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Bank of Japan

Recent Financial and Economic Developments and Monetary Policy

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I. Recent Financial and Economic Developments

A. Japan's Economy from the Lehman Shock to the March 2011 Earthquake

In the wake of the severe global contraction that followed the failure of Lehman Brothers in September 2008, Japan's economic conditions worsened sharply. Real GDP growth recorded a more than 10 percent decline on an annualized basis for two consecutive quarters from the October-December quarter of 2008. Subsequently, the economy started to recover moderately as overseas economies picked up due in part to progress in inventory adjustments and the effects of large-scale economic stimulus measures implemented around the world. The pace of recovery slowed temporarily in autumn 2010, but from early 2011 the economy began to emerge again from this phase of deceleration, led by growth in overseas economies.

Tracing these developments in terms of the forecasts of private-sector economists,[1] the average forecast in mid-2010 for GDP growth in fiscal 2011 was nearly 2 percent. Although forecasts were then gradually revised downward toward the end of the year, they were revised upward again in early 2011, and in March 2011 the average forecast for fiscal 2011 growth was slightly above 1.5 percent. I assumed office at the Bank of Japan in June this year and prior to that had been served as the president of a leasing company. I now recall that, as strains in the economy as a whole eased around January and February, I felt quite certain that the year 2011 was headed in a positive direction.

B. Supply-Side Constraints Following the March 2011 Earthquake and Their Resolution

This positive trend was severely affected by the Great East Japan Earthquake, which occurred on March 11, 2011. While in many cases an economic downturn is induced by a decline in demand, the plunge after the earthquake was basically due to supply-side constraints.

Production and exports, which had been resuming their uptrend from the beginning of 2011, plunged due to the disruption of supply chains as a result of the earthquake and tsunami as

[1] Published in the *ESP Forecast: Monthly Survey of Japanese Economic Forecasts*, by the Economic Planning Association.

well as the nuclear power plant accident. Moreover, a range of economic activities other than manufacturing were negatively affected; for example, business hours of department stores were shortened to address power shortages; many events were canceled voluntarily; and the number of tourists from abroad fell sharply. In these circumstances, business and household sentiment deteriorated, and domestic private demand became sluggish. Thereafter, strenuous efforts by parties concerned resulted in the rapid restoration of supply chains. Economic activity picked up faster than widely expected immediately after the earthquake, and by summer production and exports had recovered almost to pre-quake levels.

More recently, Japan's economic activity has continued picking up, but at a more moderate pace, mainly because exports and production in particular are adversely affected by the slowdown in overseas economies and the appreciation of the yen, as well as by the flooding in Thailand.

C. Developments in Overseas Economies

Overseas economies experienced a significant downturn after the Lehman shock, but recovered rapidly from the second half of 2009. They then decelerated again from summer 2010, partly because inventory restocking carried out in the early phase of economic recovery had run its course; however, the recovery trend itself in overseas economies remained intact.

Nevertheless, since the middle of 2011, the pace of growth in overseas economies has moderated, especially in advanced economies. Looking at the U.S. economy first, at one point it was thought that it was only temporarily being held back by factors such as supply-chain disruptions, but it now appears that the underlying pace of recovery itself remains only moderate because of the ongoing adjustment of excessive household debt and in the housing market, as well as the slow recovery in employment. European economies have slowed as a result of the deterioration in the financial environment caused by the sovereign debt problems in some countries and worsening business and household sentiment, and the level of economic activity has recently remained almost flat. Growth in emerging and commodity-exporting economies has moderated somewhat, mainly due to the effects of monetary tightening earlier and the slowdown in advanced economies, especially in Europe. As for the outlook, emerging and commodity-exporting economies are likely to maintain relatively strong growth on the whole because domestic demand has been firm on the back of strong medium- to long-term growth expectations.

D. Outlook for Japan's Economy and Prices

Turning to the outlook for Japan's economy, the pace of growth is likely to slow for the time being, mainly due to the adverse effect from the slowdown in overseas economies and the appreciation of the yen. After that, the economy is expected to return to a moderate recovery path as the pace of recovery in overseas economies picks up, led by emerging and commodity-exporting economies, and reconstruction-related demand after the earthquake gradually materializes.

According to the projections in the *Outlook for Economic Activity and Prices* (Outlook Report) that the Bank released in October 2011, the real GDP growth rate is expected to remain relatively low at 0.3 percent in fiscal 2011, due in part to the effects of the disaster, but is then expected to rise to 2.2 percent in fiscal 2012, partly because of an increase in reconstruction-related demand, and register 1.5 percent in fiscal 2013. The latest forecast of private-sector economists also is that GDP growth in fiscal 2012 will be around 2 percent.

Next, let me turn to price developments. Looking at the somewhat longer-term trend of the consumer price index (CPI) for all items less fresh food, following the sharp drop in the wake of the Lehman shock, the year-on-year rate of decline has continued to slow consistently since around the end of 2009 as the aggregate supply and demand balance gradually improved, and is currently at around 0 percent.[2] As for the outlook, the

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[2] In August, the base year of the CPI was changed to 2010 and year-on-year rates of change for all items less fresh food as far back as January 2011 were revised retroactively. Taking the average for the period from January to July 2011, the year-on-year rate of change in the CPI for all items less fresh food was revised downward by about 0.6 percentage point. The downward revision was mainly due to resetting of the index levels for durable consumer goods, which had significantly declined on the 2005 base. As a result of the resetting, the decline in the prices of those goods has a larger impact on the total CPI index.

year-on-year rate of change in the CPI is expected to remain at around 0 percent for the time being, but assuming that medium- to long-term inflation expectations remain stable, it is then projected to gradually rise to around 0.5 percent toward fiscal 2013 reflecting the improvement in the aggregate supply and demand balance.

E. Uncertainties about the Outlook

The outlook I just mentioned is subject to various uncertainties and risks. The October 2011 Outlook Report, for example, highlights, among other things, developments in global financial markets, especially those related to the sovereign debt problems in Europe, and developments in overseas economies as potential risk factors. In what follows, I will focus on the sovereign debt problems in Europe, which can be considered to present the greatest risk at the moment.

1. The effects of the sovereign debt problems in Europe

The sovereign debt problems in Europe surfaced in October 2009 when, following a change of government, the new administration in Greece revealed that the country's fiscal deficits were larger than previously announced. In April 2010, Greece requested financial support from the European Union and the International Monetary Fund. The sovereign debt problems in Europe subsequently broadened, with Ireland requesting similar support in November 2010 and Portugal in April 2011. The problems have recently spread to Italy and Spain, two major euro area economies, and yields on government bonds issued by these countries have risen to historically high levels.

Since the sovereign debt problems in Europe surfaced, there has been concern that they could lead to an "adverse feedback loop," in which price declines in government bonds issued by troubled countries lead to a deterioration in the financial conditions of European financial institutions holding large amounts of these sovereign bonds, causing these institutions to restrain lending. This could then dampen economic activity of firms and households, leading to a worsening in the real economy and further increasing fiscal deficits, which in turn would result in a further decline in sovereign bond prices. Since this summer, the risk of such an adverse feedback loop has heightened sharply and has in fact already partly materialized. The faster deceleration in European economies has started to have global repercussions through its impact on trade, having already begun to push down exports from emerging economies. In addition, with uncertainty in financial markets increasing, global investors' preference for safe assets has strengthened, resulting in a decline in stock markets and a concentration of funds in assets considered safe. This is illustrated by strong buying of the yen in the foreign exchange market. Moreover, going forward, if global investors' risk-averse behavior further intensifies, this might lead to capital outflows from emerging economies. Given that some European financial institutions have been deleveraging by reducing their U.S. dollar assets, there is concern that these institutions might restrain their lending to emerging economies, which might in turn affect trade financing.

While the euro area accounts for slightly less than 10 percent of Japan's total exports, it accounts for a large share of exports from the United States and emerging economies -- Japan's major trading partners. Therefore, how an economic slowdown in these countries will affect Japan's exports is a source of concern. Moreover, the appreciation of the yen will reduce corporate profits and thereby undermine business and household sentiment. Furthermore, if the sovereign debt problems in Europe worsen and this leads to disturbances in global financial markets, Japan will inevitably be significantly affected.

2. Outlook for the European debt problems

The outcome of the European debt problems is highly uncertain at this point. The only response is for relevant parties in Europe to work together to tackle the problems on the basis of a solid common understanding and commitment. If the determination and measures of relevant parties to address the problems win the confidence of the market, this should make it possible to prevent further contagion and the situation from deteriorating at an accelerating pace. However, a comprehensive solution will take considerable time, since at the root lies the structural problem that countries with large disparities in fiscal conditions and economic strength share a single currency without having an integrated fiscal policy. In order to buy time to work out such a comprehensive solution, European countries therefore need to implement individual measures for individual problems as and when they arise.

3. Implications of the European debt problems

At present, government bonds issued by Greece and some other countries are carrying extremely high interest rates. Only about three years ago, however, these rates were about the same as those on German government bonds, which enjoy the highest level of creditworthiness. This illustrates how devastating the damage can be once countries lose their credibility.

Turning to Japan, the ratio of government debt to nominal GDP is by far the highest among advanced economies. Reasons highlighted as to why interest rates on Japanese government bonds nevertheless remain extremely low include that Japan has a large current account surplus and that a large portion of these bonds are held by domestic investors. There is, however, no guarantee that interest rates will remain low. Therefore, it is very important to maintain firm confidence in Japan.

II. The Bank's Conduct of Monetary Policy

Next, I will outline the Bank's conduct of monetary policy after the Lehman shock.

A. Conduct of Monetary Policy after the Lehman Shock

1. Pursuing powerful monetary easing

First of all, the Bank has been pursuing powerful monetary easing. In the wake of the Lehman shock, the Bank until December 2008 had lowered its target for the policy interest rate -- the uncollateralized overnight call rate -- to virtually zero at "around 0.1 percent." Moreover, to further enhance and spread the effects of monetary easing, the Bank in December 2009 introduced a fixed-rate funds-supplying operation, through which it provides longer-term funds at a low interest rate of 0.1 percent.

In addition, in October 2010 the Bank, in order to enhance accommodative monetary conditions even further, decided to implement a comprehensive monetary easing policy composed of the following measures. First, by changing the target for the policy interest rate from "around 0.1 percent" to "around 0 to 0.1 percent," the Bank explicitly made it clear that it was pursuing a virtually zero interest rate policy. Second, the Bank confirmed that it would maintain this policy until it judged that price stability was in sight, on condition that no problems, including the accumulation of financial imbalances, were identified. Third, in order to encourage a decline in longer-term interest rates and various risk premiums, the Bank established the Asset Purchase Program (hereafter the Program), through which it conducts the fixed-rate funds-supplying operation and the purchasing of various financial assets, such as government securities, commercial paper (CP), corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs). In response to the subsequent changes in economic conditions, the Bank expanded the Program's size three times, bringing the total to about 55 trillion yen from an initial size of about 35 trillion yen. The outstanding amount of the Program currently stands at slightly over 40 trillion yen and the Bank aims to continue to bring about monetary easing effects by adding a further 15 trillion yen to reach the targeted amount by the end of 2012, when the Bank intends to complete all purchases.

2. Ensuring financial market stability

I will now explain the Bank's measures to ensure financial market stability. As evident from the Lehman shock and the sovereign debt problems in Europe, when financial markets are under strain funding conditions of financial institutions deteriorate, which in turn impedes the smooth conduct of lending activity. The Bank has been playing its part to prevent a deterioration in financial institutions' funding conditions and thereby maintain a stable financial environment for individuals and firms.

The Bank took a range of measures immediately after the Lehman shock. For example, it successively conducted same-day funds-supplying operations amounting each time to several trillion yen. It also introduced U.S. dollar funds-supplying operations and expanded the range of eligible collateral. Right after the March 11 earthquake, the Bank provided ample funds on an unprecedented scale, exceeding the amount provided immediately after the Lehman shock. Moreover, in response to the emergence of strains in U.S. dollar short-term funding markets, the Bank decided to reestablish U.S. dollar funds-supplying operations in May 2010. And just last week, on November 30, 2011, six major central banks including the Bank of Japan announced coordinated measures, including the lowering of interest rates on U.S. dollar funds-supplying operations. The central banks also agreed to establish bilateral liquidity swap arrangements enabling the provision of liquidity in any of their currencies in addition to the U.S. dollar.

3. Providing support to strengthen the foundations for economic growth

I would now like to talk about the Bank's fund-provisioning measure to support strengthening the foundations for economic growth, which was introduced in June 2010. Through this measure, the Bank supplies long-term funds at a low interest rate to private financial institutions in accordance with their efforts in terms of lending and investment toward strengthening the foundations for economic growth. By June 2011, the total amount of loans disbursed by the Bank had nearly reached the initially set ceiling of 3 trillion yen, with the measure acting as intended as a catalyst in promoting loans by financial institutions in areas with growth potential. The Bank therefore decided to establish a 500 billion yen new line of credit for equity investments and so-called asset-based lending (ABL), in which assets such as accounts receivable and inventories are used as collateral, based on the consideration that it was essential for the Bank to devise ways to encourage the provision of equity-like funds, such as equity investments, and of loans without conventional collateral or guarantees. With this new line of credit acting as a catalyst, the Bank expects to see small firms gaining easier access to loans by making use of assets other than real estate and other assets that are conventionally used as collateral.

B. Current Financial Conditions in Japan

I will now describe current financial conditions in Japan, which reflect the Bank's conduct of monetary policy I have just outlined. As I mentioned earlier, it is extremely important to maintain stability in financial markets. Having examined various markets, my view is that Japan's financial markets have maintained a high degree of stability despite the continued strains in global financial markets.

Given that bank loans account for a large proportion of corporate funding in Japan, developments in the behavior of financial institutions are very important when assessing financial conditions. Surveys on the extent to which financial institutions' lending attitudes are perceived by firms as easing or tightening indicate that lending attitudes have been easing consistently since the Lehman shock, including during the immediate aftermath of the March 11 earthquake. Moreover, surveys of financial institutions' lending attitudes as perceived by themselves also show that, whereas the lending stance of financial institutions in Europe has become increasingly cautious, that of financial institutions in Japan has remained active.

Bank lending rates in Japan are lower than those in the United States and Europe and have been on a moderate downward trend. Looking at developments in the money market, which has a large influence on lending rates, yield spreads between short-term interbank loans and government securities -- the difference between the three-month London Interbank Offered Rate (LIBOR) and yields on three-month government securities -- have widened significantly for the euro and have recently shown a slight widening for the U.S. dollar. In contrast, they remain stable at extremely low levels for the yen. As you are well aware, firms cannot raise funds at the risk-free interest rates for government bonds and the like. Instead, funding rates for private-sector entities consist of the interbank rate and credit spreads or banks' interest margins. While international comparisons of loan rate spreads are difficult due to statistical constraints, a look at credit spreads on corporate bonds in Japan, the United States, and Europe shows that these have been stable at low levels in Japan, whereas they have widened rapidly in the United States and Europe.

Finally, I would like to respond to often-heard comments that, when looking at quantitative indicators, the Bank's efforts in terms of quantitative easing appear insufficient. Although it is inappropriate to gauge the current degree of monetary easing with quantitative indicators, I would like to point out for reference that the ratio of the currency supplied by the Bank (monetary base = banknotes in circulation + coins in circulation + current account deposits at the Bank) to nominal GDP greatly exceeds the equivalent ratios in the United States and Europe, both of which experienced a sharp increase in the monetary base following the Lehman shock, and the ratio remains on an upward trend.

C. Challenges for the Future

In sum, financial conditions in Japan have continued to ease steadily. However, this has not necessarily helped to stimulate economic activity such as investment and consumption. With Japan's economic growth on a long-term downtrend and prices falling for a prolonged period, both firms and individuals face the prospects of slower economic and income growth, and this, I believe, is restraining investment and consumption at present. Furthermore, along with the continued aging of the population, the number of workers is already declining, which makes it difficult to raise growth expectations.

In order to enhance the growth potential of the economy in this environment, it is first of all essential to make the most of existing resources. Looking at the current labor market, the number of unemployed is almost three million. In addition, there are almost five million "hidden unemployed," who are willing to work but not actively seeking a job.[3] This means there remain almost eight million people who wish to work. Providing them with jobs would increase their income and boost consumption, thus generating economic growth. Furthermore, this would bring about an increase in tax revenue and, in turn, a decrease in social security expenditures.

A breakdown of employment by firm size shows that firms with less than 500 employees account for 70 percent of total employment. In fact, firms with less than 100 employees alone account for 50 percent.[4] This illustrates that the key to solving the employment problem lies in small firms. According to the *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the diffusion index of business conditions -- that is, the percentage share of enterprises responding that business conditions were "favorable" minus that of enterprises responding that business conditions were "unfavorable" -- for small firms, and especially for small nonmanufacturing firms, has remained in negative territory for more than two decades, since the bursting of the bubble economy. It is extremely important, therefore, to come up with measures to re-energize the small enterprise sector.

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[3] The number of "hidden unemployed" represents those "wishing to work" in the category of "not in labour force" in the *Labour Force Survey* released by the Ministry of Internal Affairs and Communications. Specifically, they wish to work but are not looking for a job because they, for example, consider it difficult to find a job that suits their requirements in terms of working hours, wages, or other factors; or even if they found a job, they would be unable to work due to housework and child care.

[4] The figures refer to private-sector employees in non-agricultural industries (excluding self-employed workers and family workers) taken from the *Annual Report on the Labour Force Survey 2010*, released by the Ministry of Internal Affairs and Communications.

The second challenge that needs to be addressed in order to enhance growth is to increase labor productivity. Despite changes in the economic environment, firm entry and exit rates are still low in Japan compared with countries like the United States. This suggests that the "metabolism" of Japanese industry is slow, which could be hampering productivity growth. Although progress in globalization has opened up new markets overseas, for many small firms the mainstay for their business remains the domestic market. Therefore, it is important to provide mechanisms to revitalize firms that have found it difficult to grow due to changes in the domestic market environment by switching to new business areas with greater growth potential or by expanding their business reach through tie-ups, as well as mechanisms to facilitate business startups.

In order to re-energize the small enterprise sector, firms' own efforts are essential, but more than ever it is also imperative to create clear mechanisms to encourage and support such efforts from the policy front.

If tackling these issues succeeds in raising firms' and households' expectations for future growth, this would set in motion a cycle of growth in which investment and employment increase, boosting income and hence consumption, providing in turn a further boost to investment and employment. Such a cycle would reinforce itself and brighten the future for Japan.

In order for Japan's economy to overcome deflation and return to a sustainable growth path with price stability, the Bank will continue to consistently make contributions as the central bank.