Toshihiko Fukui: Economic situation in Japan and abroad

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at a meeting in Osaka, 2 September 2004.

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Today I will discuss the economic situation at home and abroad, and the conduct of monetary policy. Amid the continued expansion of the world economy, Japan's economy has been on a recovery path since the summer of last year. The recovery has been initially driven in large part by an increase in exports. In addition to the favorable external conditions, the foundation has been laid domestically for a self-sustaining recovery. We should also note that the current recovery has been achieved while prices have been on a declining trend.

World economy and Japan's economy

Let me start with the world economy. The economies of numerous countries including Japan have become closely interrelated as globalization has progressed. This is evidenced by the growing prevalence of the international division of production processes. For example, IT-related investment has been undertaken all over the world, led by the United States. High-value-added components of IT-related goods are being produced in Japan, while processing and assembly have been concentrated in other East Asian countries.

Overseas economies, particularly the United States and China, continue to expand. The U.S. economy has been maintaining expansionary momentum with a steady increase in capital spending and a large jump in corporate profits, despite several weak economic indicators. The Federal Reserve Board raised its target federal funds rate by 25 basis points in June and August, respectively. The East Asian economies have been growing steadily, with China likely to continue its high growth.

In Japan, real GDP growth slowed to an annual rate of 1.7 percent in the second quarter, following high growth in the two preceding quarters. Nevertheless, it is our overall judgment that Japan's economy has been in a recovery process, leading to a return to a sustainable growth path in light of the background I have just described. A rise in exports has raised industrial production and corporate profits, which in turn generates an expansion in business fixed investment. In the labor market, the number of employees has been increasing.

Japan's economy is thus expected to continue recovering, gathering stronger momentum. The positive effects of the increases in production and corporate profits on household income are expected to become visible, laying stronger foundations for a gradual recovery in private consumption.

Corporate sector

It is accurate to say that Japan's current recovery is due to the better-than-expected growth of the world economy. It is also the result of the progress being made in adjusting excessive capital stock, debt, and labor of the corporate sector as well as dealing with financial system fragility. Corporate restructuring has spread from large manufacturers to nonmanufacturers and small businesses, producing tangible results. The ratio of current profits to sales and return on assets in fiscal 2004 are projected to be the highest for both manufacturers and nonmanufacturers since the bursting of the asset bubbles.

While dealing with the legacy of the asset bubbles, firms have been pursuing forward-looking business strategies, particularly in IT-related areas. For example, the markets for digital electronic appliances and environment-related products have been growing rapidly. To take advantage of the international division of production processes, Japanese firms have increasingly concentrated resources in the areas where they enjoy a comparative advantage. As a result, they have succeeded in raising productivity at home and maintaining competitiveness.

Financial system

For Japan's financial sector, the major challenges are restoring financial soundness and pursuing profitable business opportunities.

To restore financial soundness, banks have made steady progress in disposing of nonperforming loans (NPLs) recently. The ratio of NPLs to total loans has declined significantly at regional banks, which had previously been slower than major banks to address the NPL problem. Credit costs, the costs incurred by banks when they dispose of NPLs, have clearly been on a declining trend.

The financial soundness of banks and the managerial soundness of borrowers are two sides of the same coin. In this context, banks have been tackling the remaining issues necessary to resolve the NPL problem, including the revitalization of borrower firms. In view of the full removal of blanket deposit insurance scheduled for April 2005, it is vital for firms and banks to step up their efforts to resolve the NPL problem to revitalize Japan's economy.

In pursuing profitable businesses, financial institutions face the challenge of meeting the diversified needs of households and firms appropriately and efficiently. Banks have been seeking to strengthen their management and construct a more efficient system for the division of labor and collaboration through alliances and wide-ranging consolidation. Major banks have also been seeking dynamic consolidation to better compete globally. Given the reduced restriction in terms of credit costs, financial institutions have been gradually taking on new challenges such as increasing loans to small and medium-sized firms, originating syndicated loans, and selling mutual funds and insurance.

Thus, we can say that the financial system as a whole is restoring its soundness and evolving a forward-looking, more dynamic style of management. To sustain these actions, financial institutions need to upgrade the integrated risk management system, in which various types of complex risks are controlled in a consolidated manner, and construct a framework to deploy capital more efficiently. A draft of the new Basel Capital Accord released at the end of June has adopted a risk-sensitive framework to encourage the upgrading of risk management. In line with this global trend, the Bank of Japan is working to improve the functioning of financial institutions through on-site examinations and off-site monitoring.

Price developments

While the corporate goods price index, particularly raw materials and intermediate goods, has been rising partly because of higher crude oil prices, the consumer price index (CPI) has been on a slight downtrend. A small decline in the CPI is largely due to the unit labor cost reductions in the corporate sector reflecting higher productivity and the restraint on labor costs. Thus, the outlook for prices depends on future developments in productivity and wages.

Three factors underpin the rise in productivity. First, resources are being used more efficiently as a result of the adjustment of excessive capital stock and labor as well as deregulation in a variety of areas, including the labor market. Second, progress continues in IT and technological innovation. Third, as is generally observed during an initial phase of economic recovery, higher utilization of labor and equipment is increasing productivity. While the third factor is cyclical, the first two factors could spur structural changes, raising the potential production capacity of Japan's economy.

Many countries have experienced a situation in which prices do not necessarily increase in tandem with an upturn in economic activity. Economists and central bankers have been exploring a plausible explanation of this discrepancy. From the viewpoint of conducting monetary policy, we are carefully monitoring price developments while keeping in mind the following questions. If the recovery continues, will the growth in productivity slow? Or, will such growth continue thanks to deregulation and the progress in IT? Or, will wages rise along with the growth in productivity?

In terms of developments in prices over the shorter term, we should pay attention to the effects of higher crude oil prices on the general price level. Crude oil prices have been around record-high levels against the background of a rise in global demand and heightened concern about geopolitical risks. We have seen the impact of higher crude oil prices on the domestic corporate goods price index, which marked a year-on-year increase of 1.6 percent in July, the largest since the latter part of the bubble period. Higher crude oil prices are also affecting the CPI through the rise in prices of gasoline and other petroleum-related products.

We should also pay attention to the effects of the increase in crude oil prices on economic activity. The steady expansion of the world economy including the United States may be adversely affected. At home, higher crude oil prices may have a negative impact on corporate profits and households' spending behavior.

Conduct of monetary policy

Let me turn now to the conduct of monetary policy, bearing in mind the current situation in which prices are not increasing together with the economic recovery.

The Bank has made a commitment to continue the current quantitative easing policy until the year-on-year change in the CPI registers zero percent or higher on a sustainable basis. Such a commitment is unusual for a central bank. Since the CPI is still on a declining trend, the Bank is determined to pursue an easy monetary policy even as the economy continues to recover.

The positive impact of the current easy monetary policy on economic activity is strengthening as the economy recovers. The Bank's policy commitment allows firms to continue enjoying low funding costs through the stability of expectations about future interest rates. As the economic recovery raises the expected rate of return on new investment with interest rates remaining low, firms will become more inclined to undertake investment.

We expect consumer prices to continue declining slightly year on year due to the decrease in rice prices in the fall as a flipside of the increase of last year, despite higher crude oil prices. So far, we have not observed any major changes in the discrepancy between economic activity and prices, productivity, and wages. It is our judgment that we remain at the stage where we should maintain the current commitment and firmly continue the quantitative easing policy.

Eventually, we must return to the conventional monetary policy of using short-term interest rates as an operating target, from the current policy of using the current account balance at the Bank as an operating target. The process of returning to the conventional monetary policy consists of two elements.

One element is how to reduce the current account balance at the Bank of Japan. Financial institutions have a legal obligation to hold about 6 trillion yen in the current account at the Bank as required reserves. At present, given the ample provision of liquidity by the Bank, they are holding 30 to 35 trillion yen in their current accounts, far exceeding the required reserves. The ample provision of liquidity has contributed greatly to financial market stability and thus prevented a deflationary spiral as it dispels concern about liquidity risk. As we return to the conventional policy framework, we will need to reduce the current account balance at the Bank. The other element involves the pace at which short-term interest rates, which are now virtually at zero, should be raised.

How should we go through the process as we return to the conventional monetary policy? What is the most appropriate way to communicate our thinking on monetary policy as we eventually shift the policy? These are the important issues we must address in the future. We will seek a smooth transition from the current monetary policy to conventional policy by taking full account of the economic and financial situation.

Japan's economy is moving steadily toward achieving sustainable growth and overcoming deflation. The Bank is determined to support the private sector's efforts to move forward by firmly pursuing the appropriate monetary policy.