

## **Toshihiko Fukui: Achieving sustainable economic growth and overcoming deflation**

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at the Yomiuri International Economic Society, Tokyo, 13 May 2004.

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Japan's economy has now entered its third recovery phase since the bursting of the bubble, and this time it is of utmost importance to make the recovery lead to sustainable economic growth and put an end to deflation. With this in mind, I will talk about the current situation and the outlook for Japan's economy as well as the conduct of monetary policy.

### **New features of the world economy**

The interrelationships among various economies worldwide have become ever more pronounced as globalization and the IT revolution have progressed. Recently, the Chinese economy has been playing a larger role, contributing to higher world economic growth. Against this background, new features have been emerging in the world economy.

One feature is that, compared with the past, recovery in employment and household income tends to lag significantly behind the recovery in economic growth. Intensified global competition has been forcing firms to continue reducing the size of their labor forces even when the economy is recovering. Higher productivity due to the widespread IT revolution has been dampening firms' demand for labor. The abundant supply of less expensive workers in China and India has been encouraging outsourcing by firms in industrialized countries.

Another feature is related to the mechanism of price formation. There has been an increasing tendency for retail and consumer prices to remain basically unaffected by the surge in crude oil prices, international commodity prices, and shipping charges that has taken place in line with the steady recovery of the world economy. This is because the increases in raw material prices and shipping charges have been able to be absorbed mainly by reductions in wages, which seem at last to have almost run their course, and higher productivity. Hence, these increases have not been passed on into prices of finished goods.

These new world economic features have a direct bearing on the Japanese economy, and should thus be borne in mind when seeking to achieve the sustainable recovery and overcome deflation in Japan.

### **World economic recovery and Japan's economy**

Let me briefly comment on the recent recovery in the world economy before turning to the current situation and the outlook for Japan's economy. The world economy has been recovering at a steadier pace than expected. The growth rate increased to around 3.9 percent in 2003, and is most likely to increase further to around 4.5 percent in 2004.

In particular, the rapid growth of the Chinese economy has been conspicuous. It was over 9 percent in 2003, despite the adverse effect of severe acute respiratory syndrome (SARS). In fact, the Chinese economy has been growing at an annual rate of 8 to 9 percent as if it were hardly susceptible to economic fluctuations. Recently, whether the economy will smoothly adjust to a more moderate and sustainable growth path is becoming a focus of attention.

The current recovery, driven by expansion in the world economy, particularly the Chinese economy, seems to differ from the past in that Japan's economy is not just exporting its way out. As I remarked at the beginning, the interrelationships among various economies have become pronounced. It is worth noting that substantial progress has been made in the international division of production processes, particularly for IT-related goods in which the division of labor and concentration of production tend to work most effectively.

IT-related investment has been pursued actively all over the world, led by the United States. Against this background, the process of manufacturing finished goods has been increasingly carried out across a number of countries to take advantage of differences in the degree of technological progress, the make-up of the labor force, the condition of infrastructure, and the efficiency of public services.

Interrelationships among economies have also been strengthened through integrating production processes across borders. For example, the production of semiconductor fabrication machines and equipment as well as high-value-added parts for digital home appliances has been rising in Japan. These parts as well as machines and equipment have been shipped to the East Asian countries for processing and assembly, which have also been on the rise recently. Finally, finished goods have been exported, for example, back to Japan.

Thus, in the trade between Japan and other East Asian economies, both exports and imports have been increasing substantially. The recovery in the Japanese economy should be understood as taking place in tandem with the strengthening of its interdependence with the world economy, and particularly with other East Asian economies.

### **Current situation and outlook for the economy**

Japan's economy has entered a recovery phase since around the summer of 2003. During 2004, the recovery has gradually been spreading from manufacturing to nonmanufacturing firms, from large to small firms, and from urban to regional economies. The decline in employment and household income is finally coming to an end, and Japan's economy is expected to continue recovering.

At the end of April, the Bank released the economic outlook for fiscal 2004 in its *Outlook for Economic Activity and Prices*. In the Outlook, the majority of Policy Board members forecast real GDP growth for fiscal 2004 in the range of 3 to 3.2 percent. If this forecast is achieved, the economy will have maintained year-on-year growth of about 3 percent in both fiscal 2003 and 2004. Although this does not measure up to the growth rate of the United States, it is well above that of the European Union (EU).

Japan's economy is likely to continue recovering, gradually gaining momentum. Exports and production are expected to increase as overseas economies continue to record high growth. Corporate profits are likely to continue increasing reflecting firms' success in reducing costs and strengthening their financial conditions. Higher profits are likely to continue raising business fixed investment, particularly among manufacturers. A recovery in household consumption will become probable, as the positive effects of the rise in production and profitability are expected to spread gradually to the household sector via improvements in the employment and income situation as well as in asset prices.

Regarding the year-on-year change in the consumer price index (CPI), the forecasts of the majority of Policy Board members are projected to remain negative, in the range of minus 0.1 to minus 0.2 percent in fiscal 2004.

The output gap in the economy as a whole, which affects the underlying price trend, is expected to narrow, reflecting the economic recovery. The extent of the narrowing, however, is hard to estimate because firms tend to start new investment related to technological innovation before capacity utilization becomes too high.

Although the rise in commodity prices at home and abroad has started to influence the prices of raw materials and intermediate goods, its impact on the prices of finished goods is likely to be rather limited. Upward pressures on the prices of finished goods are expected to be offset mostly by the increased productivity in the corporate sector, which is one of the new features of the world economy.

Furthermore, temporary factors that have been pushing up prices, such as the increases in both medical costs and rice prices, and have contributed to a slowdown in the rate of decline in consumer prices, will start to fade.

### **Structural problems in the private sector**

As described earlier, the current Japanese economy reflects the new features of the world economy. In addition, structural problems, such as firms' excessive capital stock, debt, and labor, as well as

financial system problems have hindered Japan's economic recovery over the past decade or so. These problems still continue to weigh on the economy to some extent.

A feature common to all of the recovery phases since the bursting of the bubble is that the recovery was seen mostly among large manufacturers, and did not spread much to other firms or to households. This was because, when compared with large manufacturers, nonmanufacturing firms and small firms suffered more severely from excessive capital stock, debt, and labor, and they could not adopt aggressive strategies. Furthermore, adjustment in employment and wages undoubtedly delayed the recovery in household consumption.

The excessive debt problem of firms is none other than the nonperforming loan (NPL) problem of banks. The NPL problem triggered a vicious cycle, causing a decline in the risk-taking ability of banks, and in turn hampering the recovery of firms whose funding is highly dependent on bank loans.

It seems that the intertwined structural problems that have been such a burden on the Japanese economy are at last gradually being resolved, as the past efforts of firms and banks bear fruit. This has been evidenced by the recent recovery in corporate profits and the abatement of concerns over financial system stability.

Many point to sustainable growth of the world economy as the prerequisite for Japan's continued recovery. However, in my view, the more important prerequisite is that firms and banks accelerate their efforts to resolve structural problems.

Let me elaborate on this issue.

### **Efforts by the corporate sector**

In contrast with the period of rapid economic growth, an increasing number of firms are placing more emphasis on future cash flow than sales in assessing their business performance, and they have started taking on new business opportunities geared toward raising value added.

Firms have become extremely conscious of their financial soundness after experiencing the bursting of the bubble and concerns over financial system stability. They have been accelerating their adjustment of excessive capital stock and labor, as well as raising their capital adequacy ratios by reducing interest-bearing debts. These developments are particularly evident among manufacturers who continue to reduce debts even though their interest-bearing debts have already declined to the levels seen before the bursting of the bubble. Such developments seem likely to spread gradually to nonmanufacturing firms and small firms.

In the Bank's most recent March *Tankan* (Short-Term Economic Survey of Enterprises in Japan), profits improved in a wide range of industries, not only among large manufacturers but also among nonmanufacturing firms and small firms. In fact, corporate profits have been increasing significantly in spite of relatively small increases in sales. This indicates not only the cyclical strengthening of the economy but also the strengthening of the corporate structure accompanying progress in dealing with structural problems.

### **Problems in the financial system**

Although there are still more than a few problems left for banks to deal with, they have made substantial progress in dealing with NPL problems over the past year or so. Major banks have made considerable progress in disposing of NPLs, although the pace of disposal has varied across individual institutions. Combined with the rise in stock prices, their capital adequacy ratios recovered, on average, to around 11 percent at the end of September 2003. Regional banks have also made progress in reducing NPLs, but the pace of disposal has been slower than at major banks.

Under such circumstances, banks' lending attitude seems to be gradually becoming more accommodative. The lending attitude as perceived by firms in the *Tankan* has improved moderately. In the most recent March survey, the number of firms that responded that banks' lending attitude was "accommodative" exceeded those that responded "severe."

The Bank intends to encourage these favorable developments. Japanese banks need to realize that they will no longer be able to satisfy the diverse needs of their customers simply by increasing the supply of conventional bank loans. As a matter of fact, it is encouraging that a considerable number of

banks have already launched initiatives toward introducing new methods of credit extension, expanding existing channels for credit extension, managing their credit portfolios proactively, and developing more sophisticated risk management systems. The Bank will back their efforts to establish new business models, as stated in its "On-Site Examination Policy for Fiscal 2004."

The full removal of blanket deposit insurance in April 2005 will be an important challenge for banks, as it will put their true financial strength to the test. The Bank hopes that efforts such as those I have described will enable many banks to regain market confidence and allow them to meet this challenge on their own.

### **The situation in the household sector**

Finally, let me turn to the household sector. Consumers have been rather restrained in their spending as they have experienced prolonged economic stagnation and the frequent emergence of concerns over financial system stability.

Recently, however, there have been signs that consumers' attitude has become somewhat less restrained. For example, the growth rate of the amount outstanding of banknotes in circulation has been slowing recently. In the past, the growth in banknotes surged when major financial institutions failed in 1997 and 1998 or when blanket deposit insurance was partially removed in April 2002. This was mainly because people who felt concern over the soundness of banks increased their cash on hand. The recent decline in the growth rate of banknotes suggests that these concerns have been abating.

Household consumption has been rather firm recently despite the sluggishness in household income. This may indicate that the economic recovery has improved consumer sentiment.

There seem to have been changes in consumers' attitude and in household consumption. In this regard, we need to watch carefully whether the emerging pattern of household consumption differs somewhat from that previously observed in Japan. Thus far, the basic view of the Bank is that household consumption recovers on a sustainable basis when backed by rising household income, and it is this virtuous cycle of income and spending that we would like to see firmly established. However, in the United States, household consumption frequently increased ahead of improvement in the economy as a whole. Something similar seems to be occurring in Japan, with the introduction of state-of-the-art technology products, such as flat-panel TVs, DVD recorders, and digital cameras; consumption has been stimulated in spite of the lack of a marked increase in household income.

Let me also mention the types of savings by the household sector. Since "safety first" has been the traditional savings habit of Japanese households, an excessive proportion of their savings is held in the form of safe assets, such as bank deposits.

For the truly dynamic development of the economy, however, it is crucial that diverse channels of credit provision, particularly financial intermediation through markets, should be fostered. Financial institutions have already been striving to develop new business models geared toward this end, as well as to improve the functioning of financial markets. If households, which are the ultimate source of savings, remain extremely risk-averse, a significant mismatch in the supply of and demand for savings will emerge.

In the future, particularly after the full removal of blanket deposit insurance in April 2005, and also in the context of the reform of the Japanese postal savings system, efforts should be made across the board to encourage households to diversify risks in their savings.

### **Conduct of monetary policy**

Japan's economy is expected to continue recovering in fiscal 2004, with the momentum for recovery spreading to a wider range of industries. Persistent efforts across the board are necessary to achieve sustainable growth and overcome deflation. The Bank, for its part, will continue the extremely easy monetary policy, thereby backing private-sector initiatives to deal with structural problems and enhance market mechanisms.

The current easy monetary policy consists of three elements.

The first element is the provision of ample liquidity to the money market. As a result, concerns over liquidity have almost disappeared in the money market, and financial institutions can concentrate on their businesses without worrying about raising funds in the market.

The second element is the policy commitment. The Bank has made a commitment to continue the current policy until the year-on-year change in the CPI registers zero percent or higher on a sustainable basis. This commitment has facilitated market participants' projection of future interest rates, and market interest rates have been stable. Firms have been able to enjoy a stable market environment in which they can raise funds at low interest rates.

The current easy monetary policy is expected to have a stronger positive impact on economic activity in the private sector as the economy recovers further. Given that the Bank's policy commitment allows firms to continue enjoying low funding costs and that the economic recovery raises the expected rate of return on new investment, firms' profitability on investment will increase. Firms will become more proactive in seeking investment opportunities. Banks will also benefit from increased opportunities for profit from lending and other financial services. With this impact in mind and with a view to overcoming deflation, the Bank is determined to pursue the extremely easy monetary policy even as the economy continues to recover.

The third element is the Bank's efforts to improve the transmission mechanism of monetary easing. It is important to promote new financing channels other than bank lending in order to ensure that the effects of monetary easing permeate throughout the economy. These efforts will also improve Japanese capital markets over the long term.

As part of these efforts, the Bank started to purchase asset-backed securities (ABSs) from July 2003, and to date, the total accumulated amount of ABS purchases has amounted to around 580 billion yen. The Bank's purchases of ABSs have stimulated the capital market, and ABSs, which had been little used in Japan, are now becoming increasingly familiar.

Furthermore, the Bank hosted a Workshop on Securitization to back the development of the securitization market, and exchanged views with market participants about practical problems and possible solutions to developing the market further. The Bank released a report on the Workshop in April, and proposed specific measures to evaluate the prices of securitized products more accurately and efficiently and to reduce costs related to the structuring and trading of these products.

The Bank has already begun taking concrete measures to nurture the development of the securitization market. It is planning to conduct a "Survey on Securitization Market" and to partly remove the prohibition-of-transfer clause attached to some of the receivables whose debtor is the Bank.

### **"Exit policy"**

There are views that the Bank is avoiding discussion on the termination of the quantitative easing policy, or the so-called "exit policy," for fear of overreaction by market participants.

It is true that the zero percent year-on-year change in the CPI specified in the current commitment is merely a milestone, and therefore the Bank intends to study how to conduct monetary policy in a transparent way beyond that point. However, under the current circumstances, it is still too soon to specify a concrete policy framework. For the time being, therefore, it is important that the Bank concentrate all its efforts on achieving the goal contained in the existing commitment.

When extricating itself from an unusual financial environment as at present, the Bank should be fully aware of the risk that expectations regarding financial market developments, such as the outlook for long-term interest rates, may become unstable. As the economy passes the zero percent milestone, the Bank should be extremely careful to avoid sharp fluctuations in financial markets and to prevent any sudden discontinuities in market conditions.

Financial markets sometimes overreact to a shock, but they are also capable of absorbing it. Fundamentally, market conditions reflect the outlook for economic activity and prices. Therefore, the Bank will strive to accurately assess the economic and financial situation, communicate its thinking to market participants, and enhance the functioning of the market.

Let me add that, to achieve stability in long-term interest rates, it is particularly important that the government maintains sound fiscal discipline and takes investors' needs into consideration when issuing government securities.

## **Conclusion**

In concluding, let me point out a few things that I feel are important for the long-term development of the Japanese economy.

First, Japan should be at the forefront of the race to create new technologies and ideas. High-quality human capital is the key to achieving this goal.

Second, Japan should take the initiative in promoting the formation of a community of Asian economies whose mutual economic ties are even stronger than the fledgling ties enjoyed at present. This would help rectify global economic imbalances.

Third, Japan should play a prominent role in developing sustainable energy sources and creating innovations that contribute to solving environmental problems.

Lastly, Japan should prepare itself to deal with the various problems attending its declining population.