Spain increased the investment-GDP ratios (hereafter, investment rates), while that of Germany remained at a low level. Thus, the current account imbalances between Ireland and Spain, on the one hand, and Germany on the other, could be attributed largely to the difference in investment patterns (Chart 5). An increase in the two countries' investment rates reflected a boom in real estate and construction investment. It is a well-known fact that those two countries underwent rapid real estate price appreciation prior to the global financial crisis.

Since the global financial crisis erupted, all four peripheral countries have faced a decline in their saving rates. This implies that the improvement in the current account balances, as indicated earlier, arose solely through a sharp decrease in the investment rates. This was particularly the case in Ireland, where the drop in real estate prices was more drastic than in Spain and which experienced the sharpest decline in the investment rate. However, the decline in the investment rates for the other three countries has also been great. Given that the four peripheral countries have suffered from a substantial fall in investment, it is understandable that the idea of expanding EU-wide infrastructure-investment projects to offset the adverse impact of austerity measures has been widely stressed recently, as noted earlier.

Growing Fiscal Imbalances

On the third fundamental issue listed above—that related to accumulated fiscal imbalances—Greece was the only country where the size of the fiscal deficit was large and whose general government debt as a share of GDP exceeded 100 percent even before the global financial crisis (Charts 6, 7). In Ireland and Spain, the ratio of general government debt to GDP remained below the 60-percent target thanks to their accumulated fiscal surpluses. Portugal had been poised to bring its fiscal deficit–GDP ratio down toward the 3-percent target prior to the global financial crisis, and so its general government debt–GDP ratio remained at around 70 percent.

Since the global financial crisis, the fiscal balances of most euro-area countries have deteriorated because of the implementation of fiscal-stimulus policies and measures to bail out the banking sector. The size of deterioration of the fiscal balance between 2007 and 2011 reached minus 2.6 percentage points in Greece, minus 13.2 percentage points in Ireland, minus 1.1 percentage points in Portugal, and minus 10.4 percentage points in Spain. By contrast, the deterioration in Germany's fiscal deficit–GDP ratio was a mere 1.2 percentage points over the same period, which contributed to the widening gap in fiscal balances in the euro area. Moreover, Germany's fiscal deficit–GDP ratio is already below the 3-percent target and, according to the European Commission, the ratio is projected to drop to around 1 percent in 2012 and reach a balance by 2013. Germany achieved more than 3 percent economic growth for 2010–11, and its unemployment rate dropped to a historical low of 5.6 percent. These favorable outcomes have helped Germany conduct fiscal consolidation without having to introduce drastic measures to cut its fiscal deficit.

Meanwhile, the peripheral countries are obliged to contain their fiscal deficits further to prevent overall government debt from swelling. Since Germany faces a decline in the ratio of general government debt to GDP in the near future, this means that the internal imbalances on a stock (debt) basis are likely to expand in the region.

IV. Assistance at the EU or Euro-Area Level

Given this background, the peripheral countries, rather than the core countries, are expected to make greater economic adjustments, such as fiscal consolidation and structural reforms. Some of these reforms will take time and cause hardship before they bear fruit. To mitigate the adverse impact of the adjustments, financial assistance at the EU or euro-area level is necessary. This is especially true for the peripheral countries because of their lack of private-sector capital flows. Without regional or international financial support, such countries would have been forced to squeeze domestic absorption so drastically that the public would have had to go through intolerable suffering—notwithstanding that a correction could have been made more rapidly for both the internal and external imbalances.

First Recipient of International Financial Assistance—Greece

As is well known, Greece was the first country in the euro area to receive international financial assistance. The total amount was set at €110 billion in the first round of assistance, which was agreed to be shared between the euro-area member countries (€80 billion) and the IMF (€30 billion). Since the general government debt for Greece had been growing rapidly, the idea of private-sector involvement (PSI) gained favor in the euro area. After negotiations, a large number of private sector creditors finally agreed to voluntarily accept restructuring of the Greek debt. This PSI took place before the completion of the first round of financial assistance scheduled for Greece and was regarded as a precondition for the second round of financial assistance[12]. The total amount for the second round of assistance was set at €172.7 billion, including undisbursed amounts from the first program. The cost was agreed to be borne by the euro area (€144.7 billion) mainly through the platform of the European Financial Stability Facility (EFSF) and the IMF (€28 billion). The contribution from the euro area included the amount related to the PSI incentive and bank recapitalization.

[12] The PSI ended up covering €205.6 billion, including both Greek and foreign law sovereign bonds, and the rate of participation reached 97 percent as of the end of April 2012 as a result of applying collective action procedures to the Greek law bonds. With the PSI and additional international financial assistance, Greece's general government debt ratio is expected to decline to below 120 percent of GDP by 2020.

Newly Established Financial Support System in the Euro Area

It will be recalled that the Greek sovereign debt crisis had a contagious effect on other peripheral countries such as Ireland and Portugal. As a result of the contagion, these countries found it difficult to raise funds in the market and thus asked the EU, the euro area, and the IMF for financial support—in November 2010 in the case of Ireland and in May 2011 in the case of Portugal[13]. The EFSF was established by the euro area following the decisions made in May 2010, and it began operations in August 2010. It is backed by guarantee commitments of €780 billion from the member countries and has a lending capacity of €440 billion. In November 2011, furthermore, it was agreed to increase the EFSF's power by (1) providing partial protection certificates to a sovereign bond issued by member countries, and (2) creating a coinvestment fund to purchase sovereign bonds in primary and secondary markets.

To prevent contagion of the sovereign debt crisis to other larger member countries, the euro area decided to create a permanent crisis mechanism called the European Stability Mechanism (ESM). The ESM, which will become operational in July 2012, will take over all the features of the EFSF and have a maximum lending capacity of €500 billion, based on the paid-up capital of €80 billion. Both the EFSF and ESM will coexist until the EFSF expires in mid-2012. The new treaty to create the ESM was signed in February 2012. The decisions to grant stability support are generally taken by mutual agreement, but in the case of urgency they could be decided by a qualified majority of 85 percent of the votes cast. In addition, the IMF has made efforts to raise funds globally in an effort to establish sufficient power to be able to deal with a potentially contagious crisis arising from Europe. At the G20 summit of April 2012, the IMF announced that it had raised more than $430 billion, including contributions from the euro area ($200 billion) and Japan ($60 billion). Although not all of the IMF funds will be available to Europe, it certainly reduces uncertainty related to the issue of how to handle larger countries, such as Italy and Spain, in the case of contagion.

ECB Monetary Policy as a Crisis Response

In response to the recent sovereign debt crisis, the ECB has adopted a series of measures

[13] The amount of financial assistance for Ireland amounted to €67.5 billion, which was received from the EFSF (€17.7 billion), *European Financial Stabilization Mechanism* (EFSM; €22.5 billion), and IMF (€22.5 billion), and included bilateral assistance from the United Kingdom, Denmark, and Sweden (€4.8 billion). The assistance for Portugal amounted to €78 billion, from the EFSF (€26 billion), ESM (€26 billion), and IMF (€26 billion). The EFSM is a financing facility for EU member countries with a lending capacity up to €60 billion based on borrowing on the market by the European Commission.

since the middle of 2011. After having raised its policy rate or the interest rate on the main refinancing operations from 1 percent to 1.5 percent by raising 25 basis points each in April and July 2011, the ECB reduced the rate back to 1 percent by cutting 25 basis points each in November and December. Other recent measures included US dollar liquidity-providing operations, a cut in the reserve ratio, a modification of collateral requirements, fixed-rate longer-term refinancing operations (LTROs) with full allotment, a securities market program, and a covered-bond purchase program.

Among these measures, two notably appear to have contributed substantially to the stabilization of global financial markets: (1) the US dollar liquidity-providing operations, and (2) the LTROs with a maturity of 36 months. The ECB has been conducting US dollar liquidity-providing operations as part of coordinated actions with five other central banks to address pressures in the global money markets: namely, the Bank of Canada, the Bank of England, the Bank of Japan, the Federal Reserve, and the Swiss National Bank (Chart 8). The new action emerged in November 2011 as a response to the growing strains in US dollar financial markets. These central banks agreed to lower the pricing on the existing temporary US dollar liquidity swap arrangements by 50 basis points so that the new rate would be the US dollar Overnight Index Swap rate plus 50 basis points. At the same time, it was agreed that these swap arrangements would be extended to February 1, 2013. As a contingency measure, these central banks agreed to establish temporary bilateral liquidity swap arrangements so that liquidity could be provided in each jurisdiction in any of their currencies if necessitated by market conditions. In particular, the cut in the interest rate on the US dollar liquidity-providing operations succeeded in substantially lowering the cost of swapping euros for US dollars (Chart 9). Furthermore, the decline in the US dollar funding cost encouraged many European banks having difficulty in raising funds from the market to borrow directly from the ECB, thereby preventing forced fire sales of assets and a cut in loans denominated in the US dollar.

The second measure contributing to the stabilization of the financial market was the LTROs with a maturity of 36 months, which were conducted on December 21, 2011 and February 28, 2012. On December 8, 2011, the ECB decided to reduce the reserve ratio and modify collateral requirements together with an announcement of the three-year LTROs. The reserve ratio was reduced from 2 to 1 percent as of the reserve maintenance period, starting on January 18, 2012. To increase collateral availability, the ECB decided to reduce the credit-rating threshold for certain asset-backed securities and, as a temporary solution, allow national central banks to accept as collateral additional performing credit claims (i.e., bank loans) that satisfied specific eligibility criteria. In allowing the application for the three-year LTROs, the modification of the collateral requirements can be regarded as having contributed to easing the funding situation of European banks caused by the shortage of eligible collateral. As a result, the LTROs succeeded not only in lowering the euro-denominated funding costs in the money markets, but also bringing down the spread of the yields on Portuguese, Spanish, and Italian sovereign bonds vis-à-vis German bonds. In addition, the LTROs helped promote the issuance of senior unsecured bank bonds (Charts 10–13). Thus, it is widely regarded that the LTROs prevented a bank funding crisis and thus deleveraging on a massive scale.

Recent Developments in Financial Markets

Since uncertainty over European political and economic developments has intensified over recent months, some interest rates have risen accordingly. Nonetheless, the scale of the increase in the US dollar funding cost borne by European banks, for example, has so far been modest compared with the situation prior to the new arrangement related to the US dollar liquidity-providing operations at the end of November 2011 (Chart 9). Likewise, the euro-denominated funding cost in money markets has remained calm (Charts 10, 11). Meanwhile, the spreads of the yields on Portuguese, Spanish, and Italian sovereign bonds vis-à-vis German bonds have risen, as has the Greek spread; this was partly owing to the decline to the record low level of the yield on German sovereign bonds (Chart 13). The Spanish banking sector faces a surge in the credit spread over its financial bonds, which reflects recent growing concerns over the soundness of that banking sector (Chart 14). Stock prices are generally showing declining trends as a reflection of European sovereign debt problems and concerns over the global economic slowdown (Chart 15). Given the sensitivity of market developments, I will continue to watch closely the impact of European political and economic developments on global financial markets.

V. Impact of European Sovereign Debt Problems on the Japanese Economy and Monetary Policy of the Bank of Japan (the Bank)

I would now like to move to the final part of my presentation, and I will begin by summarizing recent economic and price developments.

Outlook on Economic Activities and Prices with Risk Factors

Recently, it has become increasingly evident that the Japanese economy is shifting toward a pick-up phase, although economic activity has remained more or less flat (Chart 16). With regard to outlook, the Japanese economy is expected to return to a moderate recovery path in the first half of fiscal 2012. This is likely since the pace of recovery in overseas economies should gradually improve—led largely by the emerging economies and reconstruction-related domestic demand in the post-Great East Japan Earthquake period. In fiscal 2013, Japan's economy is expected to maintain its growth at a pace above its potential as overseas economies continue to achieve relatively high growth. However, the economic growth rate is expected to be somewhat lower than in fiscal 2012 because the positive effects from reconstruction-related domestic demand are likely to gradually diminish (Chart 17).

With regard to prices, developments in the consumer price index (CPI; all items less fresh food) indicate that after reaching a historical trough of 2.4 percent in August 2009, the year-on-year rate of decline has continued to slow consistently since around the end of 2009. In recent months, that rate of change has been around 0 percent. In terms of the outlook for prices, the rate of change will remain in positive territory and show a gradual increase as the aggregate supply and demand balance is expected to continue improving with the moderate recovery. International commodity prices are currently bearish, partly reflecting concerns over the European sovereign debt problems; though these prices may follow a moderately rising trend owing to an expected increase in demand for food and energy in line with the growth in emerging economies. Assuming that medium- to long-term inflation expectations remain stable, the rate of change in the CPI is projected to gradually rise to a range of above 0.5 percent and less than 1 percent toward the second half of fiscal 2013. Thereafter, it will likely not be too long before the rate reaches the "price-stability goal in the medium to long term" of 1 percent for the time being, as specified in the statement released by the Bank of Japan (hereafter, Bank) in February 2012.

The aforementioned outlook is the scenario the Bank considers to be the most probable: it is, in other words, its baseline scenario. As described in detail in the *Outlook for Economic Activity and Prices*, or the Outlook Report for short, the following four major risks concerning the outlook for economic activity warrant attention: (1) uncertainty related to developments in overseas economies; (2) uncertainty with regard to reconstruction-related domestic demand; (3) uncertainty associated with firms' and households' medium- to long-term growth expectations; and (4) issues related to Japan's fiscal sustainability. Among those risks, I personally am particularly mindful of those relating to adverse spillovers of the European sovereign debt issues and political developments to the baseline scenario.

There are mainly two types of price-associated risks. The first type concerns developments in firms' and households' medium- to long-term inflation expectations; the second type relates to developments in import prices. With this second type, the possibility exists that crude oil prices will surge, mainly as a reflection of geopolitical risk. If that does occur, Japan's terms of trade will experience deterioration, which will squeeze firms' profits and reduce households' purchasing power, and ultimately it will have an adverse effect on the whole Japanese economy.

Impact of European Sovereign Debt Problems on the Japanese Economy

Concerning European sovereign debt problems, the impact can be ascertained mainly by means of three channels—international trade, finance, and exchange rates. With international trade, it would seem that the direct impact on Japan's exports has been limited, given that exports to the euro area account for only around 10 percent (Chart 18). Rather, a more significant impact could be felt indirectly through a slowdown in trade and foreign direct investment activities in emerging countries, such as China, where the euro area represents one of the largest trade partners (Charts 19, 20).

With regard to finance, the US dollar funding market and money markets remain calm. The US dollar funding cost remains low for Japanese banks since their exposure to the euro area has been limited and their balance sheets have been relatively sound. It is true, though, that Japanese banks faced a moderate increase in US dollar funding costs in the middle of the deepening European sovereign debt crisis from the middle of 2011. After the introduction of the new coordinated arrangement of the six central banks at the end of November, however, the US dollar funding market has remained calm, especially for Japanese banks (Chart 21). Money markets have also been relaxed (Chart 22). Long-term yields on Japanese government bonds (JGBs) have shown further deceleration thanks to increased demand for them as safer assets (Chart 23). Like European stocks, nonetheless, Japanese stocks are in decline (Chart 24).

The direct impact of the European sovereign debt crisis has been felt mainly through exchange rates. Because of its current status as a safer currency, the yen tends to appreciate with intensifying strains in global financial markets (Chart 25). This suggests that changes in the risk-taking behavior of global investors have become closely associated with movements in exchange rates. Recent movements have shown that enhanced nervousness in global financial markets caused by resurgence of the European debt crisis has increased risk aversion among global investors and promoted the yen's appreciation relative to mid-March this year. The yen has appreciated against the euro, partly because of the reversed interest rate differentials between German and Japanese bond yields with a remaining maturity of less than two years. If sustained, the yen's appreciation may be detrimental to Japanese firms, adversely affecting their investment and production behavior and making it harder for the Japanese economy to recover. This perspective also makes me feel that developments in Europe demand careful attention.

Conduct of Monetary Policy

The Bank is naturally concerned about the long-term prevalence of deflation in the Japanese economy. On February 14 of this year, the Bank introduced "the price-stability goal in the medium to long term"—defined as the inflation rate consistent with price stability sustainable over the medium to long term. The purpose of this action was to promote public understanding of the Bank's determination to overcome deflation. It was decided that the goal would be within a positive range of 2 percent or lower in terms of the year-on-year rate of change in the CPI, and the goal was set at 1 percent for the time being. Moreover, the Bank made it clear that it would continue pursuing powerful monetary easing—through its virtually zero-interest rate policy and continued implementation of the Asset Purchase Program (hereafter, Program)—until it judged the 1-percent goal to be within sight; this was on condition that it identified no significant risk to the sustainability of economic growth, including from the accumulation of financial imbalances. At the same time, the total size of the Program was raised by 10 trillion yen—from about 55 trillion to about 65 trillion yen (Chart 26).

On April 27, the Bank decided to increase the total size of the Program further by about 5 trillion yen—from about 65 trillion to about 70 trillion yen—following changes in its composition, including the increase in the purchase of JGBs by about 10 trillion yen[14].

[14] Moreover, the purchases of exchange-traded funds and Japan real estate investment trusts were increased by about 200 billion yen and 10 billion yen, respectively. The maximum outstanding amount of the Bank's fixed-rate funds-supplying operation against pooled collateral with a six-month term was reduced by about 5 trillion yen, taking into account the recent episodes of under-subscription. In addition, the remaining maturity of JGBs to be purchased under the Program was extended from one to two years to one to three years. The same treatment was applied to the remaining maturity of corporate bonds to be purchased under the Program. In addition, it was decided that the schedule for increasing the outstanding amount of the Program to about 65 trillion yen by around the end of 2012 would be maintained. It was further decided to increase the outstanding amount of the Program to about 70 trillion yen by around the end of June 2013.

Regarding the decision to enhance monetary easing in April, I would like to stress that a high degree of uncertainty remains in terms of the Bank's assessment, as already explained. The positive signs in economic and price developments that have emerged in recent months do not necessarily imply that the baseline scenario will be realized as projected. Even though the scenario may eventually materialize, it is still not certain how soon it may do so. Considering recent episodes, for example, there were some cases of the baseline scenario not having been fulfilled, even though the economy appeared to be on the track of sustainable economic growth and prices also initially appeared to be rising steadily. Therefore, the Bank decided to seize this occasion and further enhance monetary easing to better ensure the return of the Japanese economy to sustainable growth with price stability. As explained above, I believe this action also demonstrates the Bank's determination to implement its monetary policy commitment.

Tackling the Long-Term Structural Challenge

Finally, I would like to address an issue commonly faced by a number of major central banks in advanced countries and regions: the extremely accommodative monetary environment has not necessarily led to increased domestic demand, such as investment and consumption, as much as had been expected (Chart 27). Though there are structural factors relating to this issue, their root causes are country- or region-specific and thus different from each other.

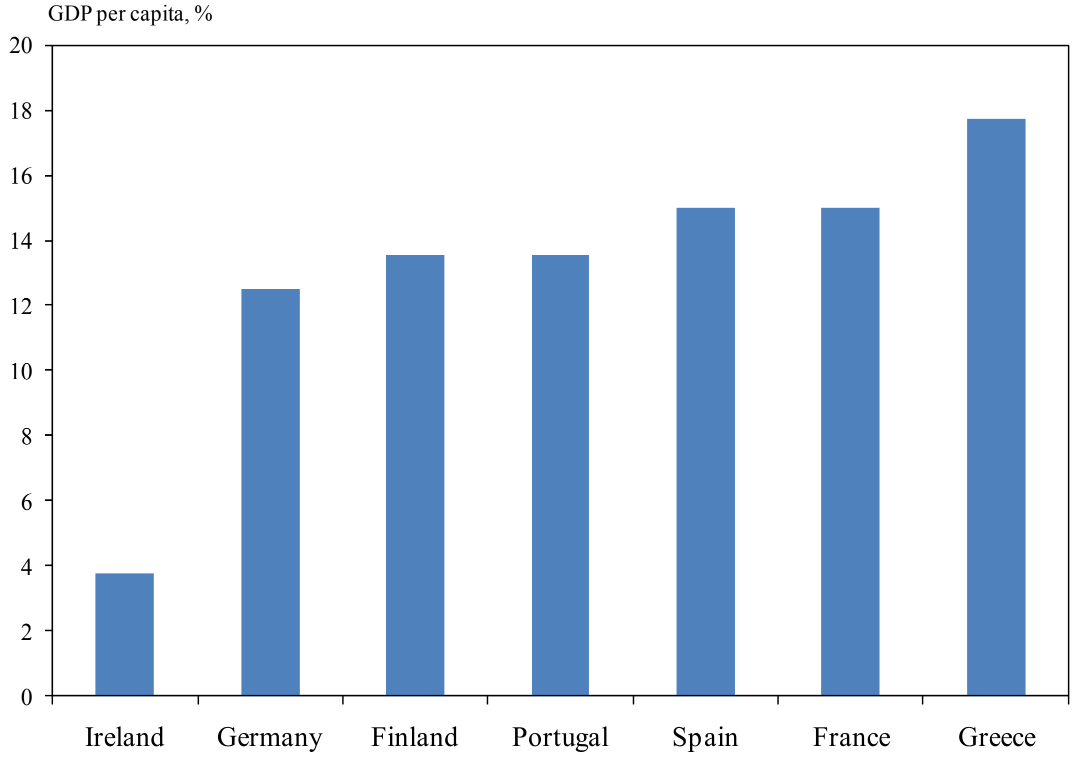
In the case of Europe, the short-term depressing impact of the fiscal austerity measures and deleveraging of the banking sector, as explained earlier, make it difficult to increase bank lending for the moment. It is likely to be some time before the region starts to enjoy sustainable, favorable growth in lending activities. In the case of Japan, the working-age population has been in decline since the mid-1990s, and this has contributed to the decreasing trend in growth rates. To overcome deflation, it is thus important to stress the need to address Japan's long-term structural challenges of diminishing growth rates amid a rapidly aging population. It is clear that we need to enhance productivity growth (of the working-age population) so as to overcome the depressing impact caused by the rapid pace of the decrease in the population and working-age population growth rates. However, it may be said that implementation of the necessary structural reforms for boosting growth and productivity has been sluggish, and the shift in economic structure has been limited. Issues related to mounting government debt and social security reforms have generated uncertainty over the future economic outlook. Moreover, a series of shocks—such as the global financial crisis, the Great East Japan Earthquake, the European sovereign debt crisis, and the 2011 Thai floods—also contributed to this outlook. These factors combined to deter expectations of further rises in growth by firms and households despite a very accommodative financial environment driven by monetary stimulus measures.

To meet the diverse challenges that arise out of this background and establish a new basis for economic growth, Japanese firms need to become more innovative and competitive in an effort to add value to their activities and explore new sources of demand, both at home and abroad. The government also needs to support the business community by creating a more business-friendly environment. Financial institutions should strive toward strengthening the foundations for economic growth by giving financial support to innovative, viable firms and providing new types of financial and other services, which are increasingly under demand. Meanwhile, the Bank's accommodative monetary policy will certainly shore up such private-sector activities through a steady decline in the cost of raising capital. By promoting longer-term economic growth, the Bank has helped sustain the business community indirectly: it introduced a fund-provisioning measure to help reinforce the basis for economic growth (Growth-Supporting Funding Facility) in 2010, and it has provided longer-term fixed-rate funds to financial institutions. This facility was expanded in March and April of this year (Chart 28). It should be emphasized that the goal of overcoming deflation will be achieved through such continuous, comprehensive efforts by firms, financial institutions, the government, and the Bank operating within their respective roles.

In conclusion, I would like to express once more my gratitude to the Society for the Economic Studies of Securities for giving me this wonderful opportunity to make a presentation in front of its distinguished members. Thank you very much for your kind attention. And I wish you all every success in your work and further development in the Society.

Chart 1

Potential Gains from the Reform Package

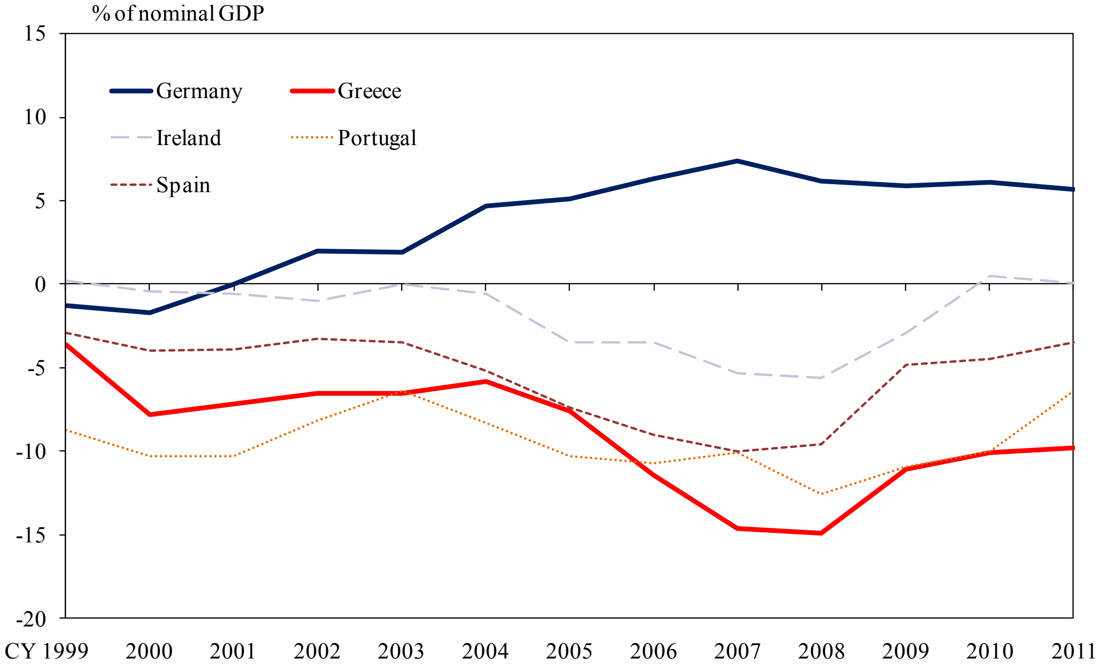


Note: The estimated cumulative GDP impact from structural reforms for ten years.

Source: OECD, “Economic Survey of the Euro Area 2012.”

Chart 2

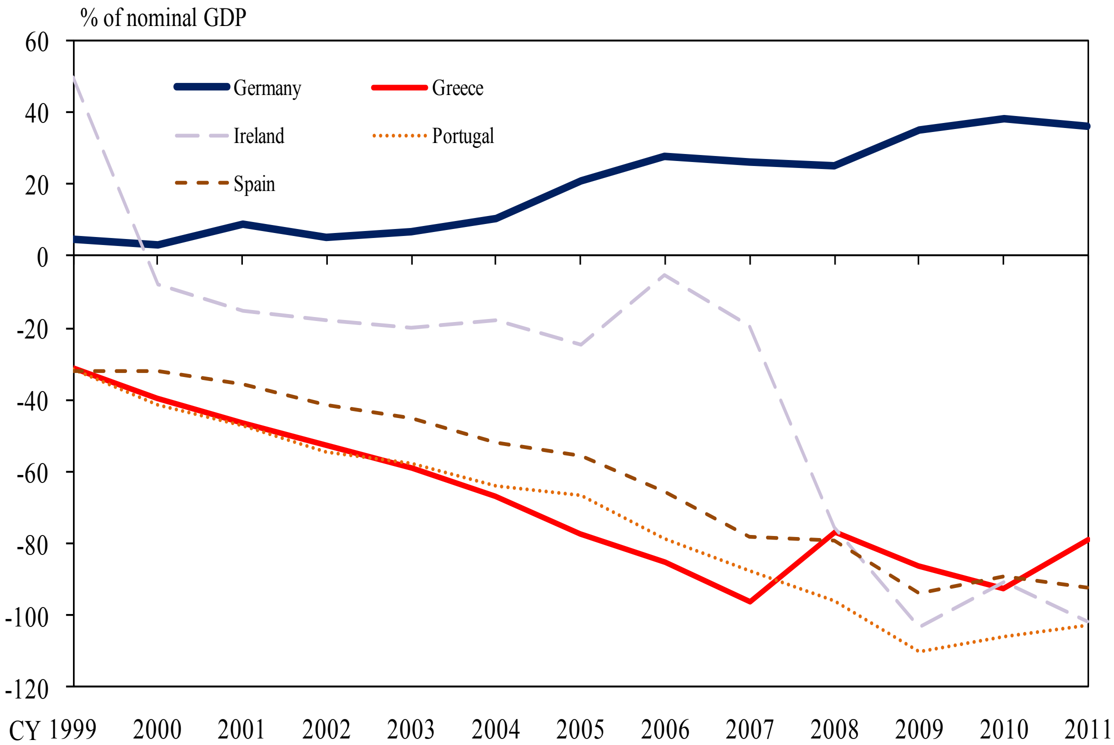
Current Account Balance



Source: Eurostat.

Chart 3

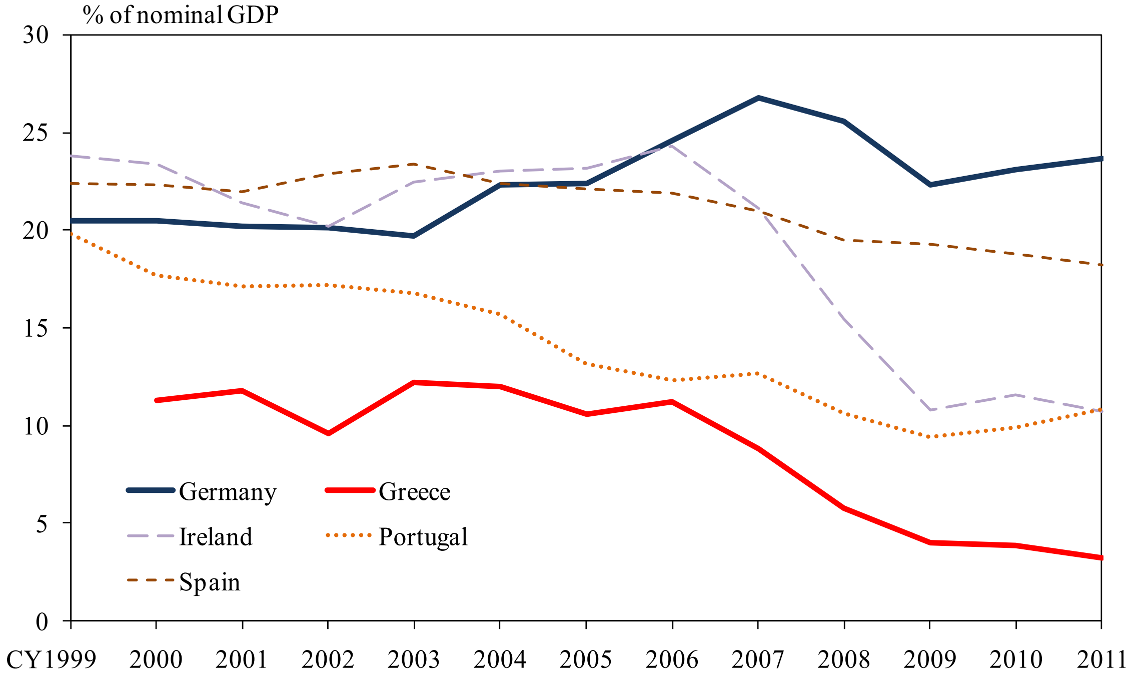
Net International Investment Position



Source: Eurostat.

Chart 4

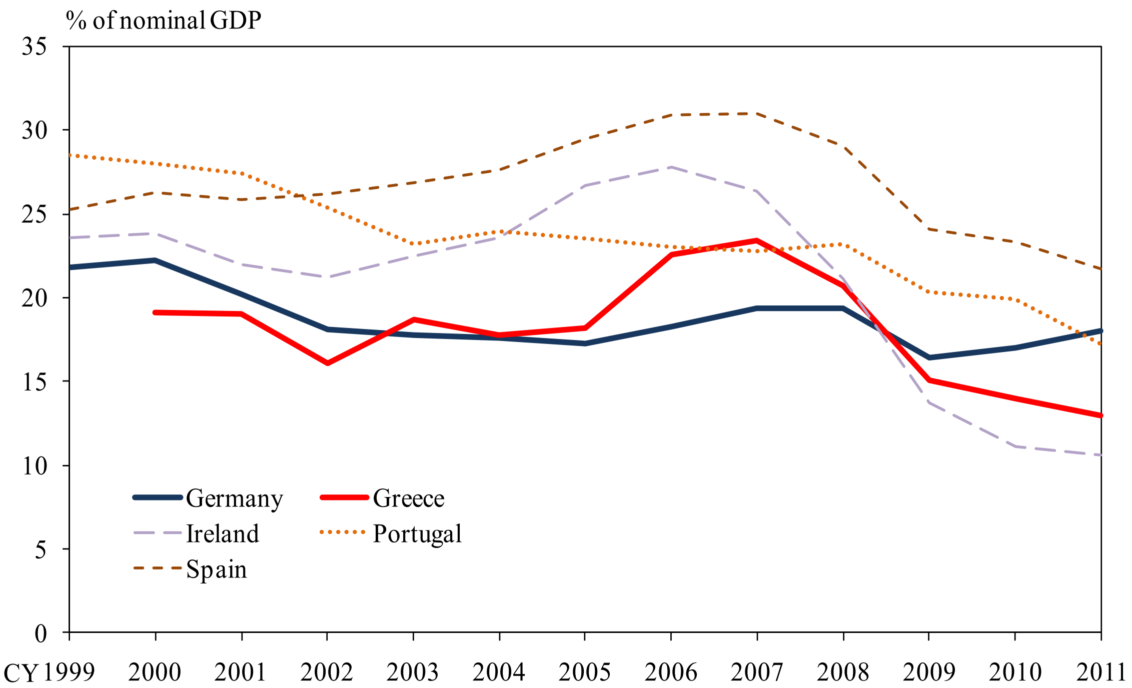
National Saving Rate



Source: Eurostat.

Chart 5

National Investment Rate

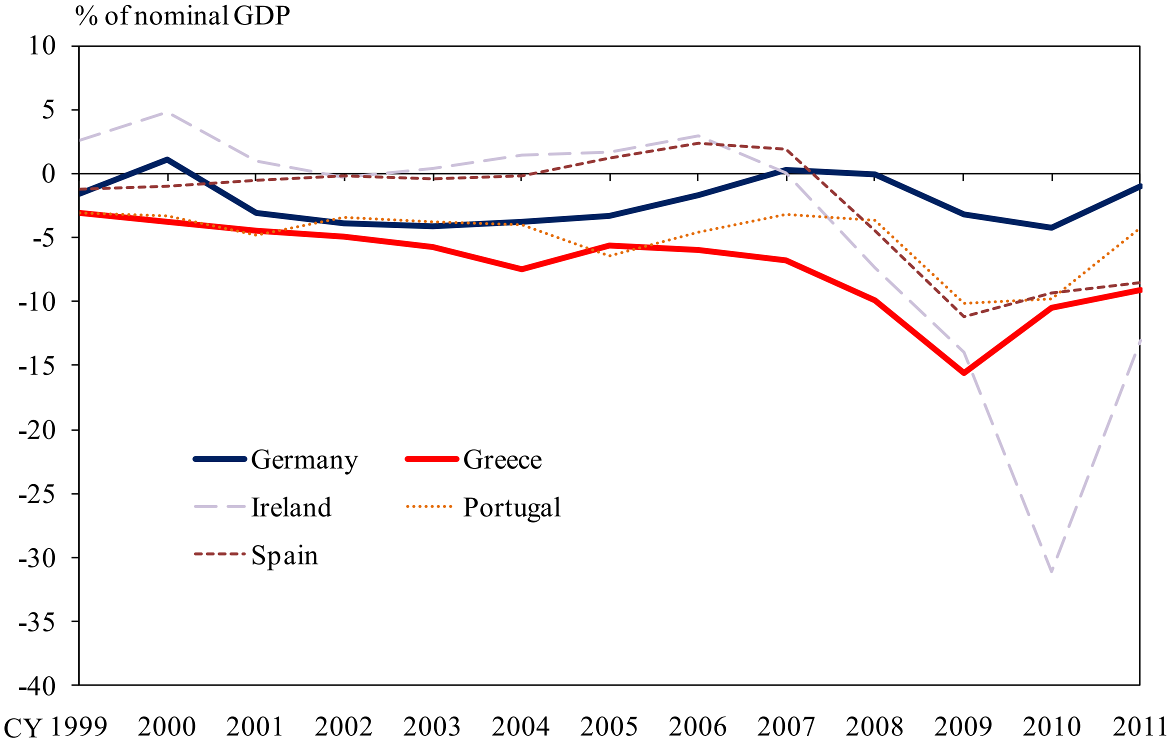


Note: National investment (gross) = national saving (gross) - current account balance.

Source: Eurostat.

Chart 6

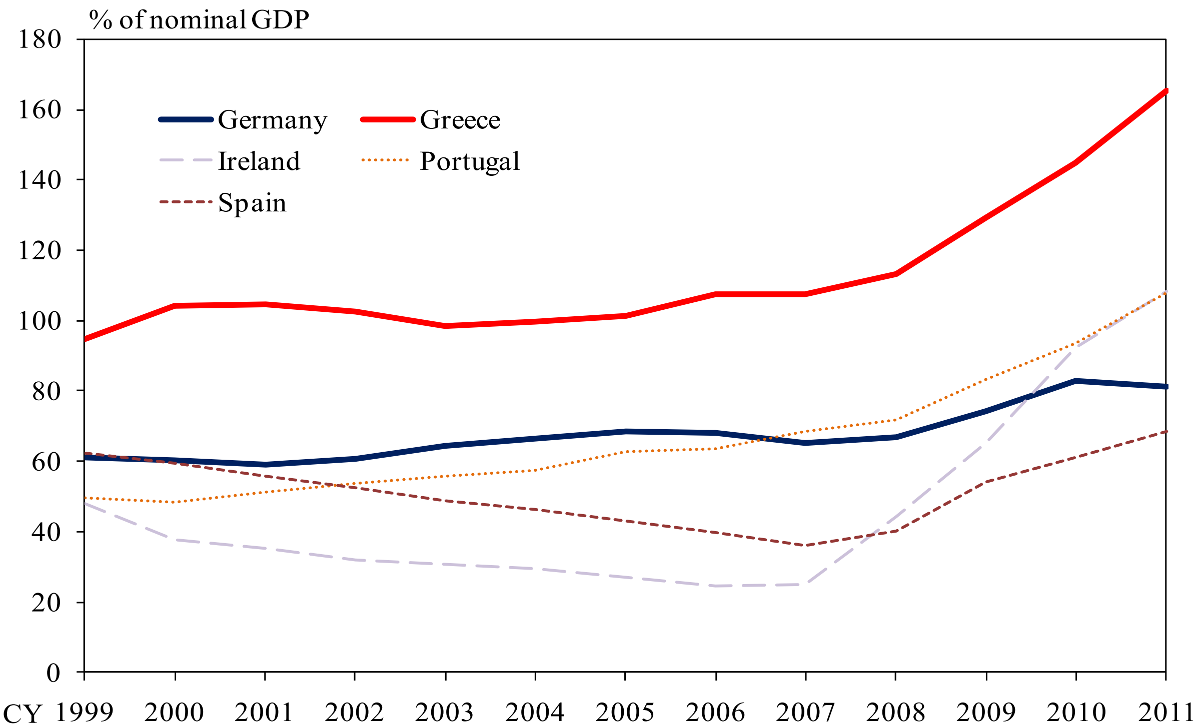
Fiscal Balance



Source: Eurostat.

Chart 7

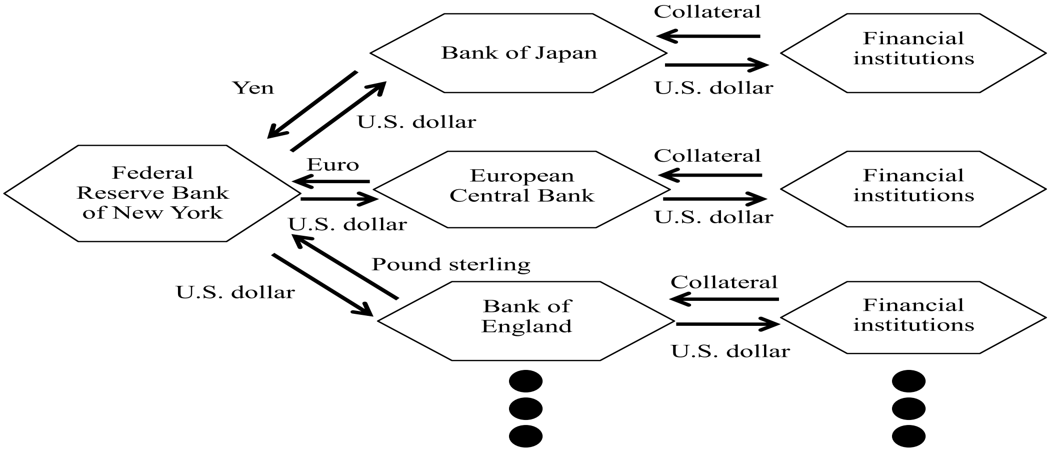
Government Debt



Source: Eurostat.

Chart 8

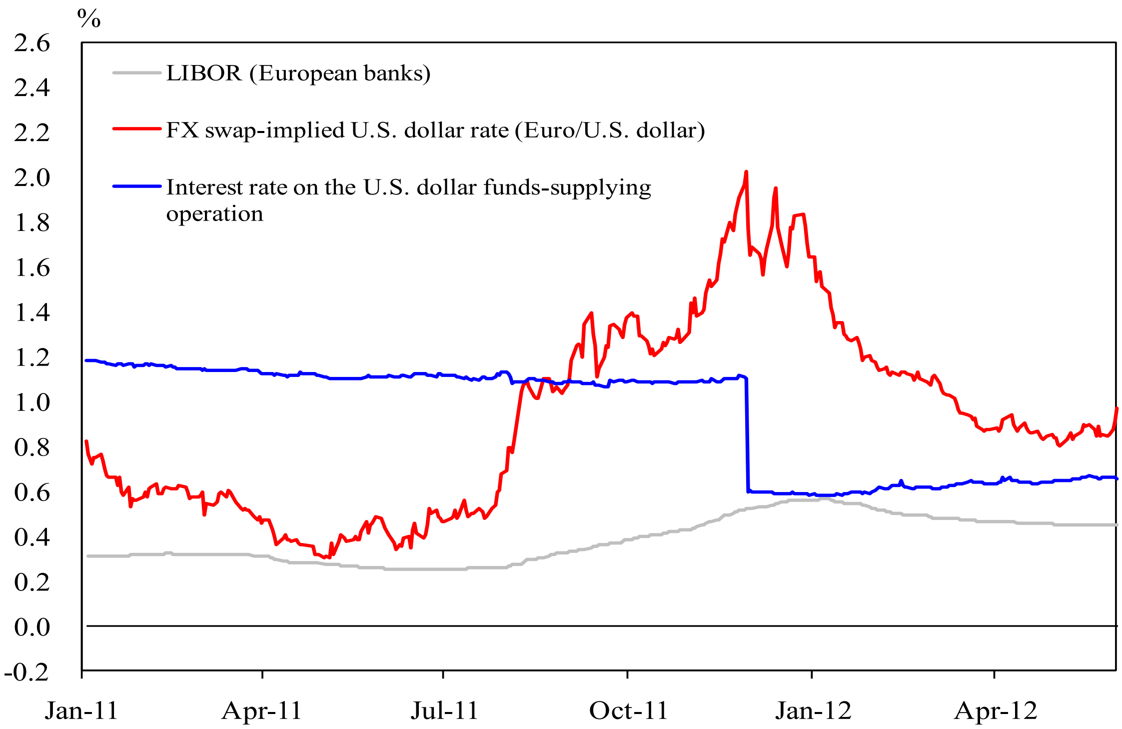
Basic Scheme of U.S. Dollar Funds-Supplying Operations



- A coordinated measure among six central banks in the United States, Japan, the United Kingdom, Europe, Switzerland, and Canada.
- Introduced in September 2008 immediately after the Lehman shock and ended in February 2010.
- Reestablished in May 2010 in response to the increased strains in U.S. dollar short-term funding markets in Europe.
- On September 15, four central banks in the United Kingdom, Europe, Switzerland, and Japan announced the conduct of U.S. dollar liquidity-providing operations.
- On November 30, six central banks agreed to lower the pricing on this operation by 50 basis points.

Chart 9

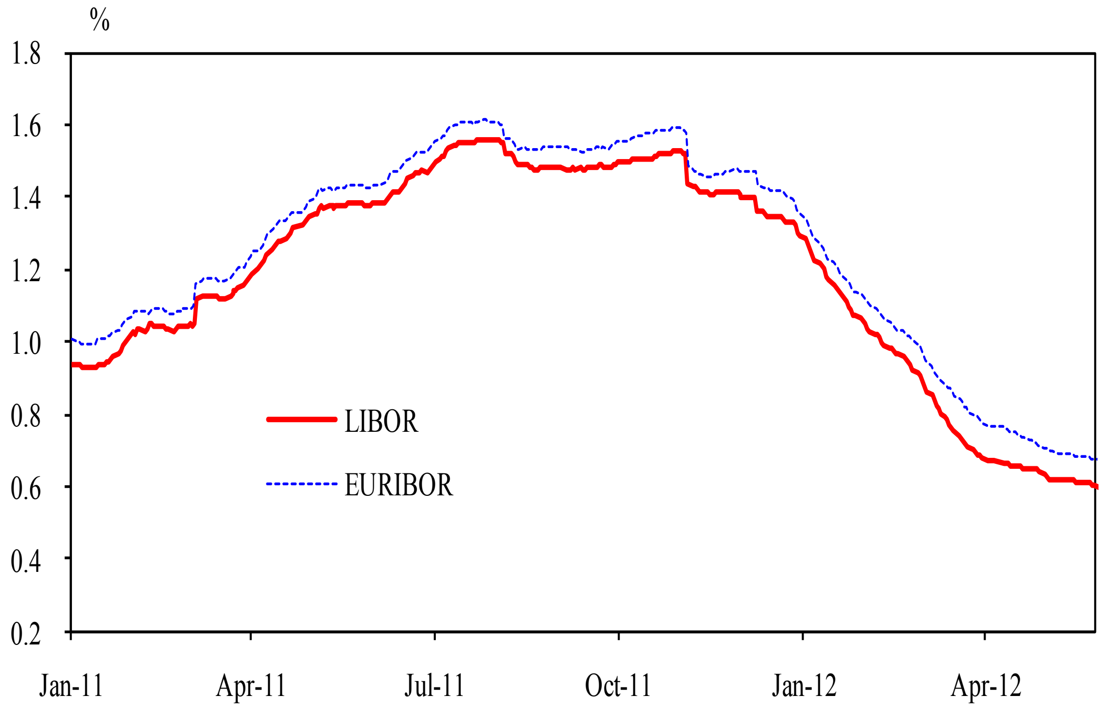
European Banks' U.S. Dollar Funding Costs (3-Month)



Source: Bloomberg.

Chart 10

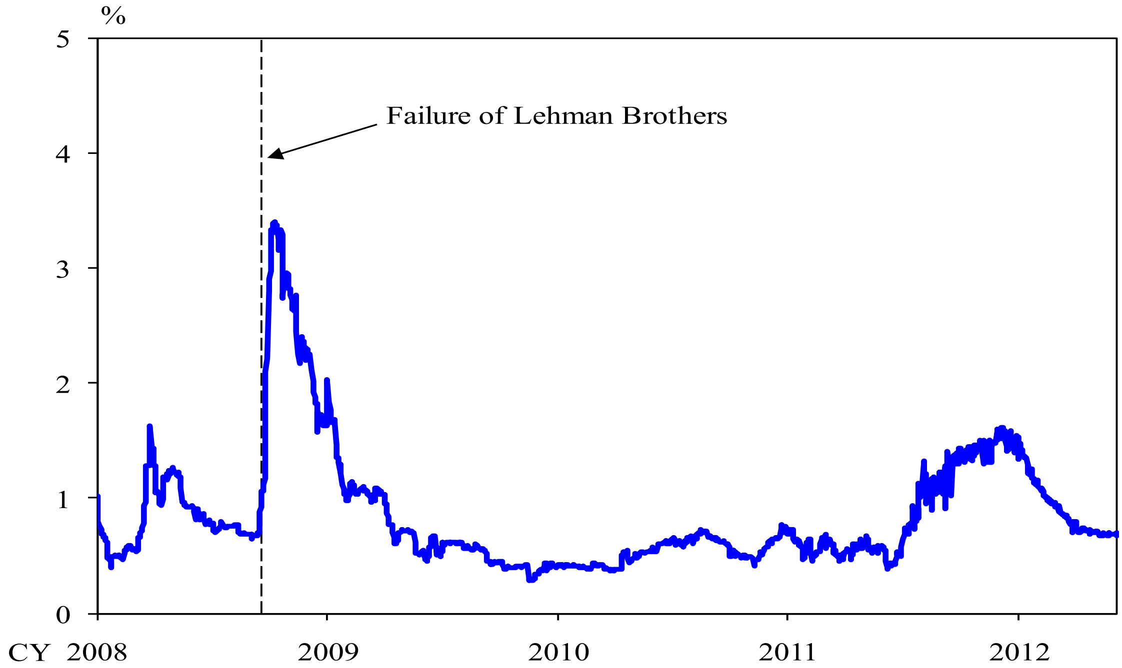
Euro Term Instruments (3-Month)



Source: Bloomberg.

Chart 11

Spread on the Short-Term Interest Rate in Europe

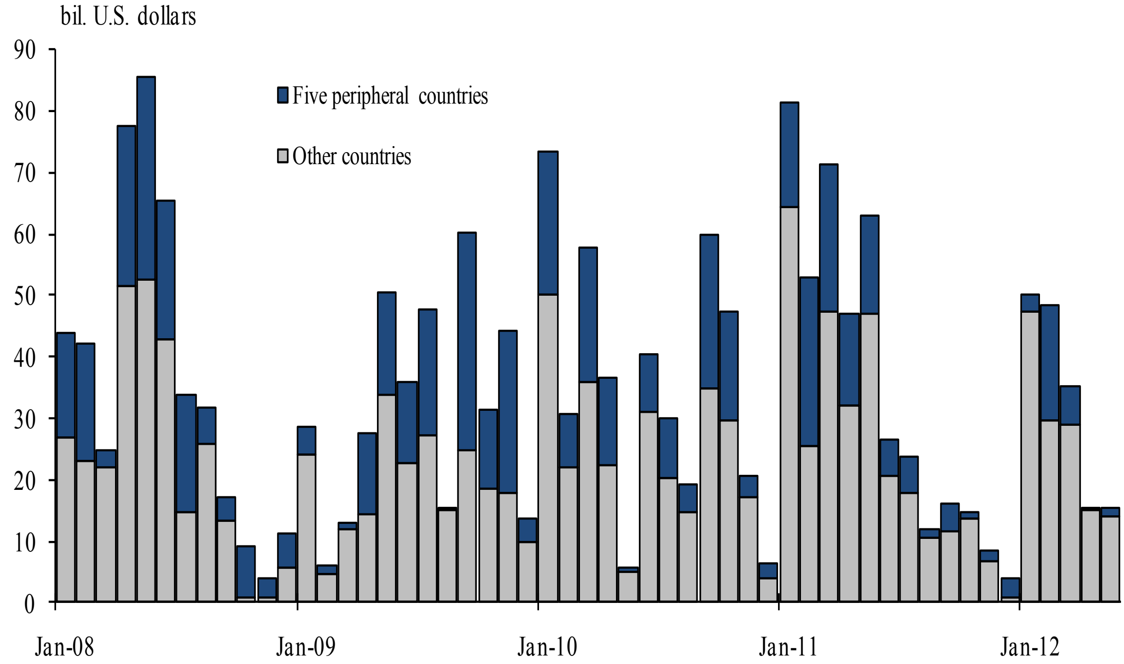


Note: The spread on the short-term interest rate is 3-month LIBOR minus yield on 3-month government securities. Data for German government securities are used.

Source: Bloomberg.

Chart 12

Volume of Bond Issuance by European Banks

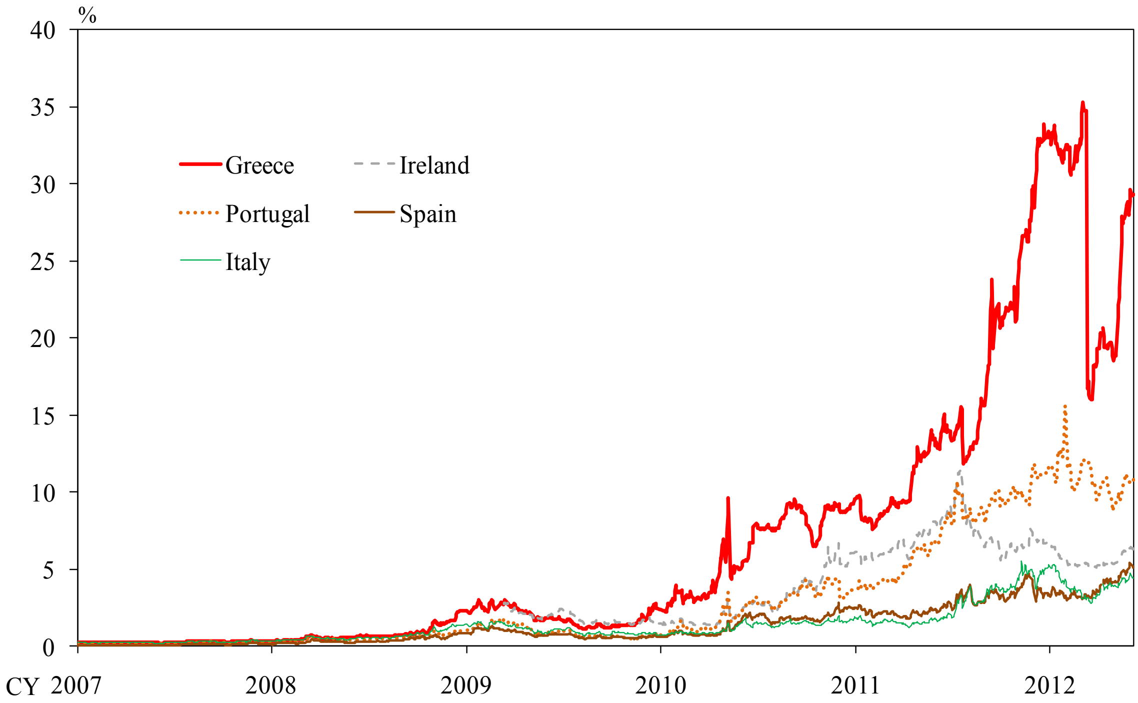


Note: Five peripheral countries are Greece, Ireland, Portugal, Spain, and Italy.

Sources: Markit; Thomson ONE.

Chart 13

Government Bond Yields in Five Peripheral Countries

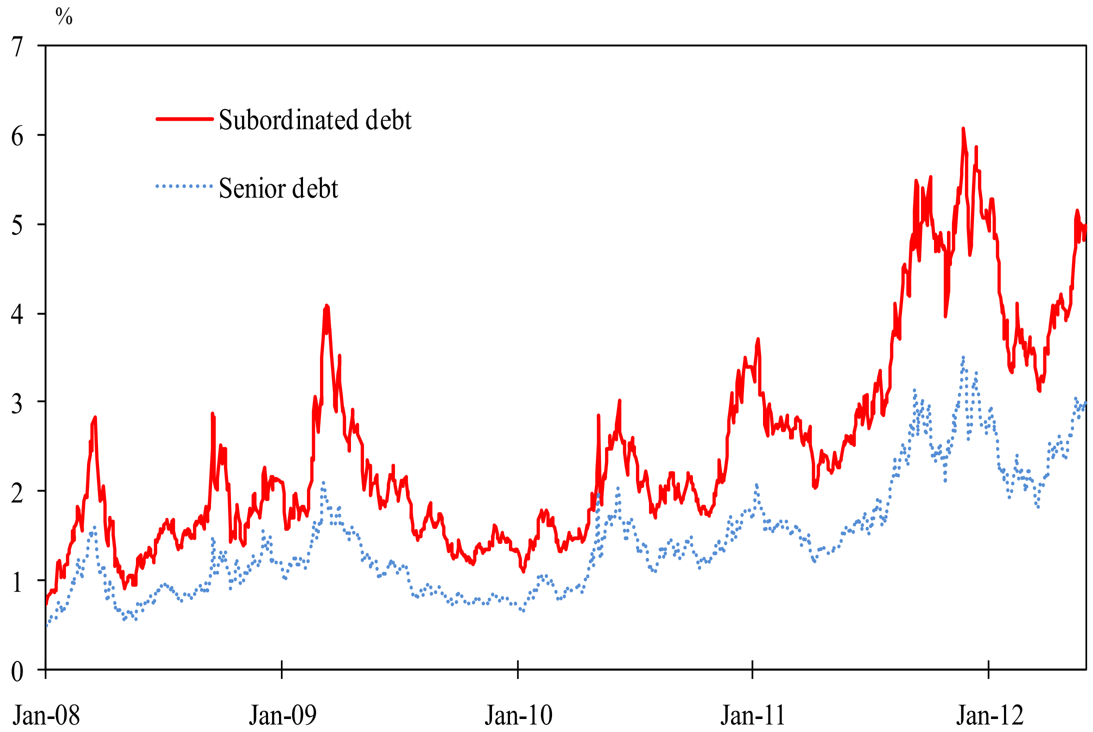


Note: 10-year spreads over German government bond yields.

Source: Bloomberg.

Chart 14

Credit Spreads of European Bank Debentures in Five Peripheral Countries

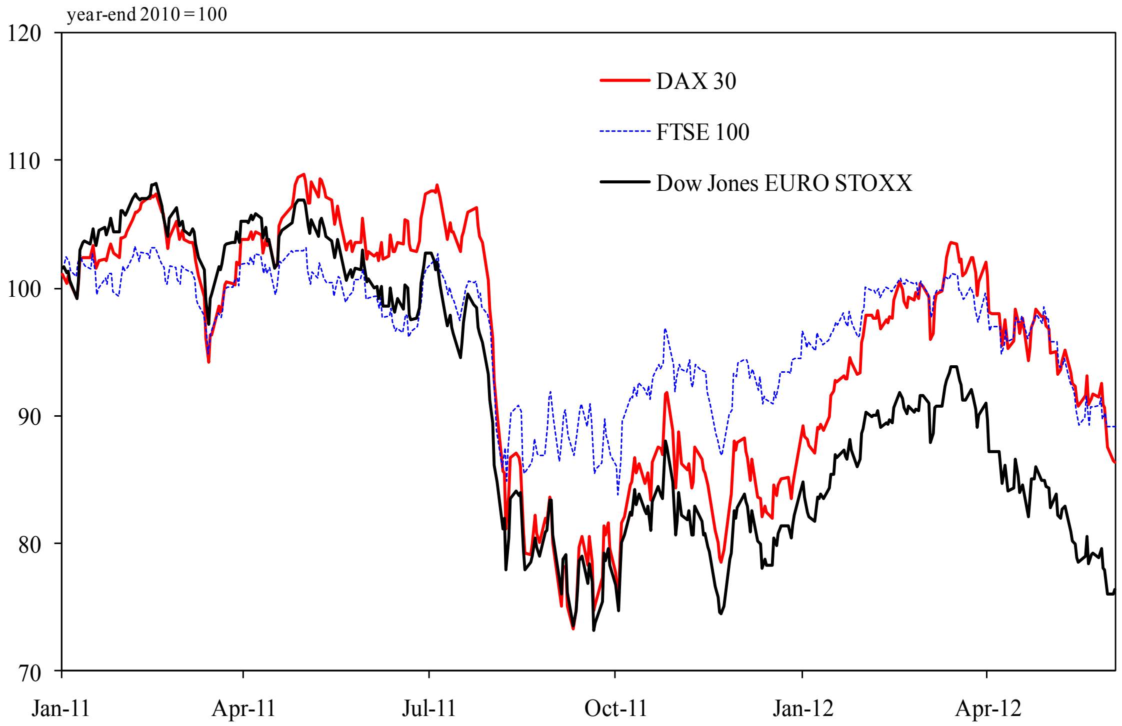


Note: Credit default swap (CDS) spreads for European banks.

Sources: Markit; Thomson ONE.

Chart 15

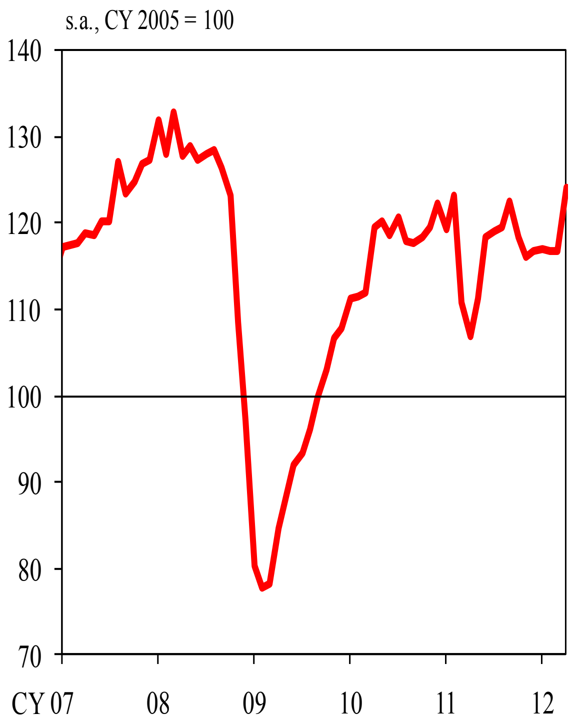
Stock Prices in Europe



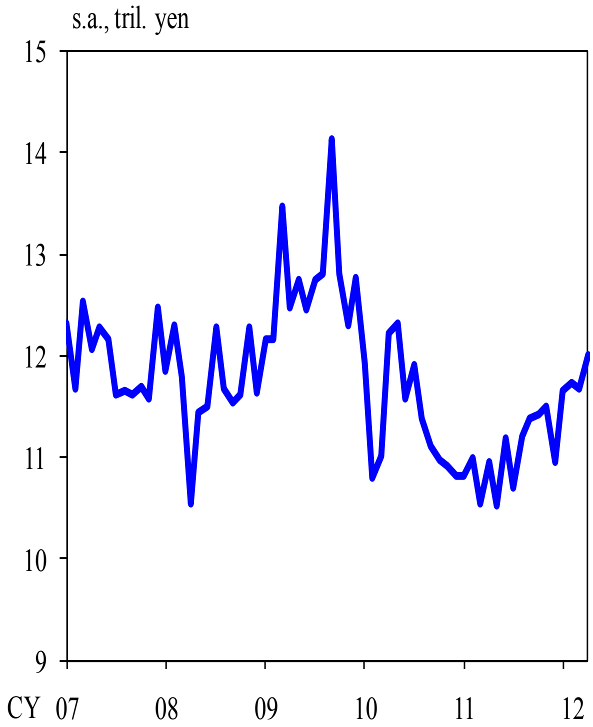
Source: Bloomberg.

Recent Developments in Japan's Economy

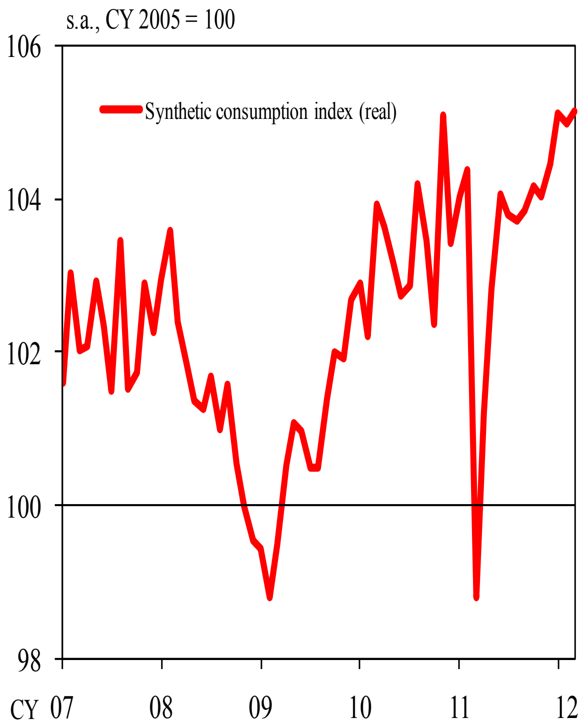
(1) Real Exports



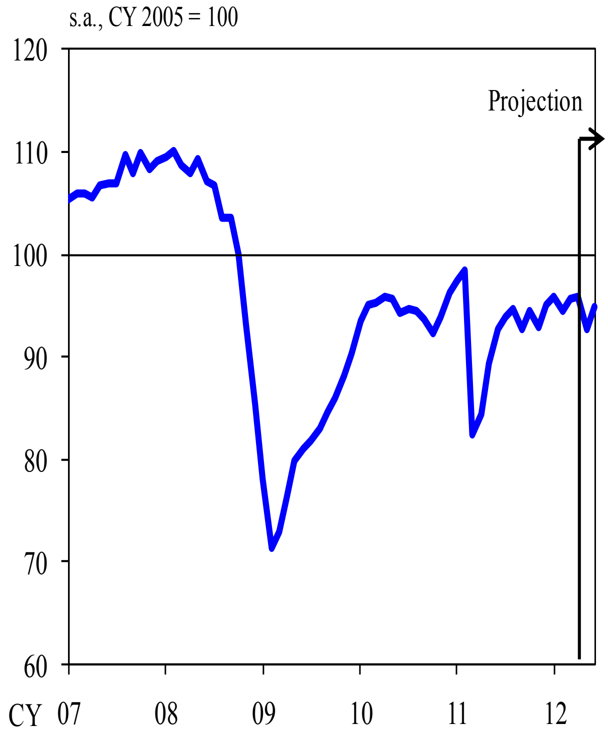
(2) Value of Public Works Contracted



(3) Private Consumption



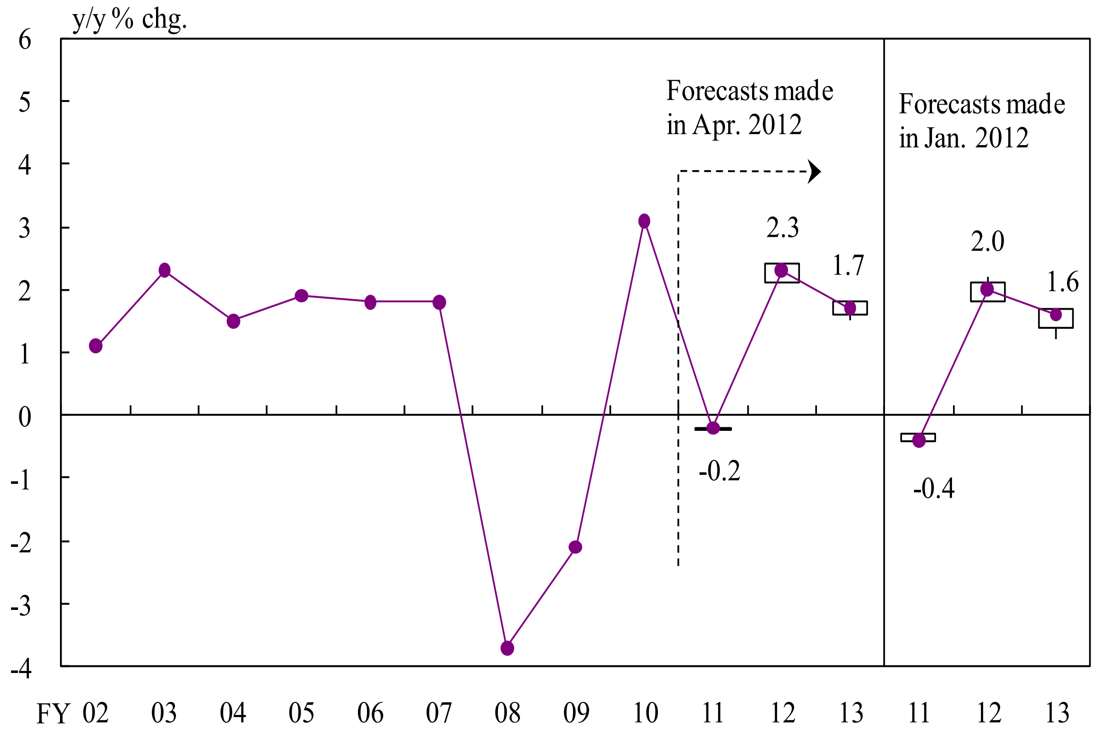
(4) Industrial Production



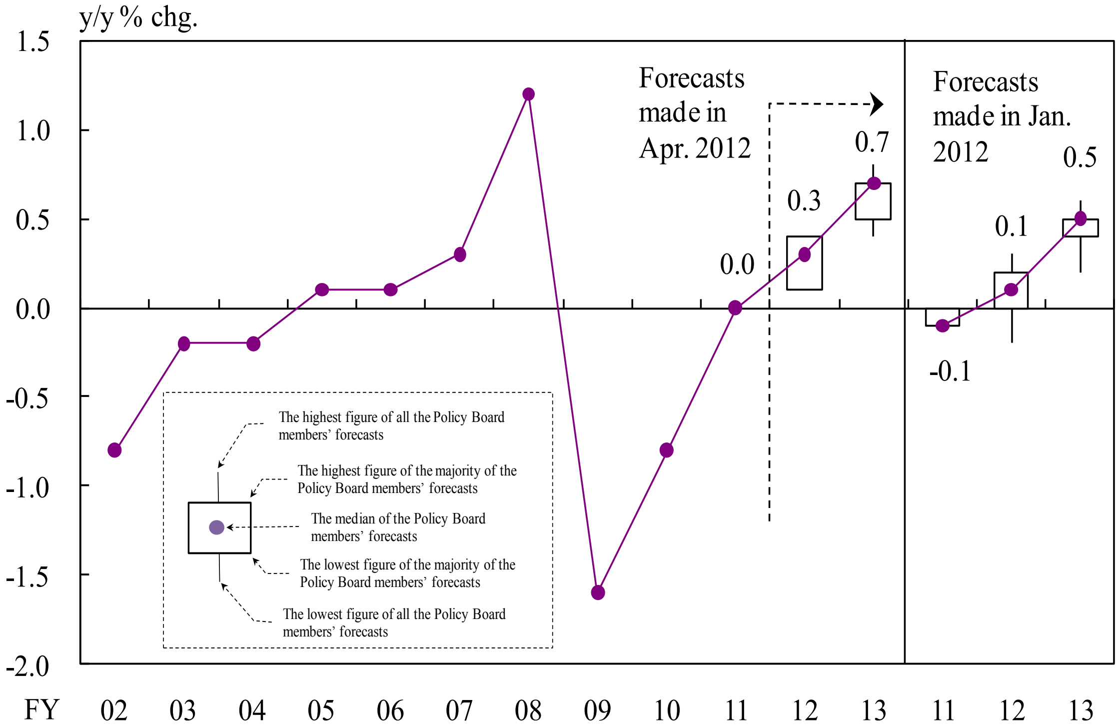
Sources: Cabinet Office; Ministry of Economy, Trade and Industry; East Japan Construction Survey; Bank of Japan.

The Bank of Japan's Economic and Price Forecasts

(1) Real GDP



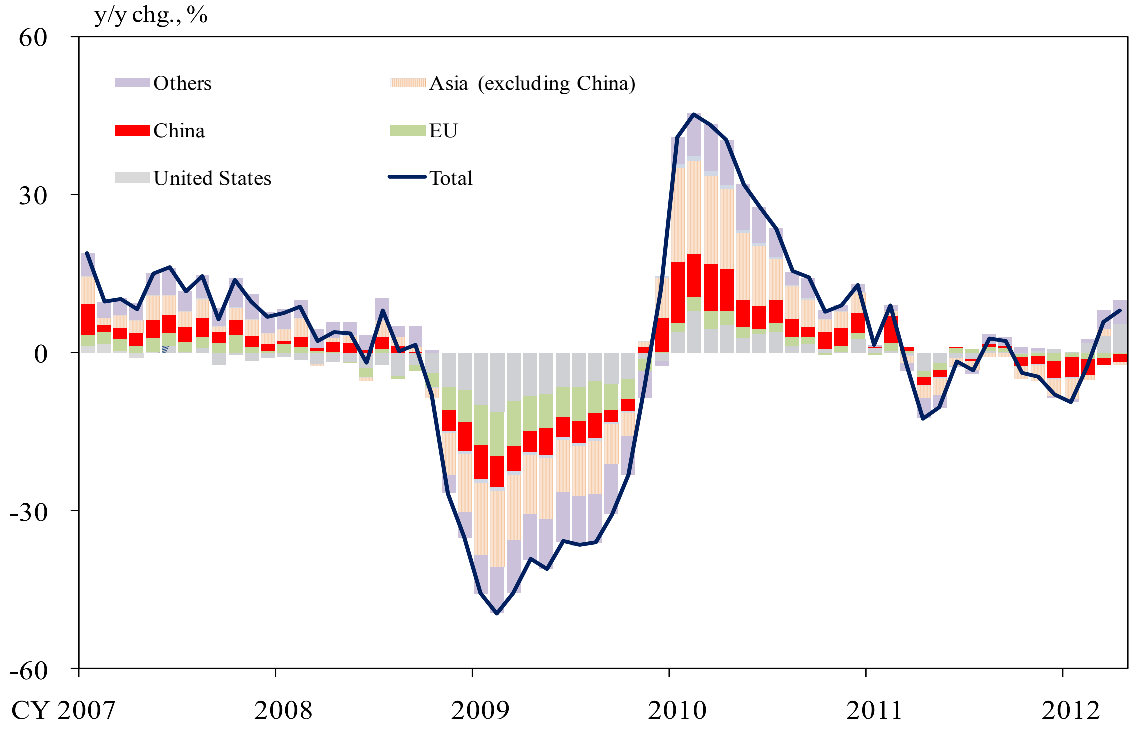
(2) CPI (All Items Less Fresh Food)



Note: The figures for real GDP for fiscal 2011, 2012, and 2013, and the CPI (all items less fresh food) for fiscal 2012 and 2013 are the Policy Board members' estimates.

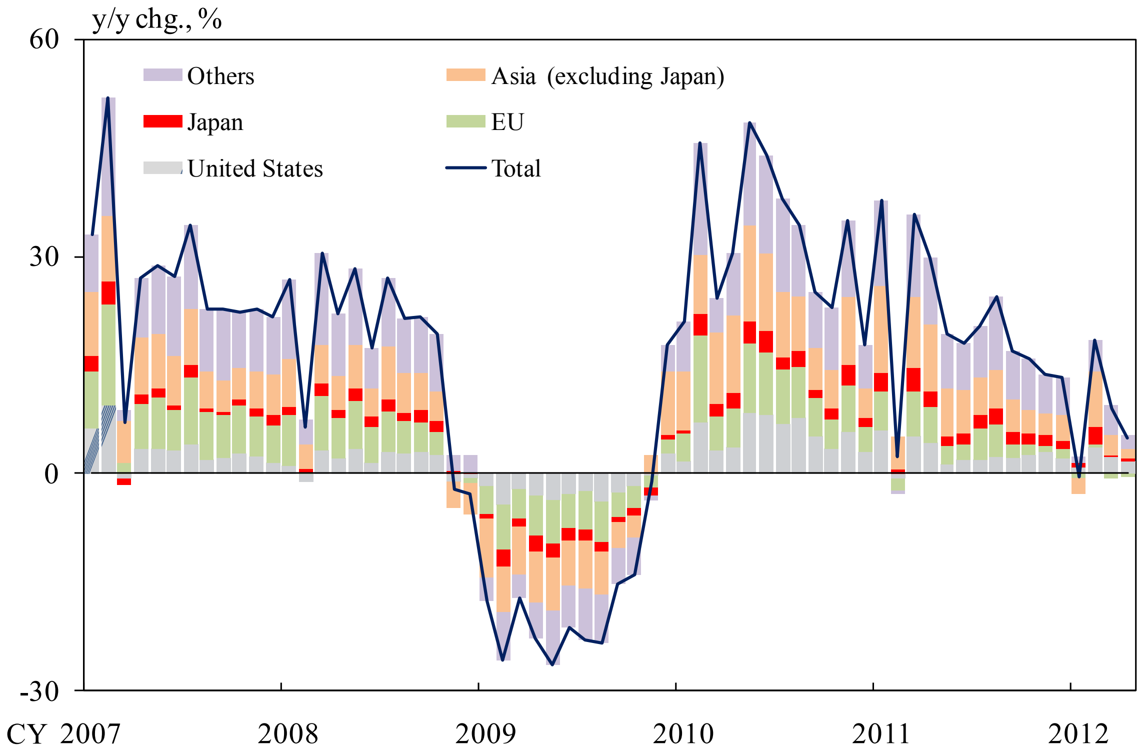
Source: Bank of Japan, "Outlook for Economic Activity and Prices."

Japan's Nominal Exports



Source: Ministry of Finance.

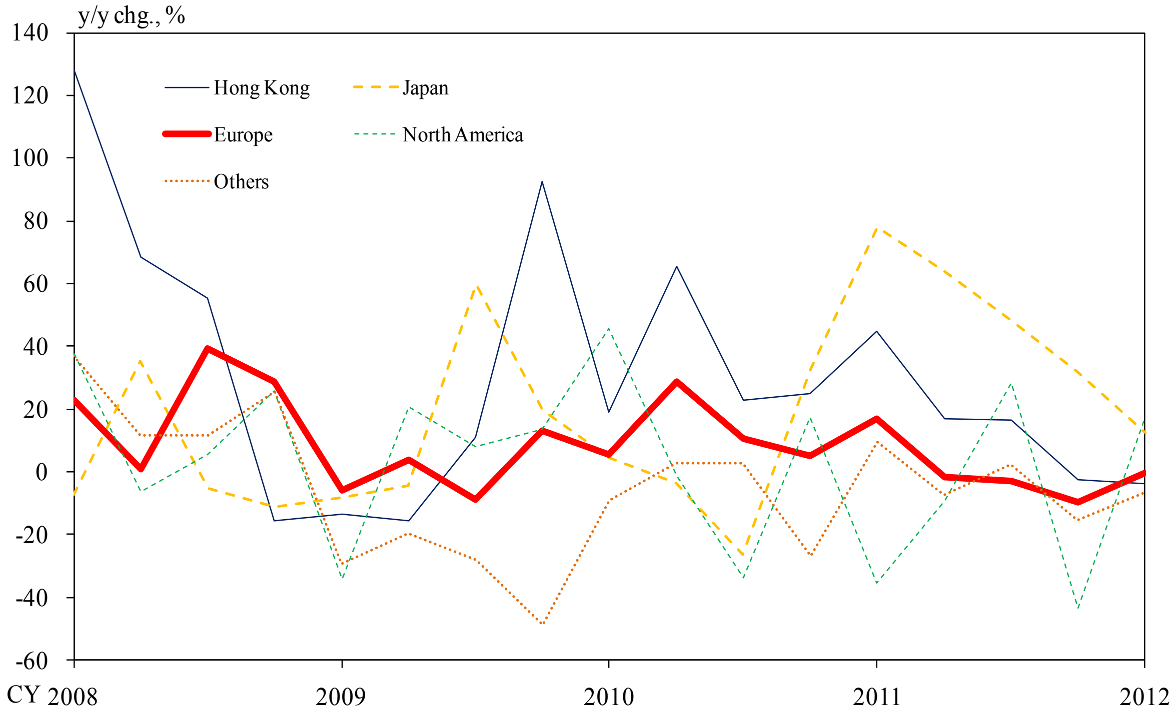
China's Nominal Exports



Source: CEIC.

Chart 20

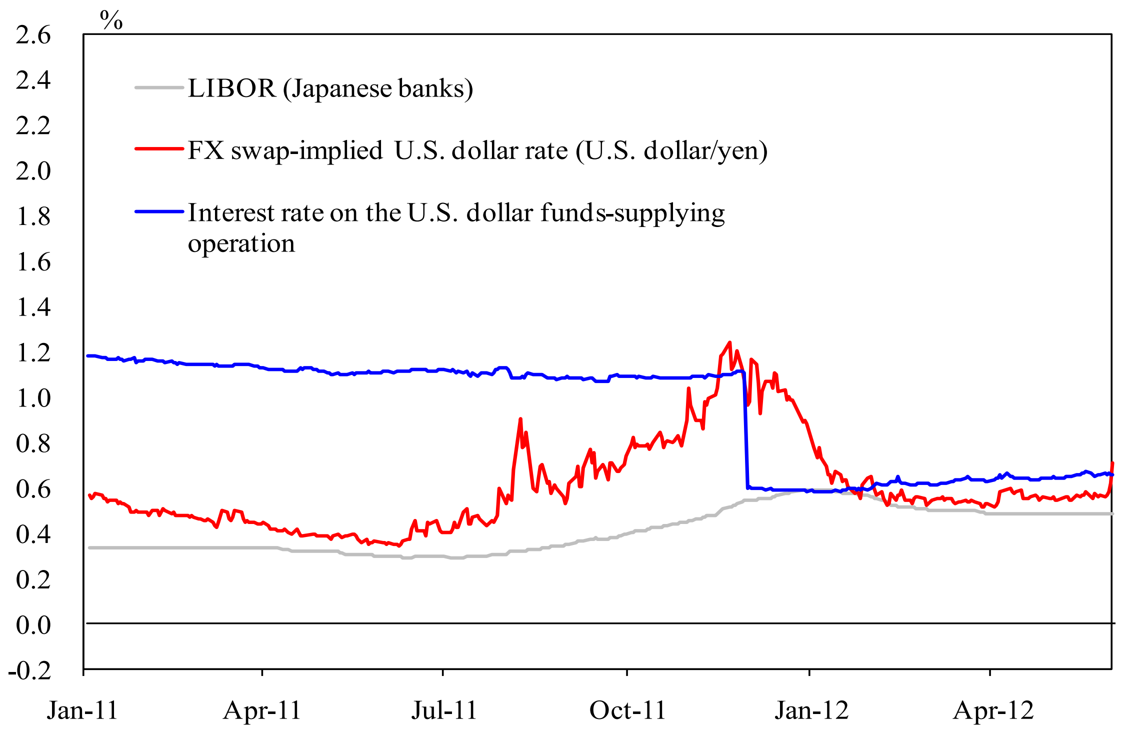
Foreign Direct Investment in China



Source: CEIC.

Chart 21

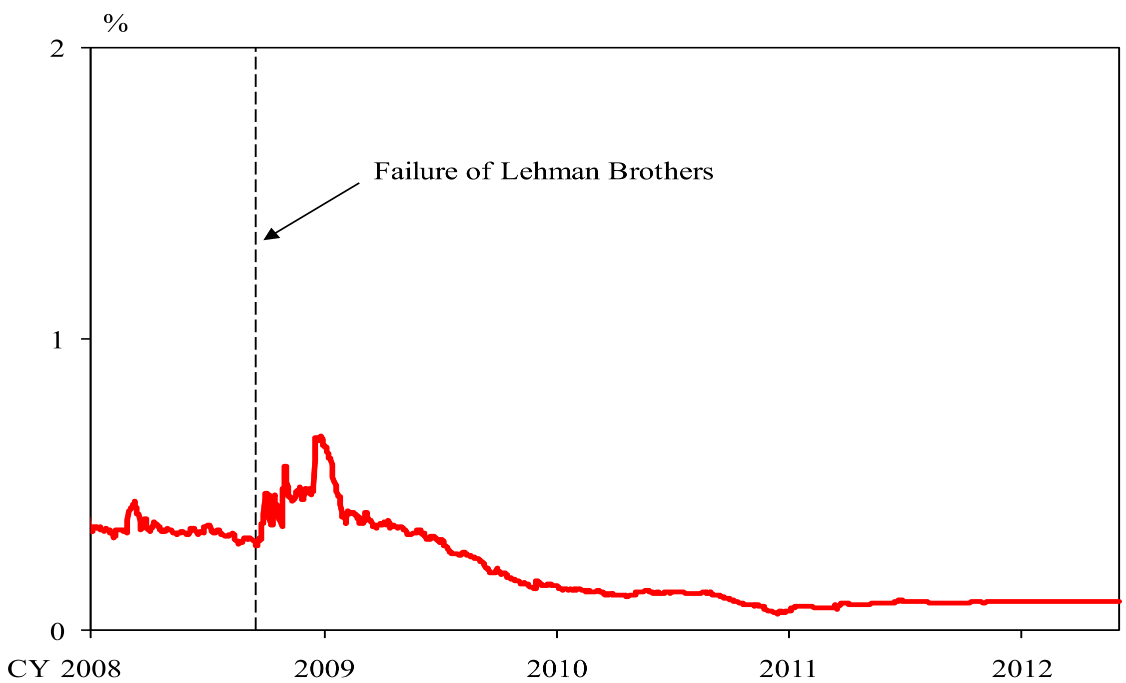
Japanese Banks' U.S. Dollar Funding Costs (3-Month)



Source: Bloomberg.

Chart 22

Spread on the Short-Term Interest Rate in Japan

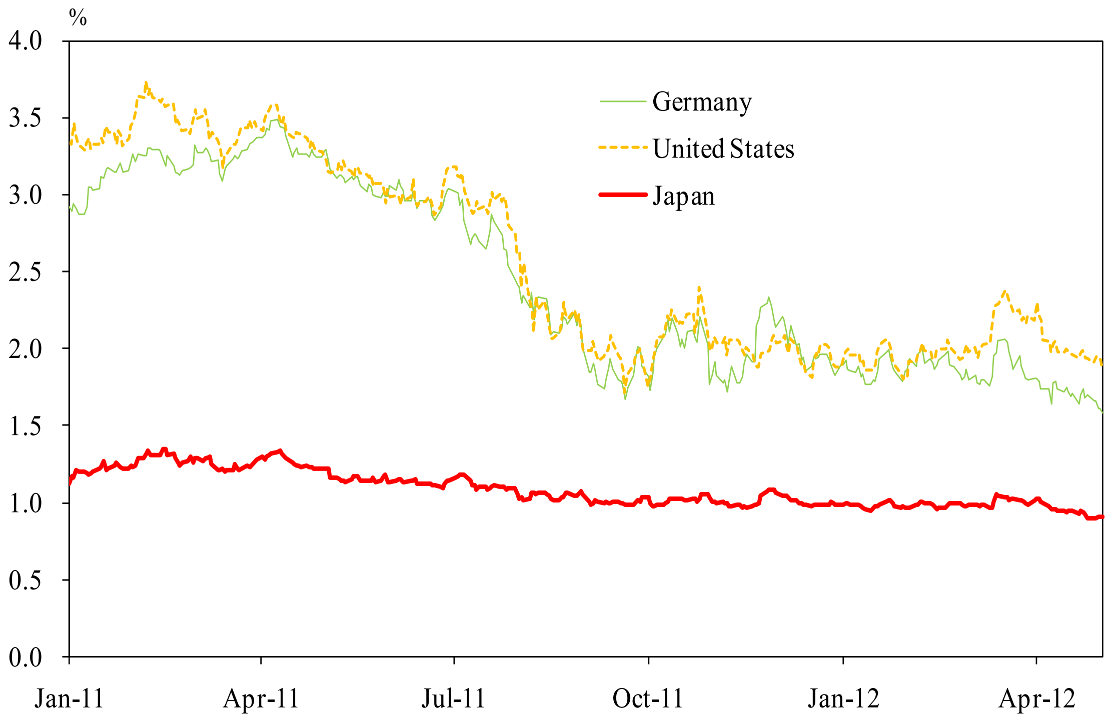


Note: The spread on the short-term interest rate is 3-month LIBOR minus yield on 3-month government securities.

Source: Bloomberg.

Chart 23

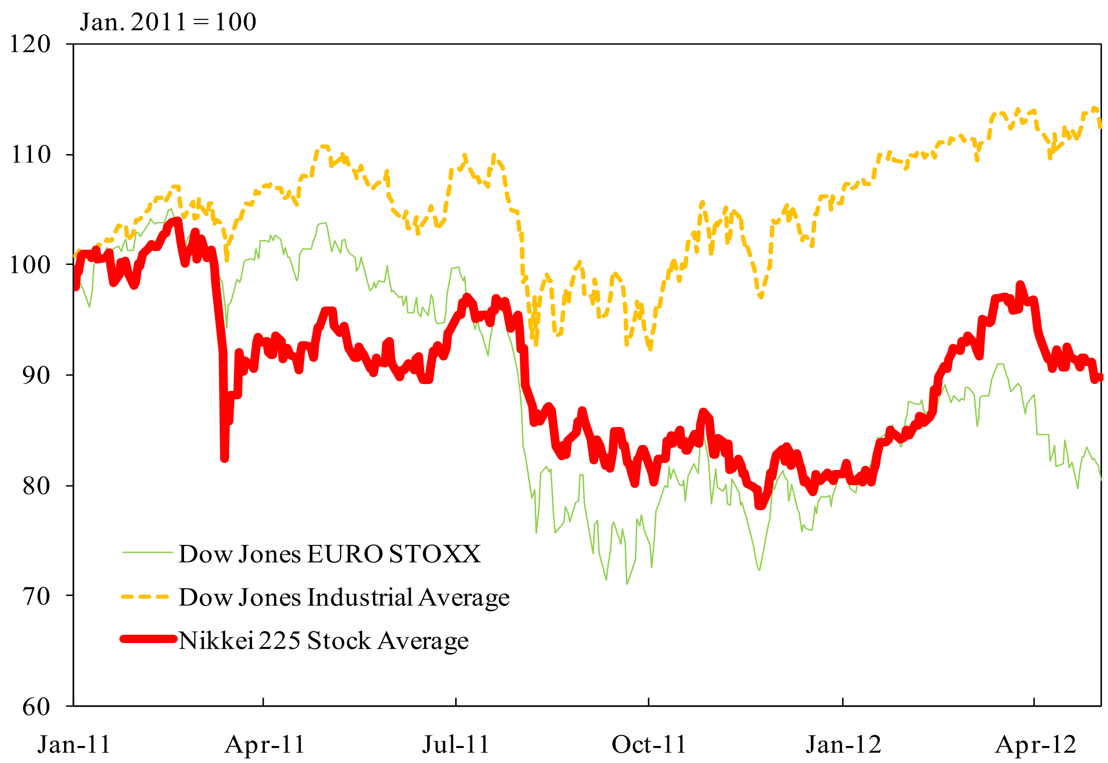
Long-Term Interest Rates



Source: Bloomberg.

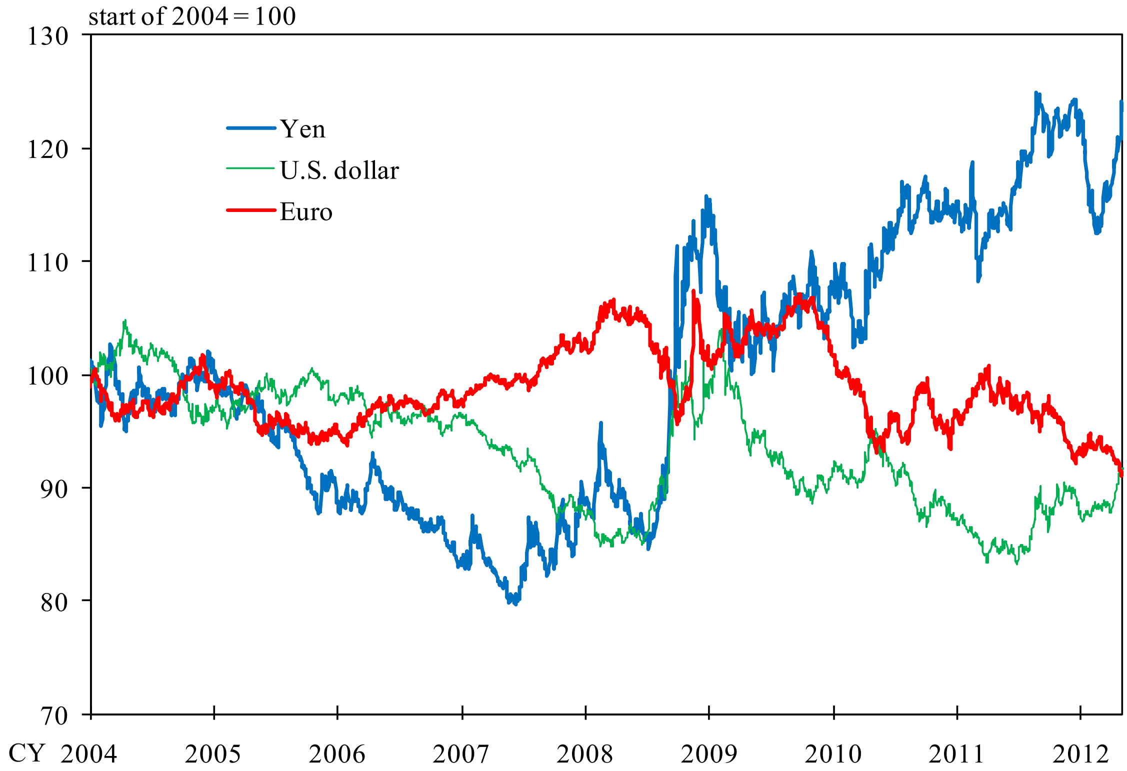
Chart 24

Stock Prices



Source: Bloomberg.

Nominal Effective Exchange Rates



Sources: Bank of Japan; European Central Bank.

The Bank of Japan's Conduct of Monetary Policy

1. Introduction of "the Price Stability Goal in the Medium to Long Term"

- ✓ The inflation rate consistent with price stability sustainable in the medium to long term.
- ✓ A positive range of 2 percent or lower in terms of the year-on-year rate of change in the consumer price index (CPI). A goal of 1 percent is set for the time being.

2. Clarification of the Bank's Determination to Pursue Monetary Easing

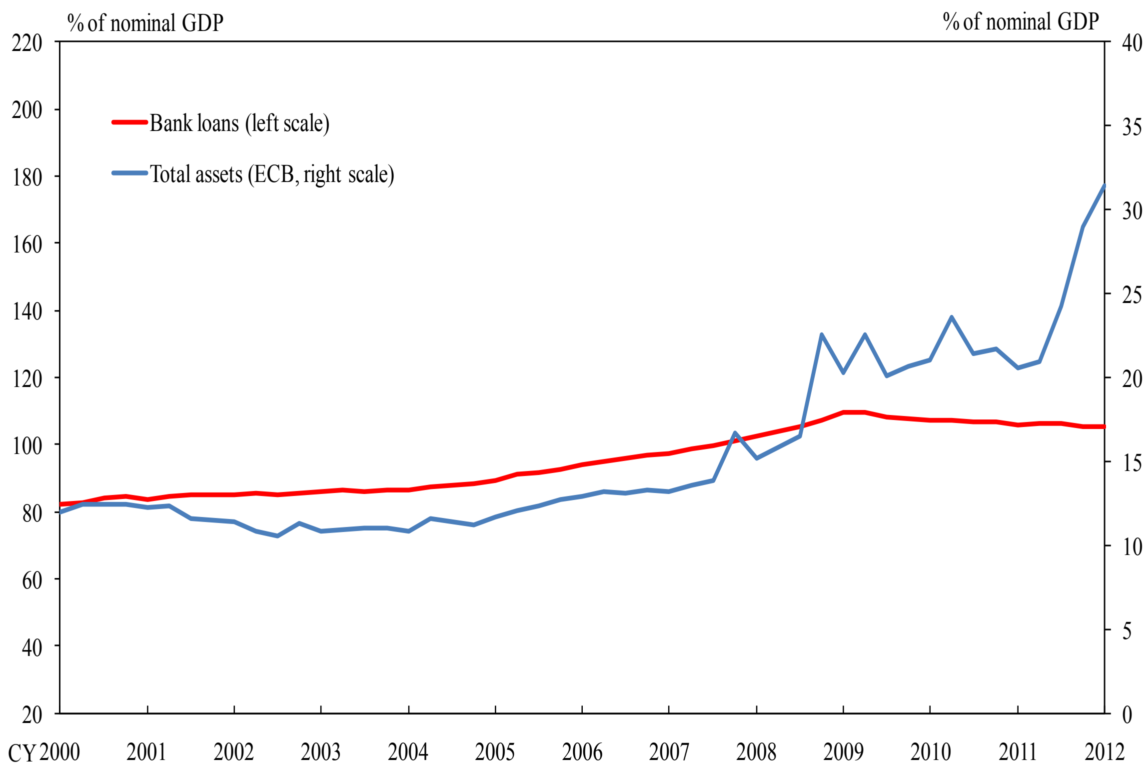
- ✓ Aiming at achieving the goal of 1 percent in terms of the year-on-year rate of increase in the CPI.
- ✓ Pursuing powerful monetary easing by conducting the Bank's virtually zero interest rate policy and by implementing the Asset Purchase Program mainly through the purchase of financial assets until the Bank judges that the 1 percent goal is in sight.
  - ➢ On condition that the Bank identifies no significant risk to the sustainability of economic growth, including from the accumulation of financial imbalances.

3. Increase in the Asset Purchase Program

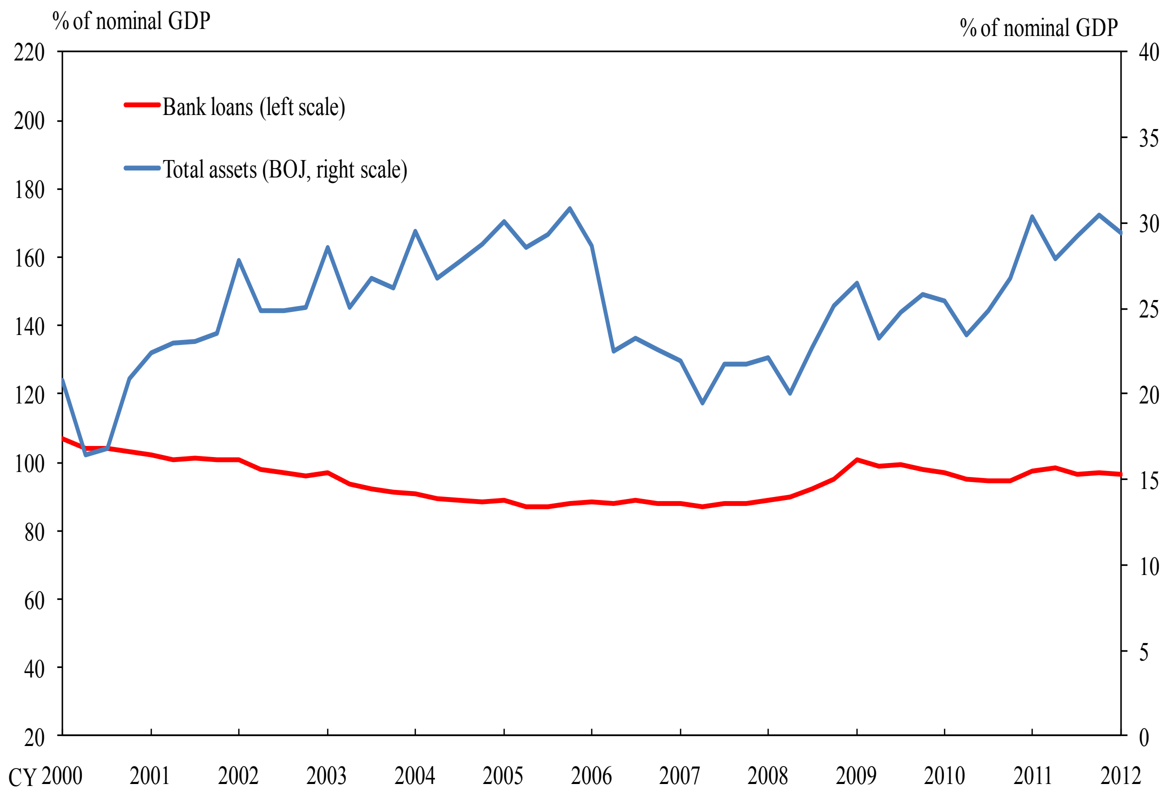
- ✓ About 55 trillion yen (Oct. 2011) → about 65 trillion yen (Feb. 2012) → about <u>70 trillion yen (April 2012)</u>
  - ➢ In addition to purchases under the Program, the Bank regularly purchases Japanese government bonds at the pace of 21.6 trillion yen per year.

Central Bank Assets and Bank Loans

(1) Euro Area



(2) Japan



Sources: Bank of Japan; European Central Bank.

Enhancement of the Growth-Supporting Funding Facility

The Bank decided to substantially enhance the Growth-Supporting Funding Facility to support strengthening the foundations for economic growth both in terms of the yen and a foreign currency.

Provision of funds to financial institutions, equivalent to the actual amount of lending and investment carried out with a view to strengthening the foundations for economic growth, over a long term (maximum duration of four years) and at a low rate (currently 0.1 percent)

1. Main Rules

- ✓ 3.0 trillion yen ⇒ 3.5 trillion yen (eligible investments and loans: 10 million yen or more)

2. Special Rules for Small-Lot Investments and Loans

- ✓ 0.5 trillion yen newly added (eligible investments and loans: 1 million yen or more but less than 10 million yen)

3. Special Rules for a New U.S. Dollar Lending Arrangement (April 2012)

- ✓ 1.0 trillion yen (12 billion U.S. dollars) newly added (eligible investments and loans: denominated in foreign currencies)

With special rules for asset-based lending (ABL) (eligible investments and loans: equity investments and ABL), the total amount is 5.5 trillion yen. The deadline for applications for new loans is March 2014.