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Bank of Japan

**A New Phase of the Global Economy  
and Challenges Facing Japan's Economy**

*Speech at the Meeting of Councillors of Nippon Keidanren  
(Japan Business Federation) in Tokyo*

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(English translation based on the Japanese original)

## **Introduction**

It is a great honor to have this opportunity to address such a distinguished gathering of business leaders in Japan today.

2017 is now just a week away. Today, to round off 2016, I would like to take a look back at this year's economic developments. Then, from a somewhat longer-term perspective, I would like to talk about the current phase of the global economy, and close my speech by touching on challenges facing Japan's economy, looking ahead to next year.

### **I. The Global Economy in 2016**

Reviewing 2016, it started off with volatile global financial markets. Specifically, Shanghai stock prices declined significantly at the beginning of the year, reflecting uncertainties regarding developments in the renminbi, and this led to a rapid worsening of investors' risk sentiment. These developments in emerging economies brought about declines in stock prices and long-term interest rates in major advanced economies. At the Group of Twenty (G-20) Finance Ministers and Central Bank Governors Meeting held in Shanghai in late February, the member countries agreed to cooperate in addressing volatility in financial markets and the heightening of uncertainties in the global economy. Due in part to this, global financial markets had stabilized temporarily. However, a "risk-off" mode in global financial markets continued thereafter through autumn, partly reflecting the United Kingdom's referendum in late June, in which the majority voted to leave the European Union (EU). On the growth and inflation front, the trend decline in the growth rate -- the so-called secular stagnation hypothesis -- and the global decline in inflation rate have been hotly debated. Many of you may have an impression that 2016 was a year in which pessimistic views on the global economy prevailed.

However, actual data indicate that the global economy is not as bad as it appears. The pace of growth in advanced economies has accelerated recently, mainly led by the solid U.S. economy (Chart 1). There are increasing expectations of acceleration in the U.S. economy's growth rate going forward, reflecting the outcome of the presidential election. In fact, various economic indicators actually continued to improve steadily even before the election. In emerging and commodity-exporting economies, the growth momentum is picking up,

albeit moderately, due in part to the effects of their policy measures. The global economy as a whole appears to be turning upward. Let me remind you of the fact that the International Monetary Fund (IMF), for the first time in a while, did not make downward revisions in its World Economic Outlook (WEO) in October, and that the Organisation for Economic Co-operation and Development (OECD) revised upward its Economic Outlook released last month (Chart 2).

From a somewhat longer-term perspective, the global economy seems to have finally moved out of its adjustment phase after the global financial crisis, often dubbed the Lehman shock, and is entering a new phase. In what follows, I will touch on changes underway in the global economy while looking back at developments after the global financial crisis.

## **II. The Global Economy after the Global Financial Crisis**

After the global financial crisis started in autumn 2008, the growth rate of the global economy significantly decelerated. A salient feature of this recession was the deceleration in growth of the world trade volume, the slowdown in the manufacturing sector, and the decline in business fixed investment. For example, the recent growth in the world trade volume, calculated by summing up the import volumes of the world's countries, has been well below the average growth rate before the global financial crisis (Chart 3). Since the global financial crisis, the level of the world trade volume also has deviated substantially downward from the trend suggested by the globally-aggregated real GDP. This deceleration in growth of the world trade volume is called "slow trade," which well characterizes the global economy after the global financial crisis.

Economists and policymakers including the Bank's staff are conducting various analyses on factors behind the slow trade. Although there is no consensus at present, structural factors such as the pause in the expansion of the global supply chain and the progress of internalization in China seem to have played an important role, in addition to a cyclical decline in demand. The breakdown by region and item shows that the decline was conspicuous in emerging economies and capital goods. The downward deviation from the trend in real imports was larger in emerging economies than in advanced economies (Chart 4). Looking at the global real imports by item, the decline in the imports of capital goods is

significant. These facts suggest that the deceleration in growth of the world trade volume was largely driven by the sluggish demand in business fixed investment, mainly in emerging economies. The continued decline in global demand for capital goods has had a significant negative impact on the manufacturing sector in Japan, which has a comparative advantage in capital goods.

With the slow trade continuing, advanced economies' exports to emerging economies have been sluggish, leading to lower production activities in the manufacturing sector. As the manufacturing sector tends to play a significant role in leading the business cycle in many economies, its slowdown has weighed on the recovery in advanced economies. In this situation, the recovery during the past few years in these economies -- the United States and Europe in particular -- has been led largely by an acceleration in household expenditures amid a lack of momentum in corporate expenditures (Chart 5).

Fortunately, there have been signs of improvement recently. Having been weak since 2015, the purchasing managers' index (PMI) -- which represents the overall business conditions in the manufacturing sector -- has improved clearly of late in the advanced economies as well as the emerging and commodity-exporting economies (Chart 6). Looking at imports in emerging economies, those in the Chinese and the ASEAN economies bottomed out and then picked up. Given that the weakness in emerging economies' imports had accounted for the major part of the slow trade, the ongoing recovery in their imports is likely to have a positive impact on a wide range of advanced economies' manufacturing sectors.

On the macroeconomic policy front, aggressive monetary easing was introduced mainly in advanced economies by employing so-called unconventional measures such as quantitative easing (QE) -- or large-scale purchases of assets including government bonds -- and the negative interest rate policy. With regard to fiscal policy, the G-20 countries provided strong fiscal stimulus in a coordinated manner immediately after the start of the global financial crisis. Thereafter, some countries -- those in Europe in particular -- conducted fiscal policies in a neutral or somewhat contracting manner for a while. This year, with the heightening of global uncertainties, the G-20 and the IMF agreed to take a three-pronged approach that uses all policy tools -- monetary, fiscal, and structural -- individually and collectively, with a

view to achieving strong, sustainable, balanced, and inclusive growth. In fact, the authorities in each economy have been supporting their respective economic growth.

Let me summarize the recent developments in the global economy. The growth momentum has been picking up in emerging economies; in advanced economies, reflecting this development, the economic recovery that had been led by the household sector is now spreading to the corporate sector, including manufacturing. Commodity prices such as crude oil prices bottomed out in the first half of the year and turned to an increase thereafter, reflecting the recovery in global demand (Chart 7). The global economy seems to be finally entering a new phase, by putting the negative legacy of the global financial crisis behind it, although considerable uncertainties lie ahead.

### **III. Japan's Economy amid the Global Economic Developments**

Now, let me turn to Japan's economy amid the global economic developments that I've just explained. The global financial crisis that started in 2008 exerted a considerable impact on Japan's economy. As you all know, it was triggered by concerns over the stability of financial systems as subprime mortgage-related losses spread in the United States and Europe. It should be noted that the downturn in the real economy in Japan was more significant than that at the epicenter of the crisis -- namely, the United States and Europe -- although losses at financial institutions were rather limited and the soundness of financial systems was well maintained (Chart 8). There seem to have been two factors behind that development. First, as I mentioned earlier, manufacturing -- in which Japan has a competitive advantage -- was stagnant on a global basis, as seen in particular with the decline in demand for capital goods. Second, the yen appreciated in an excessive manner, exerting a significant negative impact on Japan's economy, mainly on manufacturing. This was because the yen had been perceived as a safe haven currency in the global financial markets, in addition to the fact that there had been little room for further reduction in interest rates in Japan.

Under these circumstances, Japan's economy was put in an unfavorable situation. The Bank responded by lowering the short-term policy interest rate -- which already had declined to as low as 0.5 percent -- to 0.1 percent. In addition, it undertook new policy initiatives

including the purchases of risk assets such as CP, which we call "comprehensive monetary easing." Despite these efforts, Japan's economy did not get out of deflation, as the Bank was not able to provide sufficient monetary stimulus given the limited room for lowering the short-term interest rates.

It was against this background that the Bank introduced in April 2013 an unprecedentedly large-scale monetary easing, quantitative and qualitative monetary easing (QQE), in order to achieve the price stability target of 2 percent at the earliest possible time. The main transmission mechanism of QQE is lowering the real interest rates by (1) exerting downward pressure on the interest rates across the entire yield curve through massive purchases of Japanese government bonds (JGBs) and (2) raising people's inflation expectations through the Bank's strong and clear commitment. Thereafter, the Bank has pursued further monetary easing as appropriate; it expanded QQE in October 2014, followed by the introduction of the negative interest rate policy in January 2016. Thanks to a series of powerful monetary stimulus measures, Japan's economy has improved significantly during a period of more than three and a half years (Chart 9). The excessive appreciation of the yen has been fairly corrected and stock prices have increased substantially. Corporate profits have marked their historical high levels and business fixed investment has recovered. With regard to the employment and income situation, the unemployment rate has declined to as low as 3 percent, which is virtually full employment, and wages have continued to rise moderately. On the price front, Japan's economy is no longer in deflation, which is commonly defined as a sustained decline in general prices, although there remain the effects on inflation of a significant fall in crude oil prices.

That being said, in the first half of 2016, private consumption showed relatively weak developments in some indicators, mainly reflecting the negative wealth effects stemming from the decline in stock prices and the deterioration of consumer sentiment. As for business activity, exports and industrial production remained sluggish, reflecting the effects of the slowdown in emerging economies and the yen's appreciation, as well as supply-side constraints that were mainly due to the Kumamoto Earthquake. Against this backdrop, the momentum of price increases slowed moderately. However, the recent economic indicators suggest that the economy has been improving (Chart 10). An increasing number of

indicators suggest a pick-up in private consumption. For example, the consumption activity index (CAI) -- which is calculated by compiling various sales and supply-side statistics -- has been increasing steadily in recent months, after showing weakness in the first half of the year. Various surveys on consumer confidence, including the *Economy Watchers Survey*, have been improving. Looking ahead, private consumption is likely to increase moderately as the employment and income situation continues to improve steadily. Regarding employee income, the labor share in the aggregate output has been on a declining trend in recent years, being below the long-term average, with corporate profits staying at high levels. Meanwhile, a variety of indicators for the labor market -- such as the unemployment rate, the active job openings-to-applicants ratio, and the diffusion index (DI) for employment conditions in the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) -- suggest that the labor market conditions have tightened. Thus, the conditions for wage increases largely have been met. Wages are labor costs for individual firms. From the macroeconomic viewpoint, however, they are employee income, which is the source of households' purchasing power. As wages and employee income rise on a sustainable basis, private consumption will be firmer. With regard to business activity, Japan's exports and production have increased recently, on the back of recovery in demand from emerging economies that I've mentioned. By taking account of these improvements, the Bank has made an upward revision to its assessment of economic conditions at the latest Monetary Policy Meeting (MPM) for the first time in a while.

In sum, Japan's economy had struggled against the headwinds of the global economy. As the global economy is entering a new phase, Japan's economy is now able to move further forward, supported by the tailwind.

#### **IV. Challenges Facing Japan's Economy: Looking Ahead to 2017**

Lastly, I would like to touch on challenges facing Japan's economy, looking ahead to next year. As I have explained today, the global economy is entering a new phase. With the tailwind of the global economy, good business opportunities are arising. In this situation, it is imperative to get ahead of your rivals both at home and abroad. Fortunately, advanced technology, including that related to IoT (Internet of Things), AI (Artificial Intelligence), and big data, will become available for commercial use in a wide range of areas, facilitating

new types of products and services.

It is understandable that many people still have pessimistic views on the future of Japan's economy from a longer-term perspective after a long period of deflation and low growth. However, it is you in business management who can discover new growth opportunities in any situation. Joseph A. Schumpeter, an economist who emphasized the role of firms' innovation as the fundamental element of economic growth, presents the following statement in his well-known work, *The Theory of Economic Development*.

*[I]nnovations in the economic system do not as a rule take place in such a way that first new wants arise spontaneously in consumers and then the productive apparatus swings round through their pressure.*

*It is [...] the producer who as a rule initiates economic change, and consumers are educated by him if necessary; they are, as it were, taught to want new things....*

As Schumpeter notes, I think it is extremely important for Japan's economic growth that firms be innovative in various aspects and create demand for new products and services, thereby seizing on consumers' potential needs.

In terms of macroeconomic policy, it is crucial to create a favorable economic environment in which firms can make the most of the global tailwind. On the fiscal front, the government compiled the Economic Measures for Realizing Investment for the Future in August 2016, and it plans to fully implement the measures in the near future. With regard to the structural policy, the government is working on various initiatives, such as regulatory and institutional reforms to raise Japan's growth potential, including the promotion of working-style reforms in the labor market. These measures provide an environment that promotes firms' innovation and will lead to enhancement of Japan's growth potential in the medium to long run.

On the monetary policy front, at the MPM in September, the Bank conducted a comprehensive assessment on monetary easing measures implemented since the introduction of QQE; based on its findings, it introduced a new policy framework called "QQE with Yield Curve Control." This new framework consists of two components: yield



curve control and an inflation-overshooting commitment. I believe that it can further strengthen the effects of the tailwind that pushes up the economy and prices. For example, when the government increases fiscal expenditure, the interest rates tend to increase, thereby restraining private-sector investment. This is the so-called crowding-out effect. However, as the Bank contains a rise in short- and long-term interest rates, this effect can be avoided. When higher growth and inflation are expected, thanks to efforts by businesses and the government's initiatives to strengthen economic growth, keeping interest rates low will further push up growth and inflation going forward. In the current globalized financial markets, as improvement in the global economy becomes evident, there would be upward pressure on long-term interest rates in Japan. In fact, since last month, the long-term interest rates in the United States have been rising significantly, having spillover effects on long-term interest rates in many other countries. Under these circumstances, 10-year JGB yields have been stable at around 0 percent. This shows clearly that the yield curve control by the Bank has exerted its intended effects. By implementing this policy framework in an appropriate manner, the Bank can take advantage of the recovery momentum of the global economy to produce an even greater driving force for Japan's economy. As it encourages firms' proactive activities and thereby leads to expectations of higher growth, the driving force can be strengthened further in a virtuous cycle.

At the same time, the Bank commits itself to continuing with large-scale monetary easing until the year-on-year rate of increase in the observed CPI exceeds 2 percent and stays above that level in a stable manner. This is what we call the inflation-overshooting commitment -- the other component of the new policy framework. Thanks to three and a half years of monetary easing, Japan's economy is no longer in deflation. I believe most of you share the view that the current state of Japan's economy is better than it was four years ago; that is, at year-end 2012. Nevertheless, the 2 percent inflation goal, which is the global standard, has not been achieved yet. In order to ensure that Japan never falls back into deflation, it is necessary to achieve 2 percent inflation in this round of monetary easing.

Some argue that the price stability target of 2 percent is too high considering the current situation of Japan's economy. As I explained earlier, however, Japan's economy had very limited room for monetary easing at the time of the Lehman shock, unlike the U.S. and

European economies, precisely because Japan was the only country in deflation. Considering this painful experience, it is essential to secure some room for monetary policy responses by achieving the global standard of about 2 percent inflation and thereby raising the interest rate that is neutral to the economy. In fact, among central banks and academic economists outside of Japan, it is hotly debated whether 2 percent inflation is sufficient to secure room for policy responses, and some even argue that the target should be raised to 3 or 4 percent. This episode shows that the risk of falling into deflation and thereby losing the effectiveness of monetary policy is widely recognized given the experiences in Japan, as well as those in other economies after the global financial crisis. In relation to this, it is argued in Japan that the Bank should aim at a lower inflation rate, instead of the global standard of 2 percent, as Japan's potential growth rate is lower than that of other economies. However, I believe that the logic should work in the opposite direction. In theory, the interest rate that is neutral to economic activity is the sum of the potential growth rate and medium- to long-term inflation rate. In order to secure room for monetary easing, a low potential growth rate should be the reason for aiming at a higher inflation rate. It can never be the reason for being satisfied with a lower inflation rate. The lower the potential growth rate, the greater the risk of falling into deflation, necessitating a larger buffer for monetary policy. Let me reiterate that the Bank's 2 percent target is the global standard and that the inflation-overshooting commitment is designed to clarify the Bank's stance that it certainly will achieve this target.

2016 has been a tough year, both for businesses and the Bank. Fortunately, the headwind is turning into a tailwind. I am convinced that the coming new year will be one in which Japan's economy will take a big step forward toward overcoming deflation. I would like to close by expressing my hope that your business initiatives will make this happen. Thank you very much for your attention.

# A New Phase of the Global Economy and Challenges Facing Japan's Economy

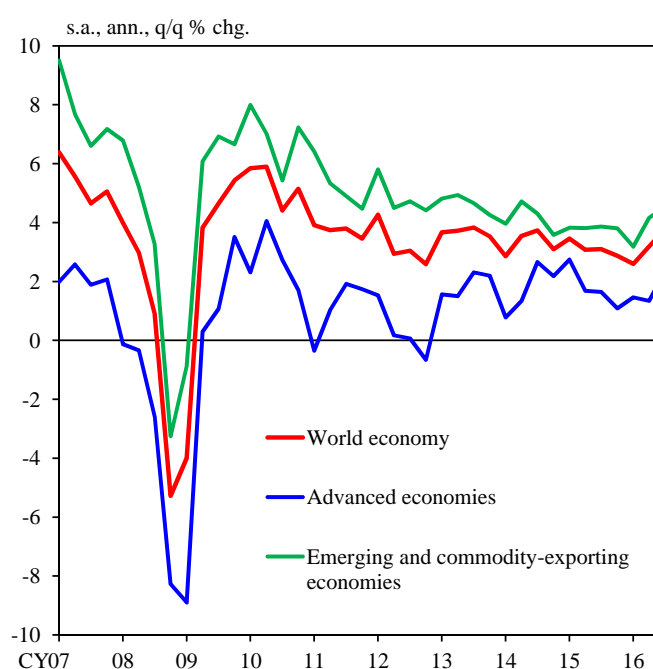
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Haruhiko Kuroda  
*Governor of the Bank of Japan*

Chart 1

## World Economic Growth Rate

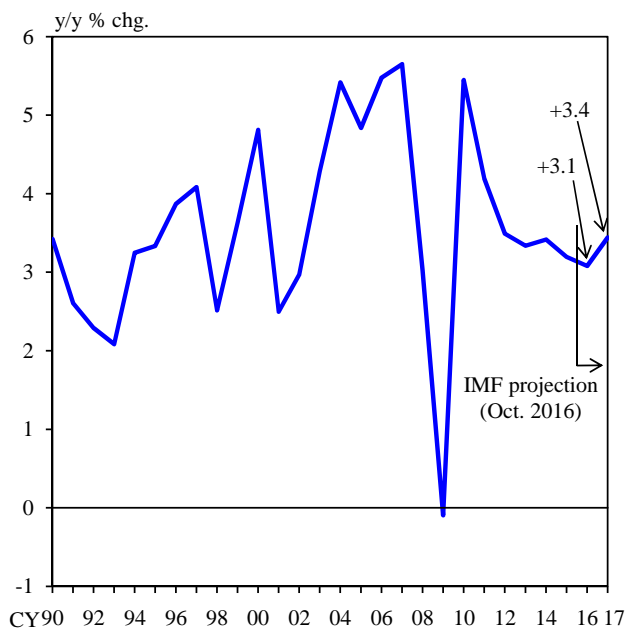


# IMF World Economic Outlook

*Projections for Major Economies  
(as of October 2016)*

	y/y % chg.			
	2014	2015	Projections	
			2016	2017
World	3.4	3.2	3.1 (0.0)	3.4 (0.0)
Advanced economies	1.9	2.1	1.6 (-0.2)	1.8 (0.0)
United States	2.4	2.6	1.6 (-0.6)	2.2 (-0.3)
Euro area	1.1	2.0	1.7 (0.1)	1.5 (0.1)
Japan	0.0	0.5	0.5 (0.2)	0.6 (0.5)
Emerging market and developing economies	4.6	4.0	4.2 (0.1)	4.6 (0.0)
China	7.3	6.9	6.6 (0.0)	6.2 (0.0)
ASEAN5	4.6	4.8	4.8 (0.0)	5.1 (0.0)

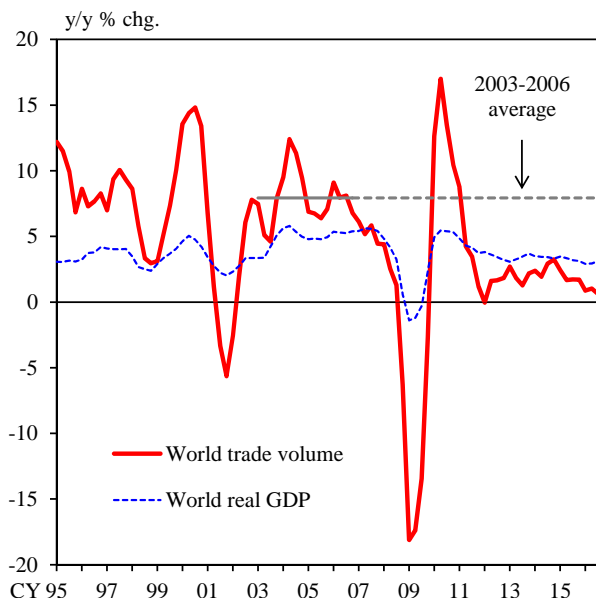
*World Real GDP Growth Rate*



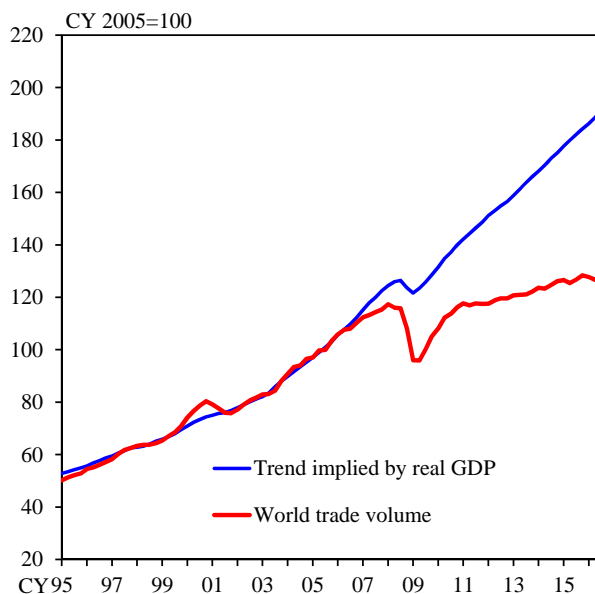
Notes: 1. ASEAN5 are Indonesia, Malaysia, the Philippines, Thailand, and Vietnam.  
2. Figures in parentheses are the differences from the July 2016 WEO projections.  
Source: IMF.

# World Trade Volume

*Growth of World Trade Volume*



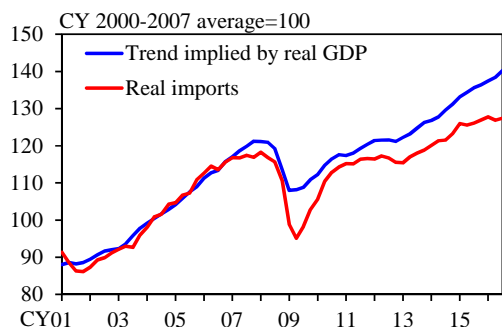
*Level of World Trade Volume*



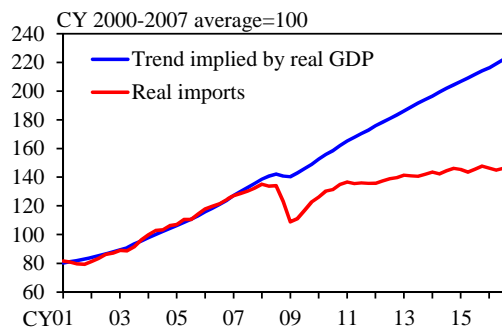
Notes: 1. The world trade volume is calculated by adding up real imports in each country.  
2. The trend of world trade volume is estimated based on the regression of the world trade volume on the world real GDP for the period before 2007.  
Sources: CPB Netherlands Bureau for Economic Policy Analysis; IMF; National statistics offices; Haver; Thomson Reuters Datastream; CEIC.

# Breakdown of World Trade Volume (Real Imports) by Region and Item

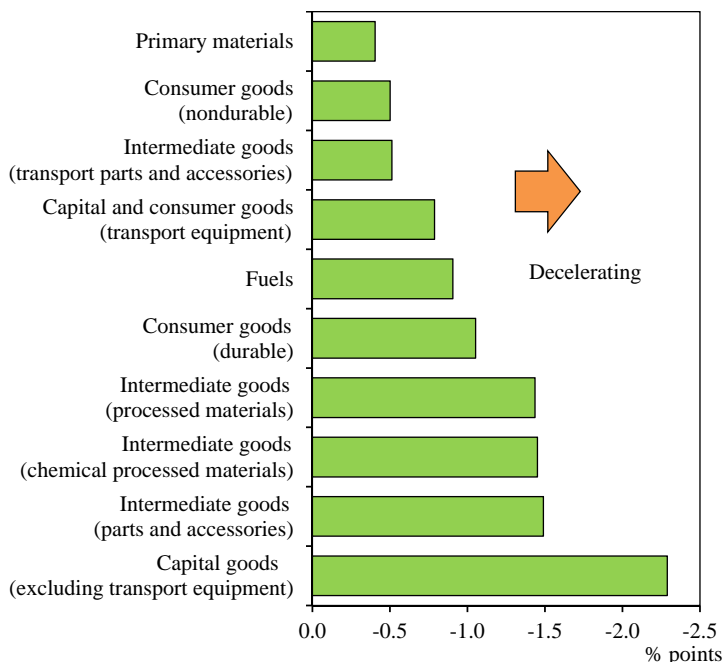
*Real Imports of Advanced Economies*



*Real Imports of Emerging Economies*



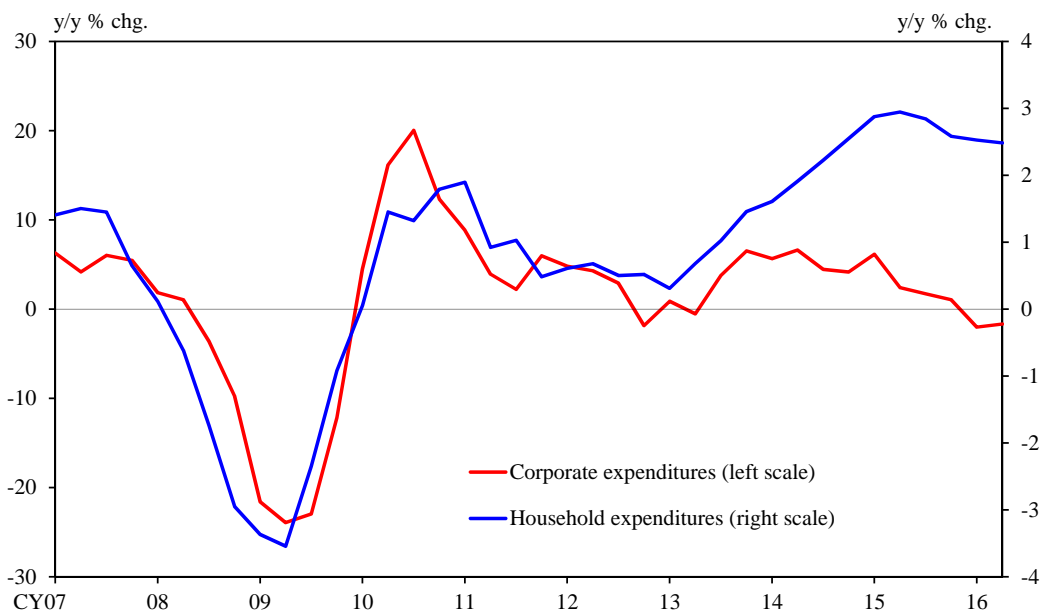
*Changes in Real Imports by Item*



Note: Figures are contributions to the difference in the growth rate of world trade volume between 2012-2014 and 2004-2006.

Sources: CPB Netherlands Bureau for Economic Policy Analysis; Haver; CEIC; UN Comtrade.

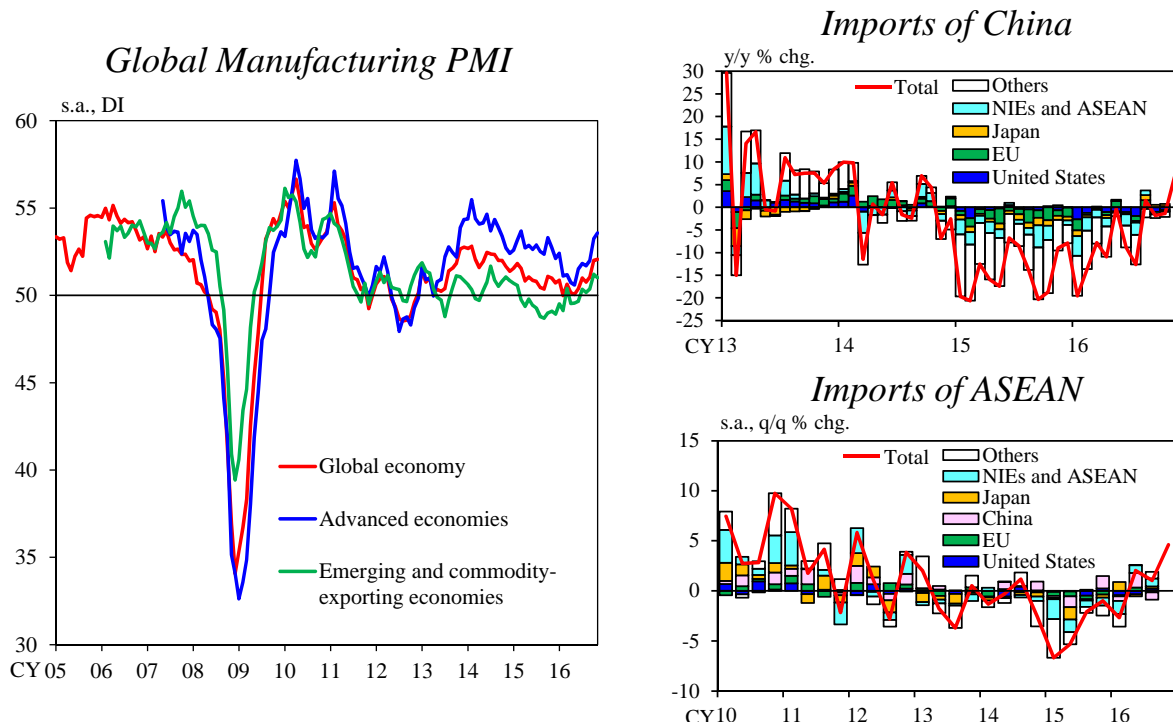
# Corporate and Household Expenditures in Advanced Economies



Note: Advanced economies consist of the United States, the United Kingdom, and the euro area. Corporate expenditures are business fixed investment and inventory investment. Household expenditures are private consumption and private residential investment. Corporate expenditures for the euro area are gross fixed capital formation.

Source: Haver.

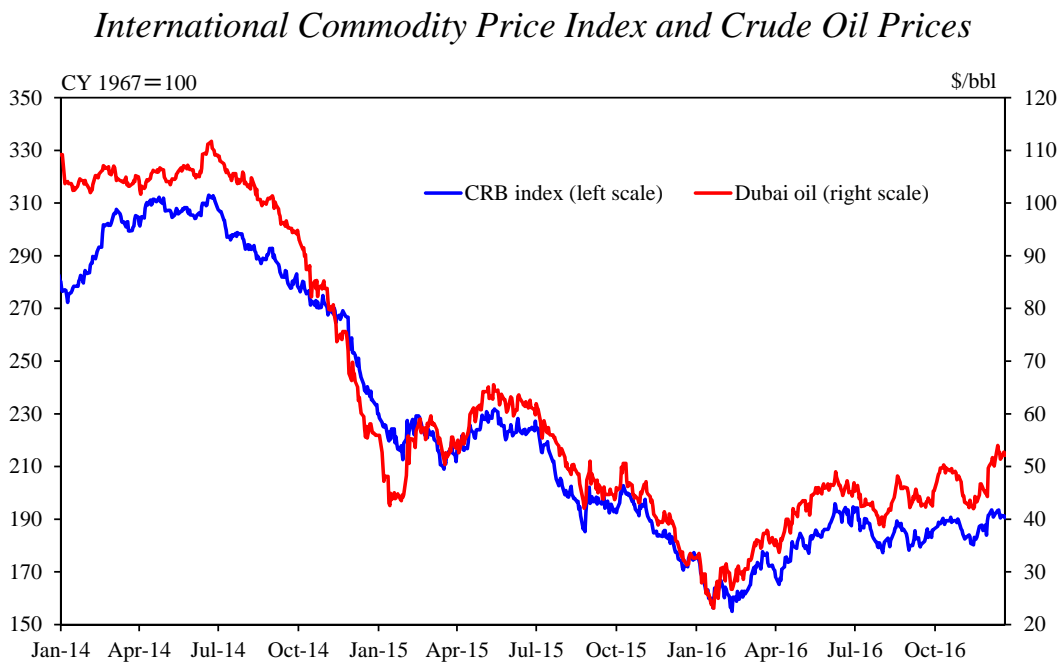
# Manufacturing PMI and Imports of Emerging Economies



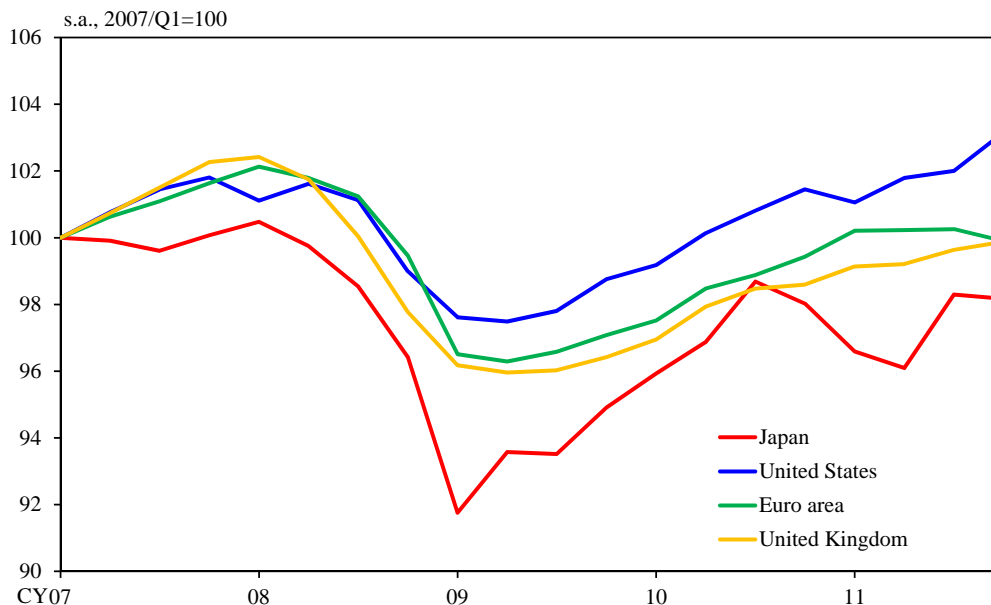
Notes: 1. Figures for the global economy are the J.P.Morgan Global Manufacturing PMI. Figures for the advanced economies PMI as well as the emerging and commodity-exporting economies PMI are calculated as the weighted averages of the Manufacturing PMI using PPP-adjusted GDP shares of world total GDP released by the IMF. Advanced economies consist of the United States, the euro area, the United Kingdom, and Japan. Emerging and commodity-exporting economies consist of 17 countries and regions, including China, South Korea, Taiwan, Russia, and Brazil.

2. Figures for imports show the breakdown by country and region of origin.  
Sources: IMF; IHS Markit (© and database right IHS Markit Ltd 2016. All rights reserved.); Haver; CEIC.

# Commodity Prices



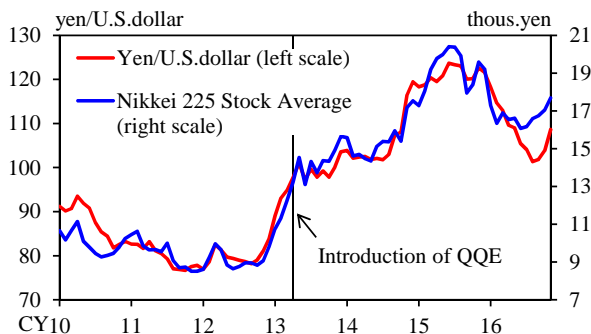
# Real GDP Developments in Advanced Economies after the Global Financial Crisis



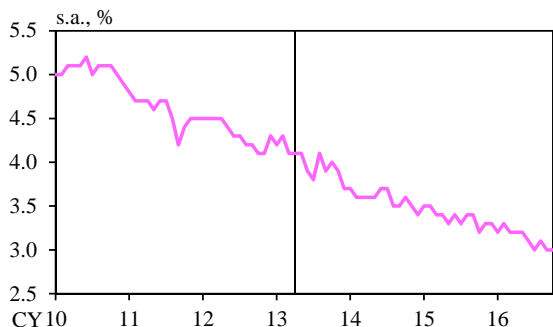
Sources: Cabinet Office; Haver.

# Economic and Price Developments after the Introduction of Quantitative and Qualitative Monetary Easing (QQE)

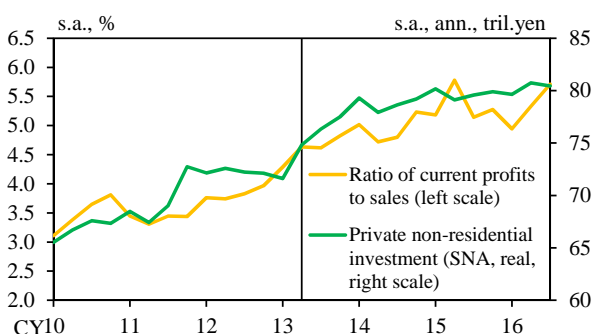
*Exchange Rates and Stock Prices*



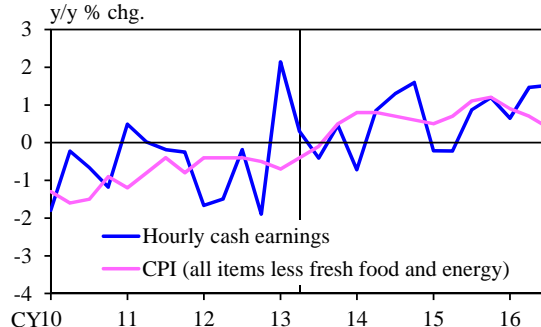
*Unemployment Rate*



*Corporate Profits and Business Fixed Investment*



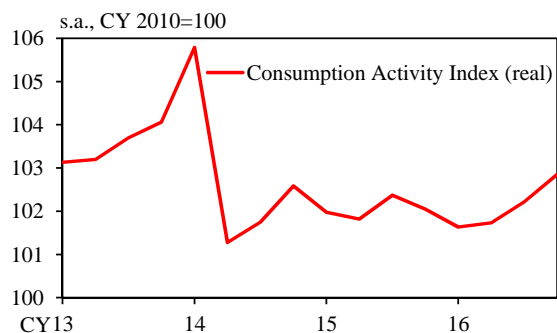
*Nominal Wages and Prices*



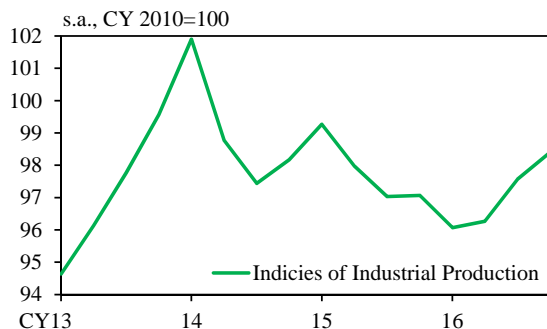
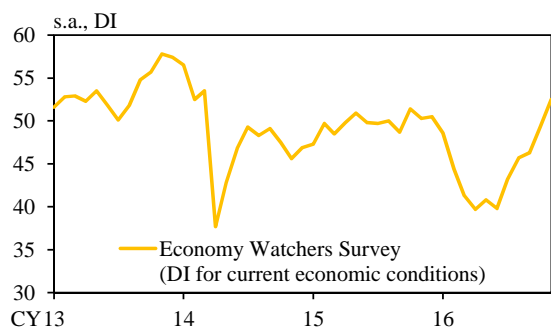
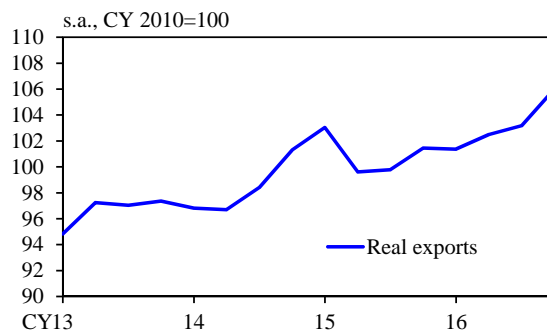
Sources: Bloomberg; Ministry of Finance; Cabinet Office; Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

# Current Economic Activity in Japan

*Indicators related to Private Consumption*



*Indicators related to Exports and Industrial Production*



Note: The Consumption Activity Index is adjusted for travel balance.

Sources: Bank of Japan; Ministry of Finance; Cabinet Office; Ministry of Economy, Trade and Industry.