Toshihiko Fukui: The Japanese and world economies – looking to the future

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at the Kisaragi-kai Meeting, Tokyo, 22 February 2008.

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Introduction

Today, I will begin by discussing recent developments in the economy and financial markets as well as the thinking behind the Bank of Japan's conduct of monetary policy. I would then like to turn to the medium- to long-term issues facing the Japanese and world economies, and to present my ideas on how to address them.

I. The current situation and the outlook for Japan's economy

A. Developments in overseas economies

Let me first touch upon recent developments in global financial markets and overseas economies, as a premise to considering the outlook for Japan's economy.

Global financial markets have been unstable due mainly to the downgrading of securitized products and heightened concern about possible further losses at financial institutions stemming from the U.S. subprime mortgage problems. Toward the end of 2007, money markets in the United States and Europe came under pressure from financial institutions' eagerness to secure year-end funds, and this caused interest rates on term instruments to surge. To address this situation, from the middle of December onward, central banks in the major economies coordinated their implementation of responsive measures such as liquidity provision. As a result, interest rates on term instruments have fallen and money markets are recovering their stability. On the other hand, the functioning of markets for securitized products, where the problem originated, remains impaired, and stock markets and foreign exchange markets have been volatile globally. Investor risk-aversion persists, and projected losses at financial institutions in the United States and Europe are greater than initially expected. Although financial institutions in these countries have successively announced measures to boost their capital, underwritten with investment from, among others, sovereign wealth funds from emerging economies and oil producing countries, market participants remain circumspect, keeping a weather eye on future disclosures of losses at financial institutions and their measures to compensate for these losses.

The world economy continues to expand as a whole, but the uncertainty regarding its future path is increasing due to the aforementioned volatility in global financial markets. In the United States, an economic slowdown is becoming more evident. Housing investment is down substantially, with the fall in housing sales and the rise in the already-elevated stock of unsold homes continuing unabated. Home prices continue to fall, and there is no indication that the bottom has yet been reached. Moreover, recently released information suggests that employment and production have weakened somewhat and that banks are tightening lending standards not only for housing loans but also for commercial real estate loans, as well as loans to both businesses and consumers. A slowing of the pace of increase in private consumption is becoming somewhat more evident, but the trend remains moderately upward. Business fixed investment, meanwhile, is also continuing its moderate upward trend. In terms of macroeconomic measures to address the situation, the Federal Reserve has been aggressively lowering its policy interest rate, and the U.S. government has decided on a fiscal package to stimulate the economy, including a tax reduction. Although lower growth in the U.S. economy may be unavoidable for the time being, it is likely to return to a path of growth close to potential, as the housing market correction draws to an end, the tightness in financial conditions eases, and the effects of policy measures make themselves felt. The risk should, however, be borne in mind that, if the negative effects from the housing market correction or financial market developments are greater than expected, the U.S. economy may slow further through negative wealth effects, credit tightening, and deterioration in business and consumer sentiment.

The euro area economy continues to expand, though the pace of increase is moderating. Although export growth has recently decelerated and there are causes for concern, such as weakness in indicators of private consumption and volatility in financial markets, activity in the corporate sector, particularly business fixed investment, remains strong and it is likely that economic growth will continue. As for other regions, growth continues to be robust, especially in China, India, and Russia, while the NIEs and ASEAN economies are also maintaining a moderate pace of expansion overall. Thus, the world economy taken as a whole is continuing to expand. However, we need to bear in mind the possibility that, depending on their extent, future disruptions in global financial markets or a slowdown in the U.S. economy may have adverse implications not only for major economies but also for emerging economies.

At the same time, attention should also be paid to the risk of inflation. In the United States and Europe, consumer prices are continuing to rise due to increased energy and food prices. In China, there are signs of overheating, visible especially in fixed investment, and inflation is rising, with food prices increasing at a faster pace. Meanwhile, given the high prices of grains such as wheat and soybeans as well as of crude oil and gold, possible shifts in international commodity prices may also influence the outlook for the global economy and the price situation.

At the G-7 Financial Ministers' and Central Bank Governors' meeting held recently, the aforementioned assessment of economic and global financial market conditions was generally agreed. Moreover, participants reaffirmed that they would address their domestic concerns within a cooperative framework so as to realize financial market stability and sustainable growth on a global basis.

B. The current situation and the outlook for the Japanese economy

As for Japan's economy, we expect that, although the pace of growth may remain slow for a while, the economy is likely to continue its sustained expansion under conditions of price stability since the virtuous circle of growth in production, income, and spending will remain basically intact. Careful attention, however, should be paid to risk factors such as the aforementioned developments in overseas economies and global financial markets as well as the effects of high energy and materials prices.

In the corporate sector, business sentiment is characterized by caution, because of the following factors. First, the revised Building Standard Law, which came into force in June last year, has been pushing down housing investment significantly. Second, the elevated prices of materials such as crude oil have been reducing profits, especially at small firms. And third, the subprime mortgage problems have been generating increased uncertainty about the future course of the world economy. However, since overseas economies as a whole continue to expand, exports to a broad range of regions, including emerging economies and oil producing countries, are increasing and their overall trend remains upward. In this situation, production to date has continued to increase. Looking forward, however, production is expected to remain flat for a while, mainly because the accelerated production of automobiles to make up for the disruption caused by the Niigata-ken Chuetsu-oki Earthquake in July 2007 is coming to an end. Nevertheless, production is likely to resume its upward momentum, given that levels of inventories and shipments are essentially well in balance. Business fixed investment is also likely to follow an uptrend, as firms are not under pressure to adjust production capacity or employment.

Let me now turn to developments in the household sector. Nominal wages per worker have been somewhat weak, but moderate growth in employee income is continuing, supported by an increase in the number of employees. The gradual increase in employee income is likely to continue, as it is expected that firms will continue to experience labor shortages and corporate profits will remain generally high. In this situation, private consumption is expected to follow a gradual uptrend. However, as prices of daily necessities such as food and gasoline have been rising recently, consumer sentiment appears to have deteriorated, and this may have adverse consequences to which attention will need to be paid. Meanwhile, housing investment, which has been suffering significant declines as a result of procedural changes accompanying the enforcement of the revised Building Standard Law, is nevertheless expected to recover gradually as the delays in the confirmation of building applications are resolved. In fact, the number of housing starts has already been showing signs of recovery. The pace of recovery, however, is still uncertain, since sales of condominiums, whose prices are rising, remain relatively weak.

Regarding prices, the domestic corporate goods price index (CGPI) has been rising mainly due to higher international commodity prices. The year-on-year rate of change in the consumer price index (CPI, excluding fresh food) posted a 0.8 percent increase in December due mainly to rises in the prices of petroleum products and food products. This positive trend in the rate of change is expected to continue: in the short run, due to the effects of high prices of petroleum products and food products; while in the longer run, because supply and demand conditions in the overall economy are expected to tighten as the moderate economic expansion continues.

C. Future conduct of monetary policy

I would now like to explain the Bank's thinking regarding the conduct of monetary policy based on the outlook for economic activity and prices and risk factors I have described.

In conducting monetary policy, it is important not to be swayed too much by short-term developments but to make forward-looking projections of economic and price trends. As I noted earlier, the growth of Japan's economy, for the time being, seems likely to decelerate while prices continue to rise, although, looking forward, the economy is likely to resume a moderate expansion under conditions of price stability. Given this, our basic stance on the future conduct of monetary policy remains unchanged. We will continue to carefully assess the levels of uncertainty associated with the projected future paths of the economy and prices and to remain attentive to both upside and downside risks, thereby ensuring the appropriate conduct of monetary policy.

II. The Japanese and world economies over the medium to long term: issues and strategic direction

I would now like to discuss medium- to long-term issues facing the Japanese and world economies and what steps should be taken to address them. The key word is "sustainability." In other words, we need to consider what we should do to achieve sustainable growth.

A. Issues facing the world economy and basic ideas to address them

1. Structural issues affecting the world economy

Various problems the world economy is facing today, such as the substantial rises in crude oil and food prices, global imbalances, and the turmoil in global financial markets, should be understood in the broader context of changes that have taken place since the 1990s – specifically, the rapid ascendance of emerging economies, the progress of economic globalization, and the globalization and increased sophistication of financial markets.

From the latter half of the 1980s, emerging economies began, one after another, to adopt market economic systems, and since the 1990s they have been rapidly increasing their presence in the global economy. For several years at the beginning of the new century, this was a factor contributing to the benign global economic and financial environment. The world economy was able to enjoy a period of unusually high growth driven by economic expansion in these emerging economies. On the price front, their abundant labor force brought about a dramatic increase in the global supply of products along with an accompanying price decline. In addition, efforts by central banks to stabilize prices allowed the situation of low inflation to continue. During the resultant period of stable prices, the financial environment was kept accommodative. The generous inflow of funds from emerging economies and oil producing countries to leading economies such as the United States also acted to facilitate the continuation of the accommodative financial conditions. It was against this background that rapid advances in financial technology were made. This benign situation, which could be characterized as "high growth," "stable prices," and "financial accommodation," lasted for a long period in the early 2000s.

However, the reverse side of this seemingly benign structural situation has emerged gradually. In many rapidly growing emerging economies energy efficiency is low, and this has increased demand for resources such as crude oil. Coupled with concerns over the possible disruptions of supply, this has led to sharp rises in the prices of international commodities. In addition, increased demand for food, as living standards among workers in emerging economies have improved, has combined with a growing interest in alternative energy to generate substantial rises in prices of foods such as grains. Given resource constraints, questions have begun to emerge as to whether the current robust growth led by emerging economies is sustainable in its present form.

Meanwhile, in financial markets, the benign economic and financial environment had allowed market participants to become lax in their risk evaluation and resulted in some extreme positions being taken. Consequently, last summer saw the subprime mortgage problems inducing a large-scale reevaluation of risks in markets for securitized products, which has since spread to encompass other markets. In the past six months, various measures have been taken in response, but global financial markets remain unstable. Since what we are witnessing is a process of risk repricing within the broad structural context discussed earlier, adjustments may be expected to take some time. It is also inevitable that, during this process, financial institutions will incur losses.

2. Basic ideas to address these issues

In considering what we should do to realize sustained world economic growth, it is necessary to put recent problems into their broader structural context.

The ongoing globalization of the economy and financial markets, as well as advances in financial technology, cannot and should not be stopped, because they basically act to increase people's welfare through the efficient allocation of resources. Rather, in the globalized economy, it is important to ensure an environment where various markets can function fully, thus allowing resources to be allocated efficiently. Furthermore, this environment should be secured swiftly, and should not be permitted to lag behind the pace of globalization and the advance of financial technology.

First, it is becoming increasingly necessary for emerging economies, in line with their growing presence in the world economy, to introduce more flexible foreign exchange systems and to improve the functioning of their financial and capital markets. Global imbalances are the result of many factors, including investment and saving behavior across different countries and the systems that determine these, with inflexible foreign exchange systems being another. In terms of the flow of funds, imbalances are maintained as the abundant funds accumulating in emerging economies and oil producing countries are invested overseas, principally in the United States. To address this problem, it is of course essential that the economies concerned take measures to improve the balance of their investment and saving. At the same time, allowing market mechanisms to operate under more flexible foreign exchange systems will contribute to the balanced and sustained growth of the world economy.

A related problem is that improvements in the functioning of financial and capital markets in emerging economies are not keeping up with the pace of globalization. Progress in this area will contribute to stable economic development in these economies by strengthening their ability to withstand disruptions in the flow of funds, as well as further enhancing the efficiency of the allocation of funds on a global basis. As an example of efforts in this respect, the Bank of Japan, with the cooperation of other central banks in Asia, is promoting a program called the Asian Bond Fund to nurture bond markets in Asia.

Second, areas can be pointed out where the rapid pace of progress in financial innovation may not necessarily have resulted in the improved functioning of financial markets. The recent turmoil in global financial markets triggered by the subprime mortgage problems has highlighted this point. Despite the involvement of technologically advanced financial institutions and credit rating agencies applying cutting-edge financial theory at every stage of the process from the original disbursement of housing loans to their securitization and sale to investors, the end result was still large-scale losses. The task now is to analyze why market mechanisms failed to achieve the appropriate risk evaluation and pricing, and how the framework can be reconstructed so as to ensure that the incentives to do so operate properly in the future. Various parties, including the authorities, should consider what they can do to help achieve this; yet, needless to say, the primary role must be played by market participants themselves. It is in market participants' own interest to strike a proper balance between risk and return, and ensuring that this intrinsic incentive is allowed to operate is fundamental to any reconstructive efforts. At the recent G-7 meeting, the interim report submitted by the Financial Stability Forum working group toward the construction of such a properly incentivized framework was discussed, and its final report is scheduled to be submitted at the next meeting in April.

Third, the issue of energy and resource conservation is important not only in environmental terms but also as the basis for realizing sustainable world economic growth. To be more specific, it is necessary to raise the energy efficiency of countries where efficiency rates are low and for resource producing countries to ensure that systems of supply are stable. We must think how this could be achieved under market mechanisms and how externalities, such as the global-scale environmental problem posed by CO_2 emissions, could be addressed. Improving energy efficiency and developing cleaner energy are areas that should benefit from technological expertise found in the private sector. Although individual countries have been trying to provide the proper incentives to achieve these ends, it should not be forgotten that this is a global issue, and one which would benefit from the application of market mechanisms. For example, a market for emission rights would not only allow the appropriate valuation of emissions costs but would also provide market incentives for the development of advanced technologies to increase energy efficiency.

There are, of course, other problems that need to be addressed, yet in terms of broad strategic direction, the response is qualitatively the same: rapid changes in the social and economic environment, such as globalization, should be dealt with by making appropriate use of market mechanisms, while adjusting the existing infrastructure as much as necessary. Such an approach will establish a basis for sustained world economic growth while avoiding the pitfalls of protectionism.

B. Issues facing the Japanese economy and basic ideas to address them

1. Demographic change: population aging and the declining birth rate

I will now turn to the medium- to long-term issues facing Japan's economy. The most significant of these in terms of achieving sustained economic growth is the progress of demographic change, specifically the decline in the birth rate and aging of the population. Faced with such demographics, we need to ask ourselves how Japan can make use of global vitality to boost its own economic strength.

The sources of economic growth are labor input and accumulated capital. Using these efficiently to enhance value added, in other words, to increase productivity, is what generates economic growth.

Looking first at the labor situation, the size of the labor force may be expected to decline along with the decrease in the working-age population. To curb this decline, the labor force participation rates of the elderly and women need to be raised. This in turn requires the provision of a better working environment for potential workers in these categories.

Second, to accumulate capital, Japanese firms need to remain an attractive target for domestic and overseas investors. The funds that flowed out of U.S. securities markets due to the subprime mortgage problems did not necessarily head for Japan. Given that Japanese firms are world leaders in terms of their technological prowess, there is no reason for overseas investors to form an unfavorable evaluation of their profitability or other such measures of their corporate strength. What seems needed, therefore, to attract inward investment into Japanese firms is to improve areas such as corporate governance and financing, consolidating the environment and infrastructure of capital markets to facilitate easy access by investors both at home and abroad. Achieving this will require a painstaking process of constant review and response.

Third, in order to increase productivity, it is necessary to move forward with institutional changes, including deregulation, so that the private sector may be able to perform to its fullest potential. To be competitive in the global economy, trading arrangements, such as free trade agreements, are important. Yet, it is also important to ensure that infrastructural arrangements, such as adequate protection of intellectual property rights to facilitate the accumulation of advanced technologies and knowledge, are continually refined and updated to accommodate the most recent changes. In the nonmanufacturing sector, in particular, it is important to accumulate knowledge and enhance the innovative potential of Japan as a whole. For this purpose, measures that take advantage of the dynamism of globalization, such as measures to attract the most talented minds from abroad, which have been introduced in other countries to strengthen their international competitiveness, should be pushed forward.

Even assuming that these necessary efforts are steadily pursued, we must still bear in mind that the issue of the declining birth rate and aging population cannot be conceived from a purely economic standpoint. Even if various incentives are put in place and the necessary infrastructure of day care facilities and so on are provided in an attempt to curb the declining birth rate, ultimately the problem remains one of personal choice. Similarly, the issue of immigration, which is often proposed as a more direct means of addressing the labor shortage, is a matter of public choice that involves not only economic but various social considerations. A major reason for Japan's low potential growth rate relative to the United States and European countries lies in the fact that it expects fewer immigrants and this is reflected in a lower expected increase in its working population. One way to raise Japan's potential growth rate is evidently to ease restrictions on immigration. I think the time has come for us to think very seriously about whether we should accept more immigrants, or whether we would prefer to remain a relatively homogeneous society and be satisfied with low economic growth. It seems increasingly necessary for Japan to decide how it wants to fit in to the global economy.

2. Fiscal consolidation

Closely related to the problem of the declining labor force is another medium- to long-term issue, the consolidation of the fiscal situation. It scarcely needs repeating that Japan's public finances are in a severe situation. What is crucial here, however, is that the problem is a medium- to long-term one to which measures with only short-term effects will not provide a viable solution; moreover, dealing with the problem will require reconsidering the income distribution.

As the nation's demographics continue to shift, the number of retirees will inevitably increase relative to the size of the working population. From a public finance perspective, the implication is that the number of those who bear the burden of public finances in the form of taxes will decrease while the number of those who benefit from public finances in the form of social security payments will increase. If the income distribution remains the same – in other words, if relative shares of the total pie are not altered – the public finances will deteriorate further. Reforming these will inevitably entail some pain. However, in the end there is no choice but to construct a sustainable new system, and if the public can be convinced of the system's sustainability, then it will go some way to dissipating their anxiety about the future.

To ease the process of reallocating shares of the pie, it is important to increase the economic growth rate. With a larger pie, it becomes possible to adjust income distribution without requiring social security beneficiaries to give up such a large amount in absolute terms. What is important is that the pie must become larger in real terms; in other words, real growth must rise. Higher inflation alone will not produce the desired effect if the real growth rate does not rise. A rise in the inflation rate without a change in the nominal size of pensions simply translates into a decrease in the real value of pensions. Neither does higher inflation represent a quick fix for the public finances. A rise in the inflation rate would indeed result in increased tax revenues, but expenditure would also increase, as would interest payments on government bonds, which would rise in line with higher interest rates.

In short, there are no quick fixes or free lunches when it comes to reconstructing the public finances. Constructing a sustainable system of public finances and social security may be painful, but it is the only certain route to travel, and it will require facing up to two necessities: first, in response to the declining birth rate and aging of the population, there must be some kind of change in the income distribution between generations; and second, this process of changing the income distribution can only be accomplished smoothly if real economic growth and economic strength are increased. The actual shape of the sustainable system that emerges, whether it is achieved by increasing the tax burden or by reducing public expenditure, is a matter for the public itself to determine.

C. The role of central banks

Lastly, I would like to discuss the role of central banks in addressing the medium- to long-term issues I have talked about.

With the further evolution of economic and financial globalization, central banks should contribute to economic and price stability through the appropriate conduct of monetary policy, while also ensuring that financial markets and the financial system are both efficient and stable by providing liquidity and making sure that markets function properly.

Let me start with the second of these roles, namely, ensuring the efficiency and stability of financial markets and the financial system.

As has become clear during the recent turmoil in global financial markets, liquidity provision by central banks plays a significant role in stabilizing financial markets. With the increase in the volume and complexity of cross-border flows of funds, coordination among central banks in their performance of this role is essential. Behind the coordinated provision of funds by central banks in December, which I have already mentioned, there lay discussion among central banks and the attainment of a consensus about the economic situation and measures to alleviate it. I believe that the framework for liquidity provision introduced in Japan to deal with the past financial crisis has proved instructive to other countries in designing appropriate measures. In addition to their provision of liquidity to markets under normal conditions, central banks stand ready to provide funds directly to individual financial institutions as the

Lender of Last Resort in cases, for example, when an institution is experiencing difficulties raising funds in the markets. Given the globalization of financial services, such cases now require closer communication among the countries involved.

It is, of course, important to respond *ex post* to market turmoil or fund-raising difficulties at individual financial institutions; however, it is also vital to share ideas and develop appropriate systems prior to such incidents. More specifically, as the financial business becomes increasingly globalized, central banks must rigorously discuss how to ensure the international cooperation and communication needed to improve operational tools and collateral arrangements as well as to enhance the compatibility of their Lender of Last Resort and macro-prudential policies. Taking a longer-term perspective, we must also consider how each country can help improve the working of progressively globalized financial markets. Given that of the various public authorities it is central banks which are closest to financial markets, they have a correspondingly important role to play in providing a steady response to the rapid globalization and growing technological sophistication of financial markets.

Next, I would like to turn to monetary policy. As globalization proceeds, assessment of the domestic economic and price situation increasingly demands that attention be paid to the influence of economic and market conditions overseas. At the same time, it has also become apparent that, since monetary policy takes effect via its influence on financial markets and the behavior of financial institutions, the globalization of financial markets means that policy actions by individual central banks are mutually influential. It is for this reason that central banks have frequent and detailed exchanges of views about each other's economic and financial situations as well as their respective thinking concerning monetary policy.

The basic task of central banks, however, remains unchanged. Each central bank, having a good understanding of conditions overseas, should assess its own economic and price situation in a forward-looking manner and carry out appropriate policies to ensure that economic growth and prices remain stable. Central bankers universally agree that the stability of the world economy is achieved by economic and price stability in each country supported by appropriate monetary policy.

Although the ultimate goal of monetary policy remains economic and price stability, I must add that to achieve this it is not enough to look only at price indices and growth rates. We must be attentive to factors likely to affect the economy and prices in the long run, such as developments in asset prices as well as the financial market situation and state of the financial system. Episodes such as the recent subprime mortgage problems or the bursting of the economic bubble in Japan indicate that changes in asset prices may on occasion result in considerable fluctuations in the economy and prices over the medium to long run. To achieve long-run economic and price stability, therefore, we need to be constantly vigilant concerning risk factors such as bubbles or financial system disruptions that cause large losses when they materialize, even though the probability of such materialization may be low. In this regard, information such as developments in asset prices as well as changes in market conditions and the state of financial system stability should be carefully analyzed.

These points of concern are incorporated within each central bank's framework for conducting monetary policy. In the case of the Bank of Japan, we examine such long-run risk factors under the "second perspective" specified in the framework for the conduct of monetary policy introduced in March 2006. The European Central Bank (ECB) crosschecks information obtained through its assessment of the economy and prices against that obtained from its monetary analysis. The Federal Reserve, with its introduction last November of measures to enhance transparency, started to make public Federal Open Market Committee (FOMC) participants' views about the level of uncertainty and risk factors affecting its medium-term outlook. Even countries that practice inflation targeting do not automatically adjust policy rates to keep inflation within their predetermined range, but retain a degree of flexibility in meeting their targets.

The Bank of Japan conducts monetary policy so as to achieve long-run economic and price stability by analyzing a wide range of information, including indicators of global economic trends and financial conditions. By ensuring economic and price stability in the medium to long term, the Bank will provide a solid foundation upon which both firms and households can formulate their plans for the future and base their actual economic behavior. I believe this will, in turn, allow us to take advantage of global economic vigor to successfully confront the issues of demographic change and fiscal consolidation.

Closing remarks

Today, I have talked about medium- to long-term issues facing the Japanese and world economies and I have put forward some basic strategies for addressing those issues. There are certainly a number of issues that require attention. However, I believe that the world economy has the potential for further development and that Japan's economy is well capable of succeeding in the global market. It is my firm hope that the economies of both Japan and the world will realize sustainable growth by successfully addressing each of these issues, and the Bank of Japan in cooperation with other central banks will continue to perform its supportive part in this process.