Toshihiko Fukui: The current situation and outlook for the Japanese economy

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at the Kisaragi-kai meeting, Tokyo, 11 November 2004.

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Today I will talk about the Bank of Japan's assessment of the economy and the thinking behind its conduct of monetary policy with reference to the *Outlook for Economic Activity and Prices* (hereafter termed the Outlook Report) published in October 2004.

I. Recent economic developments

The Japanese economy is currently in the process of recovery. Since the early 1990s, it has on a number of occasions appeared to be entering a recovery phase. Each time, however, the recovery soon ran out of steam and the economy slipped back into recession. These recessions were without exception marked by deep troughs. Excesses in production capacity, the work force, and debts, coupled with weakness in the financial system, increased the severity of the slowdowns.

The 1990s have often been called Japan's “lost decade,” but they have not passed entirely without accomplishment. On the contrary, there has been progress in structural adjustment over this period, as excess production capacity and debts have been dealt with. On the managerial front, new forms of collaboration have emerged between firms regardless of the sectors to which they belong, and individual firms have aggressively undertaken new and innovative investment, raising their ability to generate new products and services offering high value added. The fruits of these endeavors are clearly visible in recent corporate profitability. According to the forecast in the September *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the ratio of current profits to sales for fiscal 2004 should exceed the peak reached during the recovery phase of the 1990s, and is expected to attain a level comparable to the high point of the bubble period. Underpinned by such broad-based efforts by firms, the current economic recovery may be viewed as having a stronger foundation than previous ones.

Turning to the economic environment in which Japan finds itself, we observe continued worldwide economic expansion led by countries such as the United States and China. In the United States, productivity surged in the 1990s reflecting continuing technological innovation, particularly in IT. Moving into the first decade of the 21st century, despite a brief period of adjustment following the bursting of the IT bubble, since 2002 the economy has been in a recovery phase and has been achieving high growth. Although the rise in crude oil prices and slowdown in demand for IT-related goods have recently been restraining the pace of economic growth, it appears likely that the U.S. economy will continue to expand at a steady and sustainable pace. China continued to achieve high economic growth as it increasingly adopted open-market policies throughout the period from 1992, when Chinese leader Deng Xiaoping made a famous speech during his tour of southern China, to 2001, when it joined the World Trade Organization. Its presence in the global economy is growing rapidly. Although there is a risk of investment overheating, the fundamentals remain in place for continued robust growth. It is worth mentioning the projections by the International Monetary Fund for growth in the world's real GDP in 2004 and 2005 - at 5.0 percent and 4.3 percent, respectively - which support the view of continuing worldwide economic expansion.

Against the background of economic expansion overseas, Japan's exports and production are likely to continue increasing, and in turn, corporate profits and business fixed investment are expected to rise, reflecting the efforts of firms in Japan mentioned earlier. Thus, the economy is expected to continue recovering underpinned by a virtuous cycle where the improvement in corporate profits and the employment situation leads to an increase in household income and furthermore household consumption. In the Outlook Report published in October, the majority of the nine-member Policy Board forecast real GDP growth for fiscal 2004 ranging from 3.4 to 3.7 percent, with the median at 3.6 percent. Comparable figures for fiscal 2005 ranged between 2.2 and 2.6 percent, with the median at 2.5 percent. Although ostensibly this represents a slowdown, it should be noted that the growth rate for fiscal 2004 is pushed up by the high growth rate in the second half of fiscal 2003. In fact, the figures suggest that the Japanese economy is in the process of shifting to a sustainable growth track.

Turning to prices, domestic corporate goods prices are likely to continue increasing for the time being owing partly to rising domestic and international commodity prices, particularly crude oil prices. It is noticeable, however, that higher corporate productivity and restraint on labor costs have meant that consumer prices remain relatively resistant to increases in economic activity, and this tendency is likely to persist. In the Outlook Report, the forecasts provided by the majority of the Policy Board members envisioned the year-on-year rate of change in the consumer price index (CPI; excluding fresh food, on a nationwide basis) for fiscal 2004 as ranging between minus 0.2 and minus 0.1 percent, with the median at minus 0.2 percent, and for fiscal 2005 as ranging between minus 0.1 and plus 0.2 percent, with the median at plus 0.1 percent. I will return to this subject in more detail later in my remarks.

Forecasts are always subject to qualification. Factors that may cause either positive or negative deviations from the forecasts in the Outlook Report published in October include (1) developments in overseas economies, including movements in crude oil prices and demand for IT-related products; (2) developments in domestic private demand; (3) developments in domestic financial and foreign exchange markets; and (4) issues relating to the health of the financial system and the disposal of nonperforming loans. Details on these factors are provided in the Outlook Report. Here, I will touch upon two issues with an important bearing on the direction of both overseas and domestic economies, that is, crude oil prices and demand for IT-related goods.

Crude oil prices are hovering around the highest level ever recorded: West Texas Intermediate (WTI) crude oil prices have been around 50 U.S. dollars per barrel. While prices for light crude oil (which has a larger gasoline component) have surged, those for heavy crude oil (with a smaller gasoline component) have remained at a relatively low level, with the unprecedented large price difference continuing between the two. Thanks to its large refining capacity for gasoline, Japan's imports of crude oil are concentrated among medium and heavy crude oil, so that the rise in the overall price of crude oil imported to Japan is relatively small. In addition, considering factors such as the consumption of oil per unit of real GDP, which is about 70 percent of that of the United States, as well as the highly efficient utilization of energy resources in Japan, the direct impact of crude oil prices is not expected to be particularly large for the time being.

More worrisome is the indirect impact from overseas economies. If crude oil prices remain at high levels, major energy-consuming nations will see their household spending power adjusted for inflation come under pressure, considerably affecting economic activity. Some observers claim that the rise in crude oil prices will cause a decline in the pace of expansion of the global economy, and as a result push down crude oil prices. However, there is considerable uncertainty as to when this endogenous mechanism will come into play. Meanwhile, the fact is that, given the limited supply-side potential vis-à-vis rising demand and the further threat to the supply side offered by heightened geopolitical risks, the risk of a further rise in crude oil prices cannot be ruled out completely. So far, there seems to be very little risk of a slowdown in the global economic expansion, but developments in crude oil prices, along with their effects on the world economy, will have to be monitored closely.

Equally important are developments in demand for IT-related goods. At present, the Japanese IT industry, which had witnessed an unintended buildup in levels of stocks, has been in the process since the summer of adjusting production and the level of stocks in response to the slowdown in international demand for IT-related goods. This adjustment is very likely to be mild, since not only have firms adopted a more cautious production stance and been quick to take action with regard to stock levels, but also the base of IT-related demand has been expanding in response to, for example, growth in the market for digital household appliances. However, on top of the volatility and unpredictability of worldwide demand for IT-related goods, the widespread international division of the production process has meant that it is increasingly becoming difficult to gain a clear picture of developments in IT-related sectors. There is a risk, therefore, of an unexpected fall in shipments that may lead to a sizeable adjustment. In this connection, sales around the year-end both at home and abroad will have to be monitored closely.

II. Three features of the current recovery phase

Next, I would like to discuss some of the more distinctive features of the current recovery phase. The first of these is the recovery in the household income situation which, although production and corporate profits continue to increase, remains moderate to date. The second is the fact that, in spite of the moderate nature of this recovery in household income conditions, household consumption continues to show some positive movements. The third feature is the underlying price trend, with the year-on-year change in consumer prices continuing to register a slight decline notwithstanding the ongoing economic recovery. Since there is a close relationship between these features and the outlook for the Japanese economy projected in the Outlook Report, I would like to explain the Bank's view of each of them in turn in some detail.

A. Moderate improvement in the household income situation

The course of the current recovery has seen the pace of decline in household income gradually shrinking, with 2002 marking the low point. However, the year-on-year change in household income has yet to turn positive, even this year.

Movements in household income can be decomposed into movements in the number of employees and in the average wage per worker. Looking at movements in the number of employees, we see that although there has been a general decline in recent years, since the middle of 2003 the year-on-year growth rate, while fluctuating on a monthly basis, has moved into positive territory. Within these figures, we observe that while numbers of regular employees continue to decline, numbers of so-called "non-regular employees" - in other words, part-time and temporary workers as well as those working on pro rata contracts - have continued to increase rapidly, so that the proportion of non-regular employees in the work force has expanded significantly. Statistics compiled by the Ministry of Internal Affairs and Communications show that non-regular employees now make up about 30 percent of all employees.

On the other hand, while the rate of decline in the average wage per worker has been abating, the year-on-year change remains slightly negative. The point here is the significant influence of the increase in non-regular employees just mentioned. There is inevitably a substantial difference in the average wages of regular employees, consisting mostly of long-term company employees and managers, and of non-regular employees who work mainly on fixed assignments. When the proportion of non-regular employees, with their lower average wages, increases, this pushes down the overall average wage per worker. In fact, looking at the wages of both regular and non-regular employees, we see that since 2003 they have finally either stopped declining or started to rise. Clearly, it is the rise in the proportion of non-regular employees in the work force that is responsible for the continuing decline in the average wage per worker.

Of relevance in this regard, as firms strive to restrain their labor costs by making aggressive use of part-time and temporary workers, is the progress made in the deregulation of the labor market, and in particular amendments that have relaxed the laws governing the employment of temporary workers. Another factor likely to have played a role is firms' increasing emphasis on raising profitability. For example, the share of labor in income distribution, i.e., household income divided by nominal GDP, which remained at a high level throughout the 1990s, has now been declining at a significant rate for several years and has recently been hovering below its 1980s average. Such movements in labor's share are likely to have been influenced by changes in firms' attitudes to corporate management, as they take effective advantage of deregulation of the labor market to review the distribution of their income between capital and labor.

I often hear the claim that Japan's economic recovery has not made itself properly felt. The delayed recovery of household income which we have been discussing may well be one reason for this. From the standpoint of the individual, if his or her wages do not increase, then it is perfectly natural that he or she has no genuine sense of a recovery. However, when we consider the extremely high level of corporate profits, it seems reasonable to expect that the beneficial effects of this will gradually feed through from the corporate to the household sector and at some point household income will start to increase. Some firms have commented that there may be a limit to the increase in the number of non-regular employees because job-specific skills and expertise cannot be fully shared and passed on among such employees. In fact, there are signs that the increase in the proportion of part-time workers in the work force has recently been slowing slightly. In this context, we will continue to carefully monitor these and other developments in household income.

B. Firmness in household consumption

The second feature of the current recovery phase is that, despite the fact that the improvement in the household income situation has remained moderate, household consumption has continued to show some positive movements. Although household consumption recovering ahead of household income is a phenomenon often seen in the United States, it is almost unprecedented in Japan, where households are usually unwilling to borrow to spend.

The recovery in household consumption in the absence of a significant improvement in household income has occurred not only as a result of structural factors such as Japan's changing demographics, meaning that there is a larger proportion of elderly people who have a higher propensity to consume, but also because the propensity to consume among elderly people has itself been rising recently. A number of reasons may be put forward for this rise. For example, there are those who point to the influence of the nursing insurance scheme introduced in 2000. Our view at the Bank is that a significant contribution has been made also by firms' efforts to gain a better grasp of the needs of customers and to provide them with new and attractive products and services that meet their requirements. Firms that have tailored their marketing strategies to specifically target the elderly have induced the latter to part with some of their liberal endowment of disposable financial assets. For example, it is said that flat-panel TVs and expensive guided tours are most actively purchased by the elderly.

Moreover, a recovery trend has also been discernible recently in the propensity to consume of people other than the elderly. It seems that firms have succeeded in inducing consumption across a range of customer age groups. A breakdown by spending behavior shows that spending is increasing in a wide range of areas: these include travel both within Japan and abroad, education geared toward lifelong learning and self improvement, and health and sports-related services. This suggests abatement of pessimism about future household income as the economy continues to recover. In this regard, the momentum for recovery in household consumption may be expected to receive a further boost as household income starts to increase.

C. Divergence between developments in economic activity and prices

As I mentioned earlier, consumer prices have recently been less responsive to increased economic activity. The third feature of the current recovery phase is therefore the divergence between developments in economic activity and prices. Underlying this divergence is the fact that firms are now able to produce a greater number of products more efficiently and at a lower labor cost.

Higher productivity has been achieved in a number of ways. Firstly, as in previous recovery phases, a cyclical mechanism has been working to put to good use idle labor and capital. Secondly, labor and capital resources have been used more efficiently than in previous recoveries, due both to firms' own streamlining efforts and to deregulation in various fields. Thirdly, there may have been steady long-term improvements in economic efficiency, due to technological innovation, especially the progress made in IT. At the same time, on the wage front, firms have been restraining labor costs by hiring part-time and temporary workers instead of regular employees.

As a result of this higher productivity and wage restraint by firms, unit labor costs, or labor costs per unit of output, have been declining significantly for the past few years and have reached an unprecedented low level. The declining unit labor costs have absorbed rises in various other costs, stopping consumer prices from increasing despite the continued economic recovery. The current decline in prices thus seems to be undergoing a qualitative change: from being rooted in a large outgap, it has gradually sprung more from improvements in productivity and firms' efforts to trim labor costs to enhance their competitiveness.

It is unlikely, however, that this situation will continue forever. It is undoubtedly the case that higher productivity increases the potential supply capacity, causing a temporary easing of labor market conditions which is unfavorable to wage increases. Nevertheless, so long as a rise in productivity does not occur continuously, sooner or later the labor that has been freed up will be re-employed and wages will start to rise. Along with developments in wages and household income, we will also need to monitor closely whether productivity gains will slow as the economic recovery continues, or whether they will continue to increase due to deregulation and innovations in IT.

Another factor that has caused prices to be less responsive to increased economic activity is firms' caution about changing their price-setting stance in view of intensified competition. Materials prices and intermediate goods prices are clearly rising at present according to the corporate goods price index, reflecting the surge in domestic and international commodity prices. Many firms have so far avoided passing this rise in costs on to final goods prices and have kept prices unchanged for the time being, with some claiming that they have been unable to raise final goods prices because of consumers' price sensitivity. It is necessary, however, to keep a careful eye on firms' price-setting stances, which may remain constant or change as the rise in materials prices gradually spreads to intermediate goods prices in line with the continuing economic recovery.

This divergence between developments in economic activity and prices is not a development unique to Japan. Industrialized countries around the world, including the United States and the United Kingdom, have been experiencing a similar phenomenon. The extent of the divergence varies of course by country and region. However, one common factor is increases in productivity and structural changes in the labor market, specifically deregulation and changes in the attitudes of employers and employees. Another potential factor is the reduction in price-setting power suffered by firms all over the world, following the advance of economic globalization. The intensified competition in the global market economy may perhaps be explained by the major shifts in political, economic, and social frameworks after World War II, including the entry of East European countries into the global economy after the fall of the Berlin Wall, the miraculous growth achieved by Asian economies, as well as the rise of the BRICs (Brazil, Russia, India, and China) as regional economic powers. Whatever the case, assessing price developments requires a firm grasp of the issues underlying them, and in this regard, we will continue to monitor carefully the situation surrounding prices both at home and abroad.

III. Conduct of monetary policy

Three and a half years have passed since the Bank introduced the quantitative easing framework, in which current account balances are used as the main operating target. The Bank has made a commitment, unprecedented in the history of central banks, to continue with the quantitative easing policy until the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) registers zero percent or higher on a sustainable basis. With this commitment, the Bank has continued to provide ample liquidity. In the current situation where consumer prices have been less responsive to the economic recovery, the commitment has contributed to stabilizing expectations about future interest rates and thereby market interest rates, and this situation has allowed firms to continue to enjoy low funding costs. Furthermore, as returns on investment increase with the recovery, returns net of funding costs are expected to rise gradually. Thus, the positive effect of the commitment on the economy, acting via interest rates, will strengthen as corporate profits increase along with the economic recovery. With the upsurge of business initiatives in the private sector and the recovery on a more solid track, the economy will eventually achieve sustainable growth and overcome deflation.

In the Outlook Report published in October, the median forecast of Policy Board members is for consumer prices to post a small year-on-year rise in fiscal 2005. However, the economy could deviate from the scenario set out in the outlook, either above it or below it, and future developments in prices may be influenced by movements in various factors, including crude oil prices, productivity, and labor costs. As things stand, it is uncertain whether or not an occasion will arise during fiscal 2005 requiring the present monetary policy framework to be changed. The conduct of monetary policy, more specifically the timing of the termination of the current monetary policy framework and the pace at which the Bank will raise short-term interest rates to keep them consistent with actual economic conditions, depends on future developments in economic activity and prices. If higher productivity and other factors continue to a large extent to contain upward pressure on prices as the economy moves to a sustainable and balanced growth path, this will likely give the Bank more latitude in conducting monetary policy.

Central banks should respond appropriately and flexibly to changes in economic and financial developments. As the effects of monetary policy are transmitted first of all via the financial markets, it is extremely important that the appropriate monetary policy be communicated to market participants in a lucid manner. On occasion, speculation of various kinds arises about the future conduct of monetary policy in financial markets. Market expectations thus have the potential to become extremely unstable in the future as the end to the unprecedented monetary easing approaches. To prevent the emergence of this kind of instability, the Bank will endeavor to offer a lucid explanation of its assessment of economic activity and prices as well as the thinking behind its conduct of monetary policy. Furthermore, the Bank will continue to enhance its communication with market participants so that they will be better able to judge and predict the future conduct of monetary policy. The content of this communication will depend on future developments in the economic and financial situation.

Some may comment that the explanation of the thinking behind the Bank's conduct of monetary policy and communication with market participants in the October Outlook Report is abstract and difficult to understand. This is to an extent inevitable, since the response of monetary policy must depend on the economic and financial situation at the time. In the current instance, the Bank's decision to present its thinking in the Outlook Report was taken under the premise that central banks and market participants should broadly share, to the extent possible, a common understanding about the conduct of monetary policy. This should make it possible to avoid undue speculation when changes are made to an unprecedented policy framework such as the current quantitative easing. With this in mind, the Bank will continue to maintain effective communication with market participants.