Toshihiko Fukui: Towards a new path of growth for the Japanese economy

Summary of a speech given by Mr Toshihiko Fukui, Governor of the Bank of Japan, at the Kisaragi-kai meeting, Tokyo, 11 November 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, and also explains the Bank's thinking behind its conduct of monetary policy. Today I would like to focus on the October 2005 Outlook Report, which was published two weeks ago.

I. Recent economic developments and the outlook for economic activity

Japan's economy continues to recover, having emerged from the temporary pause that began in the summer of 2004. The adjustments in production and inventory in IT-related sectors, which triggered the temporary pause, appear to have run their course, and domestic private demand, such as business fixed investment and private consumption, has been stronger than expected. According to the Cabinet Office's reference dates of business cycles, the economy has been expanding since the beginning of 2002, that is to say, for almost four years now.

Although a V-shaped recovery is unlikely to ensue after the economy's recent emergence from its temporary pause, it is expected to achieve solid growth at a moderate and sustainable pace. The Bank's projection for a period of one and a half years ahead, that is, through the end of fiscal 2006, is that the economy is likely to experience a sustained period of expansion at a pace slightly above its potential. The Bank's main purpose in releasing the Outlook Report is to explain its thinking on the underlying mechanisms of economic activity and prices, and the Policy Board members' forecasts are also provided as reference figures. In the October Outlook Report, the Policy Board members forecast a real GDP growth rate for fiscal 2005 of slightly above 2.0 percent and for fiscal 2006 of around 1.5-2.0 percent. If the economy performs as projected in the October Outlook Report, it will have been expanding at a pace above its potential for a very long period of time, since the actual growth rates for fiscal 2003 and 2004 have been around 2.0 percent, exceeding the Bank's estimate of a potential growth rate of around 1.0 percent.

This outlook for economic growth rests on the following underlying mechanisms. Exports are likely to remain on the increase reflecting the continuing expansion of overseas economies, and against this background, the corporate sector is likely to continue to show strength, and the positive effects of strong corporate performance will steadily exert an influence on the household sector-in other words, economic growth will be led by domestic and external demand that are well in balance. Furthermore, the extremely accommodative financial conditions are likely to support private demand.

What is notable is that domestic private demand, especially business fixed investment and private consumption, is likely to remain strong. The context behind this is that the adjustment pressures in the corporate sector and the financial system that have been hindering the Japanese economy from achieving a sustainable growth path since the bursting of the economic bubble have mostly dissipated. Specifically, in the corporate sector, firms have almost resolved the excess in debt, employment, and production capacity-the "three excesses." As for the financial system, the nonperforming-loan (NPL) problem, which has placed downward pressure on the economy together with these three excesses, has nearly been resolved.

Diffusion indexes for production capacity and employment conditions in the September 2005 *Tankan* (Short Term Economic Survey of Enterprises in Japan) are at the level of 1992, immediately after the bursting of the economic bubble, showing that adjustments in the excesses have made much progress. In particular, the number of firms perceiving their holdings of labor as insufficient exceeded the number perceiving them as excessive, implying that firms are starting to see themselves as short of labor. Firms have also substantially reduced their interest-bearing liabilities, as evidenced by the marked decline in the ratios of outstanding debt to total assets and to sales not only at large firms but also small and medium-sized firms in the last few years.

While making adjustments in the three excesses, firms have been reviewing their business lines based on the principle of "selection and concentration" and improving their ability to generate high-value-added products and services as they face intensified global competition. As a result, their profitability has improved greatly. According to the *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. Despite the headwind of a surge in crude oil prices, corporate profits are likely to continue on an uptrend in fiscal 2005.

Given the high corporate profits, business fixed investment has been increasing steadily in a wide range of industries and is also expected to continue increasing. In the *Tankan* survey, business fixed investment plans of large manufacturers for fiscal 2005 showed a double-digit increase for the second consecutive year, and small and medium-sized firms are also revising their plans upward. As a result, business fixed investment is expected to increase for the third consecutive year for firms of all sizes in all industries.

The strength of the corporate sector is steadily spreading to the household sector. In particular, improvements in the employment and income situation are becoming noticeable. Firms have been placing priority on restraining labor costs, but their stance on employment is becoming positive with the problem of excessive holdings of labor in the corporate sector nearly resolved. One notable example suggesting a change in firms' stance on employment is that the ratio of part-time workers to regular employees, which had been generally on an uptrend since the bursting of the economic bubble, has started to decline. With respect to wages, summer bonus payments have recorded relatively high increases, and regular compensation has started to increase very slightly due partly to the peaking out of the ratio of part-time workers. Supported by the improvement in the employment and income situation, employee income is likely to continue to increase moderately, and against this background, private consumption is expected to continue to rise steadily. Although private consumption has been somewhat weak since the summer, it should be regarded as a reaction to the strong developments in the first half of 2005 and it is likely that this weakness will be temporary, given that positive influences from the corporate sector to households are spreading steadily via increases in employee income.

There have also been remarkable improvements in the financial system. The NPL problem, which has long been a burden on the Japanese economy, has generally been resolved. The amount outstanding of NPLs at major and regional banks has been decreasing since reaching its peak at the end of fiscal 2001, and due mainly to the resulting decline in credit costs, their earnings for fiscal 2004 were the highest in recent years. Net income turned positive in fiscal 2004, for the first time since fiscal 2000 at major banks and since fiscal 1994 at regional banks. Against the background of improvements in profitability and capital adequacy ratios, financial institutions' lending attitude has become more accommodative. Bank lending, excluding the effects of marketing of loan assets and disposal of NPLs, has turned positive on a year-on-year basis since this August, after a prolonged decrease. Financing in capital markets through, for example, issuance of CP and corporate bonds has also been favorable for firms. In this situation, firms' perception of their financial positions has improved to the level of the early 1990s. Such accommodative financial conditions seem to be contributing to the recent increases in housing investment as well as business fixed investment by small and medium-sized firms. These accommodative financial conditions are likely to support private demand.

II. Pace of recovery

Japan's economy is likely to continue to expand against the background I have just explained. As I mentioned at the beginning of this speech, the pace, however, is expected to be moderate with less likelihood of acceleration. The main reason for this is the cautiousness of corporate behavior, which is expected to persist.

It seems that firms have still not become confident about the future, having come through a protracted period of low economic growth following the bursting of the economic bubble. Relative to the record-high level of profits that firms have been posting, the improvement in business sentiment, according to, for example, the *Tankan* survey, is only moderate. Although business fixed investment has been increasing, it still remains substantially below the level of cash flow, and firms are reluctant to aggressively increase fixed investment by raising the funds through bank loans or capital markets. While an increasing number of firms are making more efficient use of cash flow since they have nearly completed paying back their excess debt, they still appear cautious about accelerating inventory and capital investments in response to increases in sales and production.

As a result of such corporate behavior, economic recovery is likely to remain moderate but at the same time excessive build-up of stocks is unlikely. The current economic recovery, which is already the third longest in the post-World War II period, is likely to be sustained for this reason.

III. Positive and negative deviations

Japan's economy is expected to continue to recover supported by strength in both the corporate and household sectors with adjustment pressures that have lingered since the bursting of the economic bubble dissipating. Under these conditions, it is unlikely that the economy will fall into recession due to domestic factors, although with globalization, Japan's economy could be adversely affected in the event of a major external shock, for example, a slowdown of the global economy. It is therefore necessary to pay attention to the path of the global economy, as this could pose a downside risk to Japan's economy. In particular, developments in crude oil prices, which continue to be high, and a possible shift from the current accommodative financial conditions observed globally require close monitoring.

Overseas economies, in particular the U.S. and Chinese economies, are likely to continue to expand. The International Monetary Fund (IMF) also expects a high rate of world economic growth, forecasting 4.3 percent real growth both in 2005 and 2006, even though the figure falls short of 5.1 percent, a historic high marked in 2004. Although the growth of the U.S. economy is expected to slow temporarily due to the effects of hurricanes, it is expected to basically continue to expand at a pace around its potential growth rate, partly since there is likely to be reconstruction-related demand. As for the Chinese economy, inventory adjustment has been in progress mainly in sectors related to domestic demand since the second half of 2004 in response to the government's measures to rein in the overheated economy. However, inventory adjustment pressures are likely to taper off in the face of robust economic growth.

Despite the ongoing global economic expansion, there is recently increased awareness of downside risks stemming from the surge in crude oil prices. So far, the global economy has continued to expand despite the record-high level of crude oil prices. A number of factors have contributed to this development. First, one of the primary factors of the surge in crude oil prices is increased global demand, reflecting developments such as high growth in emerging economies, and there is little influence from supply-side constraints. Second, a mechanism of income reflow from oil-producing to non-oil-producing countries is operating. The third and the most important factor from central bankers' viewpoint is that the rise in crude oil prices has not led to a sharp rise in inflationary expectations, and thus monetary policy has not been tightened aggressively. This is because inflationary expectations have been contained as a result of the intensified global competition accompanying emerging economies' transition to a market economy, and central banks have been taking appropriate monetary policy measures.

Long-term interest rates in the United States and other major industrial countries have not yet shown any clear upward movement compared with two years ago when crude oil prices started to rise and a year and a half ago when the Federal Reserve started to raise the federal funds rate target. The coincidence of surging oil prices and relatively low long-term interest rates in a climate of stable economic expansion is hard to explain on the basis of past experience. A growing sense of a surfeit of funds in the economy stemming from the slack in the global balance between savings and investment and the increase in investment in long-term bonds by institutional investors, such as pension funds, have been cited as factors. However, since long-term interest rates basically reflect the market's outlook for economic activity and prices, the fact that inflationary expectations have been contained has greatly contributed to the stability in the rates.

The maintenance of accommodative financial conditions has played a crucial role in the global economic expansion. This is evident in the United States in particular, where stability in long-term interest rates, by causing a continued rise in housing prices, has led to buoyant spending by households through the wealth effect, and this in turn has been supporting economic expansion. Should there be unexpected changes in monetary accommodation in light of rising inflationary expectations caused by, for example, a further rise in crude oil prices, not only would growth in advanced economies slow but the global economy including emerging economies could also be adversely affected, perhaps via a shift in the international flow of funds.

So much for downside risks: let us now look at upside potentials. The domestic view of the outlook for the Japanese economy tends to be pessimistic, due probably to the experience of low growth that lasted for more than a decade. The view held overseas, however, has become increasingly optimistic, with the October 8 issue of *The Economist* carrying a feature titled "The sun also rises." In fact, firmness in Japanese stock prices since this summer owes significantly to the active investment by foreign investors. As for the Bank's outlook, it assumes that corporate behavior will generally remain cautious. However, with the three excesses having run their course, and the marked progress in restructuring corporate balance sheets, it is probable that firms will become more confident about the economic outlook as the economic recovery continues. In that case, firms, supported by accommodative financial conditions, are likely to increase business fixed investment and hiring. Under such circumstances, if there are stronger positive influences from the corporate sector to households via increases in employee income, household spending may increase further. These developments would entail an acceleration of economic recovery.

Developments in asset prices such as stock prices and land prices reflect people's perceptions about the economic outlook. Asset prices are determined based on future cash flow expected to be generated, and they therefore contain important information about people's view of the future. Recently, stock prices have been strong, and land prices in some parts of Tokyo and other major metropolitan areas have started to rise, suggesting an upturn in people's expectations regarding the economy. However, land prices on the whole continue to be on the decline. Thus, not all asset prices are increasing, reflecting continuing caution in people's perception of the outlook. Since developments in asset prices reflect changes in people's perceptions as well as influence investment activity of firms and households, they require close attention.

IV. Outlook for prices

Given this economic outlook, the environment influencing prices is likely to change gradually.

The output gap is expected to continue narrowing moderately as the economy continues to recover. Firms' and households' expectations regarding prices play an important role in the formation of prices via, for example, firms' price setting stance. Various survey results show that the number of respondents perceiving that prices will rise in the future has been increasing gradually since hitting bottom in 2001-02.

The consumer price index (CPI; excluding fresh food) has been decreasing on a year-on-year basis since the middle of 1998 for more than seven years now. Recently, however, the pace of decline has slowed considerably, with a 0.1 percent decline in September year-on-year. As the effects of special factors such as the decline in rice prices and the reduction in electricity and telephone charges fall off, the year-on-year changes in the CPI are likely to turn positive toward the end of 2005. Thereafter, in this environment, the year-on-year changes are expected to remain positive. Forecasts of the majority of Policy Board members for the CPI in fiscal 2006 are between 0.4 and 0.6 percent on a year-on-year basis.

Despite the fact that the economy has been growing at a pace above its potential since fiscal 2003, over two years now, and the output gap continues to improve, the impact on prices has remained small. This is mainly because the decline in unit labor costs-labor costs per unit of production of goods and services-which was brought about by a decline in wages and a rise in productivity worked to contain upward pressure on prices. Unit labor costs are unlikely to record a clear increase in the near future because the rise in productivity will still tend to hold them down despite the increases in wages. In this situation, it is unlikely that the pace of increase in prices will accelerate.

The impact of economic activity on prices has been weakening, and this has been a global phenomenon. However, it is uncertain whether this will continue in the future. A sustained narrowing of the output gap may cause a greater-than-anticipated increase in inflationary expectations. This can prompt firms to pass increases in costs, for example, a rise in input prices, on to sales prices. Although it is most likely that the rise in prices will be contained, the risk of an upward deviation in prices should nevertheless be kept in mind.

V. Conduct of monetary policy

It has been four and a half years since the Bank first introduced the framework of the quantitative easing policy. This policy is unprecedented not only in the history of Japan but anywhere in the world. In the spring of 2001, Japan faced an economic deterioration and a decline in prices, and concerns about financial system stability intensified. With regard to monetary policy, short-term interest rates were already practically zero percent and the Bank could not reduce them further. In response to this situation, the Bank introduced the current quantitative easing policy framework, which has two pillars: provision by the Bank of ample liquidity to the money market so that the outstanding balance of current accounts at the Bank exceeds the amount of required reserves; and a commitment by the Bank to continue with this ample provision of liquidity until the year-on-year rate of change in the CPI (excluding fresh food) registers zero percent or higher on a sustainable basis.

When there were strong concerns over the stability of the financial system, the Bank's ample provision of liquidity, which met financial institutions' liquidity demand, stabilized financial markets and maintained accommodative financial conditions, and thus contributed to averting a contraction in economic activity. This was the case in 2001-02 when the disposal of NPLs at major banks reached its peak and the partial removal of blanket deposit insurance drew near, and in 2003 when public funds were injected into Resona Bank. The commitment by the Bank, together with market participants' expectations for consumer prices, has led them to expect that short-term interest rates will remain at zero percent for some time, and as a result longer-term interest rates have remained stable at low levels. The quantitative easing policy has thus been contributing greatly to the recovery in Japan's economy through the Bank's provision of ample liquidity and its policy commitment.

The effects of the quantitative easing policy have been changing with developments in economic activity and prices as well as the state of the financial system since its introduction. With regard to the effects of ample liquidity provision by the Bank, an effect of reducing very short-term interest rates to practically zero percent remains unchanged. However, as described earlier, with the progress in the disposal of NPLs, precautionary demand for liquidity has declined substantially, reflecting diminishing concerns over financial system stability. The effects of the policy commitment by the Bank have also been changing. In principle, the expected duration of the quantitative easing policy based on the Bank's commitment can either lengthen or shorten depending on market participants' expectations for prices. With more market participants recently expecting that the year-on-year rate of change in the CPI will be a positive figure in the near future, the duration of the policy as expected by market participants is shortening. As a result, the policy commitment is gradually losing its influence on the formation of longer-term interest rates. This is a natural consequence considering the characteristics of the commitment.

As a result of the above changes, the stimulative effects of the quantitative easing policy on economic activity and prices are at present increasingly coinciding with the effects of short-term interest rates being at practically zero percent.

As for a change of policy framework, the Bank will judge whether the policy commitment has effectively been fulfilled, in other words, whether the year-on-year rate of change in the CPI is registering zero percent or higher on a sustainable basis, by monitoring economic activity and price developments. Assuming that economic activity and price developments follow the projection described in the October Outlook Report, the possibility of a departure from the present monetary policy framework is likely to increase over the course of fiscal 2006. We cannot tell exactly when the Bank will actually change the framework, since it depends on future economic and financial developments. In any case, the Bank will appropriately determine the timing in view of these developments.

Such a change of framework would mean a reduction in the outstanding balance of current accounts at the Bank toward a level in line with required reserves, and a shift in the main operating target for money market operations from the outstanding balance of current accounts to short-term interest rates. At present, the effects of the quantitative easing policy are increasingly coinciding with the effects of short-term interest rates being at practically zero percent. Thus, a change of policy framework itself does not imply an abrupt change in terms of effects of policy. There will then be a period of very low short-term interest rates followed by a gradual adjustment to a level consistent with economic activity.

Conceptually, the course of monetary policy after the change of framework will be a reduction in the outstanding balance of current accounts, a period of very low short-term interest rates, and a gradual adjustment to a level consistent with economic activity.

How exactly the Bank will proceed, in other words, how the Bank will reduce the outstanding balance of current accounts and set the level and time path of short-term interest rates thereafter, will depend on future developments in economic activity and prices as well as financial conditions. In this regard, if it is judged that upward pressure on prices continues to be contained and the economy follows a sustainable and balanced growth path, this is likely to give the Bank latitude in conducting monetary policy through the entire process. Based on this, I would like to point out two things.

First, when reducing the outstanding balance of current accounts, the Bank will need to monitor financial market conditions carefully. With the Bank's quantitative easing policy, financial institutions have for a long period of time been conducting their financing based on the existence of the large current account balance at the Bank. Although the functioning of the money market will recover eventually, investment and raising of funds in financial markets may be hindered for a while after the change of framework.

And second, it is essential to ensure that financial markets are able to perform the pricing function smoothly, reflecting underlying economic and price conditions. The markets in principle perform the function of envisaging future monetary policy based on economic and price conditions and also perform the function of forming interest rates. However, given that there is no precedent for a change from the current policy framework to another, it is important for the purpose of smooth formation of interest rates that the Bank clearly explain its assessment of economic activity and prices as well as the thinking behind the conduct of monetary policy, and endeavor to stabilize market expectations. In order to realize sustainable economic growth and stable prices, the Bank will take measures in an appropriate and timely manner in response to economic and financial developments.

Conclusion

I have talked mainly about the content of the October Outlook Report as well as expected developments in Japan's economy and the thinking behind the conduct of monetary policy. The economy is on the threshold of a new path of growth, after an adjustment process lasting over ten years since the bursting of the economic bubble. The Bank will continue to conduct monetary policy appropriately and support this growth from the financial side.