

Toshiro Muto: Challenges facing Japan's economy – a case for structural reform

Speech by Mr Toshiro Muto, Deputy Governor of the Bank of Japan, at the Japan Society, London, 7 September 2007.

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It is my great honor to speak to you today, the esteemed members of the Japan Society. When I was last invited to speak here in 2004, the Japanese economy was just coming out of a protracted downturn after the collapse of the bubble and was at last moving onto a full-fledged recovery path. Japan's economy has since continued its growth and I am happy to report to you today that the recovery, which started in 2002, is now in its sixth year and has become the longest in the postwar era.

I. Current economic situation in Japan

First, let me briefly discuss the current Japanese economic situation. Japan's economy has been experiencing a sustained period of growth at the rate of around 2 percent, which is slightly above the potential growth rate, supported by strong external demand and stable domestic demand.

Conditions in the corporate sector are particularly good. According to the *Tankan* (Short-Term Economic Survey of Enterprises in Japan), a business survey conducted by the Bank of Japan, the ratio of firms' current profits to sales is at a record high and corporate fixed investment this fiscal year is likely to register its fifth consecutive year of growth.

Those favorable conditions in the corporate sector are gradually but steadily feeding through to the household sector. Although wages are not yet rising, as I will discuss in more detail later, household income is trending upward via several channels, for example, increases in the number of employees and in dividends, and private consumption is steady. Under those circumstances, the utilization of resources such as production capacity and labor is increasing. The unemployment rate has come down to 3.6 percent for the first time in nine years.

There are two main factors behind Japan's continued economic growth. The first is growth in exports on the back of the global economic expansion. The extension and deepening of the international division of the production process, particularly in Asia, along with rapid growth in newly industrialized economies, have together greatly contributed to the growth of our economy.

The second is the recovery of strength in the corporate sector along with the restoration of stability in the financial system. From the latter half of the 1980s, the formation and subsequent collapse of the economic bubble left firms burdened with excesses in debt, production capacity and labor, and financial institutions with significant holdings of nonperforming loans. Firms have since restructured their business lines and improved their financial standing, while the rate of banks' nonperforming loans has been reduced from a peak of above 8 percent to below 3 percent. I think it is fair to say that those impediments have now mostly been removed.

II. The price situation

On the price front, there is not yet any evidence of inflationary pressure despite steady growth in the economy. The annual rate of change in consumer prices (excluding fresh food) stayed negative from fiscal 1998 through 2004. Although small but positive in both fiscal 2005 and 2006, the recent figures are again negative, albeit marginally.

The absence of inflationary pressure despite steady growth in the economy is one of the distinctive features of the current recovery and also a somewhat puzzling phenomenon. Behind it, I believe, lie three changes affecting the formation of prices and wage-setting.

The first is the advance of economic globalization. As globalization proceeds, competition with newly industrialized economies that enjoy lower labor costs has been compelling firms to raise productivity and to retain their restrictive stance on labor costs, together with greater exposure to the discipline of the capital market.

The second is the influence of deregulation. Even nonmanufacturing firms, which are relatively unexposed to the global market, find themselves in a fiercely competitive environment as deregulation and realignment of the industry continues.

Attitudes on the part of employees could be listed as the third change. Employees, having experienced a protracted period when the employment situation was severe, still tend to prefer stable employment to wage increases.

Taking a rather longer perspective, however, the environment surrounding prices is likely to change gradually. First, with the economy continuing to grow steadily, overall supply and demand conditions are likely to tighten.

Second, labor market conditions are becoming tighter, as indicated by the decline in the unemployment rate. That will eventually lead to rising wages although this may be gradual.

Third, surveys of inflation expectations in the private sector suggest moderate rises in prices ahead. Given those factors, the annual rate of change in our consumer prices is expected to be around 0 percent in the short run, but gradually to rise in the longer run.

III. The conduct of monetary policy

I will now turn to the conduct of monetary policy. In a situation where prices are not rising while the economy is growing steadily, the Bank has been adjusting the level of interest rates in a gradual manner. Our policy interest rate, the call rate, now stands at 0.5 percent after being raised twice since the termination of the quantitative easing policy in March 2006.

The Bank has no plans to abandon this basic idea about the conduct of monetary policy. In other words, while assessing the situation of the economic activity and prices in a forward-looking manner, if the Japanese economy is deemed likely to follow a path of sustained growth under price stability, the Bank intends to adjust the level of interest rates gradually in accordance with improvements in the economic and price situation.

At the Monetary Policy Meeting in August, we decided to keep our policy interest rate unchanged. The Japanese economy is expected to continue to enjoy sustained growth. However, global financial markets have been exhibiting some volatility recently, triggered by the subprime mortgage problem in the United States. Although that seems basically to reflect a reevaluation of risk by investors, we believe that the market situation deserves close attention, along with the global economic developments. We will carefully assess incoming economic data and other information as well as the financial market situation both at home and abroad, so as to ensure appropriate policy decisions.

IV. Challenges facing Japan's economy

So far, I have explained the path of Japan's economy to date, and also our thoughts on the conduct of monetary policy. I hope that the economy will remain on a stable growth path and will be able to match the UK's record 15-year expansion. However, I am aware that a number of domestic issues, such as the declining birth rate and population aging along with the need for fiscal consolidation, have made some people skeptical about the future of Japanese

growth. I will use the rest of my allotted time to talk about three issues, and to explain how they are being dealt with.

The first issue is the declining birth rate and the aging population. Although the problem is being experienced by many leading economies, the situation is especially serious in Japan. It is not easy to maintain the pace of economic growth when the working-age population, of those aged between 15 and 64, is decreasing at a rate of nearly 1 percent a year.

Under such circumstances, society's key task is to bring those members of the elderly and female population who are willing to work into the workforce. Firms, as a move toward solving the problem, have been diversifying their employment patterns. As a result of such efforts, labor force participation rates among the females and the elderly are increasing and the total number of employees is growing at around 1 percent a year despite the diminishing working-age population.

Considering the labor market over the longer term, however, there is evidently a need to start exploring other possible measures to deal with the declining population. For that point, I am informed that the UK has accepted around 6 hundred thousand immigrants in the last three years and they are contributing to the growth of the UK economy. Japan too needs to consider accepting more foreign workers, while paying due attention to its impact on Japanese society as a whole.

The second issue is fiscal consolidation. Basically, I believe that it should be carried out in as transparent a fashion as possible. The long-term path of fiscal consolidation and its measures should be spelt out clearly in advance.

As for the pace of consolidation, it is important that it should be measured, with each step taken in confidence that the economy remains on a sustainable growth path. That is how fiscal consolidation has proceeded to date.

The Japanese government, while establishing a precise target for how much they intend to reduce fiscal expenditure, aims to achieve a surplus on its primary balance by the early 2010s. The primary balance deficit, which expanded to around 6 percent of GDP in fiscal 2003, is expected to fall to around 0.9 percent this fiscal year. Spending on public works for this fiscal year, in particular, has declined to around half its peak in fiscal 1995. The amount of the reduction is large, corresponding to around 4 percent of GDP.

Yet even with such steady progress in fiscal consolidation, the public debt, at over 140 percent of GDP, is still the largest among leading economies. The government's next step is to secure a stable reduction of this rate by the mid-2010s. It will be a considerable challenge when social security expenditure is increasing due to the aging population. And additional measures to reduce expenditure and maintain revenue levels, including possible changes in the consumption tax, should be examined, following nationwide discussions.

The third issue is the intensification of competition with newly industrialized economies. Particularly during the period after the collapse of the bubble economy when Japan was undergoing heavy economic adjustments, the growing presence of newly industrialized countries tended to be regarded as a threat to Japan's competitiveness.

In recent years, however, Japanese firms have become better adapted to the situation and a new international division of the production process, concentrated in Asia, has been established. That is evidenced by the changing composition of Japan's imports from Asian countries. The composition has been gradually shifting away from labor-intensive products, such as clothing and other light manufacturing goods, toward machine products that require a relatively high degree of processing, such as IT-related machinery. Against that background, intra-regional trade has been expanding. Japan has been exporting high-tech parts and importing final goods from Asian countries assembled utilizing the abundant labor force in the area.

Direct investment from Japan to Asian countries is increasing as Japanese firms seek to optimize their production processes. The profitability of overseas operations is steadily growing and the positive effects are feeding back to Japan via channels such as investment income and patent royalties.

Those transactions appear in the balance of payments as improvements in the balances for income and services, respectively. Bolstered by increasing interest earnings on bonds, the income surplus currently exceeds the trade surplus and makes up over half of the current account surplus (now around 5 percent of GDP).

As such, I would like to stress that the relationship between Japan and the rest of the world, especially Asian countries, has outgrown that of mere export competitors and has developed into a mutually constructive relationship operating through a network of supply chain management and direct investment.

I have discussed three issues facing Japan's economy. Those are the issues that cannot easily be resolved. However, as I have explained, steady steps are being taken to address them and the results are gradually becoming apparent. I believe that, by pushing ahead with such measures, it is entirely possible for Japan's economy to attain a new era of economic development. The Bank intends to contribute to the process by securing sustained economic growth and price stability through the appropriate conduct of monetary policy.

Thank you very much.