

Toshihiko Fukui: Toward achieving strong economic growth in Japan

Summary of a speech given by Mr Toshihiko Fukui, Governor of the Bank of Japan, at the Keizai Doyukai (Japan Association of Corporate Executives) Members' Meeting, Tokyo, 13 May 2005.

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Introduction

Semiannually in April and October, the Policy Board of the Bank of Japan decides the text of the Outlook for Economic Activity and Prices, or the Outlook Report as we call it, and releases it. This report describes the Bank's outlook for economic activity and prices which provides the basis for conducting monetary policy. We decided to extend the projection period for the April issues of the Outlook Report by one year to two fiscal years, and hence the report released at the end of April 2005 covers the outlook for fiscal 2005 and 2006. In deciding on the extension, the Bank gave consideration to the fact that it takes a certain amount of time for the effects of monetary policy to spread to economic activity and prices, and also looked at the practice of other central banks for reference.

Today, I would like to explain first the current situation and the outlook for Japan's economic activity and prices, particularly the content of the April Outlook Report, focusing on the underlying mechanism of developments in economic activity and prices. I will then talk about the conduct of monetary policy in such an economic and price situation.

I. The current situation and the outlook for Japan's economic activity and prices

The Bank's projections for fiscal 2005 and 2006 presented in the April Outlook Report were, in summary, that the economy is expected to experience a relatively long period of growth, albeit at a moderate pace. The economy is currently experiencing the third recovery phase since the bursting of the bubble. In the past two recovery phases, the recovery soon ran out of steam, and the economy slipped back into recession. This time, however, the economy has been on a relatively long recovery trend, and this is likely to continue.

Recently, Japan's economy has been experiencing a temporary pause, with the real GDP growth rate standing almost at the same level for three consecutive quarters from the second quarter of 2004. The major factor behind this is the progress in global adjustments of production and inventories of IT-related sectors. This has been evidenced by the sluggishness of exports of capital goods and parts, particularly those for semiconductor manufacturing equipment, and of IT-related goods such as electronic parts, and the continued decrease in production of IT-related goods. Given this situation, there was a view that the current economic recovery might stall.

However, exports have started to pick up and production has stopped declining recently, and it is gradually becoming clear that the current pause is only a temporary one, leading to a sustainable growth path in the not so distant future, and not the prelude to a descent into an economic recession.

Adjustments in IT-related sectors are likely to be completed around the middle of 2005 on the whole, although the degree of progress has differed by type of product: while adjustments for digital appliances have shown considerable progress, there has not been much in the case of mobile phones. Compared to the time of the bursting of the IT bubble in 2001, the current adjustments are likely to be mild and completed in a shorter period of time. Learning from the lessons of the IT bubble, firms have improved their global inventory management and were cautious about building up inventories. In addition, they started to make adjustments in inventories at a relatively earlier stage as soon as signs of weak demand emerged. All this contributed to alleviating the degree of adjustment. Furthermore, unlike the situation at the time of the IT bubble when demand concentrated on personal computers, there is a wider range of demand for IT products, such as digital appliances, in which Japan has a comparative advantage. This demand-side factor has also contributed greatly.

Next, I would like to explain the background to the Bank's outlook that the economy is expected to experience a relatively long period of growth, albeit at a moderate pace, after adjustments in IT-related sectors are completed in the not so distant future and the economy emerges from the temporary pause.

Our projection of continuing recovery is based on the fact that, in summary, both the economic and financial fundamentals have been strengthening.

On the economic side, there has been progress in adjustments of firms' excessive production capacity, holdings of labor, and debts. Corporate profits have exceeded the level at the end of the bubble period and excess production capacity as perceived by firms has almost been eliminated, as was evidenced in the March Tankan (Short-Term Economic Survey of Enterprises in Japan). In addition, the diffusion index for employment conditions indicated that the number of firms that perceived they had insufficient holdings of labor exceeded those that perceived they had excessive holdings of labor for the first time since the 1992 survey on an all industries basis.

On the financial side, measures have also been taken to restore the soundness of the financial system, particularly in terms of reducing nonperforming loans (NPLs), and these have made good progress. Against this background, blanket deposit insurance was fully lifted in April 2005 and the financial environment to support positive corporate activity is being established.

Despite these improvements, the behavior of firms remains cautious on the whole. Although it may sound paradoxical, the economic recovery is projected to be sustainable but remain moderate against the background of such behavior. Business fixed investment continues to grow, and some firms have started to show a positive stance in their investment, however only to a limited extent. The majority of firms are still placing priority on using the high level of corporate profits to reduce interest-bearing liabilities and, in most cases where firms increase investment, the amount does not exceed cash flow.

Given this cautious stance of Japanese firms, the tempo of the economic recovery is likely to remain moderate. At the same time, the moderate pace of recovery itself implies that Japan's economy is expected to experience a relatively long period of growth. While external shocks played a significant role in some past large fluctuations in the economy, there were cases where changes in domestic demand amplified cyclical fluctuation. When over-optimistic expectations about future growth emerge and an excessive level of business fixed investment and inventory investment is encouraged in the situation where the economy is becoming more active, it helps to boost the peak of the business cycle, but causes the trough to be deeper through additional adjustment stemming from the overshoot. Such large swings in the business cycle stemming from changes in domestic demand are not likely to occur in the current economic recovery, owing to the cautious behavior of firms.

To translate this view into actual figures, the GDP growth rate is expected to be around 1.5 percent for both fiscal 2005 and 2006, slightly above the potential growth rate.

As for the outlook for prices, the cautious behavior of firms, particularly firms' stance on restraining labor costs, will also play an important role.

The rise in the prices of commodities at home and abroad, including crude oil, has pushed up materials costs, and therefore awareness of a risk of inflation on a global basis has begun to increase. However, the rise in materials costs has been significantly offset by increases in productivity in the corporate sector and by the restraint on labor costs.

Particularly in Japan, the consumer price index (CPI) has not increased. Japanese firms are making more efforts to increase their productivity. Even though the percentage share of labor costs compared to the total added value created by the corporate sector has declined to the level recorded in the early 1990s, many firms seem to be maintaining their cautious stance of restraining labor costs. In addition, the effects of the decline in rice prices and the reduction in electricity and telephone charges are expected to continue for a while. The projected rate of change in the CPI on a year-on-year basis is around zero percent for fiscal 2005, and slightly positive for fiscal 2006, as these factors are having a strong effect on consumer prices, although gradual upward pressures basically continue reflecting the strength of the economy.

II. Positive and negative deviations from the projected outlook

As I have said before, our most likely projection is that Japan's economy will experience a relatively long period of growth, albeit at a moderate pace.

Of course, in the two-year projection period, the possibility cannot be ruled out that shocks significantly affecting economic activity and prices might occur and cause upward or downward deviations from the projected outlook. The Outlook Report pointed out factors to which the Bank should pay due attention, as they could cause economic activity to deviate: developments in energy and materials prices,

developments in the U.S. and Chinese economies, and developments in domestic private demand. I would like to comment on two points regarding the downside risks, namely, developments in energy and materials prices and developments in the world economy.

With regard to the first point, nominal crude oil prices have been at historically high levels, although on a real basis they are substantially below their historical peak. This basically reflects the tight supply-demand situation due to a decline in spare production capacity in oil-producing countries with continuing expansion in the global economy. From a broader perspective, China and East European countries have joined the global market economy since the 1980s, and dramatically expanded their production capacity of various goods using their comparative advantage in labor costs. These changes have been putting downward pressure on the prices of final goods, and they have been causing the prices of raw materials to rise significantly by consuming substantial amounts of natural resources. It should be said, however, that some speculative movements have been observed in the recent rise in crude oil prices as evidenced in the fact that there were sharp price reactions to weather forecasts in the United States and Europe and reports on oil inventories in the United States.

As evident in the fact that the crude oil consumption per unit of real GDP in Japan is only about 70 percent of that in the United States, Japan's energy efficiency is high compared to other economies, and this alleviates the negative effect of high crude oil prices on the economy. In addition, the yen's appreciation in the past two years has partially restrained the rise in crude oil prices denominated in yen. However, closer monitoring is required of the risk of downward deviation of the economy, due to possible emergence of a profit squeeze and decline in real purchasing power, as the price of Middle Eastern crude oil, which accounts for a significant proportion of Japan's imports, has risen in the current situation unlike during the price hike last year. In addition, as evident from continuing high price levels in the futures market, the possibility cannot be ruled out that expectations that crude oil prices will remain high may become more widespread. If the high price is actually sustained, the trajectory of global economic growth might deviate downward, and we need to be aware of the indirect effects of any deceleration of the global economy on the Japanese economy through the resulting reduction in exports.

The second point I would like to discuss as downside risk is the outlook for the world economy.

The world economy continues steady expansion, occurring mainly in the United States and China, and it is thought very likely that it will continue expanding at a rate roughly equivalent to the potential growth rate. At the meeting in April, the G-7 countries concurred that global expansion remained robust and economic growth in 2005 is likely to be solid. The IMF forecast of real GDP growth for 2005 and 2006 is 4 to 5 percent. Regarding price developments, the rise in energy and materials prices, including crude oil, has so far been absorbed by the corporate sector partly through productivity increases, and as a result, inflation has been contained.

However, with the possibility of high materials prices continuing for a considerable period, awareness of a risk of inflation on a global basis has begun to increase. In the U.S. economy, although inflationary pressures are most likely to be contained, due consideration has been given to a possible increase in inflation expectations, since productivity growth has been decelerating and unit labor cost has been increasing in a situation where domestic supply-demand conditions are already tight. The U.S. Federal Reserve indicated its judgment on prices in the press release issued after the policy change in May as follows: "Pressures on inflation have picked up in recent months and pricing power is more evident. Longer-term inflation expectations remain well contained." The Bank will closely monitor, with consideration of their implications for the Japanese economy, changes in the global circumstances surrounding prices and the effects on the global economy through financial markets, for example, a rise in long-term interest rates.

In China, strong economic growth is continuing supported by firm domestic and external demand. However, it is pointed out that fixed asset investment continues relatively high growth and there is the risk of an infrastructural bottleneck arising, for example from the shortage of electricity. China has structural problems, including the large income gap between metropolitan and rural areas. The Chinese economy should be watched carefully from the viewpoint of whether it can continue to achieve sustainable growth.

III. Characteristics of corporate behavior and future prospects

One of the characteristics of Japan's current economic recovery is that the economy is growing at a moderate pace. As I have already mentioned, this is against the background of cautious corporate

behavior. In other words, if corporate behavior becomes more active, it could cause the outlook for economic activity and prices, which I have just explained, to deviate upward.

One might wonder why firms continue to be cautious even in a situation of continued economic recovery with improved profitability. I will present some possible explanations for their cautious behavior.

First, it is rational of firms to want to repay interest-bearing liabilities and increase capital as appropriate, because they have become more conscious of business risk and financial risk after experiencing the severe downturn in the business cycle after the bursting of the bubble and instability in the financial system. Firms have been strongly aware of the necessity of strengthening their resilience to unexpected shocks by squeezing inventories and fixed costs. They have also been making efforts to reduce their debt-to-capital ratios in light of the heightened awareness of credit ratings and financial markets' evaluation with the progress of globalization of financial markets.

Second, the intensified global competition accompanying emerging economies' transition to market economy, which I mentioned earlier, is likely another factor.

Cautious corporate behavior can be seen in most advanced nations, including the United States, though to a varying degree. The yield spread derived by subtracting the expected earnings on stocks from long-term interest rates has been on a declining trend in these countries. This means that the stock markets' expectations for economic growth have been declining.

While corporate scandals in the United States related to accounting rules and delayed structural reforms in Europe may also have had some effect on investors' sentiment, intensified global competition seems to have contributed to the cautiousness of corporate behavior.

It is quite natural for Japanese firms to feel that they are most exposed to global competition pressure partly due to Japan's geographical proximity to other Asian countries. In addition, there is increased awareness that there will be greater changes in the business environment in the future, such as further population aging as well as the lower birth rate resulting in a decrease in population. With the experience of a prolonged period of low economic growth, expected growth for the Japanese economy may have declined somewhat. According to a survey of firms conducted by the Cabinet Office, the expected growth rate over the next five years was declining from the level of 4 percent in the early 1990s. Although it has recently bottomed out and started to increase slightly, it is still at around 1 percent.

Third and last, some point out that the present high profitability of firms has been supported by the extremely low interest rates and that this situation cannot continue forever.

However, with advances in the process of structural adjustment, an environment is in fact being established for firms to take positive action.

On the financial front, firms have been making progress in reducing debt. The ratio of corporate debt outstanding to sales for nonmanufacturers has declined, but is still slightly higher than in the first half of the 1980s. As for manufacturers, the ratio has declined to lower levels than in that period. In this situation, an uptrend in the capital ratio has become more marked for both manufacturing and nonmanufacturing firms. Firms have recently been active in equity financing, which has been a primary factor promoting these developments. In the extremely low long-term interest rate environment since 2000, the cost of corporate debt has declined significantly due to the progress in repayment and refinancing of past borrowings with high funding costs. Some say that the cost of corporate debt may have declined as far as it can. On the other hand, the profitability of large firms is above the levels during the bubble period and even that of small and medium-sized firms is at the highest level since the bursting of the bubble. As a result, profitability exceeds the cost of debt. This means that an environment is being established that encourages firms to use cash flow for business fixed investment rather than repaying debt.

In view of the situation, an increasing number of firms are expected to use free cash flow for business fixed investment and other investments, and research and development, both for the purpose of growth, rather than for repaying their debt, with a view to enhancing corporate value in the medium to long term. Firms that have developed a strategy to diversify their business may make use of mergers and acquisitions. Due partly to strengthening corporate governance, firms may increasingly buy back their own stocks or increase their propensity to pay dividends, both of which would increase payouts to shareholders. An increasing number of firms will be taking a more positive attitude to business activity with funds they raise, taking advantage of an accommodative financial environment.

On the employment front, an increasing number of firms may raise nominal wages and bonuses and recruit a larger number of new graduates in order to ensure that they have a sufficient number of skilled workers and to better attain a more balanced composition of workers.

Such movements should spread in the process of the economy taking a balanced growth path, and this is in turn expected to enhance economic growth, creating cyclical momentum.

So far, I have focused on corporate behavior in relation to overall economic activity. I intend to pay close attention to how these developments in the corporate sector affect prices.

Looking at factors that push down prices, the price fall in Japan in 2001-02 was, to a large extent, due to the weakness in demand. Recently, however, downward pressure on prices stemming from weak demand has been abating, and that stemming from other factors is increasing. While the reduction in electricity and telephone charges against the background of deregulation is one of the factors, significant factors behind the fall in prices of final goods and services are higher productivity and, above all, firms' persistent stance of restraining labor costs.

Two notable characteristics of the recent Japanese economy - that the economy is growing at a moderate pace and that consumer prices remain relatively unresponsive to the output gap - are both a reflection of firms' cautious behavior. Therefore, close attention should be paid to whether firms' activities become more positive and whether their stance of restraining labor costs might change. As expected economic growth increases, views on prices are expected to change. In fact, deflationary expectations of households and firms have been subsiding steadily since they peaked in 2001, as evident in recent surveys that show an increase in the percentage of individuals and firms expecting a rise in prices. The fact that land prices in the Tokyo metropolitan area are beginning to rise after the decline came to a halt may be a sign of an increase in expected economic growth. Attention should also be paid to how price expectations and land prices will develop in the future.

IV. Monetary policy

The Bank currently implements a quantitative easing policy with the outstanding balance of current accounts held at the Bank as the main operating target. The framework is based on the following two key elements.

First, the Bank continues to provide ample liquidity to the money market. To be more specific, it has been providing ample liquidity so that the outstanding balance of current accounts at the Bank substantially exceeded the amount of required reserves, which is about 6 trillion yen at present. This will continue to generate confidence among market participants about raising funds and has resulted in an overnight call rate of almost zero.

Second, the Bank has made a commitment, unprecedented in the history of central banks, to continue this policy until the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) registers zero percent or higher on a sustainable basis. This commitment will continue to have the effect of lowering longer-term interest rates by causing market participants to expect short-term interest rates to remain at zero for longer.

V. The effects of monetary policy

More than four years have passed since the Bank adopted the quantitative easing policy. While the framework of the policy has remained unchanged, the policy effects should continue to change over time depending on developments in economic activity and prices, and also the conditions of financial markets and the financial system.

At around the time of the introduction of the quantitative easing policy, the real GDP growth rate was minus 1.1 percent year on year and the CPI decreased by 1.0 percent year on year for fiscal 2001. Furthermore, anxiety about financial system stability persisted as financial institutions were burdened with a large amount of NPLs. In this situation, there was a risk of a credit crunch as financial institutions became extremely cautious about extending credit to firms unless they were confident about raising enough liquidity, and there was strong awareness of the risk of the economy falling into a deflationary spiral.

In such an economic and financial situation, the Bank needed to firmly maintain an accommodative financial environment by providing ample liquidity flexibly and in a timely manner, thereby easing the

public's and market participants' concerns about the availability of funds and ensuring stability in the financial markets. As a result of the Bank's provision of ample liquidity, financial markets remained stable and rapid tightening in corporate financing was not observed, even when financial institutions' liquidity demand had continued to rise in a situation where, for example, bank stocks plunged and there was heightened uncertainty regarding measures to deal with the NPL problem in the fall of 2002.

During this period, in a sense, the policy effects stemming from the ample liquidity provided by the Bank, through which concern about the availability of liquidity was eased, may have been greater than those of the Bank's policy commitment, namely, its commitment in terms of policy duration.

Since then, both the economy and the financial situation have been on an improving trend. Since fiscal 2002, the year-on-year growth rate of real GDP has been positive, and the year-on-year rate of decline in consumer prices has diminished to almost zero percent. An accommodative corporate financing environment has been supporting these developments. Together with an increase in financial institutions' capital adequacy ratios and an improvement in firms' financial strength and profitability, increased confidence among financial institutions and firms about the availability of funds brought about by the quantitative easing policy has produced this desirable environment.

The quantitative easing policy framework provides stronger support for economic recovery, the more the economic recovery gains momentum. Here, the effects stemming from the Bank's commitment in terms of policy duration are gradually playing a larger role than those stemming from ample liquidity provision by the Bank.

Interest rates usually rise with an improvement in economic activity and an increase in prices. The Bank's commitment, however, keeps longer-term interest rates low by stabilizing expectations about the future level of interest rates, and this will allow firms to continue to enjoy low funding costs. While funding costs remain low, the rate of return on investment increases with economic recovery, and, accordingly net returns on investments in economic activity will improve.

The quantitative easing policy has continued to contribute to the Japanese economy with some changes in the way it affects the economy, as I have just described. Recently, the market situation that surrounds the policy is changing significantly with the enhanced soundness of the financial system and abatement of anxiety about financial system stability. Financial institutions have become more confident about raising funds in the market. Furthermore, they are increasingly placing emphasis on strengthening their profitability with a view to improving their credit ratings and raising stock prices, and this may have been reducing their incentive to maintain funds in current accounts at the Bank that yield no interest.

As financial institutions' demand for liquidity has been declining, their demand for funds supplied through the Bank's market operations has decreased. Recently, as a result, undersubscription, where financial institutions' bids fall short of the Bank's offers, has occurred frequently in funds-supplying operations. This phenomenon can be considered as an encouraging sign that the conditions surrounding the financial system have improved.

This situation, in turn, is causing difficulty in providing funds through the Bank's market operations. At Monetary Policy Meetings, Policy Board members have been discussing whether to maintain the current high target range for the outstanding balance of current accounts at the Bank. I must stress that the discussions have been from the viewpoint of examining what is the most appropriate way for the Bank to maintain the current quantitative easing policy framework, in response to the current situation where financial institutions' demand for liquidity is declining and financial market conditions are changing. The Bank will firmly maintain the framework whereby the Bank provides ample liquidity significantly exceeding the required reserves in accordance with its commitment based on the CPI, thereby firmly maintaining monetary easing.

I would like to explain our thinking in relation to the timing of the change in the policy framework.

As I explained earlier, the forecasts of Policy Board members for the year-on-year rate of change in the CPI are around zero percent for fiscal 2005 and slightly positive for fiscal 2006. Price developments may deviate from the forecasts due to deviations of economic activity from the projected path, and also to factors unique to prices, for example, emergence of inflationary sentiment or the effects of various measures to promote competition such as deregulation. Therefore, it is not certain whether the conditions in the Bank's commitment will be fulfilled and there will be occasion to change the present framework of the quantitative easing policy during the projection period covered in the April Outlook Report. However, assuming that our projections regarding prices in fact materialize, it is likely that this possibility will gradually increase over the course of fiscal 2006.

Nevertheless, if economic activity and prices continue to be in line with our projections presented in the Outlook Report, that is, higher productivity and other factors continue to contain to a large extent upward pressure on prices as the economy follows a sustainable and balanced growth path, this will likely give the Bank latitude in changing the policy framework and in conducting monetary policy thereafter.

I hope that the management of Japanese firms, including those of you present at this meeting, will take advantage of the current accommodative financial environment and take up new business opportunities in a more positive manner. I am confident that this will lead to more dynamic development of the Japanese economy.