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Bank of Japan

Recent Economic and Financial Developments in Japan

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I. Developments in Overseas Economies

The financial crisis has recently taken a growing toll on economies worldwide, and global economic growth has slowed dramatically. The International Monetary Fund (IMF) forecasted in November that the growth rate of the world economy would drop sharply, from 3.7 percent in 2008 to 2.2 percent in 2009. It also forecasted that in 2009 advanced economies would register negative growth and as a result emerging economies alone would support global economic expansion. In the three decades since the early 1970s, the world economy grew by 3-4 percent annually, and in recent several years the growth rate rose as high as about 5 percent. The situation, however, has changed completely.

Let us look at developments by country and region. In the U.S. economy, which seems to have entered a contraction phase in December 2007, most economic indicators are still deteriorating today, even a year later, showing the most severe developments since the 1980s or even the 1970s. Housing market adjustments, which began in 2006 and triggered the current economic downturn, have continued, as indicated by the continued fall in home prices and declines in housing starts and home sales by about 40 percent from a year earlier. Against this backdrop, the soundness of financial institutions that provided mortgage loans or invested in related securitized products has been seriously impaired, and this in turn has reduced their ability to provide funds to the economy, thereby aggravating economic conditions further. As a result, job cuts have intensified across a wide range of industries and private consumption has weakened.

Economic conditions in Europe are also deteriorating. The economies of Spain, Ireland, and Italy, which suffered from the impact of falling home prices and other factors, have been slowing since early 2008. In addition, the economies of the United Kingdom, Germany, and France, which previously were the growth engines of the region, since the summer have also experienced a slowdown, especially in business fixed investment and exports, and economic conditions in these countries are currently deteriorating substantially.

Turning to China, its economic slowdown has become evident: real GDP growth decelerated sharply in the July-September quarter from the double-digit pace until then; exports have recently dropped below the previous year's level; and growth in production has also slowed significantly. In India and other Asian economies, too, both domestic and external demand are weakening. Similarly, a range of other economies -- in the Middle East, Russia, and Eastern Europe -- that had enjoyed high rates of growth due to the surge in commodity prices or capital inflows from U.S. and European financial institutions have been severely shaken by the plunge in commodity prices and the financial crisis, and some of these economies had to seek financial aid from the IMF. Thus, dark clouds are now spreading over economies around the world.

Regarding the global economic outlook, it is highly likely that economic conditions in the United States and Europe will continue to deteriorate and that growth in emerging economies will continue to slow. Especially in the near term, it is expected that the pace of the deterioration or the slowdown in growth will accelerate in economies worldwide, as the financial crisis is likely to exert strong downward pressures on them.

II. Developments in Japan

A. Economic Developments

Against this global background, Japan's economic condition is also deteriorating. Exports in nominal terms experienced a 26.7 percent year-on-year decline in November 2008, representing a slump greater than the one observed in 1985 following the appreciation of the yen, and the largest decline on record since data were first collected in January 1964. By destination, after exports to the United States started to decline in the autumn of 2007, those to Europe started to fall in summer 2008 and those to Asia in October 2008. Exports to Asia, including China, account for about half of Japan's exports in nominal terms, and it can be said that they are a lifeline for the Japanese economy. However, in October and November 2008, exports to the NIEs, China, and the ASEAN countries all started to decrease. As a result, growth in exports to major countries and regions has become negative on a year-on-year basis, and future developments are cause for severe concern. Moreover, mainly reflecting the drop in exports, production is declining sharply. Corporate profits, which had marked successive record highs for several years up to fiscal 2007, are continuing to fall as a result of the rise in commodity prices in the recent past and the economic deterioration, and business sentiment is deteriorating. Under these circumstances, business fixed investment is also declining due to a drop in new orders, cancellation of existing orders, and successive downward revisions in capital spending plans for the fiscal year.

Looking now at employment and income, reflecting the weakness in exports and production, the labor market conditions have started to soften and the number of employees has remained unchanged. The employment situation has been rapidly becoming severe, particularly in the manufacturing sector, about which there are an increasing number of media reports on cuts in part-time and temporary workers. Moreover, corporate profits are likely to decrease, and the year-on-year rate of change in wages is around zero percent. In this situation, private consumption is weakening as consumers are refraining from buying non-essential goods such as apparel. Since swings in private consumption so far have been relatively small, it is expected that a large drop can be avoided. However, with the employment and income situation becoming increasingly severe, consumption may continue to weaken, and attention should therefore be paid to future developments.

B. Price Developments

Next, let us look at price developments. In international commodity markets, prices of energy and mineral resources as well as crops surged in the last few years as a result of growing global demand, particularly from emerging economies, supply bottlenecks resulting from delayed improvements in transport infrastructures, and speculative inflows of funds. But the prices have plunged since summer 2008. In parallel, the rate of increase in the consumer price index (CPI) in Japan, which once rose sharply, has fallen. Given the deterioration in economic conditions, CPI inflation is expected to slow further, but the rise in prices continues in items where producers had been unable to pass on past increases in input prices to output prices. For this reason, the trend observed since August 2006 that, of the 521 items that make up the CPI (excluding fresh food), the number of items showing a price increase exceeds that of the number of items showing a decrease continues as before, and in the figures for October -- the latest available -- the difference reached a record high of 167 items. Putting it another way, this difference expressed as a ratio of all items making up the CPI (excluding fresh food) has risen to over 30 percent. Moreover, even excluding food and energy, the number of items showing a price rise is continuing to increase, and this means that prices are rising on a broader basis. Although the upward pressure on prices overall is limited as the weight of each item is small, it is necessary to remain watchful.

III. The Current Financial Crisis

A. Origins of the Crisis

Next, I would like to present to you my interpretation of the current financial crisis, a topic that cannot be avoided when trying to understand the economic and financial situation at the moment. Problems in the United States regarding so-called "subprime mortgages" for borrowers with a deficient credit history first emerged around 2006, and turmoil in financial markets stemming from these surfaced in earnest from the summer of 2007. The root causes of the turmoil seem to be (1) excessive mortgage lending based on loose lending standards, and (2) the securitization and resale of a large portion of such loans. These may be said to be two sides of the same coin. Financial institutions transferred the mortgage claims to structured investment vehicles (SIVs) they had established and then the SIVs, by issuing and selling securitized products, transferred the risks and returns to investors, earning commissions in the process. By doing so, financial institutions could maintain their own financial soundness and circumvent restrictions on capital adequacy ratios, while earning a steady flow of income. To generate much profit from these commissions, each of which is small, it became necessary to expand the provision of mortgage loans and engage in securitization on a large scale. This business model seems to have led to a relaxation of lending standards and excessive mortgage lending.

Furthermore, it appears that, as a result of the transfer of risk through securitization to investors that financial institutions did not know, financial institutions' risk management standards slipped vis-à-vis creditors. On the other hand, it appears that investors' interest in the quality of underlying loan assets also slipped, and even when investors did take such an interest, it was almost impossible to assess the quality of underlying assets. Amid this declining risk awareness among all parties concerned, even "subprime mortgage loans" -- assets with a high risk of loss -- came to be widely offered to investors as seemingly suitable investment products.

B. Emergence of the Financial Crisis

The financial crisis began with the fall in U.S. home prices. When home prices that had surged started to decline in mid-2006, observers began to see cases where the value of collateral fell below the amount of mortgages. Many U.S. mortgage loans are tied to the value of the home -- not to the creditworthiness of the individual borrowers -- and therefore when the value of a home falls below the amount of the mortgage loan concerned, the risk increases that the loan will become uncollectible. This means that the risk of losses on securitized products backed by such loans also increases and the prices of those securitized products fall. When this happens, irrespective of whether or not actual losses are incurred, investors that mark to market incur paper losses. Sales to dispose of such losses lead to further sales, thereby creating a downward spiral in prices.

The initial stages of the crisis originated from the SIVs just mentioned. A few SIVs in Europe became inoperative, as it became difficult for them to obtain liquidity due to the fact that the market value of housing-related assets they held became impossible to assess. This made it difficult for other SIVs and financial institutions that had backed them to secure liquidity, resulting in turmoil in a range of financial markets. This was the BNP Paribas shock, which occurred on August 9, 2007. Problems soon spread to financial institutions in the United States and around the world. The dispersion of risk through securitization has an advantage in that large risks are not concentrated among a few institutions. However, the risks do not simply disappear. It could be said that because all participants transferred risks and exceeded their risk limits, everyone came to bear significant risks.

Thus, as the crisis began with difficulties related to liquidity, central banks sought to stabilize markets by supplying large amount of liquidity. In December 2007, the U.S. Federal Reserve established swap lines with the European Central Bank (ECB) and the Swiss National Bank, enabling them to supply U.S. dollar funds in Europe.

Even if the liquidity crisis were to subside, the root of the problem will not be resolved until the decline in home prices and related securitized products comes to a halt, as it will continue to degrade financial institutions' assets. Accordingly, the focus next turned to the nonperforming loans (NPLs) and undercapitalization of financial institutions. Initially, sovereign wealth funds (SWFs), primarily from the Middle East, injected capital into U.S. and European financial institutions as part of their investments. However, as stock prices plummeted, the number of such investors dwindled. On January 18, 2008, credit ratings of U.S. monoline insurers that guaranteed securitized products were downgraded due to their difficulty in raising funds, and this triggered a fall in the prices of securitized products overall. Then Bear Stearns, a U.S. investment bank that held large amounts of securitized products, ran out of cash as it had failed to raise necessary funds, and on March 14, it was decided that the Federal Reserve Bank of New York would provide financing to facilitate JP Morgan Chase's acquisition of Bear Stearns. On July 13, the U.S. government was prompted to provide support to two government-sponsored enterprises (GSEs) that formed part of the government's housing policy and were facing financial difficulties. On September 15, Lehman Brothers, another U.S. investment bank that had incurred huge losses from securitized products, filed for bankruptcy, as it could not raise money or find an acquirer. There were media reports that the Fed and the U.S. Treasury Department had also looked for a buyer.

C. Spread of the Financial Crisis

The bankruptcy of a financial institution as large as Lehman Brothers severely shook global financial markets. As a result, in money markets, financial institutions with surplus funds stopped lending if they perceived any kind of risk, while those with a shortage of funds were unable to borrow any funds even if they had collateral. Central banks thus stepped in once more to supply large amounts of liquidity. At this point in time, central banks were virtually the only providers of liquidity. The Bank of Japan also provided funds to the money market, supplying several trillion yen per day over a number of consecutive days. As the shortage particularly of U.S. dollar funds spread throughout the world, from September 18 to 24, the Fed extended its U.S. dollar swap agreements to nine major central banks, including the Bank of Japan, the Bank of England (BOE), the Bank of Canada, and the Reserve Bank of Australia, and a framework for supplying U.S. dollar funds to each of the countries was arranged. Of the nine central banks, the Bank of Japan, the BOE, the ECB, and the Swiss National Bank subsequently announced that they would conduct tenders of U.S. dollar funding at fixed interest rates and provide an unlimited amount of funds against the appropriate collateral. Moreover, on October 29, the Fed concluded swap agreements with other central banks such as those of Mexico and South Korea. Meanwhile, the U.S. government, concerned about the impact that the possible additional collapse of major financial institutions would have, seems to have changed its stance to ensure that subsequently no other financial institution would go under. In this connection, on September 16, the Fed extended emergency funding to American Insurance Group (AIG), a major U.S. insurer.

Although all these steps have eased market nervousness somewhat, the problem of NPLs and undercapitalization of financial institutions remains unresolved. Consequently, the U.S. Treasury Department submitted to Congress the Emergency Economic Stabilization Act (EESA), which would have allowed the government to buy up troubled assets from financial institutions to the tune of 700 billion U.S. dollars. But rescuing specific companies with taxpayers' money was controversial, and the proposal was rejected by the House of Representatives on September 29, 2008. This sent shockwaves around financial markets yet again. In response to these developments, the House approved the bill on October 3 after introducing some changes. However, after the bill was passed by the House, the Treasury Department decided to inject capital into financial institutions rather than applying the funds to purchase distressed assets, using its discretionary powers to implement measures as laid down by the act. In addition, various other measures were put forward: the Federal Deposit Insurance Corporation has started to guarantee bonds issued by financial institutions and raise the ceiling on guaranteed deposits, the Fed has started to purchase CP (short-term corporate debt), and the Securities and Exchange Commission has banned short-selling of stocks.

Having witnessed the shocks resulting from the bankruptcy of Lehman Brothers in the United States and the initial rejection of the EESA in the House of Representatives, countries in Europe at this time also swiftly introduced various measures, such as implementing a blanket guarantee on deposits, nationalizing or injecting capital into financial institutions, and guaranteeing their short-term debt. Moreover, given the globalized nature of finance, there were efforts to devise an internationally coordinated response to address the issues. For example, on October 8, six major central banks implemented a rate cut. Also, on October 10, a "plan of action" aimed at stabilizing financial markets was announced at the Group of Seven (G-7) meeting of finance ministers and central bank governors, and each of the member countries announced rescue measures for financial institutions. Furthermore, at every opportunity, such as the financial summit on November 15 and the Asia Pacific Economic Cooperation (APEC) summit on November 22, declarations were issued showing the determination to take a concerted stance.

D. Effects of the Financial Crisis on Economic Activity

When financial institutions' financial strength drops and as a result their ability to extend loans declines, the impact on economic activity becomes very acute. In particular, countries that depended excessively on borrowing from U.S. and European financial institutions, such as Iceland, Hungary, and South Africa, have slid into economic crisis and have had to rely on emergency funding from the IMF. Even in other countries, financial institutions have become cautious about lending that is risky. Such events have acted as a damper on economic activity, and this has caused an increase in NPLs at financial institutions and even more cautious lending attitudes, creating a vicious cycle. This adverse feedback loop between financial and economic activity is the issue causing the greatest concern worldwide at the moment. Thus, measures to dispose of NPLs at financial institutions and economic stimulus measures are necessary. Large-scale economic stimulus measures are being put forward by China and by each of the countries in Europe. Meanwhile in the United States, final details of a bailout plan for the U.S. automakers remain unclear, and it is proving difficult to hammer out effective measures at a time when the presidency is in transition. The focus will therefore be on measures taken after the inauguration of President-Elect Barack Obama.

IV. Measures Taken by the Bank of Japan

Next, I would like to summarize chronologically the measures taken so far by the Bank of Japan against the background of adverse effects of the global financial crisis affecting Japan's economy. First, as stated earlier, from September 16, 2008, immediately after the failure of Lehman Brothers, the Bank injected abundant liquidity into the money market by flexibly conducting same-day funds-supplying operations. Then, on September 18, 2008, the Bank introduced U.S. dollar funds-supplying operations against pooled collateral and began to provide ample U.S. dollar liquidity to Japan's money market, as a coordinated measure with other central banks in major economies. It was the first time in its long history for the Bank to provide U.S. dollar liquidity in Japan. Operations were initially conducted through multiple-rate competitive auctions, but on October 14, 2008, the Bank decided to adopt operations whereby funds are provided at a fixed interest rate for an unlimited amount against pooled collateral. The supply balance stands at the U.S. dollar equivalent of about 10 trillion yen.

On October 14, to facilitate corporate financing, the Bank announced that it would conduct CP repo operations, or purchase of CP with repurchase agreements, more actively. The Bank recently increased the frequency and the size of CP repo operations substantially.

On October 31, the Bank decided to lower its target for the uncollateralized overnight call rate by 20 basis points and encourage it to remain at around 0.3 percent. The Bank also introduced the complementary deposit facility, which enables the Bank to provide yen funds more smoothly. Under this facility, the Bank pays interest on excess reserve balances, that is, balances held by financial institutions at the account with the Bank in excess of required reserves under the reserve deposit requirement system. As a result, the Bank has become able to provide a large amount of liquidity, while avoiding a situation in which the uncollateralized overnight call rate falls significantly below the targeted level. Making use of this facility and others, the Bank is providing liquidity over the year-end, more frequently and in larger amounts than in 2007.

On December 2, 2008, to facilitate corporate financing during the run-up to the calendar and fiscal year-ends of 2008, the Bank decided to adopt more drastic measures as temporary ones effective through April 30, 2009. The first was a measure to ease the eligibility criteria for corporate debt -- corporate bonds and loans on deeds to companies -- to be pledged to the Bank as collateral when financial institutions wish to borrow money, from a credit rating of "A-rated or higher" to "BBB-rated or higher," effective from December 9, 2008. The second measure was the introduction of Special Funds-Supplying Operations to Facilitate Corporate Financing utilizing corporate debt, which will become effective from January 8, 2009. Under these operations, financial institutions can borrow unlimited amounts of funds over the fiscal year-end at an interest rate lower than the market rates against the value of corporate debt pledged to the standing pool of eligible collateral. The Bank hopes that these measures will facilitate financial institutions' lending activity and transactions in the corporate bond and CP markets through greater funds availability and lower borrowing costs for them.

On December 19, 2008, the Bank lowered its target for the uncollateralized overnight call rate by a further 20 basis points to 0.1 percent. In addition, to further facilitate the provision of ample liquidity, the Bank decided to increase the amount of outright purchases of Japanese government bonds (JGBs) from 1.2 trillion yen to 1.4 trillion yen per month. Furthermore, the Bank is considering the introduction of additional measures to facilitate corporate financing including the outright purchases of CP. For a central bank, implementing policy measures that involve taking on the credit risks of individual firms is extremely exceptional. However, "we are in exceptional times," as British Prime Minister Gordon Brown said, and therefore I think in such times "exceptional measures" are required. The Bank will do its utmost to respond with measures to ensure stability in the financial markets.

V. Amid a Worsening Economy, Moves toward New Opportunities

Next, I would like to talk about ways to revitalize Japan's economy. Having shown relatively high growth over the past several years, Japan's economy is now deteriorating rapidly. The fruits of the economic expansion of the past several years have been confined to large firms and metropolitan areas with strong links to the global economy, but economic hardship has now struck before these fruits could spread to households and small firms as well as regional areas. Under such circumstances, it is necessary for both the private and public sectors to draw up and implement strategies for future growth. It may be said that Japan's economy is now at a point when it should build up its strength to realize further growth. In this context, the following issues are key.

A. Further Expansion of Overseas Activities

Further declines in and aging of Japan's population are likely to restrain economic growth. Generally speaking, global economic growth is higher than growth in Japan. In these circumstances, by diversifying export destinations and establishing overseas production and sales bases worldwide, Japanese firms have been able to avoid the impact of economic cycles of specific countries and benefit from high global growth. This has provided a source of growth for Japan's economy.

The recent drop in global stock prices and appreciation of the yen mean that conditions have become even more favorable for the expansion of global activities, and a conspicuous development is that not only external demand-oriented industries but also domestic demand-oriented ones -- such as providers of food products, food services, and daily necessities -- are actively engaging in M&A and expanding into foreign countries in order to benefit from medium- to long-term growth in overseas economies. Small firms also are gradually increasing exports and expanding overseas business activities. This situation underscores the growing importance for Japan of further strengthening its connections with overseas economies by concluding more economic partnership agreements (EPAs) and free trade agreements (FTAs). Globally, there are more than 200 bilateral or multilateral EPAs and FTAs. However, Japan so far has concluded only nine EPAs and has largely agreed on only two more, with Vietnam and Switzerland; it has not entered into any agreements with many of its major trading partners.

B. Inward Direct Investment

The expansion of Japanese firms' overseas activities benefits the domestic economy via, for example, an increase in manufacturers' exports of materials and machinery equipment to be used in overseas production and of industrial and construction machinery. In addition to such outward direct investment, it is similarly important that Japan promote inward direct investment. Although inward direct investment in Japan is gradually increasing, it continues to remain low compared with other major economies. An impression among foreign investors that regulation in Japan is obscure and its market therefore closed has also been suggested as a hurdle for inward direct investment.

Given that Japan's outward direct investment is likely to continue to increase, Japan should attract more inward direct investment. This would open up more opportunities for Japanese firms to strengthen their global competitiveness through strategic tie-ups with foreign firms. An increase in inward investment could also bring macroeconomic benefits, as a diversification in Japanese firms' management -- or participation in management by various types of investors including foreign ones -- could reduce swings in business fixed investment stemming from domestic factors and thus increase the robustness of domestic demand.

C. Securing Sufficient Human Resources and Improving Labor Productivity

It has been estimated that Japan's population will decline to 80 million by 2060, which would be less than that of the United Kingdom, whose population is likely to increase from the current 60 million. If this turns out to be the case, the rapid decline in population combined with aging would put economic growth and social vigor at risk. Currently, the number of immigrants in Japan is about 2 million, only 1.6 percent of the population. It is noteworthy that the ratio of immigrants to the population overall in the United States, Germany, and the United Kingdom -- all of which have been posting long-term and sustainable economic growth -- is as high as 12.9 percent, 12.3 percent, and 9.1 percent, respectively. In countries with a large number of immigrants, however, the increase in immigrants has caused certain social problems, and some countries have revised their liberal immigration policies accordingly. As not only the United States and European countries but also emerging economies are gaining strength, Japan should take the current situation more seriously and act promptly to secure necessary human resources in the international market before it becomes too difficult. I hope that a long-term and comprehensive approach will be taken soon regarding this issue.

At the same time, it is important for Japan to increase labor productivity. For this purpose, Japanese firms should treat workers fairly. For instance, a great deal of improvement is required in staff training. Since a large number of baby boomers have been retiring, it is vital to ensure that the skills and expertise of firms in the manufacturing sector and various other sectors are steadily passed on to the next generation. It is also important that firms ensure employees have a healthy work-life balance, non-regular employees receive training, and the status of non-regular employees is changed to that of regular ones. Social arrangements that allow women to keep their job without anxiety when giving birth and raising children are also important. Firms' efforts in these directions should not be so extreme as to harm their competitiveness in the long run. However, it is fundamental to have sufficient skilled labor to achieve sustainable growth of both Japanese firms and the economy as a whole. To this end, firms should devise strategies to ensure that as many employees as possible are satisfied with their job and are more productive, and to encourage them to stay in their job for a long period of time.

D. Issues Relating to Natural Resources and the Environment

The recent surge and drop in prices of natural resources and food have brought large swings in prices and real income in both the exporting and importing countries and have threatened social stability worldwide. For Japan, it is crucial to secure sufficient amounts of natural resources and food supplies. Japan needs to strengthen its capacity to procure natural resources and food by getting involved in activities at the source of production, for example, mine development for mineral resources and the management of local farms and factories for food. Both the public and private sectors need to plan and put into action medium- to long-term strategies to this effect, taking fully into account the risks involved.

Dealing with environmental issues is indispensable for sustainable growth of not only Japan's economy but also the global economy. In particular, constraining global warming has become a major political issue. While Japanese firms need to reduce their greenhouse gas emissions, there is high expectation that -- by making the best use of their world-leading technology that is environmentally friendly and supports efficient use of energy -- they will create new global business and, at the same time, contribute to solving the problem. Even in the current economic downturn, the business opportunities to respond to environmental challenges are too numerous to mention. They range from building liquid crystal factories that save vast amounts of industrial water to the development and application of heat-resistant alloy metals for use in steam turbines that lead to greater efficiency in power generation, automotive carbon fibers that are lightweight and highly durable, resins produced from plant life, ships that can run on solar cells, and automobiles and motorcycles that can be driven only on electricity. Environmental issues are one of the areas in which Japanese firms can demonstrate leadership, and it is hoped that they will make contributions in many aspects. Action by Japanese firms in this regard will help to reduce global consumption of natural resources and mitigate the severity of the resource problem.

E. Avoiding Large Swings in Economic and Financial Activity: Learning from the Past

Long-lasting economic growth tends to cause a buildup of economic and financial excesses at some point, threatening further growth. The ongoing financial crisis is an example of a situation in which the risk assessment by market participants became slack amid long-lasting, favorable economic and financial conditions, and correction in the markets followed. In hindsight, such developments are considered a natural course of events. However, history shows that memories of financial events tend to fade after a relatively short period of time and that each of the economic bubbles in the past is different, and this is why people are usually not alert to the seriousness of these kinds of developments.

Common factors behind the emergence of previous economic bubbles that have been highlighted include accommodative financial conditions, rising asset prices, a bullish mood, the development of new financial products, and the appearance of financial genius. It is true that, due to the expansion of the market economy and the progress in economic globalization, the economy and financial markets are constantly changing and new developments are arising. Notwithstanding, it is important for firms, financial institutions, and also the public sector to be humble and learn from past events -- those that occurred not only in Japan but also worldwide -- so that they can capture the essence of current economic and financial phenomena and avoid large swings in economic and financial activity. At the same time, it is necessary to take prompt policy action to stabilize economic and financial activity once a correction of economic and financial excesses takes place, as was recognized in the process of dealing with the current crisis.