Toshihiko Fukui: Achieving sustainable growth

Speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at a luncheon for the EU Ambassadors, Tokyo, 28 November 2003.

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Today, I will talk about Japan's economic outlook and the conduct of monetary policy in pursuit of sustainable growth.

Japan's economy is starting to recover gradually. Exports and production are increasing. Corporate profits are rising, and business fixed investment is staging a modest recovery. The majority of the Bank of Japan's Policy Board members forecast real GDP growth of around two and a half percent in both fiscal 2003 and 2004.

Behind Japan's nascent economic recovery is the synchronized recovery of the world economy. The US economy is clearly on the rebound, European economies are showing signs of a moderate recovery, and closer to home, East Asian economies have regained their high growth paths after quickly overcoming the adverse impact of SARS.

Increasing interdependence between the United States, East Asian countries and Japan is one of the keys to achieving sustainable growth in Japan. For example, Japanese firms strategically incorporate China not only as a low-cost production center but also as a potentially huge consumer market for goods and services. This is underscored by the increasing amount of both exports to and imports from China. We also observe an increasingly important mechanism whereby, for example, a recovery in the US economy stimulates East Asian economies, and this in turn has a positive impact on Japan.

Looking at the domestic front, steady progress has been made in solving structural problems. The debt to sales ratio for all industries has declined from its peak in 1993. The employment and income situation has somewhat improved recently. Corporate profits have increased largely as a result of firms' restructuring efforts. This has led to a recovery in business fixed investment.

While economic activity is improving, mild deflation is expected to continue. Indeed, the most recent figure for the Bank of Japan's Policy Board members' forecast of the Consumer Price Index excluding volatile food prices, which we generally refer to as the “core CPI,” is slightly negative, between minus 0.2 and minus 0.5 percent for fiscal 2004.

The combination of economic recovery and continuing deflation suggests a number of underlying problems, which may have some policy implications.

First, the output gap remains large. Since real GDP growth in both fiscal 2003 and 2004 will be slightly above potential growth, the output gap will be reduced only marginally.

Second, inflation has been declining globally. This is due mainly to the successful conduct of monetary policy worldwide and the increasing penetration of emerging countries into market economies. Firms have not regained pricing power in the market. Therefore, there is a strong possibility that inflation will stay at a relatively low level, while the growth rate will increase.

Third, Japan's economy is still suffering from structural problems such as excess debt, excess labor, and financial system fragility. Because of these structural problems, cyclical recoveries at large manufacturers are not able to generate strong positive spillover effects for non-manufacturers, small to medium-sized companies, or households.

To return to a sustainable growth path and overcome deflation, Japan must thus solve its structural problems and enhance the growth prospects of both firms and households. In Japan, as in Europe, structural reform to ensure the more efficient use of capital and labor is urgently called for.

Despite the recent progress, we should not be complacent about the need for structural reform. The process of solving structural problems is still half-finished. For example, the debt to sales ratio for non-manufacturing industries is still higher than it was before the bubble period. In addition, the sense that they are still holding excess labor remains among firms, whether in manufacturing or non-manufacturing, and whether large or small.

Banks have also made progress in their restructuring. Large banks have reduced outstanding amounts of nonperforming loans and have increased provisioning. They have also reduced the risk pertaining to stock prices by selling their shareholdings to the market as well as to the Bank of Japan under our stock purchasing scheme. Almost all banks have reduced their shareholdings to levels below their Tier 1 capital.

Banks' financial results turned out to be better than expected for the first half of the current business year ended in September. Because losses resulting from the disposal of nonperforming loans were smaller than operating profits, most banks posted profits. The average capital adequacy ratio for large banks was around 11 percent.

Given the scheduled removal of blanket deposit insurance in the spring of 2005, time is running short for us to engage in the further restructuring of the financial system to restore the soundness of the banking system. Moreover, the decline in bank lending illustrates not only that demand for loans is weak but also that the risk-taking ability of banks has not recovered sufficiently.

Under such circumstances, the Bank of Japan has adopted quantitative easing as its fundamental policy framework. And we have made our commitment to maintain the current quantitative easing, that is to maintain zero interest rates, until the core CPI shows a year-on-year rate of increase of zero percent or above on a sustainable basis.

Quantitative easing has helped to maintain financial market stability and to make the environment surrounding corporate finance more accommodative, thereby underpinning economic activity. Concerns about a liquidity shortage in the money market have been almost dispelled, and short- to medium-term interest rates have been low, reflecting the Bank's commitment in terms of policy duration.

In the area of corporate finance, borrowing rates have been stable at low levels. Although the outstanding amount of loans has been declining, the lending attitudes of banks as perceived by firms and the funding situations of firms themselves have been improving. During 1997 and 1998 amid the currency crises in Asia and Russia, the failures of several large Japanese financial institutions triggered a credit crunch. Since then, however, firms have not experienced such hardships, thanks to the provision of ample liquidity by the Bank and the strengthening of the safety nets.

Under quantitative easing, the Bank has raised the target for the outstanding balance of current accounts three times this year, resulting in a total increase of 10 trillion yen. In April and May, the Bank raised the target in response to downside risks, including the negative effect of SARS and the decline in stock prices. In October, the Bank raised the upper limit of the target. This was intended to give the Bank more flexibility in providing liquidity through its money market operations. Unlike earlier increases in the target, the objective of the increase in October was not to deal with downside risks, but rather to reinforce the recent momentum for recovery.

In my view, two things are important to strengthen the framework of quantitative easing. One is to clarify our commitment to maintain the quantitative easing policy, thereby enhancing the transparency and increasing the effectiveness of monetary policy. The other is to strengthen the transmission mechanism of monetary policy in the area of corporate finance.

In October, with a view to enhancing the transparency of monetary policy, we decided to clarify our commitment to maintain the quantitative easing policy. We also decided to improve the way we communicate to the market our thinking on the economic outlook.

In terms of our commitment, we specified two conditions for terminating quantitative easing. First, the most recently published year-on-year rate of increase in the core CPI must register zero percent or above, and such a tendency must be confirmed over a period of a few months. Second, we need to be convinced that the future year-on-year rate of increase in the core CPI will not fall below zero percent. To be more specific, the majority of Policy Board members must forecast that the rate of increase in the core CPI will be above zero percent during the forecasting period.

While these two conditions are necessary conditions, there might be cases in which even though the above conditions have been met, the Bank might still deem it appropriate to continue quantitative easing.

As a way to improve our communication with the market, we have introduced the following measures with particular emphasis on the timing and frequency of communication in conjunction with the clarification of our commitment. We decided to release an interim assessment of the state of the economy and prices in January and July. Previously, the Bank released its view of the "standard scenario" for the economy after reviewing the outlook and risk assessment of the economy and prices twice a year, in April and October. Now, in addition to these, the Bank will discuss possible deviations from this standard scenario at Monetary Policy meetings and report the outcome of its discussion in the January and July monthly reports. The Bank also decided to change the schedule for publishing its monthly report as well as to hold the Governor's press conference on the same day as the Monetary Policy meetings.

We hope that the clear and concrete commitment to continue quantitative easing will help the effects of monetary easing to permeate the economy more efficiently. We believe this will contribute to strengthening the foundation for a more sustainable economic recovery.

Some argue that such clarification of the Bank's commitment may impair the flexibility with which it is able to conduct future monetary policy. For example, if market participants consider the Bank's commitment to be too inflationary, this will cause the yield curve to steepen. It reflects not only the eventual increase in future short-term interest rates, but also the greater risk premium attached to concerns that a “too-easy” policy may be continued for “too long.”

In this sense, the idea of policy commitment involves a delicate balancing act between securing the short-term economic recovery and achieving long-term sustainable growth. Considering that deflation, though mild, is expected to continue under zero interest rates, I believe an unusual policy commitment, which is linked with a specific and observed economic indicator, is necessary in striking the best possible balance under the circumstances.

To strengthen the policy commitment, I am well aware that there are those both at home and abroad who argue for adopting an inflation target or a numerical definition of price stability. In this regard, let me reiterate that when nominal interest rates are constrained by the zero bound and financial institutions are not performing their intermediary function sufficiently, we cannot expect the transmission mechanism of monetary policy to function properly. Under such circumstances, it is hard to believe that the adoption of inflation targeting would increase the effectiveness and enhance transparency regarding the future conduct of monetary policy.

I believe that the current policy commitment is most effective in enhancing the transparency of monetary policy and stabilizing the expectations in the market. It clarifies under what conditions and for how long the Bank intends to maintain the framework of its current quantitative easing policy.

In addition to enhancing transparency, we need to strengthen the transmission mechanism of monetary policy in the area of corporate finance. In this regard, the Bank has begun purchasing asset-backed securities backed by private sector corporate debt. The credit markets in Japan have traditionally been dominated by bank lending. However, given a situation in which banks' ability to take risks is constrained, we need to expand the markets for asset-backed securities and other such credit instruments, which are not susceptible to fluctuations in banks' capital levels. To date, the Bank has purchased about 200 billion yen of asset-backed securities and asset-backed commercial paper.

We hope that our efforts will contribute to the further expansion of the asset-backed securities market by raising awareness of its advantages among financial institutions and investors as well as encouraging the origination of asset-backed securities in the market. Earlier this month, the Bank initiated a series of workshops with a wide range of market participants on how best to coordinate efforts to improve the markets for asset-backed securities and other similar credit instruments.

Our current framework for quantitative easing coupled with measures to strengthen the transmission mechanism of monetary policy will improve the financial environment within which firms and banks engage with the structural problems. It will thus facilitate the Japanese economy's return to a sustainable growth path and also bolster the efforts to overcome deflation. Since the strategy of the Bank of Japan relies on the efforts of the private sector, this policy may take time to pay off, but it is the most effective way of tackling the roots of the structural problems.

In closing, I express my sincere hope that the current momentum for recovery in both Europe and Japan will be successfully translated into sustainable economic growth.