

Toshiro Muto: The outlook for Japan's economy

Summary of a speech given by Mr Toshiro Muto, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Oita, 23 June 2005.

* * *

I. Japan's economy: current situation and immediate prospects

Japan's economy has been at a temporary pause since summer 2004 due partly to adjustments in production and inventories of IT-related goods. Inventory adjustments in IT-related sectors are still continuing, but steady progress has been made and production is increasing moderately. Corporate profits have been at high levels, and this has not only led to an increase in business fixed investment but also had positive effects on the household sector through a rise in household income. The result is that private consumption has been steady, as evidenced by the fact that various sales indicators increased in the January-March quarter and have continued to be relatively strong. Therefore, the underlying mechanism of economic recovery remains firm, although recently growth in exports has been sluggish, especially in those to China. In the not so distant future, the economy is likely to gradually emerge from the current plateau and move onto a sustainable growth path.

The Bank of Japan's economic outlook is explained in detail in the *Outlook for Economic Activity and Prices* (the Outlook Report) released at the end of April 2005. In short, the economy is expected to experience a relatively long period of growth, albeit at a moderate pace. In terms of real GDP growth, the growth rate is expected to be around 1.5 percent for both fiscal 2005 and 2006, slightly above the potential growth rate.

On the price front, the consumer price index (CPI) has been declining slightly on a year-on-year basis partly due to the decline in rice prices and the reduction in electricity and telephone charges caused by the intense competition accompanying deregulation. The effects of the rise in domestic and overseas commodity prices, including the surge in crude oil prices, has been largely contained due to a decline in unit labor costs (labor costs per unit of output): in other words, wage growth has been restrained compared to the rise in productivity. Even though labor's share of the total value added generated by the corporate sector has declined to the level recorded in the early 1990s, many firms are still cautiously continuing to restrain 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. Although underlying economic strength continues to exert gradual upward pressures, a marked increase in prices is unlikely in the immediate future. In the April Outlook Report, consumer prices are projected to remain around zero percent on a year-on-year basis in fiscal 2005, and to become slightly positive in fiscal 2006.

The Bank's outlook for economic activity and prices is based on the perception that firms' business stance will remain cautious. The recent recovery phase is characterized by its moderate pace and the scarcity of signs of acceleration. Furthermore, the spread of the recovery to regional economies remains weak. As evidenced by the continued increase in business fixed investment observed at the macroeconomic level, some firms are taking a more positive stance. Such cases are, however, still limited, and a large number of firms with increased profits are still placing priority on reducing interest-bearing liabilities and taking a "wait-and-see" attitude toward investment. Most firms have kept any increases in business fixed investment within the limits of their cash flow.

Given that Japanese firms maintain this cautious stance, the pace of economic recovery is likely to remain moderate. At the same time, the fact that the pace of recovery is moderate increases the chances of a relatively long period of growth. Looking at past economic fluctuations, corporate activity is seen to have amplified cyclical fluctuations in some instances. As economic activity picks up, the emergence of over-optimistic expectations about future growth tends to trigger an excessive level of business fixed investment and inventory investment. Such a situation may heighten the peak of the business cycle, but it also deepens the trough thereafter as additional adjustment is needed to compensate for the overshooting. However, these kinds of large swings in the business cycle are unlikely to occur in the current economic recovery, owing to the cautious behavior of firms.

In the long term, the cautious business stance of firms will hinder the economy from realizing and building on its potential strength. Amid increasing competition and a rapidly changing technological environment, the maintenance of high profitability in the medium term requires that firms continue to

invest in highly profitable areas while ensuring that management resources are promptly reallocated in response to constantly changing circumstances. If firms remain cautious and postpone new investment, realizing the economy's potential, let alone enhancing that potential, becomes more difficult. With this in mind, I would now like to reexamine the nature of the structural adjustment pressures faced by the economy in the 1990s. These, I believe, will help shed some light on why there has not been more widespread positive activity in the corporate sector and what measures should be taken to encourage its spread.

II. Two types of structural adjustment pressure faced by the Japanese economy

The first type of structural adjustment pressure faced by the Japanese economy in the 1990s was the pressure to change the industrial structure exerted by the expansion of supply capacity in Asian countries. Other Asian countries have more abundant supplies of labor than Japan, while Japan has a comparative advantage in terms of capital stock and technology. Economic theory suggests that the Japanese manufacturing sector will focus less on labor-intensive manufacturing industries whose products can be substituted with imports from other Asian countries and tend to specialize in capital- or technology-intensive industries. Theory also suggests that, if growth in the nonmanufacturing sector can be realized, this will enable the surplus labor emerging as the share of labor-intensive industries declines to be successfully absorbed. The expansion of production capacity in Asian economies was therefore expected, through the adjustment process detailed above, to shift the Japanese economy's orientation from external demand to domestic demand.

In the event, the manufacturing sector witnessed both increased specialization in capital- or technology-intensive industries and a decline in the share of labor-intensive industries. However, Japanese firms' efforts to reallocate their business resources, concentrating on highly profitable markets and withdrawing from other areas, ended up being only moderately successful. They could not keep up with changes in business conditions that were remarkable for their extent and the speed with which they occurred. The profitability of individual firms thus dropped significantly. In addition, the poor performance of the manufacturing sector hindered growth in the nonmanufacturing sector: household income declined, and generation of corporate demand such as advertising activities and computer software development was weak. As Japanese consumers became more sensitive about prices, especially the balance between price and quality, there was an unprecedented level of import penetration from other Asian economies, and this was part of the reason why the nonmanufacturing sector, particularly the wholesale and retail industry, also ended up suffering from a significant drop in profits.

In addition to adjustment pressure affecting the Japanese industrial structure, another type of adjustment pressure is associated with the fall in land prices after the bursting of the economic bubble. This had a powerful negative impact, on the nonmanufacturing sector in particular. It is a well-known fact that the significant fall in land prices gave rise to a huge amount of nonperforming assets in the real estate, and wholesale and retail industries. This has impacted negatively on the entire economy by generating nonperforming-loan problems at financial institutions and reducing their risk-taking capacity, as well as by damaging the balance-sheet soundness of firms holding nonperforming assets.

In the 1990s, the Japanese economy was therefore unfortunate enough to be simultaneously confronted with two types of structural adjustment pressure different in nature: the pressure to change the industrial structure and the pressure related to the decline in land prices which caused balance-sheet problems. As a result, the surplus labor in the manufacturing sector generated as production of labor-intensive goods contracted was not absorbed by growth in the nonmanufacturing sector. Instead, the phenomenon of surplus labor was observed in almost all categories of both manufacturing and nonmanufacturing industry. This was markedly different from that witnessed in the U.S. economy in the early 1990s, when the decline in the number of employees in the manufacturing sector was perfectly offset by increased employment in the nonmanufacturing sector, especially in the health-care and information services industries. The 1990s has thus become known to Japanese economic history as the "lost decade."

III. Progress in dealing with these structural adjustment pressures

Since the mid-1990s, most Japanese firms have devoted considerable efforts to downsizing and restructuring their businesses. The actual implementation of business restructuring has differed significantly across individual firms, depending on specific conditions at firms and within their given

industries. It has ranged from drastic cost-cutting efforts, gradual withdrawal from business areas offering only low profitability while expanding operations in strategically important areas, and the thorough disposal of nonperforming assets, to forging alliances with rival companies when individual restructuring efforts proved unsuccessful. In the event, these efforts seem to be bearing fruit, and clear progress in dealing with the two types of structural adjustment pressure can recently be observed in the indicators even at the macroeconomic level. Worth specific mention are the progress in dealing with the three excesses, namely excess capacity, labor, and debt; and the bottoming out of land prices.

In the Bank's March *Tankan* (Short-Term Economic Survey of Enterprises in Japan), for example, the relevant production capacity indicator showed a significant contraction in the extent of excess capacity. Moreover, the most recent diffusion index measuring tightness in the labor market registered a labor shortage for the first time since November 1992, although its extent was marginal. There is also an increasing number of firms intending to hire regular employees. The debt-to-sales ratio peaked in 1993, declining thereafter and currently down to a level last seen in the mid-1980s. Japanese firms have continued efforts to repay their debt, and as a result, about one-third of listed firms currently run their business with almost no debt. As for land prices, these have bottomed out and begun to rise, especially at the top end of the market. Looking at price movements for individual locations, the prices of locations near the top end of the market, which are considered to have high utility value, are seen to have either stopped declining or to have started to increase. According to the latest Urban Land Price Index, which surveyed land prices as of end-March 2005, although prices for all districts continue to decline, the pace of decline in the six major metropolitan areas has clearly slowed down. Within these six areas, prices of land in commercial districts have started to increase for the first time in 14 and a half years.

Firms' efforts to improve their capability of generating high-value-added products and services have combined with the above developments to contribute to drastic profitability gains at Japanese firms. For example, the ratio of current profits to sales has almost reached its bubble period level. Presuming that progress in dealing with their problems is ultimately reflected in firms' profitability, the current situation may be considered evidence of light at the end of a long tunnel for Japanese firms.

IV. Remaining issues and proposed solution strategies

In spite of this progress in addressing their problems, positive forward-looking business activity has not been widespread among firms. Various factors lie behind this, but the main one is the substantial fall in people's expectations of economic growth which has been generated by the prolonged period of sluggish economic growth. In fact, the *Annual Survey of Corporate Behavior* released by the Cabinet Office showed that firms' expectations with regard to Japan's economic growth tend to be based on movements in actual growth over the preceding few years. Applying this to future economic developments, the effects of the prolonged period of sluggish economic growth may be expected gradually to fade and firms' expectations of growth to increase once the economy returns to a sustainable growth path. However, even when memories of past experience gradually fade away, firms' expectations of growth will not increase if they do not respond proactively to recent changes in the economic environment. Among these changes, those considered most crucial by corporate management are the issues of the ageing population and the declining birthrate. I will elaborate on these in what follows.

As far as the economic effects of these demographic trends are concerned, the workforce has been declining since 1999, and this will eventually depress economic growth, unless labor is substituted with capital assets or there is an increase in the rate of technological innovation. The personal saving rate of the elderly is relatively low, so that a rise in the proportion of the elderly in the population will result in a fall in the overall saving rate. Should such a decline in saving reduce capital accumulation, this might also act to depress economic growth. In fact, the speed at which the population is ageing and the birthrate declining has recently been accelerating rapidly. This trend has not only exacerbated concerns about a possible contraction of the domestic market, but also added to the numbers worried that the pension, medical care insurance, and various other social security systems might be forced toward bankruptcy. Thus, most of the problems confronting the Japanese economy can be linked either more or less directly to the issues of population ageing and the declining birthrate.

In light of this, we must give top priority to finding a way to stop the trend, especially the decline in the birthrate. Entangled with this issue, however, are people's individual values and notions of how the social structure ought to be, so that identifying some quick-acting remedy is difficult. The proposed

policy must therefore be efficacious, but it must also be steady and long term in scope. We must overhaul the labor market so as to encourage greater labor force participation, while simultaneously realizing a social environment in which people feel the desire to start families and raise children without needing to worry unduly. The government has an important role to play in this regard, and in fact, with the establishment of a new committee in the autumn of 2004 to consider social remedies for the declining birthrate, there has been a concerted effort by all government ministries and agencies to determine appropriate measures for areas of top priority such as enhancement of child care services. Turning to the ageing population, however, the position is somewhat different. It should be noted that this phenomenon is a result of Japan's economy and society having successfully developed, meaning that people can live longer and healthier lives than in previous generations. The ageing of the population should therefore be seen as a positive development even for firms.

Looking at firms' actual behavior, although concern about major changes in the economic environment is deep-seated, many firms are actively engaging with the ageing population, treating it as a new business opportunity. For example, there are many cases where firms have targeted their marketing strategies at the elderly, and have succeeded in stimulating consumers' drive to spend, particularly among those with high levels of disposable financial assets. This success is seen in consumption of various goods and services, such as expensive digital appliances, particularly flat-panel TVs; expensive package tours both within Japan and overseas; educational services promoting lifelong education and self-improvement; and services related to well-being and sports.

Given that the ageing of the population may thus be seen to provide a wide range of business opportunities for firms, there still appear to be plenty of growth opportunities for nonmanufacturers and in sectors catering to domestic demand, even with a falling population. Business opportunities are not restricted to the domestic arena, and Japanese firms will of course always retain the option of extending their operations overseas. Recently, Japanese firms, not only manufacturers but also nonmanufacturers such as retailers, distributors, trading houses, and financial institutions, have been actively engaged in business in Asia. This business includes not only relocating labor-intensive production but also increasing product variety by promoting technology transfer, opening up new markets, and enhancing local sales, all of which further the expansion of Japanese firms' overseas business. Those of you who live in Oita and other parts of Kyushu can experience the impact of globalization more directly due to your geographical proximity to other Asian countries.

Dealing with changes in the economic environment requires a head-on and proactive approach from Japanese firms rather than a "wait-and-see" attitude. The most effective prescription for survival is for firms to sharpen both their ability to respond incisively to changes and the creativity with which they provide attractive new products and services. From the viewpoint of the overall Japanese economy, unless Japanese firms succeed in developing business aggressively in global markets and expanding domestic income, then it becomes rather hard to envisage growth in domestic demand. The need for firms to respond proactively to changes in the environment does not apply only to demographic changes such as societal ageing and the declining birthrate, but is of more fundamental relevance. During past phases of high economic growth, economic recovery spread throughout the country via increases in public investment. However, this conventional mechanism of economic recovery is changing, and firms are seeking ways to revitalize regional economies by taking advantage of their regional uniqueness to provide high-value-added products and services. The more proactively firms tackle changes in the environment and take advantage of the resulting business opportunities, the more solid the footing of the economic recovery. As such activity spreads and the recovery becomes clearer, expectations of growth will gradually rise. It is even possible to envisage the emergence of a virtuous cyclical mechanism in which rising expectations of growth fuel further progressive activity by firms.

V. Structural adjustments and macroeconomic policies

For firms to become more proactive in tackling changes in their environment, implementation of structural reforms aimed at raising the productivity of the overall economy is a prerequisite. The Bank has repeatedly emphasized this point. Specifically, there should be a thorough review of fiscal expenditure which should be better geared toward stimulating private demand and raising the productivity of the overall economy. At the same time, easing the regulatory burden on firms and making it easier for them to undertake new business is also vital. Moreover, alleviating public concern about pension and medical care insurance and other social security systems is a *sine qua non* for households to be able to spend money freely. Once the implementation of these structural policies

leads people to expect the productivity of the overall economy to increase, there will be a positive impact on firms' investment activity and household spending behavior.

Within the context of structural adjustments as a whole, what then is the role of the Bank's monetary policy? In this regard, the Bank is often criticized for maintaining monetary easing, on the grounds that this may hinder necessary adjustments by allowing unprofitable firms to stay in business. As described earlier, the two types of structural adjustment pressure, the pressure acting to change the industrial structure and the pressure associated with the fall in land prices, are subsiding. In this situation, the prospect of a sustainable economic recovery has gradually become more realistic. Firms, however, have not yet become sufficiently vigorous in pursuing new business opportunities, leaving room for concern about their response to remaining issues. With this in mind, the role expected of macroeconomic policy, including the Bank's monetary policy, is to ensure a favorable economic environment that enables necessary adjustments to be carried out smoothly, while being careful not to distort resource allocation too much.

VI. The Bank's conduct of monetary policy

Based on this thinking, the Bank has continued to implement the 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 such ample liquidity that the outstanding balance of current accounts at the Bank has substantially exceeded the amount of required reserves, which is about 6 trillion yen at present. This has continued to generate confidence among market participants about raising funds and has resulted in short-term interest rates of almost zero percent. Making financial institutions feel secure about the availability of funds helps to maintain an accommodative corporate financing environment and also to firmly support private-sector economic activity from the financial side. Even when there were strong concerns about financial system stability, financial markets were stable, the financial environment remained accommodative, and a possible credit crunch was avoided. This combination of market stability and the accommodative financial environment also played a major part in preventing the economy from falling into a deflationary spiral of price declines, deterioration in corporate profits, and contraction in economic activity. Portfolio rebalancing by financial institutions holding current accounts at the Bank, which involves shifting large amounts of surplus funds from non-interest-bearing current accounts at the Bank into other interest-bearing assets, has been pointed out as a possible effect of raising the target for current account balances under the quantitative easing policy, although there has been little evidence of it to date.

The second element of the policy framework is the Bank's 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 leads market participants to expect short-term interest rates to remain at zero for longer. The result is to keep longer-term interest rates steady at low levels, underpinning corporate profits, and improving the return on investment. Within a financing environment where they can raise funds at low rates even while the economy continues to recover, firms will pursue new business opportunities more vigorously and adopt a more proactive business stance, thereby raising expectations of economic growth.

At the Monetary Policy Meeting (MPM) on May 19 and 20, 2005, the Bank decided to maintain the current guideline for money market operations, which specifies a target for the outstanding balance of current accounts at the Bank of around 30 to 35 trillion yen, and the Bank also decided to add the following sentence to the proviso in the guideline: "When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target." At the MPM on June 14 and 15, 2005, the Bank maintained the guideline in this form.

The Bank decided to amend the proviso in the guideline because financial institutions' demand for liquidity has been declining, reflecting abatement of concern over financial system stability, and there has been a stronger feeling that liquidity in financial markets is in abundance. As a result, undersubscription, where financial institutions' bids fall short of the Bank's offers, has occurred frequently in funds-supplying operations. If the Bank tries to keep the outstanding balance of current accounts at the Bank within the target range even when liquidity demand has declined substantially,

this could, depending on the means employed, have negative effects on the functioning of financial markets, for example, by distorting interest rates. Given this situation, the Bank decided to maintain the current target range of "around 30 to 35 trillion yen" but also to allow the balance of current accounts to fall short of the target in cases when liquidity demand was judged to be exceptionally weak.

Although this decision was made merely as a response to the decline in financial institutions' demand for liquidity which has accompanied increasing confidence in financial system stability, some market participants have instead interpreted it as a step toward termination of the quantitative easing policy. I would like to stress that there has been no change in the Bank's underlying policy of maintaining the target range of "around 30 to 35 trillion yen," and that the decision at the MPM to add a sentence to the proviso in the guideline was definitely not an indication of a shift in the quantitative easing policy. Instead, it was simply intended to facilitate the smooth implementation of the quantitative easing policy by enabling the Bank to give due consideration to the functioning of the market mechanism in its liquidity provision.

As for the future conduct of monetary policy, the Bank will firmly keep in place the current quantitative easing policy framework detailed earlier with the commitment based on the CPI. Although the timing of a change to the quantitative easing framework is not certain at present, if current projections regarding economic activity and prices in fact materialize, the possibility of a change in the policy is likely to gradually increase over the course of fiscal 2006. As long as upward pressures on prices continue to be to a large extent contained and the economy follows a sustainable and balanced growth path, this will likely give the Bank latitude with regard to changes in the policy framework and the subsequent conduct of monetary policy. Based on this thinking, the Bank will continue to conduct monetary policy in an appropriate manner giving due consideration to changes in economic activity and prices, as there is uncertainty with regard to their future developments.