

Toshihiko Fukui: An overview of Japan's economy and financial system

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at a meeting with business leaders in Sendai, 1 October 2003.

The speech was delivered by Kazumasa Iwata, Deputy Governor of the Bank of Japan, on behalf of the Governor.

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I. Current State of the Japanese Economy and Developments in Financial Markets

Let me begin by discussing the world economy.

The U.S. economy has spurred a moderate recovery supported by personal consumption. Recovery is beginning to spread to orders received by manufacturers and capital spending with the rise in world demand for IT-related products. The large-scale tax cuts are beginning to have a positive impact on personal consumption. Growth seems increasingly likely to start accelerating, while pressure on labor adjustment remains. Economic activity in East Asia is also heading for recovery. In China, the adverse effects arising from severe acute respiratory syndrome (SARS) have virtually ended, and exports of the NIEs and ASEAN are expected to increase with the worldwide recovery in IT-related demand. In Europe, there are signs of improvement in corporate sentiment, although the impetus for recovery is not yet evident.

The above assessment of the global economy was endorsed at the G-7 meeting last month in Dubai.

Turning to the domestic arena, capital spending is recovering gradually as corporate profits increase. Largely thanks to this recovery, real GDP posted an annualized growth rate of 3.9 percent in the April-June quarter, far exceeding market expectations. The Tankan survey released on October 1 shows that the capital spending plans of large manufacturers for fiscal 2003 are expected to increase 11 percent on a year-on-year basis, and that of all enterprises is slightly larger than the figure in the previous year. Thus, the recovery of capital spending is expected to become more certain.

Personal consumption has been weak recently due partly to the cold summer. However, signs of favorable change are emerging on the employment and income front.

Although overall economic activity remains virtually flat, signs of recovery are gradually being observed. The likelihood seems to be increasing that, with the recovery of exports and capital spending leading to an increase in production and corporate profits, the Japanese economy will return to a self-sustained, though moderate, recovery path.

According to the Tankan survey released on October 1, corporate sentiment is generally improving, as is shown by the fact that the judgment of business conditions by large manufacturers has turned to "favorable" for the first time since December 2000. This result is more or less in line with the assessment of Japan's economy that I have just described.

It should be noted that there still remain persistent structural adjustment pressures stemming from excess debt and labor. Therefore, the extent and strength of the likely recovery permeating through the economy are uncertain, and must continue to be monitored carefully.

In the stock market, the Nikkei 225 Stock Average is moving above the 10,000 yen level, about 30 percent above the recent bottom in the spring, although the market is slightly bearish recently due to the appreciation of the yen. We consider that such movements reflect the signs of recovery that I have just described.

Yields on 10-year Japanese government bonds have risen significantly above their June levels of below 0.5 percent.

Long-term interest rates reflect market participants' prospects of the economy. Thus, higher long-term interest rates after June are basically the reflection of improved prospects. Such observation can be reinforced by the simultaneous rise in long-term interest rates and stock prices.

Markets respond to various factors, and thus they are subject to overshooting in the short term. For example, some point out that the recent volatile movement of long-term interest rates was partly due to the speculation over the Bank's monetary policy. In this regard, let me reiterate that the Bank has made a firm commitment to maintaining the current policy of quantitative easing until the year-on-year

increase in the consumer price index (CPI) becomes stably zero or above. This is a clear and specific commitment based on the published monthly data of the CPI, not its forecast. Once the significance of this commitment is fully digested in the market, I believe it will contribute greatly to market stability. Let me reassure you that the Bank continues with this commitment, and communicates its policy stance to the market as and when necessary.

The yen has been appreciating since around the time of the G-7 meeting last month. It appears that such movement has been affected partly by misinterpretations by market participants regarding the G-7 statement. There is no change in the view held by the finance ministers and central bank governors of the G-7 countries that exchange rates should move in a stable manner reflecting economic fundamentals, and that the G-7 countries will cooperate as appropriate if there is excessive short-term volatility in the foreign exchange market.

It is extremely important for the recovery of Japan's economy that the yen moves in a stable manner. The Bank will continue to closely monitor the exchange rate and its effect on the economy as well as long-term interest rates and stock prices.

II. Conduct of Monetary Policy

The Bank has been striving, and will continue to strive, to maintain financial market stability and ensure economic recovery by flexibly providing ample liquidity under the quantitative easing framework.

It is also important to strengthen the transmission mechanism of monetary policy so that the effect of monetary easing permeates through the economy. In this regard, the Bank has recently started the outright purchase of asset-backed securities (ABSs) and has been preparing the acceptance of syndicated loans as collateral in its monetary operations.

Although it is unprecedented for the central bank to purchase ABSs in that it directly accepts the credit risk pertaining to private-sector debt, the Bank decided on this measure so that the effects of monetary easing would permeate through the economy. It will continue to support, in cooperation with market participants, the development of the ABS market, which has large potential to become a new channel of financial intermediation.

The syndicated loan market has been expanding steadily in Japan. We hope that, prompted in part by the acceptance of such loans by the Bank as collateral, the market will expand further, and will contribute to facilitating corporate finance.

III. Revitalization of the Corporate Sector and Regional Economies

For the sustainable recovery of Japan's economy, a self-sustained growth mechanism-whereby revitalization of the corporate sector increases the income and consumption of the household sector, which in turn leads to further revitalization of the corporate sector-must operate in the economy.

In this regard, companies must enhance their competitiveness by creating high-value-added goods and services under the global competition.

This viewpoint is equally important in the development of regional economies. We should recognize that there is a limit to the conventional approach such as public works spending in developing regional economies. Companies in regional economies must also enhance their ability to create high-value-added goods and services from a global viewpoint.

In this regard, let me offer two observations.

First, we should view the expansion of other Asian economies, including China, favorably as a new market opening, not as a threat.

Second, there exists large potential demand for medical care and welfare services as well as environment-related business, given the aging population and the growing importance of environmental issues.

IV. Financial System

Although the Japanese financial system still faces many difficult problems, we are beginning to see the result of the efforts to date toward overcoming the nonperforming-loan (NPL) problem and restoring the soundness of the financial system. Let me mention four points in this regard.

First, adequate provisioning and write-offs based on appropriate assessment of the economic value of NPLs are extremely important in maintaining the financial soundness of banks. In the financial results of all banks for fiscal 2002, substantial losses were posted for the second consecutive year. While this underlines the severe predicament of the financial system, it also illustrates the result of the efforts, by major banks in particular, to reduce their NPLs and strengthen their provisioning.

Second, it has become commonly recognized that corporate revitalization is an integral part of dealing with the NPL problem. For example, the Industrial Revitalization Corporation of Japan (IRCJ), which began operations in May this year, has decided to work on six companies to date through the purchase of their debt from non-main banks. Since the debt purchase by the IRCJ will be terminated at the end of March 2005, we hope that the IRCJ will be used actively for the remaining rather short operating period. It is vital for the management of both companies and banks to become aware of the urgency of corporate revitalization through the effective dialogue, and act with speed and decisiveness.

Third, it is desirable to reduce the risk associated with stock price fluctuations in banks' shareholdings for financial system stability. At the same time, unwinding cross-shareholdings is also desirable from the viewpoint of strengthening corporate governance. Considerable progress has been made in reducing banks' exposure to stock price fluctuation risk. So far, the Bank has purchased a total of some 1.8 trillion yen worth of shares from banks. It recently decided to extend the purchase period for an additional year since some banks' shareholdings still exceed their core capital, and there is demand for this stock purchase operation.

Lastly, banks should strengthen their profitability. The ultimate purpose of restoring the soundness of the financial system is to enable banks to fully perform their financial intermediation function, thereby providing support for sustainable growth. To this end, banks need adequate profitability and sufficient capital bases. The management of banks must select and concentrate various resources in key strategic areas. In this process, it should be kept in mind that banking is a service industry and banks should pay close attention to the needs of customers. We are beginning to see some movements toward this direction, and we hope that they will prevail.

Before closing, let me briefly touch on the outlook for the financial system. The removal of the full protection of deposits in settlement accounts, scheduled in April 2005, should not be perceived simply as a change in the type of coverage of deposit insurance. It should be regarded as the termination of special protection that has been provided as a temporary buffer to avoid potential confusion. It should be recognized as a turning point for the reform of banks' management, which is free from the protection of the government. In this regard, banks must have clear business strategies for strengthening their profitability.

At the same time, banks must have capital bases that are sufficient relative to the risks associated with their new business model. If banks find their capital bases insufficient, they need to take measures to boost their capital. Given the limited time remaining until the removal of blanket deposit insurance, I think it is desirable to establish a new framework for injecting public funds into banks as the "last instance of public support" in the event that they cannot raise sufficient capital in the market. The establishment of such a framework will facilitate the process of restoring the soundness and effective functioning of the financial system.