November 28, 2011
Bank of Japan

Japan's Economy: Current Situation, Outlook, and Challenges

Speech at a Meeting with Business Leaders in Nagoya

Masaaki Shirakawa
Governor of the Bank of Japan

Introduction

I am honored to be here today to speak and exchange views with business leaders from the Chubu region. I would like to take this opportunity to express my deep gratitude for your cooperation with the Bank of Japan's Nagoya branch.

This region currently faces a very severe economic situation, as the significant relative importance of the automobile industry to the regional economy has amplified the impact of negative events including supply-chain disruptions due to the Great East Japan Earthquake, the appreciation of the yen since this summer, and the floods in Thailand since last month. While the Bank has been fully aware of such economic conditions as a result of having obtained information from various sources including reports from the Nagoya branch, I came here today to learn of your concerns directly. Before we exchange views, I will first talk about the outlook for and risks facing Japan's economy, followed by the Bank's conduct of monetary policy. I will then offer my views on the most pressing issue for Japan's economy -- strengthening its medium- to long-term growth potential.

I. The Outlook for and Risks Facing Japan's Economy

I will start with the outlook for Japan's economy. Although the economy has faced very severe supply constraints since this March, including supply-chain disruptions and electricity shortages due to the earthquake and tsunami, economic activity has recovered faster than expected thereafter, which reflects the remarkable capability of Japanese firms and the Japanese people to respond to such adversity. As well as the expected gradual decline in the pace of growth that generally follows this kind of rapid recovery phase, new concerns have surfaced since this summer: I am talking, of course, about the slowdown in overseas economies and the rapid appreciation of the yen against the backdrop of the tensions in Europe. As a result of these factors, the tempo of Japan's economic recovery has been moderate. Moreover, given the addition of new ones such as the floods in Thailand, Japan's economy is expected to be impacted by the adverse effects of these negative events for the time being. Considering their high growth potential, however, emerging economies will start leading the global economy again, assuming that they achieve a soft landing through appropriate policy responses, and growth rates of overseas economies are likely to pick up. In Japan, reconstruction-related demand after the earthquake is expected to gradually materialize. In the Bank's current baseline scenario, therefore, Japan's economy is expected to return to a moderate recovery path after slowing for the time being. According to the Bank's projections released at the end of last month, the real GDP growth rate will remain relatively low in fiscal 2011, at 0.3 percent, but will continue to register positive growth in fiscal 2012 and fiscal 2013 -- of 2.2 percent and 1.5 percent, respectively. Meanwhile, the year-on-year rate of change in the consumer price index (CPI) is currently at around 0 percent following a gradual narrowing of the negative CPI growth rates since the summer of 2009. It is expected to gradually rise to around 0.5 percent as we approach fiscal 2013, with the improvement in the aggregate supply and demand balance (Chart 1).

As illustrated, in the Bank's baseline scenario, the slightly more long-term perspective is that Japan's economy will eventually return to a sustainable growth path with price stability. At the same time, the Bank fully recognizes that such an outlook is subject to various uncertainties. The most significant risk factor is the sovereign debt problem in Europe, or in the words of European authorities in official documents, "the sovereign debt crisis." How will this problem develop in the coming period and how will it affect global financial markets and the global economy? In Europe, interest rates on government bonds issued by countries whose fiscal situations have become subjects of concern have been rising significantly and, more recently, rates have started to rise even in Italy, the third-largest economy in the euro area (Chart 2). As a result, European financial institutions with large holdings of the government bonds in question have faced difficulties raising funds from the market due to rising concerns about their creditworthiness, thereby making it inevitable that they restrain lending in order to maintain liquidity. As illustrated, in Europe, an adverse feedback loop is operating with respect to the fiscal situation, the financial system, and economic activity, under which a decline in confidence in fiscal conditions has increased concerns about the stability of the financial system, which in turn has started to affect economic activity. Such economic and financial developments in Europe have been affecting economies in other regions around the world.

The sovereign debt problem has also been an underlying cause of the yen's appreciation since this summer. Global investors have become increasingly risk averse amid growing uncertainty regarding the global economy. When a global financial crisis materializes, it always does so in the form of a currency crisis. In this regard, although Japan faces a wide range of challenges in the medium to long term as I will point out later, the yen has been considered a relatively safe asset and is therefore an attractive buying option for investors, due in part to Japan's current account surplus and the resultant significant amount of net external assets.

II. The Bank's Conduct of Monetary Policy

The Three-Pronged Approach

Amid the slowdown in overseas economies and appreciation of the yen, the Bank has recently taken measures to enhance monetary easing twice -- in August and October this year -- due to heightened concerns about the likelihood of a future slowdown in Japan's economy (Chart 3). As the Bank has heard various opinions with regard to the Bank's conduct of monetary policy, I would like to give a rather detailed explanation of the policy, starting from the current framework. As many of you may be aware, the Bank has taken the three-pronged approach of pursuing powerful monetary easing under the framework of the "comprehensive monetary easing" implemented in October 2010, ensuring financial market stability, and providing support to strengthen the foundations for economic growth. Through this approach, the Bank has continued to consistently make contributions as the central bank in order for Japan's economy to overcome deflation and return to a sustainable growth path under price stability as soon as possible.

Regarding the first of these three measures -- powerful monetary easing under the comprehensive monetary easing framework -- the Bank sets the policy rate at around 0 to 0.1 percent, which can be deemed a virtually zero interest rate policy, and is publicly committed to continuing this policy until it judges that price stability is in sight. Moreover, it has established on its balance sheet a program for purchasing financial assets, called the Asset Purchase Program, under which it purchases from the markets not only long- and short-term government bonds but also -- in a highly extraordinary measure for a central bank -- risk assets such as CP, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs). Through this measure, the Bank aims to encourage a decline in longer-term interest rates and various risk premiums. The Program has increased to a total of 55 trillion yen after being repeatedly expanded in size, and the Bank is proceeding with its purchases of various financial assets amounting to approximately 15 trillion yen in the period until the end of next year.

Second, the Bank has been ensuring financial market stability. This becomes especially important at a time like this given the increasing anxiety in global financial markets due to the sovereign debt problem in Europe. In this regard, the Bank has continued to provide ample yen funds, and has established frameworks for providing U.S. dollar funds, in cooperation with central banks in North America and Europe (Chart 4). While maintaining close contact with overseas central banks, the Bank will do its utmost to ensure market stability.

Third, the Bank is providing support to strengthen the foundations for economic growth, which is another extraordinary measure for a central bank (Chart 5). Under this framework, the Bank supports the efforts of firms and financial institutions aimed at strengthening the growth potential of Japan's economy by providing financial institutions with long-term funds at a low interest rate.

The Accommodative Financial Environment

How, then, are effects of such powerful monetary easing transmitted to economic activity?

Proceeding with this discussion requires consideration of the transmission mechanism of monetary policy in two stages (Chart 6). The first stage is the transmission of monetary easing effects from the realm of monetary policy to the financial environment; in other words, this refers to the extent to which borrowing and availability of funds for firms and households become more accommodative. The second stage is the transmission of effects from the financial environment to the real economy, or in other words the extent to which firms and households make use of the accommodative financial conditions to increase their investment and spending.

Looking at the first stage, financial conditions in Japan have continued to ease steadily amid increased strains in global financial markets against the backdrop of the sovereign debt problem in Europe (Chart 7). More specifically, market interest rates including longer-term ones have been at extremely low levels, and corporate bond and CP yield spreads over Japanese government bonds (JGBs), or credit spreads on corporate bonds and CP, have remained stable at low levels. Moreover, bank lending rates have declined moderately. Various surveys of firms suggest clear improvement in both the lending stances of financial institutions as perceived by firms and in firms' financial positions. This is in sharp contrast to the situation in Europe and the United States, where financial conditions have tightened since the summer against the backdrop of market anxiety due to the sovereign debt problem in Europe. The Bank assesses that the improvement in Japan's financial conditions can be partly attributed to the Bank's highly stimulative monetary policy, which I touched upon earlier.

Shifting our focus to the second stage of the transmission of monetary policy, unfortunately even an extremely accommodative financial environment has not led to an active increase in investment and spending by private economic agents. This is in fact a prime source of concern for the Bank as well as Japan's economy.

As a response to this situation, some believe that economic activity would eventually be stimulated if the Bank took further drastic measures. In reality, however, interest rates in Japan, particularly actual funding rates for private economic agents, have continued to ease and are the lowest among advanced economies. As for quantitative indicators, the monetary base -- funds provided by the central bank -- and money stock -- funds possessed by households and firms -- relative to nominal GDP indicate that the amount of fund provision in Japan is the largest among advanced economies, far exceeding the amounts in the United States and the euro area (Chart 8). While the United States substantially increased its amount of fund provision after the Lehman shock, Japan conducted such aggressive fund-provisioning at an earlier stage given that it experienced a financial crisis at an earlier stage. This may explain why the Bank's active efforts may not be so noticeable. Nonetheless, the hard fact based on data is that Japan's monetary base relative to nominal GDP already attained in 2002 the level currently reached by that of the United States, and has been rising further over the past several years.

Although the Bank continues to enhance monetary easing, given the accommodative financial environment surrounding Japan that I have described, it is more important to make efforts to take advantage of such conditions -- namely, efforts aimed at strengthening the economy's growth potential. I will discuss this in more detail later, but before that let me turn to the effect of and responses to the yen's appreciation, which is closely connected to this issue and is considered a matter of grave concern among people in this region.

III. Responses to the Yen's Appreciation

Regardless of whether a currency is appreciating or depreciating, the impact of foreign exchange rate fluctuations is highly significant for business, for local economies where businesses cluster, and for the national economy as a whole. Looking back, the yen was on a significant depreciation trend toward the middle of the 2000s, which was followed by a period of significant appreciation. The current appreciation of the yen has both advantages and disadvantages, and how they each materialize differs depending on the phase and time horizon. After considering all these factors, the Bank has concluded that, in the current time of high uncertainty regarding the future prospects of overseas economies, due attention is necessary to the risk that the yen's appreciation will dampen future growth through a decline in exports and corporate profits as well as a deterioration in business sentiment. This is the very reason that the Bank has embarked on monetary easing measures twice since this summer.

The most debated issue at present with regard to the yen's appreciation is the possibility that Japan's firms will accelerate their shift to overseas production, which may result in a hollowing-out of domestic industries. The trend of a rising share of overseas production among Japanese firms can be basically understood as a part of firms' growth strategy to place production sites near markets that are experiencing rising demand, against the backdrop of a global shift of growth centers toward emerging economies. Having said that, the timing of this global shift is also affected by foreign exchange rate developments. As you may recall, in the phase of significant yen depreciation toward the middle of the 2000s, the profitability of domestic production improved dramatically and firms started to refocus on domestic production while pausing their shift to overseas production. However, as the aftershocks of the collapse of Lehman Brothers and impact of the sovereign debt problem in

Europe have persisted, the yen has stayed at a higher level than the period before these problems emerged. Given this development, firms are returning to the strategy of shifting production overseas that they had been pursuing in response to the expansion of global markets. Therefore, during this period of transition in business strategy, the pace at which production is shifted overseas will generally accelerate compared to the past average. During this period, if the pace of this shift increases excessively, it may be difficult to create replacement job opportunities at home at a similar pace. Moreover, if core companies and factories with long-term competitiveness move overseas, they are less likely to return home even with a correction in the yen's appreciation. Therefore, as well as the risks that I have pointed out so far, the impact of the recent appreciation of the yen on Japan's economy warrants due attention.

At the same time, the appreciation of the yen also has advantages, including lower import costs for energy and materials, which increases the purchasing power of firms and households. After the earthquake, the trade balance turned negative due to the expansion of imports of crude oil and LNG against the backdrop of the suspension of operation of nuclear power plants and an associated increase in electricity generated from thermal power. The yen's appreciation has also worked to offset the negative impact of such drain of income to overseas. Such advantages are not uniformly extended to all firms and industries. With regard to the impact on the national economy as a whole, it is also important to consider how to make use of such advantages to promote the development of new businesses and reform of the industrial structure. Unfortunately, however, we have rarely seen such positive initiatives so far.

IV. Necessity to Strengthen Medium- to Long-Term Growth Potential

Let me now move on to the topic of strengthening the growth potential of Japan's economy, which I briefly touched upon earlier. I believe this is the most fundamental challenge currently facing Japan's economy.

The growth rate can be broken down into the rate of growth in the number of workers and the rate of growth in GDP per worker, or productivity. The long-term downtrend in Japan's economic growth is determined by two factors: a decrease in the number of workers due to the rapid aging of the population and low productivity growth (Chart 9). With this in mind, what will happen in terms of the future growth rate? Assuming that labor market participation by the elderly and female population remains unchanged, based on long-term projections of demographic trends, the rate of decline in the number of workers will accelerate further to 0.6 percent in the 2010s and 1.3 percent in the 2030s (Chart 10). The rate of growth in the number of workers and the rate of growth in productivity together constitute the economic growth rate. Assuming that the productivity growth rate is around the average of the past 20 years, that is, around 1 percent, the annual rate of economic growth for the 2010s onward will ultimately remain between 0.0 and 0.5 percent on average and enter negative territory in the 2030s.

Given that such a situation can be clearly foreseen, we must do our utmost to improve it, even if only slightly. This means that in order to strengthen the economy's medium- to long-term growth potential and thereby prevent it from entering a period of stagnation, it is necessary to both prepare a working environment that encourages an increase in labor market participation by elderly people and women and make efforts to enhance productivity growth. Productivity growth is defined as the capacity of individuals to generate added value, or in other words, the ability to earn. Aside from being somewhat lucky, the ability to earn cannot be acquired without actual efforts to achieve it, and this applies to both individuals and firms. Active efforts to respond to a changing business environment are thus required. Taking the example of firms' shifting of production overseas, in order to realize an expanded equilibrium of profits and employment, firms need to rebuild development and production systems at home, especially for goods and services enabled by high technology and with high brand value, and explore the domestic market with a focus on capturing diversifying needs while further expanding their overseas operations to carry out production and sales activities that can be shifted overseas. More than anything, it will be firms' efforts and their spirit of willingness to take on challenges that will make such developments possible. At the same time, it is equally important for the government to support firms' potential to make progress through, for example, reform of regulations and tax systems. The Bank also supports firms in their efforts by providing them with a stable financial environment. As the key to growth lies in adapting to changes, it becomes just as important for society as a whole to share a sense of values that regard the active metabolism of the economy in a positive way.

Low growth over a protracted period tends to draw attention to aspects of Japan's economy that are facing challenges. Taking a step back and looking at the state of the country objectively, however, Japan possesses countless qualities that reflect its uniqueness and strengths, including the following: its advantage in international competition in terms of geography, in that it is located in Asia; its *genbaryoku*, or "competitiveness at worksites," which was demonstrated in the way that post-earthquake supply-side constraints were resolved; its adherence to high-quality manufacturing and courteous service; and its financial system stability. I believe that, if firms pursue a dual strategy of expanding business globally and exploring domestic demand while taking advantage of their strengths, it will become gradually evident that Japan's economy as a whole is on course toward effectively capturing both external and domestic demand. Once such a virtuous circle begins to be formed, Japan's growth potential will strengthen. The course future developments will take depends on whether we are capable of accurately identifying the true cause of the severity of the current situation and engaging in the necessary efforts to address these issues.

Concluding Remarks

As I have already used up most of my time, I would now like to conclude my remarks. As I mentioned at the start, Japan's economy is likely to continue to face a severe situation for the time being, especially with respect to exports. The Bank is determined to support Japan's economy as it seeks to return to a sustainable growth path, by continuing to pursue powerful monetary easing with due recognition of the actual situation. In order for Japan's economy to regain its strength in the medium to long term and thereby overcome its deflationary trend, it needs to make efforts to end the decline in its growth potential, the fundamental cause of the deflationary trend. The Bank hopes that various endeavors will be made so as to enable the economy to take full advantage of the extremely accommodative financial environment.

In this regard, this region has long been known for its deep-rooted spirit of entrepreneurship. In a period of large-scale changes, the first step to opening the door to dramatic growth is to accept those changes and view such uncertainties as opportunities to be seized. The Bank will continue to support your efforts, so that regional innovation and new business models will inspire and motivate not only the region but Japan's economy as a whole.

Japan's Economy: Current Situation, Outlook, and Challenges

November 28, 2011

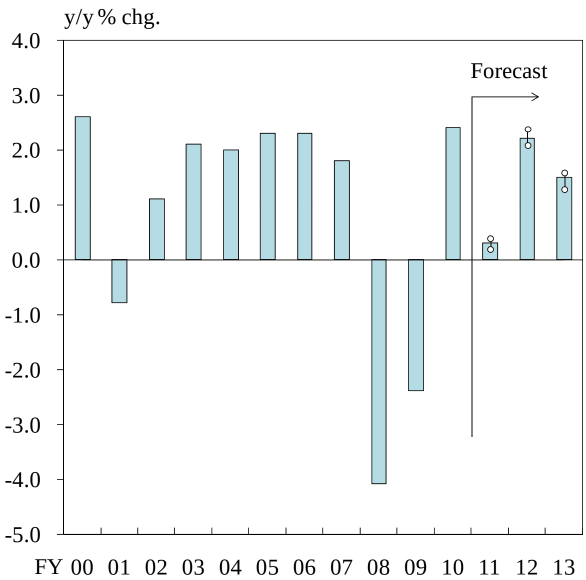
Masaaki Shirakawa

Governor of the Bank of Japan

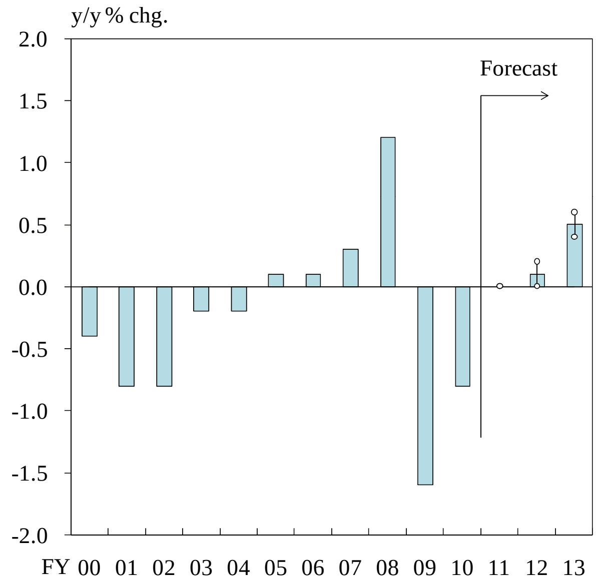
Chart 1

The Bank of Japan's Economic and Price Forecasts

A. Real GDP



B. CPI (all items less fresh food)



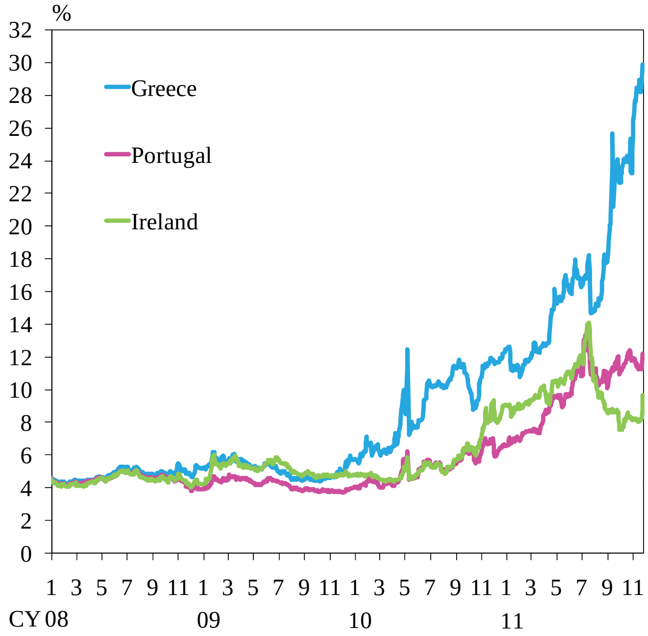
Note: The forecast bars show the median of Policy Board members' forecasts, and the white dots show the range of forecasts of the majority members (excluding the highest figure and the lowest figure from the point estimates, to which each member attaches the highest probability of realization) presented in the October 2011 *Outlook for Economic Activity and Prices*.

Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Consumer Price Index"; Bank of Japan.

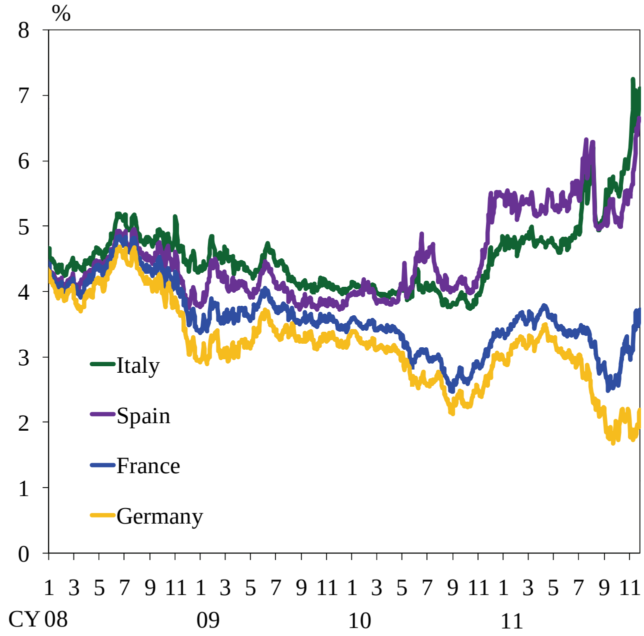
Chart 2

The euro area continues to face strains surrounding the sovereign debt problem, and yields on many countries' government bonds have been rising since summer 2011.

A. Yields on Peripheral Countries' Bonds



B. Yields on Core Countries' Bonds



Note: 10-year government bond yields. Data for yields on Irish bonds for October 12 onward are 9-year government bond yields.
Source: Bloomberg.

Chart 3

The Bank of Japan's Conduct of Monetary Policy

Pursuing Powerful Monetary Easing via the Comprehensive Monetary Easing

- Implementing the virtually zero interest rate policy.
- Committed to continuing the virtually zero interest rate policy until it judges that price stability is in sight on the basis of the "understanding of medium- to long-term price stability."[Note]

  [Note] On the basis of a year-on-year rate of change in the CPI, a positive range of 2% or lower, centering around 1%.
- Establishing the Asset Purchase Program

Ensuring Financial Market Stability

Providing Support to Strengthen the Foundations for Economic Growth

Increase in the Asset Purchase Program

- The Program has had three increases, expanding to about 55 trillion yen from the initial size of about 35 trillion yen (the latest increase was decided on October 27).
  — The increased purchases are to be completed by around the end of 2012.

trillion yen

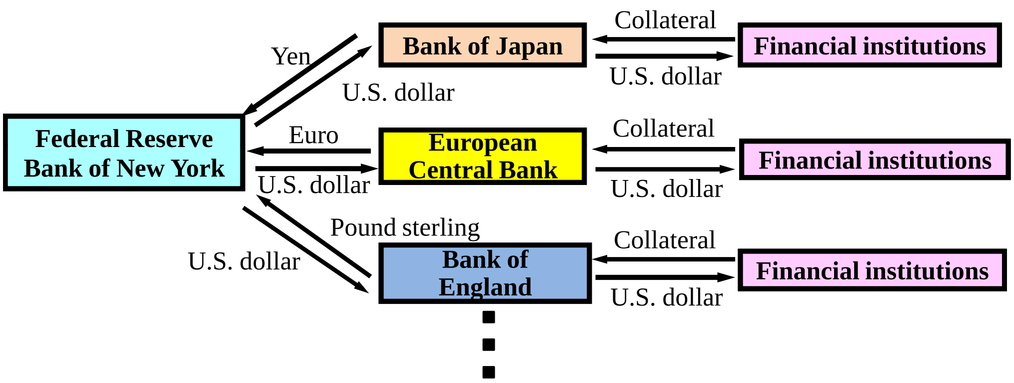
	Started in Oct. 2010	Mar. 2011	Aug. 2011	Oct. 2011	Amount outstanding as of Nov. 20
Total size	About 35	About 40	About 50	About 55	40.7
JGBs	1.5	2.0	4.0	9.0	2.2
T-Bills	2.0	3.0	4.5	4.5	2.8
CP	0.5	2.0	2.1	2.1	1.4
Corporate bonds	0.5	2.0	2.9	2.9	1.4
ETFs	0.45	0.9	1.4	1.4	0.8
J-REITs	0.05	0.1	0.11	0.11	0.06
Fixed-rate operation	30.0	30.0	35.0	35.0	32.0

Note: In addition to purchases under the Program, the Bank regularly purchases JGBs at the pace of 21.6 trillion yen per year.

Chart 4

Central banks in major economies have strengthened the frameworks for providing U.S. dollar liquidity.

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



- A coordinated measure among six central banks in the U.S., Japan, the U.K., 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.

B. The Decision Made in September 2011

- ✓ On September 15, three central banks in Europe (the Bank of England, the European Central Bank, and the Swiss National Bank) and the Bank of Japan announced the conduct of U.S. dollar liquidity-providing operations over the year-end.
- ✓ These three central banks decided to introduce the 3-month operations in addition to the ongoing weekly 7-day operations with a view to fully ensuring the funding of financial institutions in Europe. The Bank of Japan, which had already conducted 3-month operations, decided to bring forward the conduct of such operations covering the year-end in coordination with measures taken by European central banks.

Chart 5

Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth

Existing Framework (June 2010)

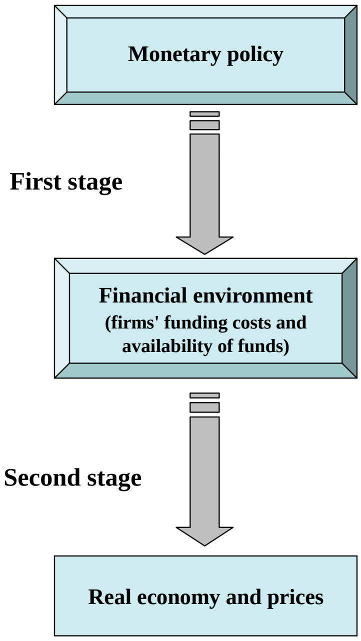
- ❍ Provision of funds against collateral such as government securities to financial institutions, equivalent to the actual amount of lending and investment carried out with a view to strengthening the foundations for economic growth, over a long term (one year; maximum duration of 4 years) and at a low rate (currently 0.1 percent).
- ❍ Latest amount outstanding of loans: 3 trillion yen (maximum amount: 3 trillion yen)

New Line of Credit (June 2011)

- ❍ Total amount of loans: 500 billion yen (set separately from the 3 trillion yen ceiling in the existing framework)
- ❍ Eligible investments and loans:
  - A. Equity investments (investments and loans with equity-like features)
  - B. Loans without real estate collateral or guarantees (including asset-based lending (ABL))

Chart 6

Transmission Mechanism of Monetary Policy



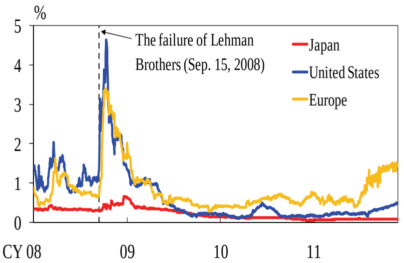
Financial conditions have continued to ease steadily

- **Market interest rates including longer-term ones have declined**
- **Credit spreads on corporate bonds and CP have remained stable at low levels**
- **Bank lending rates have declined moderately**
- **Improvement has been seen in both the lending stances of financial institutions as perceived by firms as well as in firms' financial positions**

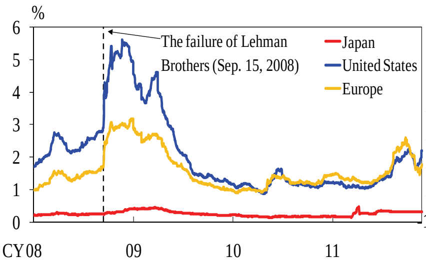
Chart 7

On the back of the sovereign debt problem in Europe, banks' and firms' funding conditions have become increasingly severe in the U.S. and Europe. Meanwhile, those in Japan have continued to ease steadily.

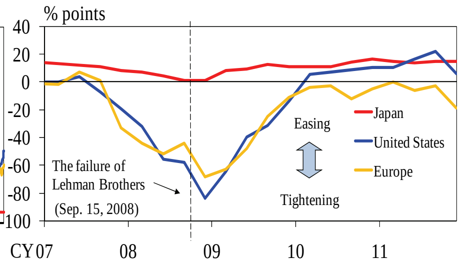
A. Degree of Strain in Money Markets



B. Spreads on Corporate Bonds



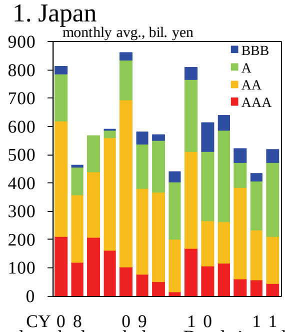
C. Financial Institutions' Lending Stance



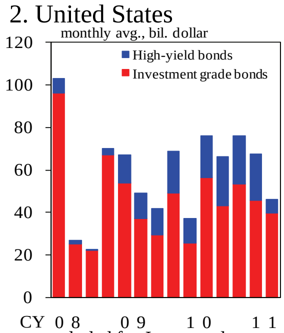
Notes: 1. The degree of strain in money markets is 3-month Libor minus yields on 3-month government securities. Data for German government securities are used for Europe.
2. The spreads on corporate bonds (rated AA) are corporate bond yields minus government bond yields.
3. Financial institutions' lending stance is the average of the DIs for large, medium-sized, and small firms for Japan, large and medium-sized firms for the United States, and large firms for Europe.

D. Volume of Corporate Bond Issuance

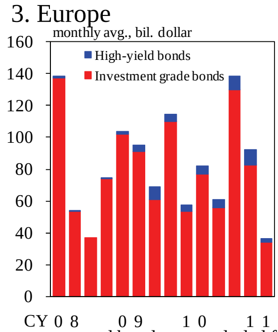
1. Japan



2. United States



3. Europe

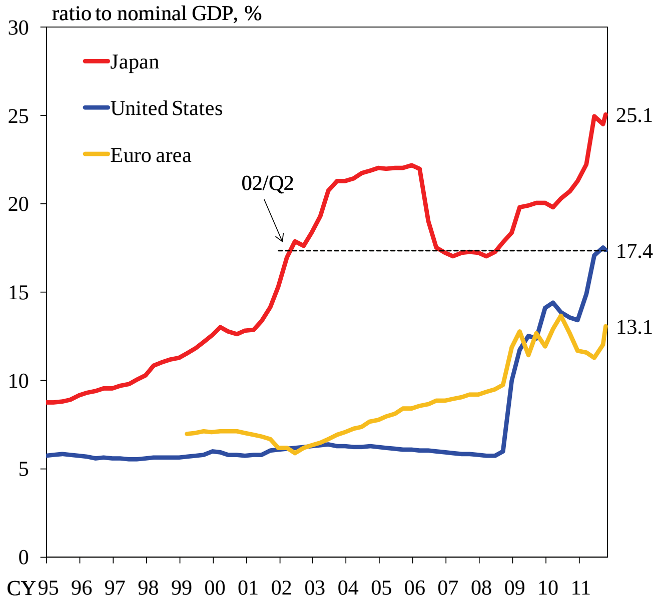


Note: Based on the launch date. Bonds issued by banks are excluded for Japan, and some government-guaranteed bonds are excluded for the U.S. and Europe.
Sources: Bloomberg; Bank of Japan; FRB; ECB; Japan Securities Dealers Association; I-N Information Systems; Thomson Reuters.

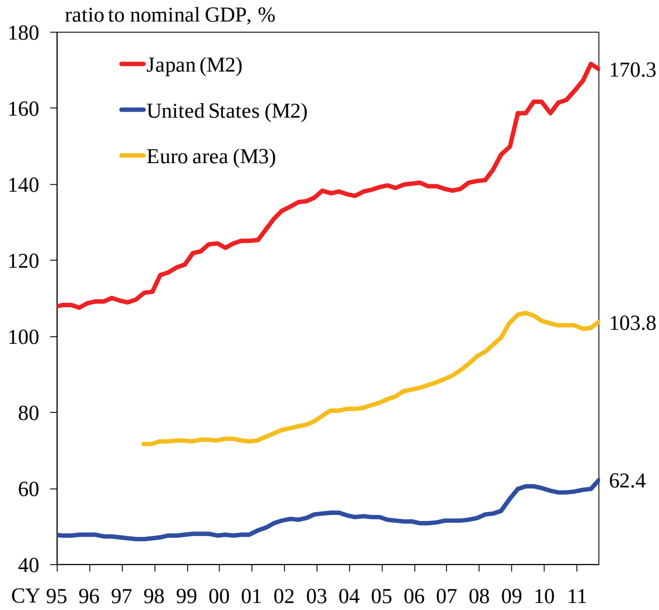
Chart 8

Japan's money supply as a ratio to nominal GDP has been at a high level compared to the U.S. and Europe, and has recently increased further.

A. Monetary Base



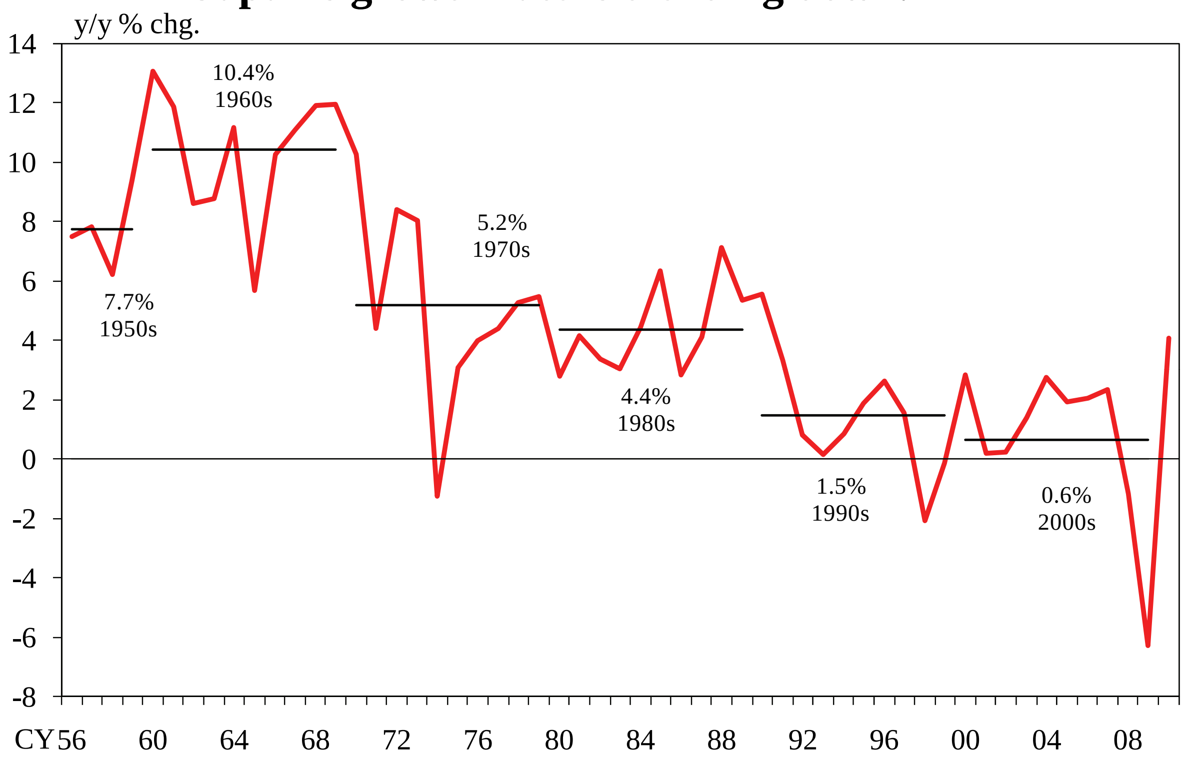
B. Money Stock



Notes: Monetary base is the sum of banknotes in circulation, coins in circulation, and current account deposits at a central bank.
Money stock (M2) is the sum of cash and deposit money deposited in financial institutions including domestic banks.
Sources: Cabinet Office, Bank of Japan, FRB, BEA, ECB, and Eurostat.

Chart 9

Japan's growth rate is trending down.

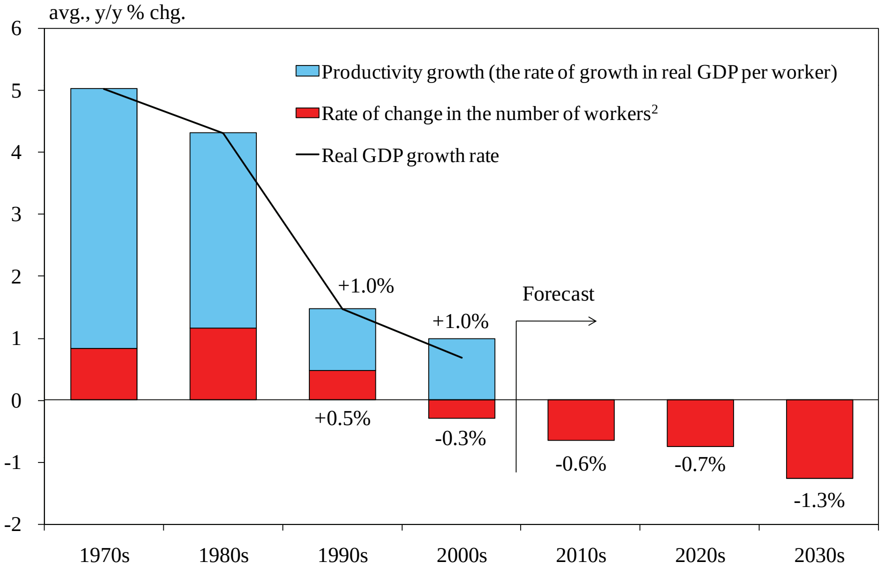


Note: Data up to 1980 are based on the 68SNA (System of National Accounts), while those from 1981 are based on the 93SNA.
The average for the 1950s is the average from 1956 to 1959.
Source: Cabinet Office, "National Accounts."

Chart 10

Low labor productivity growth and the decline in working-age population affects the long-term downtrend in Japan's growth.

A. Decomposition of Real GDP Growth in Japan[1]



B. Productivity Growth of G-7 Countries (2000s)[3]

%

Japan	1.5
United States	1.7
Germany	0.9
France	0.9
United Kingdom	1.5
Italy	-0.1
Canada	0.7

Notes: 1. Data are on a fiscal-year basis.
2. The rates of change in the number of workers from the 2010s onward are calculated using the projected future population (medium variant) and the projected labor force participation rates (assuming that the labor force participation rates in each age/sex group remain the same as those in 2009).
3. To eliminate the effects of the financial crisis after the failure of Lehman Brothers, figures are the average growth rates from 2000-2008.

Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Labour Force Survey"; National Institute of Population and Social Security Research, "Population Projections for Japan: 2006-2050"; OECD.