Toshihiko Fukui: Elaboration on the Bank of Japan's assessment of the economic and financial situation

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at a meeting with business leaders, Nagoya, 13 December 2004.

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The Japanese economy has been in a recovery phase since the summer of 2003. With the recent release of weak economic indicators mainly related to exports and production, market participants seem to have become a little bearish about the economic outlook. We believe, however, that the current slowdown in the pace of recovery is temporary, and that the economy is likely to move gradually onto a sustainable growth path. Today, I will elaborate on the Bank of Japan's assessment of the economic and financial situation, and the thinking behind the conduct of monetary policy.

Developments in overseas economies

Let me start with overseas economies, which provide the background to Japan's economic activity. Overseas economies, the United States and China in particular, are expected to continue expanding, albeit at a slower pace.

The U.S. economy is continuing its expansion supported by domestic private demand, including household consumption and business fixed investment. It seems to be emerging from a soft patch: the pace of increase in household consumption has picked up again, and growth in employee numbers has been recovering albeit with some fluctuations. Looking forward, the U.S. economy is expected to continue expanding steadily despite the fact that tax cuts have run their course and crude oil prices remain at high levels.

The Chinese economy is continuing to show robust growth underpinned by steady demand at home and abroad, and still seems to be overheating. Since this spring, the public authorities have taken administrative measures to deal with this overheating. Furthermore, the People's Bank of China raised its policy rates for the first time in nine years at the end of October 2004. We continue to closely monitor the effects of these measures on the economy.

The current economic situation and the sustainability of the economic recovery

Although growth in exports and production has been sluggish since the summer of 2004 and the annualized growth rates of real GDP for the April-June and July-September quarters of 2004 have both turned out to be more or less flat, there are several reasons for believing that a recovery mechanism remains in place.

First, exports and production are expected to resume trending upward. Their recent sluggish growth has been attributed to the lagged effect of the slowdown in overseas economies, and they are picking up again as overseas economies start growing. In addition, adjustment in production and inventories of IT-related goods is unlikely to be as severe as at the time of the bursting of the IT bubble in 2001. This is because demand for IT-related goods, such as digital home appliances and electronic parts for automobiles, has been expanding, and manufacturers have been adjusting their production and inventories promptly.

Second, with the rise in corporate profits, business fixed investment is expected to continue increasing. Although growth in business fixed investment slowed in GDP terms during the July-September quarter and the pace of increase in shipments of capital goods moderated, manufacturers seem to have maintained positive investment plans, supported by the higher corporate profits evidenced in the semiannual financial statements of listed companies at the end of September. Construction starts have been increasing in a wide range of areas, such as factories, office buildings, shopping malls, and delivery centers. Part of the reason for this may have been the growing tendency for pricing in real estate transactions to be based on the discounted cash flow method. We will get a clearer picture of corporate profitability and business fixed investment, particularly of small businesses and non-manufacturers, with the release of the upcoming December Tankan (Short-Term Economic Survey of Enterprises in Japan).

Third, the effects of improvement in the corporate sector are spreading steadily to the household sector, albeit at a moderate pace. Employee numbers are continuing to increase, and the perception that labor is in excess is becoming less acute among companies. The rate of decline in wages per worker is diminishing gradually despite companies' continuing labor cost restraint. Household income has bottomed out, and is likely to rise gradually with the increase in corporate profits and the relaxing of companies' perception that labor is in excess. Household consumption, underpinned by improved consumer sentiment, has been steady thus far, and is expected to increase at a moderate pace in line with the rise in household income.

We will continue to be vigilant against downside risks to the economy, such as those stemming from developments in IT-related demand and crude oil prices. Although adjustment in IT-related goods is unlikely to be severe, it may be somewhat protracted due to the inherent volatility in IT-related demand. We cannot deny the possibility that a prolonged adjustment in IT-related goods, if it happens, may affect the ongoing recovery through deterioration in business and household sentiment. In addition, although crude oil prices have recently stopped rising, they remain at historically high levels. We need to continue closely monitoring their impact on economic activity and prices, including the effects of their past rises.

In foreign exchange markets, attention has been paid to the downtrend of the U.S. dollar. Concern about the U.S. twin deficits is often cited as a reason for the weaker dollar. The U.S. economy, however, continues to maintain high growth, and with inflation rates remaining low due to increased productivity, it is still providing golden opportunities for investors in increasingly global financial markets. Confidence also remains high that fiscal and monetary policy will be directed toward securing sustainable economic growth. Given this situation, the United States is not experiencing difficulty in financing its deficit. Having said this, we need to carefully monitor foreign exchange rates and their impact on the economy since speculation may cause short-term volatility in foreign exchange and other financial markets.

Let me briefly comment on the recently released GDP statistics, which some see as confirming the weak economic recovery. The recent introduction of the chain index method for calculating the GDP deflator resulted in a downward adjustment of the real GDP growth rate from the figure calculated using the previous method. The problem with the previous method was that the base year was fixed, and this caused an increasing downward bias in the GDP deflator the further it moved away from the base year. The chain index method, which revises the weighting of various goods and services every year, has thus been introduced to reflect changes in the economic structure more appropriately. GDP statistics, which describe overall economic conditions, have their own properties and limitations like any other statistics. Since our evaluation of the economy has incorporated these properties and limitations, the introduction of the new calculation method is not thought to affect our overall assessment of the economy.

Progress in structural adjustments supporting economic recovery

The difference between this recovery and the two previous recovery phases since the bursting of the bubble is that, in both the corporate sector and the financial system, there has been progress in dealing with the structural factors affecting the Japanese economy, and as a result, the private sector has become more proactive.

Companies have made steady progress in addressing the structural problems of their excess holdings of debt, labor, and capital, and at the same time have made efforts to formulate business models generating high value added. Corporate profitability has therefore improved considerably. Ratios of current profits to sales in fiscal 2004, for both manufacturing and non-manufacturing companies, are expected to reach their highest levels since the bursting of the bubble.

Turning to the financial system, considerable progress has been made toward restoring the system to soundness. Recessionary phases since the bursting of the bubble have tended to involve a vicious circle in which the fragility of the financial system has amplified the extent of the recession, but this risk has diminished in line with the improvement in the condition of the financial system.

More concretely, financial institutions have made headway in dealing with their nonperforming-loan (NPL) problems, assessing and provisioning for NPLs more appropriately and employing a variety of measures to remove NPLs from their balance sheets and revitalize companies. Recently, progress has been made in the rehabilitation of large borrowers with a succession of schemes for radical reconstruction, some of which include the use of the Industrial Revitalization Corporation of Japan.

Efforts to revitalize regional businesses are also gradually bearing fruit, and as the economic recovery takes hold, improvements in companies' financial conditions and a more favorable assessment of these by market participants have become evident.

In the semiannual financial statements released last month, the ratio of NPLs to total loans for major banks stood at 4.6 percent, within sight of the target of halving the volume of NPLs on their books. For regional banks, the NPL ratio has been steadily falling, down to 6.4 percent from 6.9 percent registered at the end of March 2004. The costs of writing off and provisioning for loan losses, otherwise known as "credit costs," have declined overall, and this meant that most banks managed to close their books in the black. During this period unwinding of cross-shareholdings, which had been deemed excessive, progressed with a concomitant reduction in exposure to market risk. In addition, efforts geared toward reducing expenses and expanding fee business also began to bear fruit.

Thanks to this reduction in their exposure to credit risk and the market risk pertaining to stock price volatility, financial institutions have been less constrained in the uses to which they can put their capital, and this situation has encouraged them to seek new business opportunities. Indeed, there has been an intensification of efforts to strengthen profitability and reorganize businesses: banks' lending attitudes toward small and medium-sized businesses in particular have become more positive; some financial institutions are paying back previous injections of public funds; mergers between financial institutions are becoming widespread; and tie-ups with non-bank institutions are increasing.

As the April 2005 date for the full removal of blanket deposit insurance approaches, individual financial institutions may be expected to redouble their efforts to improve business performance. This will not only further reinforce the soundness and stability of the financial system, but it will also inject fresh vigor into the financial system as a whole.

At this juncture, a variety of businesses, including foreign companies and non-banks, will each be making use of their own particular strengths to compete by offering a wide range of financial services. In the markets for such diverse financial services, competitiveness will depend on the ability to accurately identify and respond efficiently to the full diversity of client needs. In their efforts to achieve this, it is hoped that various market players will generate a range of channels for financial intermediation, and that the financial system as a whole will become more innovative and increasingly robust to external shocks.

Making full use of the functions of on-site examination and off-site monitoring of financial institutions, the Bank backs up private financial institutions' efforts to develop creative new financial services, and hence to reinforce and improve the performance of the financial intermediary function.

Against this general background, although bank lending remains down year on year, this may be considered largely due to factors affecting companies' demand for loans. One of these factors is the problem of companies' excessive debt. In the non-manufacturing sector, although progress has been made, the ratio of total liabilities to total sales remains high and companies continue to pay down their interest-bearing liabilities. The situation is somewhat different in the manufacturing sector, where this ratio has fallen to a rather low level compared to the first half of the 1980s.

Considering that there has been a rise in corporate profitability, with the cost of raising funds remaining low, and that bankruptcy risk has fallen on the whole, it might reasonably be expected that companies, especially manufacturers, would be looking to increase their return on capital by raising their leverage. However, companies have become highly ratings-conscious. Their experiences in past periods of financial uncertainty remain fresh. And, their expectations of future growth are not yet sufficiently high. As a result, they retain an overall tendency to favor repaying their debts and strengthening their capital bases.

To grasp future developments in bank lending and its corollary, movements in the money stock, it is necessary not only to pay attention to the behavior of financial institutions and to debt repayments, particularly in the non-manufacturing sector, but also to keep a close eye on the extent to which companies' views regarding the economic outlook become more bullish as the recovery continues.

Outlook for prices and the conduct of monetary policy

The Japanese economy has been in a recovery phase since the summer of 2003. Domestic corporate goods prices have been rising partly due to high crude oil prices. Consumer prices, however, have been on a slightly declining trend due to the fact that the rise in corporate goods prices has mostly been offset by higher productivity and labor cost restraint.

The Bank has been providing ample liquidity in accordance with its commitment to continuing with the quantitative easing policy until the year-on-year rate of change in the consumer price index (excluding fresh food prices, on a nationwide basis) registers zero percent or higher on a sustainable basis. The positive impact of the commitment on the economy, acting via interest rates, has increased as the economic recovery has progressed. This impact is expected to become stronger as corporate profits continue to increase in line with the economic recovery.

The Bank's thinking on the future conduct of monetary policy was explained in the *Outlook for Economic Activity and Prices* published in October 2004. The Bank said that if higher productivity and other factors continue to broadly contain the upward pressure on prices as the economy follows a sustainable and balanced growth path, this will give the Bank more latitude in conducting monetary policy. Here, the "conduct of monetary policy" includes monetary policy decisions relating to 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 economic conditions at the time.

If prices remain less responsive to increased economic activity, the Bank can more flexibly and effectively respond to emerging economic situations. For example, it could choose to continue with the quantitative easing policy as long as possible, or it could choose to raise interest rates at a moderate pace after the termination of the policy. Whatever policy option is chosen in the future, it seems unlikely that the Bank will be required to take precipitate action. It is in this sense that it enjoys "latitude" in making monetary policy decisions. As an end to the quantitative easing policy approaches, the Bank will further endeavor to offer a lucid explanation of its assessment of the economic situation 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 predict the conduct of monetary policy.