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Bank of Japan

Japan's Monetary Policy and Developments in Economic Activity and Prices

Summary of a Speech at a Meeting with Business Leaders in Nara

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I. The Bank of Japan's Business Operations

Let me start my speech today by briefly explaining the business operations and functions of the Bank. The Bank conducts monetary policy with the aim of achieving price stability and thereby contributing to the sound development of the national economy, pursuant to the Bank of Japan Act. In the mind of the public, the Bank is most strongly associated with its role as the authority in charge of monetary policy, in order to achieve price stability and -- as another of its objectives -- financial system stability, but the Bank in fact carries out a wide range of business operations.

Examples of the Bank's business operations include the following. First, as part of its role as the sole issuer of banknotes, the Bank ensures the smooth circulation of clean banknotes across Japan. As of the end of May, there were about 13.1 billion banknotes in circulation with a total value of around 78.84 trillion yen. Second, to maintain financial system stability, it acts as the "bank of banks" by ensuring the smooth settlement of funds and monitoring financial institutions' business conditions. Third, it acts as the "bank of the government," receiving and disbursing treasury funds and conducting services relating to Japanese government securities (JGSs). Fourth, the Bank conducts surveys and research on developments in economic activity and prices at home and abroad, such as the *Tankan* (Short-Term Economic Survey of Enterprises in Japan), which requires the support of survey respondents nationwide. And fifth, in cooperation with overseas central banks, the Bank executes business operations in the field of international finance. These various business operations are carried out by the roughly 5,000 employees at the Head Office, 44 branches and local offices in Japan, and seven overseas representative offices.

The flow of money in an economy is often compared to the circulation of blood in the human body in that, once it stops or slows, the whole system can fail. Maintaining the functioning of the nation's payment and settlement system is, therefore, an important element of the central bank's role in supporting economic activity. To this end, the Bank is continually improving its business continuity arrangements by preparing for emergency situations -- natural disasters such as earthquakes, terrorist attacks, computer system failures, and the spread of epidemics such as influenza -- including ensuring that essential staff necessary for the conduct of business operations are always available.

On Friday, March 11, the Great East Japan Earthquake occurred during normal business hours at 2:46 p.m., and the Bank immediately set up a disaster management team headed by the Governor. The Bank of Japan Financial Network System (BOJ-NET) -- the core system for the interbank settlement of funds and securities -- continued to operate as usual following the earthquake. To prevent a shortage of cash in the disaster areas, the Bank's branches in the Tohoku region provided a total of 55 billion yen during the weekend immediately after the earthquake. Also, to ease liquidity concerns, the Bank provided ample funds to the money market, totaling 82.4 trillion yen, in the week starting March 14, the first business day after the earthquake, thus preventing any turmoil in the market. Power outages at some of the Bank's branch premises were dealt with by the use of stand-by in-house power generation systems. To exchange damaged or soiled banknotes and coins for clean ones, the Bank increased the number of staff at branches in the disaster areas and opened a temporary cash exchange counter in Iwate Prefecture, where the Bank does not have a branch. As of the end of May, the amount outstanding of cash exchanged at the branches in the Tohoku region, including Sendai, Fukushima, Akita, and Aomori, and the temporary counter in Morioka in Iwate Prefecture, was 1.883 billion yen. These business operations may seem distant from the conduct of monetary policy at first glance; however, public confidence in the currency and the Bank could be undermined, which in turn could hamper the Bank's conduct of monetary policy, should the Bank fail to provide central banking services in a stable manner.

II. Recent Developments in Economic Activity

A. Overseas Economies

Next, I will discuss developments in economic activity at home and abroad, starting with the situation overseas.

With advanced economies continuing to recover at a modest pace, the global economy has continued to recover moderately, driven mainly by strong growth in emerging and commodity-exporting economies. According to the International Monetary Fund (IMF) *World Economic Outlook* released in April, the global economy is projected to grow 4.4 percent in 2011 and 4.5 percent in 2012, indicating that global economic growth is likely to remain firm. The impact of the earthquake on overseas economies generally appears to be limited.

Led mainly by robust domestic demand, emerging and commodity-exporting economies have continued relatively high growth and are driving global growth. However, in many of these economies, concerns about inflation have been mounting due to the earlier rise in international commodity prices, prompting their central banks to lean toward monetary tightening by, for example, raising policy rates and reserve requirement ratios. China's economy currently continues to grow at a rate of around 9.0-10.0 percent, while inflation runs at a rate of about 5.0-6.0 percent, exceeding the government's inflation target of 4 percent. Against this background, the People's Bank of China recently implemented the fifth increase so far this year of the reserve requirement ratio and strengthened liquidity controls, including setting a ceiling on aggregate credit newly extended by banks, and is strengthening its stance to curb inflation. These measures may dampen economic growth to some extent, but given that China is enjoying a virtuous cycle of growth in exports, production, income, and spending, the economy, on the whole, is likely to continue to grow at a relatively high rate.

The U.S. economy has been recovering and is likely to remain on a recovery trend. The seasonally adjusted annualized quarter-on-quarter growth rate of real GDP in the January-March quarter of 2011 was 1.8 percent. Although this is lower than the 3.1 percent recorded in the preceding quarter, it confirms that, mainly thanks to exports and private consumption, the U.S. economy continues to recover. However, balance-sheet adjustments in the heavily indebted household sector remain a major drag on the economy, the prolonged sluggishness in the housing market persists, and the unemployment rate, which stood at 9.0 percent in April, is still high. Although private-sector employment has continued to trend up, the improvement still lacks the momentum to make up for the approximately 8 million jobs lost since the Lehman shock. While the Federal Reserve has announced that it will end purchases of an additional 600 billion U.S. dollars of Treasury securities by the end of June 2011, as scheduled, it also emphasized that it will continue to maintain an accommodative monetary policy stance for an extended period in a situation where the U.S. economy lacks vigor as a whole.

European economies as a whole have been recovering moderately, albeit with some differences in growth by country. While peripheral countries in the euro area are registering low growth, large core economies, such as Germany and France, are enjoying steady growth supported by increases in exports, particularly to the emerging economies, and private consumption. As for the outlook, the pace of economic growth in Europe as a whole is likely to remain moderate, given that countries in the euro area are implementing austerity programs as part of their fiscal consolidation measures and because of the uncertainties regarding how the debt problems in countries such as Greece will develop. In this environment, the European Central Bank (ECB) in April raised its policy rates for the first time since the Lehman shock owing mainly to increases in international commodity prices. However, given the major risk factor presented by problems involving the credit risk of government bonds issued by peripheral countries in the euro area, the outlook for European economies, particularly Greece, remains highly uncertain.

While the issue of fiscal consolidation in Europe and the United States has been gaining attention, let me touch upon the fiscal status of Japan. Although Japan has the highest ratio of public debt to GDP among major industrialized countries, yields on Japanese government bonds (JGBs) have remained stable at low levels. One likely explanation is that JGBs continue to command market confidence, despite Japan's grave fiscal situation. Fiscal consolidation is not a task that can be achieved over a short period of time. It is therefore important for Japan to steadily work on measures aimed at fiscal consolidation while market confidence regarding the creditworthiness of JGBs remains in place.

B. Japan's Economy

Following a V-shaped recovery after the Lehman shock, Japan's economy had been on a moderate recovery trend, but the situation changed completely with the earthquake on March 11. The economy is currently facing strong downward pressure, mainly on the production side.

Although the preliminary results for the industrial production index for April show a small increase of 1.0 percent from March -- mainly due to progress in the restoration of supply chains -- the level of production remains at only around 85 percent of that in February, that is, just before the earthquake. Automobile production in particular dropped sharply, and the number of passenger cars produced in April marked a year-on-year decline of 60.2 percent. In these circumstances, real exports have continued to decline, registering a 6.9 percent fall in April from the previous month, due largely to the substantial decline in automobile exports caused by production constraints. However, production is likely to improve, with the production forecast index for May suggesting a month-on-month increase of 8.0 percent and that for June suggesting an increase of 7.7 percent. Moreover, in the automobile industry, production activity is gradually returning to normal. Parts makers announced that they would resume production of core components in June and hoped to achieve pre-quake production levels by the end of October. Major automakers also announced that they would raise production so that, from early autumn, production levels would gradually return to close to normal. Thus, although at present production continues to be well below normal levels, firms in the Japanese auto and parts industries seem to have become more confident about the restoration of production sites in coming months, which significantly contrasts with the early post-quake stage, when they found it difficult to specify the timing of such restoration. These developments, I think, can be interpreted as a positive development.

Private consumption has also been weak, caused by sluggish sales due to supply constraints and restraint in consumption due to a deterioration in consumer sentiment. That being said, looking at retail sales indicators for April, although sales at convenience stores slowed, they still showed a year-on-year increase of 3.0 percent, while the year-on-year rate of decrease in sales at department stores decelerated considerably to 1.8 percent in April from 15.0 percent in March. A similar trend can be observed for sales in the food service industry. According to the Economy Watchers Survey for April, conducted between April 25 and 30, the diffusion index (DI) for current economic conditions remained at a deeply depressed level, but that for future economic conditions marked an increase of 11.8 percentage points, suggesting an improvement in business sentiment. Although consumers continue to restrain consumption of nonessential items, reports in the media as well as anecdotal evidence suggest that consumption has been gradually increasing since May, which included a string of holidays known as "Golden Week," as voluntary restraint and supply constraints on goods and electricity have eased. That being said, substantial differences across regions and industries remain.

The number of foreign visitors to Japan continued to fall substantially, registering a year-on-year decrease of 62.5 percent in April, following a drop of 50.3 percent in March. Partly as a result, the occupancy rates of major hotels in Tokyo (19 respondents) and Osaka (15 respondents) dropped sharply in April, according to a survey by Nikkei Inc.

C. Baseline Scenario of the Outlook for the Economy and Prices

Next, I will talk about the outlook. The main reason behind the current drop in economic activity is the supply-side shock caused by the earthquake and, as highlighted in the *Outlook for Economic Activity and Price*s (Outlook Report) released at the end of April 2011, the prospects for Japan's economy crucially hinge on a recovery in production and exports.

For the time being, Japan's economy is likely to continue facing downward pressure, mainly on the production side, since it is likely to take some time to reconfigure supply chains and electricity supply constraints are likely to occur at peak times in the summer. However, from early autumn onward, with further progress in the reconfiguration of supply chains -- which have been seriously disrupted, particularly in the automobile industry -- and easing in electricity supply constraints, production and exports are likely to increase again against the backdrop of steady growth in overseas economies. In this situation, private consumption is likely to pick up again gradually and, together with a rise in demand for reconstruction, this is likely to accelerate the pace of recovery in the second half of fiscal 2011. In fiscal 2012, demand for reconstruction is likely to remain high, while overseas economies, especially emerging and commodity-exporting economies, are likely to continue growing steadily. The transmission mechanism by which increases in exports and production feed through into income and spending is likely to strengthen, and Japan's economy is projected to grow at a pace above its potential in fiscal 2012 due in part to a rebound from the significant deceleration in fiscal 2011. The Bank's forecast for real GDP growth released for reference in the Outlook Report is 0.6 percent for fiscal 2011 and 2.9 percent for fiscal 2012.

As for price developments, the year-on-year rate of change in the consumer price index (CPI) for all items excluding fresh food in fiscal 2011 is likely to be slightly higher than in the previous year due to the falling off of the effects of subsidies for high school tuition introduced in fiscal 2010 and to the rise in international commodity prices. The Bank's forecast for the average annual rate of increase in the CPI is around 0.7 percent for both fiscal 2011 and 2012. However, it needs to be noted that in August the Ministry of Internal Affairs and Communications, which is in charge of compiling the CPI, will announce revised CPI figures based on a change of the base year from 2005 to 2010, and that as a result the year-on-year rate of change in the CPI may be revised downward.

D. Upside and Downside Risks to the Baseline Scenario of the Outlook

The baseline scenario I just presented is subject to various upside and downside risks, which warrant attention.

First, there is a high degree of uncertainty -- both on the upside and on the downside -- about the effects of the earthquake on Japan's economy. In addition, if firms and households were to maintain an overly pessimistic view regarding the outlook for Japan's economy, domestic demand -- such as business fixed investment and private consumption -- could be restrained over the medium to long term, posing the risk of a decline in the expected growth rate of the economy. Further, economic activity might turn out weaker than in the baseline scenario presented in the Outlook Report if -- due to delays in the reconstruction of supply chains, for example -- firms accelerate the shift of production and/or parts procurement overseas or the share of Japanese products in overseas markets falls, or if the tense situation at the nuclear power plant and electricity supply constraints continue to linger. On the other hand, economic activity in Japan might turn out stronger than projected if, due to the damage caused by the earthquake, firms strengthen efforts to establish new production sites in Japan and reconfigure supply chains to diversify risks, make new investments aimed at promoting more efficient use of energy, or create new demand by developing new products in response to changes in lifestyles. Furthermore, the earthquake has brought into focus a wide range of issues that have been left unaddressed for years. If this can be grasped as a chance to carry out fundamental reforms, then -- I would like to think -- it may present an opportunity for Japan's economy to emerge from its prolonged stagnation.

The next risk factor concerns developments in overseas economies. For the U.S. and European economies, downside risks prevail: the U.S. economy is burdened by balance-sheet adjustments in the household sector, while in Europe sovereign risk problems are lingering in some peripheral countries such as Greece, and these problems may act to reduce economic activity through disturbances in financial markets. On the other hand, emerging and commodity-exporting economies for the time being are likely to maintain relatively high growth led mainly by robust domestic demand. However, with concern increasing over overheating or inflation, there is also a risk that due to monetary tightening to address such concerns, activity in these economies might fall below expectations, which would pose a downside risk to Japan's economy.

Lastly, attention needs to be paid to the risk that private demand might be pushed down in Japan due to a deterioration in corporate profits triggered by a rise in raw material prices in international commodity markets, reflecting geopolitical risks such as increased tension in North Africa and the Middle East.

E. Japan's Economy and the Automobile Industry

As I mentioned, automobile production has continued to drop sharply: the number of passenger cars produced in April marked a year-on-year decline of 60.2 percent and automobile-related real exports a decline of 46.0 percent for the same month. This significant drop in production and exports in the automobile industry has played a large part in the recent substantial downturn in Japan's economy.

Industrial production in March fell 15.5 percent from the previous month. This was mainly attributable to a significant decline of 49.7 percent on a month-on-month basis in the production of transport equipment excluding ships and rolling stock (i.e., the production of two- and four-wheeled vehicles and related parts), which in 2005 accounted for 15.7 percent of Japan's total industrial production. A key characteristic of automobile production is that, with its various sub-sectors, it involves a wide range of other industries, generating substantial production spillovers. For example, according to the Ministry of Internal

Affairs and Communications' Input-Output Tables for 2005, the transport equipment industry (here including ships and rolling stock due to statistical constraints) generated production spillovers of a factor of 2.82. In other words, each unit of demand that arose in the transport equipment industry both directly and indirectly generated domestic demand that was 2.82 times that amount. This figure illustrates the breadth and magnitude of the transport equipment industry, given that the average production spillover effect for all industries only has a factor of 1.93. Together with the fact that in fiscal 2010 exports in this sector accounted for 21.6 percent of Japan's total exports on a customs clearance basis, this implies that automobile-related industries are indeed the main engine of Japan's economy.

As is well known, in order to maximize efficiency, supply chains in the Japanese automobile industry form a complex system in which the production and supply of parts -- of which there are said to be more than 30,000 -- and final assembly are synchronized across corporate boundaries to shorten lead times and minimize inventories. Moreover, corporate groups in the industry are in fact structured like multi-layered pyramids with broad bases, each comprising a large auto assembler and its subcontractor parts makers. However, irrespective of this multi-layered nature of the supply system, there had been a consolidation and concentration of production bases and lines, aimed at enhancing cost-competitiveness and production efficiency, which led to a concentration of production lines for core components at certain parts makers and resulted in large assemblers relying heavily on a very small number of parts makers. This was a source of risk to which large auto assemblers paid little attention. It was this defect in the supply system that led to bottlenecks in the aftermath of the earthquake and affected automobile production worldwide.

Given the large role the automobile industry plays in Japan's economy, as highlighted earlier, it can be said that the speed and breadth of the economic recovery following the earthquake will greatly depend on the reconstruction of parts makers' production sites and the recovery in production and exports of the automobile industry overall.

As the earthquake unexpectedly revealed, Japan's economy is highly dependent on certain industries. This entails the risk that when these industries contract sharply, so does Japan's economy as a whole. Such an industrial structure also carries risks in the case of intensified competition when emerging economies rapidly catch up with Japan in these industries, or in the case of the emergence of powerful innovative products that replace those produced by Japanese firms. The "Industrial Structure Vision 2010" introduced by the government advocates a shift from an industrial structure heavily dependent on a small number of competitive industries, including the automobile industry, to a more diversified structure in which multiple industries play the role of growth driver. Adopting such a structure is vital to build a nation that can withstand changes in the economic environment.

III. Conduct of Monetary Policy

I will now move on to the conduct of monetary policy. With a view to overcoming deflation amid intense global competition and returning the Japanese economy to a sustainable growth path with price stability, the Bank, even prior to the earthquake, conducted aggressive monetary easing through its comprehensive monetary easing policy while implementing measures such as the fund-provisioning measure to support strengthening the foundations for economic growth. In this situation, in response to the earthquake, the Bank further enhanced monetary easing through its comprehensive monetary easing policy and introduced measures to support financial institutions in disaster areas. I will discuss each of these measures in turn.

A. Further Enhanced Monetary Easing under the Comprehensive Monetary Easing Policy

On October 5, 2010, the Bank decided to implement comprehensive monetary easing based on the recognition that it was highly likely that the return of Japan's economy to a sustainable growth path with price stability would be delayed compared to what had been projected earlier, partly due to the slowdown in overseas economies and the effects of the yen's appreciation on business sentiment.

In a situation where there was little room for a further decline in short-term interest rates due to the virtually zero interest rate policy pursued by the Bank, the policy I just mentioned consisted of three measures aimed at further enhancing monetary easing: first, changing the target for the uncollateralized overnight call rate from "around 0.1 percent" to "around 0 to 0.1 percent" in order to further clarify the Bank's adoption of a virtually zero interest rate policy; second, clearly stating that the Bank would continue the virtually zero interest rate policy until it judged that price stability was in sight; and third, establishing an Asset Purchase Program with a total size of about 35 trillion yen.

After the earthquake, there were concerns that, amid expectations of unprecedented damage from the disaster, any deterioration in business and household sentiment and heightening of risk aversion in financial markets would adversely affect economic activity. In view of this, the Bank, at the Monetary Policy Meeting on March 14, 2011, immediately following the earthquake, increased the amount of purchases of assets, mainly of risk assets, from about 5 trillion yen to about 10 trillion yen, bringing the total amount of the Asset Purchase Program to about 40 trillion yen. In addition, given that the market faced severe stress following the earthquake, the Bank provided liquidity in a timely and flexible manner. Through these measures, the Bank helped markets to regain stability at an early stage.

B. Introduction of Measures to Support Financial Institutions in Disaster Areas

In order to support financial institutions in disaster areas in their initial efforts to meet the need for funds among firms and individuals for restoration and rebuilding, the Bank introduced a funds-supplying operation for the provision of loans totaling 1 trillion yen with a loan duration of one year and a loan rate of 0.1 percent. On May 23, the Bank conducted the first loan disbursement through the measure, providing financial institutions with a total of 74.1 billion yen, and on June 1 announced that it would conduct its second loan disbursement on June 28. It plans to continue disbursing loans generally once a month. In addition to implementing this operation, the Bank relaxed the eligibility standards for collateral submitted by financial institutions in disaster areas for the provision of funds. I sincerely hope that such efforts by the Bank will support rebuilding efforts in the disaster areas.