Toshihiko Fukui: Economic activity and recent financial developments in Japan

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at a meeting with business people in Nagoya, 3 September 2003.

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I. Current situation of the Japanese economy and policy focuses

A. Current conditions

Economic activity as a whole has been flat since February this year, as has been described in the Bank of Japan's Monthly Report of Recent Economic and Financial Developments. Recently, however, we have gradually begun to observe some signs of improvement. For example, machinery orders and the second-quarter GDP have turned out to be better than anticipated, and stock prices continue to rise.

Such domestic developments should be understood in a global context, as economic globalization progresses and the Japanese economy deepens its ties with overseas economies even further.

As you all know, during the first half of this year, the world economy was mired in the adjustment process that followed the IT boom of the 1990s, which came to an end in the fall of 2000. Furthermore, uncertainty about the economic outlook was amplified by the war in Iraq and severe acute respiratory syndrome (SARS) in East Asia. Uncertainty about the financial system problem in Japan persisted, and the fall in stock prices, including bank shares, became rather marked.

Fortunately, these uncertainties have decreased since the early summer. The actual operation of the war in Iraq concluded relatively early, and the effects of SARS have been less than many people feared. We have even begun to observe some signs of recovery in the demand for IT-related goods, although we have not yet fully confirmed the extent of their adjustment.

In these circumstances, pessimistic views on the economic outlook have receded, and an increasing number of people have become confident about a rebound of world economic growth from the second half of this year.

For example, in the United States the so-called central tendency of projected real GDP growth for 2003 among members of the Federal Open Market Committee (FOMC) has been revised upward, to 2.5 to 2.75 percent. This projection implies that real GDP growth would rise to the 3 percent level for the second half of 2003, from around 2 percent for the first half. For 2004, the FOMC members predict further acceleration of real GDP growth to 3.75 to 4.75 percent. In Asia, China is most likely to return to a stable growth path after overcoming the negative impact of SARS. With higher dependence on information technologies, the NIEs will expand production as the global demand for IT-related goods recovers, in the United States in particular. There is little likelihood that Europe will be a drag on the global economic recovery, although its economic outlook still seems rather unclear.

Given these overseas developments, the Japanese economy is expected to gradually increase exports and production. In addition to the possible increase in external demand, domestic demand also shows some favorable signs. Planned business fixed investment for fiscal 2003 at the moment is the largest since fiscal 2000, against the backdrop of a substantial increase in corporate profits. Moreover, we see a slightly favorable change in direction in the job and income situation of the household sector, although the situation remains severe.

B. Policy focuses

Such a path for Japan's economic recovery has been within our standard scenario since this spring, and it appears increasingly likely that this scenario will be realized.

However, questions remain as to the strength and breadth of the economic recovery once it is achieved, as well as the risk that the standard scenario may not be realized. In tackling these questions, we should keep three points in focus.

The first focus is the outlook for overseas economies, the U.S. economy in particular. In this regard, we should also pay attention to the global demand for IT-related goods.

Although the U.S. economy is on a mild recovery path led by private consumption, business fixed investment and production generally remain weak, and the labor market condition continues to be severe. With residual adjustment pressure after the bursting of the IT bubble, firms are still rather restrained in their business expansion. In spite of these subdued conditions, we have recently begun to see changes and hopes for improvement. Global demand for PCs, semiconductors, and other IT-related goods is increasing. People strongly hope that a substantial tax reduction and monetary easing will work to accelerate recovery. We will monitor how these changes and hopes are translated into improving business activity and the labor market condition in the United States, and subsequently whether such an improvement has a positive impact on the world economy.

The second focus is the financial market in Japan. Stock prices rebounded from around May, and the Nikkei 225 Stock Average regained the 10,000 level after August 18 as views about the economic outlook turned slightly more favorable. Long-term interest rates also rose. In my view, these movements could be interpreted as the correction of overly pessimistic market expectations in the first half of 2003 amid various uncertainties.

Fundamentally, stock prices and long-term interest rates reflect market views about the economic outlook, so we should strive to correctly understand these views. Having said this, it is also true that markets can often move irregularly in response to a variety of factors. For example, in the United States, the 10-year long-term interest rate rebounded to the mid-4 percent level after falling to around 3 percent in June. As factors behind this gyration, many point to the deterioration of the fiscal balance and the hedging activity of investors in mortgage securities, in addition to changing views about the economic outlook. In Japan, people have already begun to talk about the possibility of overshooting of long-term interest rates, which cannot be justified by economic fundamentals. We will closely monitor financial market developments, including the possibility of large swings in long-term interest rates due to factors other than economic fundamentals.

The third focus is the extent of economic recovery spurred by exports and production amid the persisting problem of excess debt and labor.

The problem of excess debt differs from firm to firm, and industry to industry, but broadly speaking, it is largely a problem for the nonmanufacturing industry. For example, the ratio of net debt to sales has been declining significantly for the past ten years in the manufacturing industry, but remains high in the nonmanufacturing industry due to the delay in adjustment. The nonmanufacturing industry tends to retain various inefficiencies mainly because it has been traditionally less exposed to international competition than the manufacturing industry.

The manufacturing industry is the driving force behind the economic recovery if it is led by exports and production. But, to achieve sustainable growth, it is critically important whether such an initial recovery will lead to the dynamic and forward-looking improvement of the nonmanufacturing industry.

The problem of excess labor is important when we judge whether the recovery of the corporate sector might lead to an increase in private consumption through a rise in income. The Tankan (Short-Term Economic Survey of Enterprises in Japan) has been showing a consistent pattern of excess labor for both the manufacturing and nonmanufacturing industry since the bursting of the bubble economy. Recent labor statistics also show a continued decline in regular employment. These data suggest persistent pressure for labor market adjustment and continued severe conditions for employment and income.

Looking closely at the latest statistics, it should be noted that we have begun to observe some signs of favorable changes in the labor market. The level of employment ceases to fall if part-time workers are included, and the decline in wages is bottoming out if bonus payments for the summer are taken into account.

II. Conduct of monetary policy

In these economic conditions, the Bank has been conducting a quantitative easing policy, maintaining financial market stability and strengthening the momentum for recovery by flexibly providing ample liquidity. Since I became Governor, the Bank has raised the quantitative target for the outstanding balance of current accounts held at the Bank twice, in April and May. Faced with a number of uncertainties, including the war in Iraq, SARS, stock prices, exchange rates, and the problem related to Resona Bank since this spring, we have taken a preemptive approach to monetary policy so that these uncertainties do not jeopardize the not very robust foundation for economic recovery.

The Bank has also made a strong commitment to continue the current monetary easing until the year-on-year increase in the consumer price index (CPI) becomes stably zero or above. This commitment strengthens the policy effect on interest rate stability, as participants in financial markets can anticipate monetary easing as long as the year-on-year increase in the CPI remains negative.

Furthermore, the Bank has been strengthening the transmission mechanism of monetary policy so that the effect of monetary easing permeates through the economy. As part of such efforts, it began purchasing asset-backed securities in August. Underlying assets included not only receivables but also lease and loan assets, which we hope facilitate the funding of small to medium-sized firms. It was quite unusual for the central bank to directly assume the credit risk of the private sector, but we thought such a measure was necessary in light of the prevailing economic conditions, and the state of the financial system and markets.

The Bank has been taking necessary measures, without undue regard for precedent, to return to sustainable growth and overcome deflation, and it will continue to do so.

We should also emphasize stronger global linkage when we examine the problem of deflation, in the same way as economic activity.

Inflation has been declining globally, due mainly to the appropriate conduct of monetary policy and the increasing penetration of emerging countries into market economies. This phenomenon is termed “global disinflation.” Even if the world economy recovers, there is a strong possibility that inflation will stay at a relatively low level, while the growth rate will increase. In fact, various private-sector forecasts show that for 2004 growth will be higher compared to 2003, and inflation will remain under 2 percent in the United States, Europe, and Asia. In such circumstances, central banks have been implementing monetary policy with more attention to the risk of deflation. For example, the Federal Reserve Board announced in its FOMC statement in August that “policy accommodation can be maintained for a considerable period.”

Japan is suffering from deflation, a worse problem than disinflation. This makes a stronger case for the Bank to continue implementing an easy monetary policy, compared to other central banks.

III. Revitalization of the corporate sector

Stronger global linkage has some bearing on the commonly observed facts that business sentiment has been slow to improve and fixed investment has not become as active as anticipated in various countries under monetary conditions that are easier than in the comparable stage of past business cycles.

This partly reflects residual pressure for adjustment. But it also reflects more intensified competition in the corporate sector together with the progress in globalization, as well as increasing difficulties firms face in sustaining pricing power under the new conditions in which prices are being determined. We may be approaching a stage where corporate profits can only be increased by creating new value-added goods and services, and the investment opportunities for such creation are becoming more difficult to find.

For example, in Japan, the corporate management and economic framework established during the high-growth period are so firmly embedded that it is a very difficult and challenging task to transform them.

In this regard, I have been advocating three directions for firms to pursue with a view to building a new framework for the Japanese economy. The first is to boost their competitiveness and generate new consumer demand by creating new value-added goods and services. The second is to increase their business activity in the expanding Chinese and other Asian markets, and further deepen economic interdependence with them. And the third is to address global challenges such as the development of sustainable energy sources and environmental protection. If firms can make positive contributions in these directions, they will certainly be able to expand the frontier of innovation to revitalize the Japanese economy. I hope that such efforts will place the Japanese economy in a unique position in terms of the sustainable development of the world economy.

IV. Current situation of the financial system and challenges

The Japanese financial system, although still facing severe conditions as a whole, is steadily moving toward restoring its effective functioning.

Since last fall, there has been a growing recognition among financial institutions and related parties that an appropriate evaluation of the economic value of nonperforming loans (NPLs), and higher provisioning and more aggressive write-offs of these loans based on such an evaluation, are important in accelerating the disposal of NPLs. Further efforts have been made in this direction. In fiscal 2002, Japanese banks recorded a large net loss for the second consecutive year. This result clearly reflected the severe conditions faced by the Japanese financial system. At the same time, it signified the aggressive disposal of NPLs as shown by the substantial decrease in NPLs outstanding at major banks.

The time has now come to move to the final stage to restore the effective functioning of the financial system, keeping in mind the complete removal of blanket deposit protection scheduled in April 2005.

This removal, in my view, should not be perceived simply as a change in the type of coverage of deposit insurance protection. Instead, it should be recognized as a turning point for financial institutions in the reform of their management. Protection has been provided as a temporary buffer to avoid potential confusion. Following the complete removal, financial institutions must pursue a dynamic management strategy based on their own judgment.

To this end, it is the financial institutions themselves, not the regulatory authorities, that should take the initiative in dealing with NPLs. Moreover, they should redouble their efforts to strengthen their earnings power besides accelerating the disposal of NPLs.

V. Disposal of NPLs and corporate revitalization

In addition to the appropriate evaluation, higher provisioning, and more aggressive write-offs in the disposal of NPLs, increasing attention is being paid to the importance of corporate revitalization from the viewpoint of promoting the reform of industrial structure.

The Industrial Revitalization Corporation of Japan (IRCJ), which began operation in May this year, recently decided to support four firms. The IRCJ will subsequently purchase the loan assets of these four firms from lenders other than their main bank, decide on a restructuring plan and then implement it. Individual financial institutions, major banks in particular, are establishing a subsidiary specializing in corporate revitalization. Moreover, we observe an increasing number of cases in which financial institutions set up an internal section specifically devoted to corporate revitalization, and form an alliance with outside experts like lawyers and certified accountants.

The success of corporate revitalization requires a speedy and decisive response on the part of both firms and financial institutions. Some firms with useful technology and expertise find it difficult to improve their business performance because of the large financial legacy from the past. Often these firms, in collaboration with financial institutions, can solve their problem by boldly eliminating unprofitable businesses and concentrating their managerial resources on core businesses. In this regard, it is mutually beneficial for both firms and financial institutions to promote a sufficient dialogue and reach a shared recognition about the present and future of the firms' management.

To smoothly promote corporate revitalization, we need to improve and expand the market for loan asset liquidation, including NPLs. The expansion would help banks take NPLs off their balance sheets, but it would also invite a variety of investors with diversified risk preferences and expertise into the corporate revitalization business. If the market expands and prices for loan assets are formed efficiently, these prices will indicate the market's evaluation of corporate revitalization.

VI. Earnings power of financial institutions and a stronger capital position

When the effective functioning of the financial system is finally restored, major banks will enjoy strong international competitiveness, and local banks will be able to provide new financial services for regional development. These benefits will only be possible with the strengthening of earnings power.

To strengthen earnings power, individual financial institutions must form their own judgments on a number of issues. For example, how should they change their traditional practice for transactions?

What kind of new businesses should they develop? How should they reorganize their business model? The Bank would like to support the efforts of financial institutions toward this end by providing appropriate advice through on-site examinations and daily monitoring.

In this process, financial institutions must ask themselves whether their capital position is sufficient to pursue a new business model, and if not, they of course need to boost their capital position. Needless to say, financial institutions should raise capital in the markets. In the limited time before the complete removal of blanket deposit protection, however, some may not be able to do so sufficiently. In this case, fundamentally there are two options: either reducing their business scope in line with their existing capital position or accepting the public injection of capital. I think the latter option is desirable under the current conditions in Japan. In other words, we should facilitate the process of restoring the effective functioning of the financial system through a new system of capital injection, which differs from the existing system that seeks to preempt crises.

Conclusion

A number of developments indicate that the Japanese economy is moving in a desirable direction, even though it continues to face severe conditions. I believe it is the competitiveness of the private sector, both firms and financial institutions with progressive technology and expertise, that will bring about the reemergence of a truly strong Japanese economy. The Bank stands ready to provide full support to the private sector's efforts toward this end by maintaining an easy monetary policy.