Toshihiko Fukui: Overview of the Japanese economy

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at a meeting with business leaders, Nagoya, 8 December 2005.

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Introduction

I understand that this has been a very active and full year here in the Chubu region with the opening of Central Japan International Airport (Centrair) and the success of Expo 2005 Aichi Japan. The Japanese economy has also been recovering its vibrancy, as if absorbing the dynamism of your region. I attended the meeting of the G-7 countries in London last week. The G-7 countries shared the view that overall global economic growth remained and should continue to be solid although there were risk factors such as high crude oil prices and increasing inflationary pressures. In my remarks today, I will present the Bank's view regarding recent economic and financial developments, and explain our thinking on the conduct of monetary policy.

The current state of Japan's economy and the outlook

Japan's economy continues to recover, having emerged from the temporary pause that began in the second half of 2004. The economy is likely to experience a sustained period of expansion at a pace slightly above its potential. The Bank released the *October Outlook for Economic Activity and Prices* (the Outlook Report) about a month ago. This Outlook Report projects that such economic growth will continue during the rest of fiscal 2005 and through fiscal 2006.

In addition to the continued expansion of overseas economies, another major factor behind the ongoing recovery is that the corporate sector has essentially completed its adjustments of the "three excesses," namely, production capacity, employment, and debt. In relation to the financial system, it may also be noted that financial institutions have now mostly overcome the nonperforming-loan (NPL) problem and recovered their management stability.

In the corporate sector, corporate profits have increased for three consecutive years since fiscal 2002, and this trend is continuing during fiscal 2005 with the ratio of profits to sales primarily at large firms surpassing the levels recorded during the bubble era. The semiannual book closings for the first half of fiscal 2005 indicated that high profits were being maintained across a wide range of industries. As a background to the favorable corporate profits over the past three to four years, firms have reduced the "three excesses," and this has been effective in greatly lowering break-even points. Amid these developments, the global economic growth rate accelerated through 2003-04, and domestic private demand has been firmer than predicted in fiscal 2005, pushing up sales and strongly supporting the recent improvement in profits.

Domestic private demand has been firmer than expected because while business fixed investment has increased against the background of high corporate profits, strong corporate performance is positively influencing the household sector via increases in wages and employment, as well as increases in dividends and stock prices. According to the *Tankan* (Short-Term Economic Survey of Enterprises in Japan), large and small firms believe that they are presently facing their greatest personnel shortages in 13 and eight years, respectively. Under these conditions, the number of part-time employees peaked in early fiscal 2005 and the number of full-time employees is growing. Turning to wages per worker, regular payments have been rising, mostly because of increases in wages for full-time employees, and special payments have also been increasing against the background of high corporate profits. According to surveys by private institutions, winter bonuses at large firms for 2005 will increase at a high rate, surpassing the rise in summer bonuses. Consequently, household income continues to rise gradually. Moreover, the dividend income received by households is growing year by year, with the percentage of dividend income against interest income rising from about 40 percent to about 80 percent over the past three to four years. Amid this improvement in the employment and income situation, consumer confidence is generally good and private consumption has been steady.

In this manner, a virtuous cycle has begun whereby favorable corporate profits are leading to stronger business fixed investment and spreading to the household sector in various ways, increasing household expenditures and feeding back to the corporate sector via the growth in private consumption. The economy is thus unlikely to fall into a recession due to domestic factors for the time being.

Also, as I have mentioned, the financial system has been improving significantly. The percentages of NPLs at financial institutions have declined greatly since they peaked at the end of fiscal 2001, and banks posted record-high profits in their semiannual book closings at the end of September 2005, surpassing those achieved during the bubble era. Bank lending (amount outstanding, after adjusting for the liquidation of loans and loan write-offs), which had long maintained negative growth, began to rise year on year from August 2005. While the corporate sector as a whole continues to repay debt, repayment pressures are gradually easing, and amid the continuing recovery in business conditions some firms are moving ahead with their external funding activities, taking advantage of the accommodative financial environment. Additionally, land price adjustments have advanced, especially in major cities, and the increase in housing-related investment, among others, is another factor contributing to the rise in bank lending.

Future risk factors

Of course, there are certain risk factors for the economic outlook. The Bank is paying particular attention to the rise in crude oil prices and the developments in overseas economies. Crude oil prices marked a record high around the end of August 2005 (about 70 U.S. dollars/barrel for WTI crude oil) following the hurricane damage in the United States, and have softened somewhat recently, but remain at a rather high level. The rises in crude oil prices in recent years are largely attributable to increased global demand, reflecting developments such as high growth in emerging economies. Therefore, high crude oil prices may be compatible with the expansion of the global economy if both oil-producing countries and oil-consuming countries take adequate actions to deal with increased demand. Nevertheless, as demonstrated by the rapid increase in crude oil prices with the U.S. hurricane damage through the end of August, there is some risk that crude oil prices may shoot up to a level that is not compatible with the demand increase accompanying the expansion of the global economy when there is a keen awareness that refining capacity and other supply constraints are intensifying. If that risk manifests in the future, it may influence the global economy and the economy of Japan by further decreasing the real purchasing power of the non-oil-producing countries and by the full-scale emergence of global inflationary concerns.

As for overseas economies, price stability is being maintained in the United States as the Federal Reserve has raised interest rates to prevent the emergence of inflationary pressures while crude oil prices remain at a high level. In Europe and Asia, concern is shifting toward the risks on the inflationary side. The European Central Bank raised interest rates at the beginning of December 2005. The maintenance of an accommodative financial environment under price stability forms part of the background to the expansion of overseas economies in recent years, and a future loss of price stability could change this structure and exert a negative influence on the growth of the global economy. While I mentioned before that the Japanese economy is unlikely to fall into a recession due to domestic factors, we must note that an unexpected slowdown in overseas economies or other large external shocks could decelerate economic growth in Japan.

Price conditions and the outlook

Turning to price conditions, domestic corporate goods prices are currently rising at a pace slightly below 2 percent year on year, reflecting the increase in crude oil and other international commodity prices and the depreciation of the yen. While the rate of increase is likely to ease, corporate goods prices are projected to continue rising with strong upward pressure.

The consumer price index (CPI; excluding fresh food, on a nationwide basis) had been moving slightly below the previous year's levels, but posted a zero percent rise from 2004 in the recently released figures for October 2005. The CPI figures for January through March 2006 are expected to show relatively clear positive year-on-year increases. This is affected by the factors that the negative contribution from lower rice prices has dissipated and the influence from electricity and telephone charge reductions is weakening. In addition, it is affected by the factors that the decline in unit labor costs is shrinking under rising wages, and the gap between supply and demand is narrowing in the Japanese economy as a whole, as indicated by the perceptions of a labor shortage in the *Tankan*. The year-on-year changes are expected to remain positive thereafter as Japan's economic growth is projected to exceed the potential growth rate. Surveys on price developments also indicated that expectations of prices were being revised upward.

Financial market developments

Against this background of a positive turn in the outlook for economic activity and prices, net purchases of Japanese stocks by foreign investors have been posting record highs, stock prices have risen substantially, and the Nikkei 225 Stock Average recovered the 15,000 yen level at the beginning of December 2005, the highest level in about five years. Meanwhile, the yen has depreciated further in the foreign exchange market, falling to 121 yen to the U.S. dollar in early December and continuing its declining trend against the euro and Asian currencies. It is said that the recent depreciation of the yen reflects market participants' view on differentials between Japanese and foreign interest rates, given the greater awareness of inflation risk abroad and heightened expectations of higher interest rates. The influence on the economic activity and prices from these financial market developments including the rise in stock prices continues to warrant careful monitoring.

The Bank's conduct of monetary policy

The Bank has been maintaining the quantitative easing policy since March 2001. The two pillars of the quantitative easing policy are: the Bank's provision of ample liquidity to the money market so that the outstanding balance of current accounts at the Bank substantially exceeds the amount of required reserves of about 6 trillion yen; and the Bank's commitment to continue with this provision of ample liquidity 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 is unprecedented as central bank monetary policy, but stipulating the conditions beforehand has made it possible for market participants to act based on the commitment and that has contributed to boosting the transparency and effectiveness of monetary policy.

Reviewing the subsequent policy effects, when there were strong concerns about financial system stability, the provision of ample liquidity by the Bank, which met financial institutions' liquidity demand, stabilized financial markets and maintained accommodative financial conditions, and contributed to averting a contraction in economic activity. In financial markets, the Bank's provision of ample liquidity pushed short-term interest rates down to practically zero percent. Longer-term interest rates have remained stably at low levels, because the commitment by the Bank has led the market to expect that the short-term interest rates will remain at zero percent when prices continue to decline.

Now that concerns about financial system stability have subsided substantially and prices are beginning to rise, the commitment is losing its influence on the formation of longer-term interest rates. Thus, the effects of the quantitative easing policy are coinciding with the effects of short-term interest rates being at practically zero percent.

After the quantitative easing policy is maintained in accordance with the commitment, future monetary policy will follow the path of the processes of "reducing the outstanding balance of current accounts toward a level in line with required reserves," "maintaining very low interest rates," and "gradually adjusting interest rates to a level consistent with economic activity and price developments."

In explicating these processes in somewhat greater detail, with respect to the timing for changing the quantitative easing policy framework, the Bank will judge whether the year-on-year rate of change in the CPI registers zero percent or higher on a sustainable basis in accordance with the commitment. Assuming that developments follow the projection described in the Outlook Report, the possibility of meeting the conditions of the commitment and of departing from the present monetary policy framework is likely to increase over the course of fiscal 2006.

In reducing the outstanding balance of current accounts, the Bank will need to monitor financial market conditions carefully, because the outstanding balance of current accounts at the Bank has been exceeding substantially the amount of required reserves for a long period of time.

Up to this point, the outstanding balance of current accounts, substantially above the level of required reserves, has kept very short-term interest rates practically at zero percent, with some minor fluctuations if any. Considering that the effects of the quantitative easing policy are coinciding with the effects of short-term interest rates being at practically zero percent, a change of the policy framework itself does not imply any major change in the policy effect. If the trend toward positive year-on-year growth in the CPI becomes firmly established, real short-term interest rates will effectively decline, providing powerful stimulus to economic activity and prices.

The level and the time-path of interest rates under the subsequent two processes will certainly depend on economic activity and price developments. 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.

The Bank conducts monetary policy to realize the sustainable growth of the Japanese economy under price stability. At present, the economic recovery is continuing and the environment influencing prices is beginning to change. If the year-on-year rate of change in the CPI registers zero percent or higher on a sustainable basis, that will mark a sort of milestone toward realizing such a goal. The Bank will continue to conduct monetary policy appropriately in accordance with the changes in economic and price conditions to provide support from the financial side for the good performance of the Japanese economy over the long term.

Appropriate monetary policy is also important from the perspective of financial market stability. For example, long-term interest rates have remained stable in the United States in part because of market confidence that the appropriate conduct of monetary policy by the Federal Reserve will maintain price stability into the future. In Japan as well, as noted in the Outlook Report, together with the maintenance of appropriate monetary policy, the Bank's explanation of its thinking on the conduct of monetary policy in detail will contribute to smooth formation of prices in financial markets.

Closing remarks

Chubu is a region that has taken advantage of its manufacturing strengths, vigorously developed private-sector business activities, and pulled the Japanese economy forward. Such originality and inventiveness based on private-sector initiatives will be of the utmost importance for the Japanese economy to realize sustainable growth. In that sense, I look forward to the further remarkable development of the Chubu region.