Toshihiko Fukui: Recent developments in economic activity and prices and the Bank of Japan's conduct of monetary policy

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at a meeting with business leaders, Osaka, 29 September 2005.

*   *   *

Introduction

Today I plan to focus on recent developments in economic activity and prices and the basic thinking behind the Bank of Japan's conduct of monetary policy.

The current situation and the outlook for economic activity and prices

The Japanese economy has recently emerged from a pause that started during the summer of 2004 and continues to recover. The current economic expansion has lasted three years and eight months as of this September, based on the Cabinet Office's reference dates of business cycles, thus recording the third longest expansion phase in the post-World War II period. The economy is expected to continue to recover, albeit at a moderate pace.

Real GDP growth has been strong so far this year with a large annualized increase from the previous quarter of 5.8 percent in January-March 2005, followed by a 3.3 percent increase in the April-June quarter, although it either remained unchanged or dipped slightly over the three quarters from April-June 2004.

This favorable performance can be attributed to the stronger-than-expected domestic private demand, such as business fixed investment and private consumption, along with moderate export growth due to the expansion in overseas economies. In this environment, positive effects stemming from the increased corporate profits have gradually spread to household income, feeding back to the corporate sector via the increase in private consumption: in other words, there is a positive interaction between the corporate and household sectors. Industrial production is on the increase with the completion of adjustment in IT-related sectors.

Overall, the current economic recovery appears moderate in pace, but sustainable. The economy is thus unlikely to fall into recession due to domestic factors. In the corporate sector, profitability has substantially improved, as the adjustment in excess capacity and employment has finally come to an end. According to *Financial Statements Statistics of Corporations by Industry*, current profits of Japanese firms have increased for three consecutive years from fiscal 2002, with both profits and the ratio of current profits to sales for fiscal 2004 exceeding those during the height of the bubble era. In fiscal 2005, profits are forecast to grow for the fourth consecutive year, signifying buoyancy in corporate performance.

Backed by high corporate profitability, business fixed investment is growing steadily in a wide range of industries. Still, given the historically high levels of profits and cash flow, the current level of business fixed investment appears too modest. This cautious corporate behavior contributes to the mild and long-lasting recovery. However, as the economy continues to recover and the business outlook becomes brighter, an increasing number of firms are likely to start earmarking more cash flow for business fixed investment, the wellspring of their future profits, with their focus on maximizing corporate value. We will examine the robustness of business conditions, by using, for example, the results of the September *Tankan* (Short-Term Economic Survey of Enterprises in Japan), which will be released in early October.

Now turning to the household sector, the employment and income situations appear to be improving steadily after a prolonged period of difficulty, as a result of firms' efforts to reduce excesses in the workforce and personnel expenses. The number of employees has been increasing since last year. More recently, the number of full-time employees has begun to increase, while the rise in the number of part-time employees, who were more in demand when corporate restructuring was in full swing, has slowed. Regular payments are steadily increasing and bonus payments for this summer have also increased.

Given such improvement in the employment and income situations, private consumption has been firm, and is on an upward trend, albeit with some fluctuations. Although sales of automobiles and sales at department stores were slightly weak in July and August, this was mainly in reaction to the substantial increase in sales during the April-June quarter, and the upward trend in private consumption remains intact.

Of course, risk factors do exist and ought to be taken into account in assessing an economic outlook. We should pay attention to the protracted surge in crude oil prices and its possible effect on overseas economies, including that of the United States.

Crude oil prices, which have been rising for the past few years, marked a record high around the end of August. Rises in crude oil prices entail the risk of deceleration of world economic growth as a result of declines in the real purchasing power of non-oil producing countries. So far, however, the world economy continues to expand at a robust pace and shows no sign of this risk materializing. There are several reasons for this. First, the recent rises in crude oil prices have not been caused by oil production capacity constraints. Rather, they are to a large extent attributable to an expansion of demand mainly in emerging countries, whose economies have enjoyed rapid growth. Second, rises in oil prices tend to cause income transfer to oil-producing countries through deterioration in the terms of trade of non-oil producing countries, thereby boosting the purchasing power of the former. The critical point in this regard is how the increased income is spent. Judging from the recent rise in Japanese exports to oil-producing countries and other evidence, it seems that a mechanism of income reflow from oil-producing countries to non-oil producing countries is in fact operating.

In addition, it should be stressed that the recent crude oil hike has not led to a rise in a broad range of categories in consumer prices nor a heightening of inflationary expectations in major countries, and as a result, there has been no need for a rapid tightening of monetary policy. This can be explained by factors such as the increased credibility of monetary policy in countries pursuing price stability, and also the expansion of supply of low-priced products flowing into the global market as a result of entry of emerging countries. Long-term interest rates remain at low levels in major economies as a result of stable prices and accommodative monetary policy. The pervasive low interest rate environment has laid the foundation of world economic growth, as seen, for example, in the U.S. economy, where low mortgage interest rates have boosted housing prices and this in turn has been supporting an increase in household expenditure.

If crude oil prices remain high, we should keep close watch for any sign of a rise in inflation expectations or rapid tightening of monetary policy, leading to deceleration in world economic growth. In this context, we should also assess the negative effects of the hurricane which hit the United States late last month and has caused devastating damage to the oil production facilities and refineries in the area.

Based on the above economic outlook, I will elaborate on price developments. The corporate goods price index continues to rise, mainly reflecting the rise in crude oil prices, and this uptrend is expected to continue for the time being.

With regard to the consumer price index (CPI), the change in the core CPI, which excludes fresh food, is hovering slightly below zero percent on a year-on-year basis. It is likely to become zero or slightly higher toward the end of the year since the negative contribution of rice prices and the reduction in electricity and telephone charges is expected to dissipate. The year-on-year rate of change in the CPI is expected to increase thereafter, as the

Japanese economy is likely to continue growing at above its potential rate, causing the gap between supply and demand to shrink further, and also the recent uptrend in wages is likely to exert upward pressures on prices.

The bank's conduct of monetary policy

Based on the above assessment of economic activity and prices, I will explain the Bank's thinking on the conduct of monetary policy.

The Bank has been implementing the quantitative easing policy to achieve sustainable economic growth under price stability. The framework consists of two key elements. First, the Bank provides ample liquidity to the money market far in excess of required reserves. Second, the Bank is firmly committed to maintaining such ample provision of liquidity until the year-on-year rate of change in the core CPI registers zero percent or higher on a sustainable basis. This framework underpins expectations, based on inflation projections among market participants, that the quantitative easing policy will continue for some time. As a result, market interest rates remain steady at low levels, including those with relatively longer maturities.

With regard to the first element, the Bank's provision of ample liquidity greatly contributed to maintaining financial system stability and an accommodative corporate financing environment by responding to precautionary demand for liquidity of financial institutions when there were strong concerns about financial system stability. Since then, concerns about financial system stability have largely subsided, as evidenced by the smooth implementation of the full removal of blanket deposit insurance in April 2005. As a result, the quantitative easing policy is effectively becoming closer to a maintenance of zero interest rates. In the current situation, the quantitative easing policy contributes to maintaining an accommodative financial environment by stabilizing market interest rates, thus allowing firms to continue to enjoy low funding costs.

As for the conduct of monetary policy, the Bank will continue to maintain the quantitative easing policy based on the commitment mentioned earlier since the core CPI is still registering a slight year-on-year decline.

The Bank formulated this commitment when it introduced the quantitative easing policy in March 2001. At the time, following the bursting of the global IT bubble, and the resultant sharp fall in aggregate demand, the economy had fallen into recession and prices were declining. The Bank decided to employ an unprecedented measure, linking its commitment in terms of policy duration to the observed CPI, to create further monetary easing effects even under zero interest rate conditions.

Thereafter in October 2003, the Bank clarified its commitment to maintaining the quantitative easing policy. Specifically, the Bank specified two conditions. First, the year-on-year rate of increase in the core CPI must register zero percent or above over a few months. Second, the prospective year-on-year rate of increase in the CPI must not be zero percent or below. These two conditions, as necessary conditions for terminating the policy, constitute a firm commitment: in other words, the Bank commits itself to continuing the policy until they are fulfilled. At the same time, the Bank made it clear that these two conditions are not *sufficient* conditions in the sense that the Bank will not *necessarily* make an automatic decision to terminate the policy as soon as they are fulfilled. To put it in a nutshell, the Bank will decide whether to terminate the policy by examining developments in economic activity and prices and judging whether the situation justifies asserting that the year-on-year rate of change in the CPI is registering zero percent or higher on a *sustainable basis*--in other words, whether the commitment has effectively been fulfilled as a whole.

Of course, the timing of terminating the quantitative easing policy crucially depends on developments in economic activity and prices. Based on the projections regarding economic activity and prices mentioned earlier, the probability of terminating the policy is likely to gradually increase over the course of fiscal 2006.

At that juncture, the Bank will shift the operating target for money market operations back to short-term interest rates from the outstanding balance of current accounts at the Bank. Since, as I pointed out earlier, the quantitative easing policy is effectively becoming closer to a maintenance of zero interest rates, a change in the policy framework itself does not imply an abrupt change in monetary policy. Although the future course of monetary policy obviously depends on developments in economic activity and prices, an accommodative financial environment is likely to be maintained, 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, as projected in the April 2005 *Outlook for Economic Activity and Prices*.

Conclusion

The Japanese economy has emerged from a pause and continues to recover, albeit at a moderate pace. The Bank is determined to carry out monetary policy so as to support private-sector initiatives, and thereby realize sustainable economic growth and stable prices.