Toshiro Muto: What lies beyond this cyclical recovery?

Speech by Mr Toshiro Muto, Deputy Governor of the Bank of Japan, at the Japan Society, London, 7 June 2004.

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Good afternoon, ladies and gentlemen. Today, after touching on a short-term outlook for the Japanese economy, I will talk about further challenges Japan faces.

I. Short-term outlook for the Japanese economy

The outlook for the Japanese economy is reasonably good for the foreseeable future. As you see in Chart 1, economic growth, after showing 3.2% for fiscal 2003, will be 3.1% for fiscal 2004 according to the median forecast by the Bank of Japan's Policy Board at the end of April.

The ongoing economic recovery is the third of its kind since the bursting of the bubble in the early 1990s. During the so-called "lost decade," we had two economic recoveries: one with 3.6% growth for fiscal 1996, and the other with 3.0% growth for fiscal 2000. The first recovery was immediately followed by a sharp slowdown and the second by negative growth. Compared to these two cases, now the chances are better that the recovery will be sustained. Behind that are three factors.

The first factor is an encouraging outlook for the world economy in spite of some risks associated with persistently high oil prices. Many economists believe that the United States will grow at a faster pace than its potential growth rate. While the economic growth of China is expected to decelerate somewhat from the overheated pace, it is still likely to be fairly rapid.

The second factor is great demand for digital consumer electronics at home and abroad. This provides favorable business conditions for Japanese manufacturers, whose competitive edge lies in high-end electronic devices including flat-screen panels. This is an important reason for the recovery in business fixed investment. The Bank's corporate survey Tankan shows that nominal capital spending by large manufacturers will increase by more than 7% for fiscal 2004 after a 9% increase for fiscal 2003.

Third and the most important factor behind the good economic outlook is progress in the structural adjustments. Chart 2 illustrates that the ratio of corporate debt to cash flow has been declining steadily. The improvement is observed even in the small and medium-sized nonmanufacturing firms, the sector which was once under a particularly heavy debt burden. As for the adjustment in labor, Chart 3 shows that the share of labor costs in the nominal GDP declined to the lowest level since the early 1990s.

In connection with the structural adjustments, as Chart 4 shows, progress has also been made in reducing nonperforming loans. As far as major banks are concerned, they as a whole seem to be hitting the March 2005 target, namely, lowering the share of nonperforming loans in total credits to half of that in March 2002. Of course, Japan's financial institutions are still facing quite a few problems. In this regard, they should step up their efforts to reduce nonperforming loans and contribute to corporate restructuring. And they should be well prepared for the removal of the blanket deposit insurance, which is scheduled for April 2005.

As the structural adjustments have progressed, an opportunity for sustained growth is finally arising. In order to turn this nascent opportunity into full-scale revitalization of the economy, both the private sector and the government should work harder.

II. Conduct of monetary policy

On the part of the Bank of Japan, we continue to maintain the monetary conditions which should help deflation come to an end. Chart 5 shows that deflation has been easing but the year-on-year change in the consumer price index (CPI) has not yet reached positive territory even with the help of upward one-off factors including a rise in rice prices. Based on the assessment that the underlying trend of the CPI is still moderately negative, the Bank is conducting an extremely accommodative policy with three features.

First, the Bank is providing unusually ample liquidity to financial markets. The so-called “quantitative monetary easing” keeps short-term interest rates at almost zero, thereby ensuring the stability of financial markets, which in turn supports economic activity.

Second, the Bank is conducting its policy with the commitment to continue quantitative easing until deflation ends. The resultant “policy duration effect,” by working on expectations about future monetary policy, contributes to further stabilizing financial markets.

Third, the Bank is making efforts to enhance the transmission mechanism of monetary easing. For instance, the Bank has already been expanding the types of money market operations. Moreover, the Bank is eagerly communicating with market participants and other authorities as to how to expand the securitization market.

Of the three features of the current monetary policy, let me elaborate on the second one: the Bank’s policy commitment. In this commitment, the Bank will maintain quantitative easing until the core CPI registers stably zero percent or an increase year-on-year. More specifically, before the Bank considers terminating quantitative easing, certain conditions must be met: the core CPI inflation has been positive over a few months and it is forecast to remain positive in the future.

As for the inflation forecast, the semiannual *Outlook Report* at the end of April shows that the Board members’ median outlook for the core CPI for fiscal 2004 is –0.2%. Although the narrowing output gap and the lagged effects of a rise in commodity prices will contribute to moderating CPI deflation, they will not be strong enough to make year-on-year CPI firmly positive for fiscal 2004.

I believe that sustained reforms in both the private and the government sectors, together with the Bank’s commitment to keep monetary easing, will help the economy gather momentum, which in turn will lead to a better possibility that deflation comes to an end.

III. Longer-term issues for the Japanese economy

Despite the encouraging short-term outlook, the aging and declining population is a source of concern for economic growth in the long run. Any attempt to address this concern would cause a conflict of interests with regard to income transfer and risk sharing. How to deal with this type of conflict is a particularly daunting challenge.

Challenges arising from population aging

Let me explain how serious the demographic change is in Japan. As is shown in Chart 6, Japan’s population is expected to start declining in 2007. Moreover, the share of elderly people of 65 and older has been increasing since around 1990 and is now approaching 20%. In 2050, the share is expected to reach 36%, the second highest in the world after Spain. Not only is the share among the highest, but the rising pace of the share is unparalleled. There are calculations by the United Nations as to how many years it takes for the elderly people’s share of each country to double from 10% to 20%: 42 years for Spain, 70 years for Germany, 75 years for the United Kingdom, but only 21 years for Japan.

The rapid population aging will certainly have significant impacts on the economy. First, the labor force will decrease. According to the Bank’s research staff, assuming that the labor participation rate at any given age stays constant, the decline in the labor force caused by the demographic change will pull down the economic growth rate by 0.5% in the 2010s.

The second impact of population aging is on the savings rate. Chart 7 illustrates that the household savings rate in Japan has already been declining in line with population aging. It declined from about 15% in the early 1990s to merely 6.4% in 2002. Assuming that the declining savings rate restrains capital formation, the Bank’s research staff estimated that the economic growth rate in the 2010s would be reduced by 0.5%. Together with another 0.5% decline coming from the labor factor that I mentioned, the economic growth rate overall will decline by as much as 1%.

The third problem caused by the population aging is increasing doubt about the sustainability of the pension system. Chart 8 shows that the Japanese birthrate has been steadily declining, with the most recent figure being as low as 1.32. If it continues for the next hundred years, a rough estimate suggests that Japan’s population will become only one-third of the current population. While a much higher birthrate is required to maintain the current pension system, raising the birthrate in a short period of time is not realistic. Therefore, there is an imminent need for massive pension reform, notwithstanding the difficulty in allocating the huge losses carried over from the past system.

Inevitable rise in the cost of the social safety net

As the population ages, not only pension benefits but also demand for medical services and elderly care will increase. However, younger generations are unsure as to whether the increasing demand will be met. According to a survey conducted by the Bank's affiliate, the Central Council for Financial Services Information, among the households headed by those under 60, 19% were "very worried" about retirement in 1995, and the share more than doubled to 45% in 2003.

Changes in the social structure and lifestyle may also be sources of uncertainty about the future. Traditionally, family members cared for their aged parents and neighbors helped each other, while businesses, under the so-called "lifetime employment system," provided employees with education, welfare, and job security. However, as lifestyles have been changing and companies have been involved in increasingly fierce global competition, those traditional safety nets have become less dependable. This puts the public sector in a position where it has to play a greater role in providing social safety nets.

As for the national burden, there appears to be some room for enhanced safety nets. Chart 9 shows that the "national burden," defined as the sum of taxes and social security contributions, currently stands at 36% of national income. The ratio is much smaller than those for some European countries. If we use the "potential national burden," which includes the fiscal deficit, the same conclusion still holds. Although this suggests that shouldering a somewhat heavier burden for somewhat better safety nets is a reasonable option for Japan, the question of how much remains.

All in all, it is not easy to achieve a national consensus on how much higher benefits and burdens will be appropriate. It may take some time before Japanese people make a choice.

IV. To the second stage of structural reforms

The worst scenario is that Japan will fall into a "heavy burden but insufficient benefit" society, which might actually take place without a gain in productivity. It is exactly in this context that the structural reforms should be propelled further. Among many reform agenda, I will focus on the importance of facilitating further integration of Japan into the global economy.

Further integration into the global economy

Although at home resources are constrained by the declining population, there is a great source of usable technology, labor, and management skills abroad. I believe that what determines a nation's long-term economic growth is not its population but its flexibility in taking advantage of globally available resources. Let me discuss two aspects of globalization: use of the foreign management resources and use of foreign labor force.

The first aspect is to introduce more foreign management resources. As Chart 10 shows, although foreign direct investment into Japan has been increasing considerably, the stock of direct inward investment as a ratio to nominal GDP is still much lower than the same ratio for other countries.

One good example is the United Kingdom in the 1980s. Tax incentives, infrastructure improvements, and other measures were taken to promote foreign inward investment. Japanese manufacturers, encouraged by the U.K. government, decided to build their factories here; Nissan was an early good example and many others, particularly automobile companies and electrical appliances companies, followed suit. The core of the reform in the United Kingdom was perhaps its willingness to be open to the world.

Many years later in the late 1990s, it was again Nissan that became a model, this time, of demonstrating the merits of learning from foreign management. Mr. Carlos Ghosn came to Nissan as a new president, transforming the company at a crisis into one with years of record performance. The revival of Nissan, by creating a more competitive environment, contributed to invigorating the entire automobile industry and triggered a large-scale restructuring of suppliers.

The second aspect of global integration is more extensive use of foreign labor. Some people express their concern that if the introduction of foreign workers is too rapid, unbearable friction will arise, particularly for a homogeneous country like Japan. However, in certain areas of the economy, for example the service industry, the growth potential hinges on the availability of the labor force. There must be a balance between expanding foreign employment, directly or through outsourcing, and avoiding excessive socioeconomic changes.

After all, many countries are getting more active in the global allocation of resources, and Japan has to compete with them. Under these circumstances, a key to economic prosperity lies in a continuous trial and error process of combining globally available technology, management, and human resources with the merits our economy has on its own.

Concluding remarks

As I have discussed, Japan's economy is still facing many challenges, particularly in the long run. On the other hand, prospects of a continued economic recovery are good at least for the time being. The Bank of Japan, for its part, will continue making every effort to bring deflation to an end, thereby creating a better environment for further progress in structural reforms.

Thank you for listening.