Toshihiko Fukui: Recent economic and financial developments in Japan

Speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at a meeting in Fukuoka, 8 December 2003.

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I. The current economic situation and the route to sustainable growth

Largely in line with the standard scenario in the Outlook and Risk Assessment of the Economy and Prices published at the end of October, Japan's economy is starting to recover gradually, after a period of generally flat economic activity that lasted up until around summer. With corporate earnings improving, business fixed investment continues its gradual recovery. Against the backdrop of an improvement in overseas economies, exports, which had been flat until summer, have started to turn upward. Production, whose recovery had been somewhat delayed due to the unusually cool summer, is starting to increase recently.

The fact that the rise in exports and business fixed investment has led to a recovery in production suggests that cyclical momentum for a recovery is kicking in, and that the Japanese economy is at last settling onto a recovery path.

From the second half of fiscal 2003 through fiscal 2004, a moderate recovery is expected to continue. Exports and production are likely to continue increasing against the background of high growth in the United States and Asia, particularly in China, with a recovery in global demand for IT-related goods. In Europe, it is becoming more apparent that the economy has bottomed out. There is a greater probability that these increases in exports and production will promote further business fixed investment along with the improvement in corporate earnings.

The pace of the recovery will most likely be contained to a moderate clip, considering ongoing structural adjustment pressures as well as not so favorable prospects for employment and income. The corporate sector, especially non-manufacturing, is still suffering from excess debt. With no clear signs of improvement in employment and income, personal consumption is expected to continue following a generally flat trend. It will be quite some time before we can eliminate the word “moderate” from the description of the current recovery.

After decreasing constantly for five and a half years, the consumer price index excluding fresh food, which we refer to as the core CPI, increased by 0.1 percent year-on-year in October. This was partly due to a hike in rice prices caused by the unusually cool summer, in addition to factors such as the rise in medical treatment costs and the tobacco tax.

Although the core CPI may fluctuate due to temporary factors, its underlying trend is expected to be for a slight decline during the rest of fiscal 2003 and throughout fiscal 2004 since aggregate demand is projected to remain short of potential supply capacity.

Naturally, this standard scenario entails various uncertainties, or what we term risk factors. Among them, we pay particular attention to the global demand for IT-related goods, the U.S. economy, the domestic financial system, and financial market developments. These risk factors may cause the Japanese economy to deviate from the standard scenario laid out in the Outlook and Risk Assessment, either upward or downward.

To overcome deflation and return to a sustainable growth path, a cyclical recovery alone is not sufficient. Structural problems must be dealt with, and expectations of higher growth must be formed. We need to address excess debt in the corporate sector and weakness in the financial system. We need to raise expectations of growth among firms and households, who seek for new value added, so that these may be translated into brisker spending.

In the corporate sector, steady efforts have been made, stretching over more than 10 years, to solve problems such as excess debt and labor. In fact, large manufacturers have largely succeeded in eradicating these excesses. As break-even points have been lowered, the ratio of current profits to sales for such firms has improved to its highest level since the bursting of the bubble.

Some manufacturers are aggressively pursuing improvements in productivity by investing in newly growing businesses and constructing a more efficient international division of labor. Spread of such movements throughout the corporate sector, including to non-manufacturers and to small and medium-sized firms, is one of the key factors to enhancing expectations of growth generally and reinvigorating Japan's economy.

II. Conduct of monetary policy

The Bank of Japan is continuing to provide ample liquidity, targeting an outstanding balance of current account deposits at the Bank under its quantitative easing policy. Since the beginning of the year, the target has been significantly raised twice, in April and May, in light of risk factors such as the war in Iraq and severe acute respiratory syndrome.

Furthermore, in October, the Bank raised the upper limit of the range for the target balance of current account deposits. This was intended to reinforce the nascent recovery by enhancing the flexibility of money market operations when providing liquidity to the market. With the economy in an incipient recovery phase with its concomitant uncertainties, there is the potential for subtle fluctuations in the expectations of market participants and changes in funding needs. The Bank has sought to respond flexibly in its market operations to any possible changes of these sorts, so that it can reinforce the current stirrings of recovery.

The outstanding balance of current account deposits now stands around 30 trillion yen, having risen from around 20 trillion yen at the beginning of the year. The Bank conducts market operations centering on this balance by carefully monitoring daily market conditions.

In order to help the effects of monetary easing through the provision of ample liquidity to permeate the whole economy, the Bank is taking measures to strengthen the transmission mechanism of monetary policy in corporate finance. In August, the Bank began the purchase of asset-backed securities collateralized by assets mainly related to small and medium-sized firms. The Bank recently decided to accept syndicated loans as eligible collateral.

In addition to their immediate monetary policy implications, these measures will also contribute, over the long run, to establishing a new shape for corporate finance, better compatible with Japan's future economy. We hope that our initiatives will act as a trigger, spurring the private sector to explore various new market-based funding channels to supplement the traditional bank lending channel.

III. Enhancing transparency in the conduct of monetary policy

There are two points that are of pivotal importance when conducting monetary policy. One is to implement effective policy in a timely manner. The other is to provide the public with a lucid explanation and promote their understanding of the Bank's evaluation of economic and price developments as well as the thinking upon which it bases its policy decisions.

The new Bank of Japan Law stipulates that the Bank, which has been given independence to conduct monetary policy at it own discretion, must make efforts to be more accountable for its decision. We think that the greater the public understanding of the thinking behind monetary policy, the more effective that monetary policy will be.

Bearing these points in mind, the Bank made two major decisions to enhance the transparency of monetary policy at the Monetary Policy Meeting in October.

First, measures were taken to provide the public with a lucid explanation of the Bank's evaluation of economic and price developments in a timely manner. In addition to the semiannual report on the Outlook and Risk Assessment of the Economy and Prices in April and October, the Bank decided to carry out interim assessments of economic and price developments in January and July, and to release the result of its discussions accordingly. These interim assessments are designed to investigate possible deviations of economic and price developments from the standard scenario presented in the Outlook and Risk Assessment three months before.

Second, the Bank published a more detailed description of its commitment to maintaining the quantitative easing policy. The Bank had already committed to maintaining the current policy until the core CPI registers a stable year-on-year rate of increase of zero percent or above. In October, it decided to clarify the meaning of the phrase "registers stably a zero percent or an increase year-on-year" in a more concrete manner.

Specifically, quantitative easing will be continued until the following two conditions are met.

First, not only must the most recently published core CPI register a year-on-year rate of increase of zero percent or above, but this tendency must be confirmed over a few months.

Second, the year-on-year rate of increase in the prospective core CPI must not be expected to register zero percent or below. In other words, the majority of Policy Board members need to make the forecast that the core CPI will register a year-on-year rate of increase greater than zero percent during the forecasting period. This forecasting period is roughly a year starting from April in the April Outlook and Risk Assessment, and roughly a year and a half, which is the second half of the current financial year starting from October and the whole of the next financial year ending in March, in the October Outlook and Risk Assessment.

The above two conditions are necessary conditions. However, we have also announced that there may be cases when the Bank will judge it appropriate to continue with quantitative easing even if these conditions are fulfilled.

Since its announcement, we have received a few questions about this detailed description of the commitment. Let me answer two major questions.

The first question is why the Bank does not carry out interim assessments of economic and price developments every month. Since the economy is changing constantly, perhaps, theoretically speaking, we should carry out the interim assessments every month, or even every week.

Against this theoretical possibility, we judge it appropriate that the Outlook and Risk Assessment and interim assessments should be released roughly every three months in light of their objective to present a basic view of how the economy will develop over a reasonable period of time. We cannot revise the basic view about the economy and prices in an appropriate manner without sufficient accumulation of critical data. Also we may confuse the market if we release assessments based on insufficient data or if we change our assessments too frequently. Actually, many central banks abroad release their monetary policy reports or inflation reports every three months.

This does not, of course, imply that the Bank will make policy changes only every three months. Although conducting the basic evaluation roughly every three months, we need to closely examine the ever-changing state of the economy and prices and to carefully deliberate on the need for policy changes at every Monetary Policy Meeting. As has always been the case, if the need arises, the Bank will adjust its policy in a timely and appropriate manner, regardless of the frequency and timing of the release of the Outlook and Risk Assessment and interim assessments.

The second question concerns the risk that more detailed description of the commitment to maintaining the quantitative easing policy may affect the Bank's ability to conduct monetary policy in a flexible and timely manner in future. It may be natural to ask this question, because it is extremely unusual for a central bank to link its future policy conduct to a particular economic indicator, such as the core CPI in the case of Japan.

While paying due attention to this kind of risk, we have come to the conclusion that, with a number of obstacles still confronting Japan's economy as it seeks to overcome deflation and settle onto a more solid recovery path, such a detailed description of the commitment is necessary at the current time. This detailed description is a manifestation of our strong determination regarding the future conduct of monetary policy.

IV. Current state of the financial system

On the whole, the current state of the financial system in Japan remains severe. It should be noted, however, that at some financial institutions, especially major banks, efforts to improve financial conditions have gradually begun to bear fruit.

For the financial year ending in September, profitability improved significantly at all major banks, except for Resona Group, which received an injection of public funds. This was mostly thanks to successful reductions by all major banks of losses from nonperforming loan disposals, on a year-on-year basis at the end of September 2003. These reductions were partly due to large capital increases and higher provisioning in the previous financial year ending in March 2003. After registering a record high at the end of March 2002, the amount outstanding of nonperforming loans continued to decrease as progress was made in the removal of nonperforming loans from balance sheets.

Major banks improved stability of their profitability by reducing their shareholdings, which had been blamed for large fluctuations in profits. In fact, banks' shareholdings had decreased to levels well below Tier 1 capital at the end of September.

To strengthen profitability, major banks made efforts in cutting costs and increasing fee incomes. These efforts have gradually begun to be reflected in their financial results.

Moving on to conditions surrounding regional financial institutions, let me first touch on the recent case of Ashikaga Bank. Last month, Ashikaga Bank informed the government that it had negative net worth at the end of September, and that there was a risk of suspending repayment of deposits. Considering the significant financial role played by Ashikaga Bank in the region, including Tochigi Prefecture, the government judged that a serious disruption of the financial system in the region might occur if no measures were taken. The Prime Minister summoned the Financial System Management Council, of which I am a member, and decided upon the temporary nationalization of Ashikaga Bank, pursuant to Article 102 of the Deposit Insurance Law at the end of last month.

As a temporarily nationalized bank, Ashikaga Bank will continue normal operations, and all of the bank's obligations, including deposits and interbank borrowings, will be met smoothly. A new management team will carry out appropriate business operations, while seeking to transfer its business to an assuming financial institution as soon as possible. As part of this process, the Bank of Japan will provide liquidity, including the extension of special loans pursuant to Article 38 of the Bank of Japan Law if necessary.

Fortunately, at present, no other regional financial institution faces conditions of comparable severity. In fact, financial statement at the end of September 2003 showed improvements at more than a few regional financial institutions as losses from the disposal of nonperforming loans were reduced.

Regional financial institutions, however, seem to lag behind major banks in addressing tasks, such as appropriately evaluating the economic value of nonperforming loans, making provisions accordingly, and working toward corporate revitalization. While land prices continue to decline, small and medium-sized nonmanufacturing firms, which dominate regional economies, find their business recovering only too gradually. In these difficult circumstances, it is increasingly hoped that regional financial institutions will play an active role. We at the Bank will do as much as we can to support their efforts in this regard, through supervision and other means, whenever the occasion presents itself.

V. Issues for 2004

2004 is the final year of preparation for the removal of blanket protection of demand deposits in April 2005. This removal, in my view, should not be perceived simply as an adjustment of the extent to which deposit insurance protection is applicable. Rather, it should be recognized as the last hurdle before the management of financial institutions becomes truly independent from regulatory authorities.

At the end of March 2005, major banks are expected to reduce their nonperforming loan ratios to about half autumn 2002 levels. At the same time, the Industrial Revitalization Corporation of Japan will cease its purchase of loan assets. From April 2005, fixed asset impairment accounting rules will be introduced.

Firms continue to strengthen their business structures and competitiveness. Initiatives based on the private sector's creativity and vitality will be the driving force for Japan to achieve steady economic growth under global competition.

Together with firms, financial institutions also play an important role in supporting the Japanese economy. Dynamic expansion of the economy will not be possible if financial institutions remain dependent on regulatory authorities and generous safety nets. Not only firms but also financial institutions will be confronted with frequent new entries to and withdrawals from the market, as well as consolidation and reorganization in their respective industries. This makes it all the more critical for financial institutions to demonstrate their firm intention to stand on their own feet, and enhance their credibility in the market.

In this regard, let me point out some of the major tasks to be addressed in 2004. In order to achieve reform of the economic structure and a sound financial system more rapidly, financial institutions, especially major banks, must work harder with firms to revitalize the corporate sector, while expediting the disposal of nonperforming loans. It is true that some financial institutions have already established subsidiaries specializing in corporate revitalization. Further efforts, however, are still required in areas such as the more effective use of the Industrial Revitalization Corporation of Japan and the Resolution and Collection Corporation.

In corporate revitalization, regional financial institutions basically face the same problems as major banks. There are more than a few borrower firms with competitive technology and expertise, which find it difficult to improve profitability because of the financial legacy of past borrowing. For this reason, the strategically important issues that many regional financial institutions address include the provision of detailed consultation services to borrower firms, the extension of greater assistance to borrower firms, and the prompt realization of business revival. We hope that their efforts will bear fruit.

Financial institutions also have an important role to play in helping the corporate sector to develop the new businesses that will underpin Japan’s future economy, while at the same time supporting ailing business firms. Regional financial institutions in particular are expected to play an active role in generating new businesses in their region. We observe the first shoots of new regional businesses in a variety of areas: biotechnology and other advanced technologies, new industrial clusters linked to recycling and other environment-related technologies, as well as regional city revival, sightseeing, medical care, and nursing services.

To strengthen such trends, regional financial institutions are expected to play a new role in their regions. In this regard, the thinking behind their business decision-making in the past needs to be radically overhauled. For example, decisions about whether or not to assume particular risks should be based on a close examination of the nature of projects at hand rather than depending unduly on traditional collateral or guarantee-based methods. They should also raise their levels of expertise at providing advisory services relating to the smooth management of projects. This in turn will lead to the revitalization of regional financial institutions themselves.

Once the blanket protection of demand deposits is removed, financial institutions will no longer be able to count on support from the authorities. In principle, they will have to rely entirely on their own intellectual resources and creativity in dealing with the tasks facing them, including the nonperforming loan problem.

It is conceivable, however, that there may be financial institutions, which are keen to rebuild their financial base, but which may not be able to strengthen their capital positions within the limited time frame without outside assistance. To deal with this possibility, injections of public funds which may be executed without reference to systemic risk should be considered apart from the measure stipulated in Article 102 of the Deposit Insurance Law.

I am aware of a variety of learned opinions calling for caution in establishing another system of capital injections. Bearing these opinions in mind, I hope that we will somehow manage to find a way to design an appropriate new framework - one that will function as the last public support to the efforts of the private sector.

In closing, let me reiterate our determination to support the efforts of the private sector and to exert ourselves to the full to achieve sustainable growth.