Toshihiko Fukui: Toward sustainable economic recovery

Speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, to the Naigai Josei Chousa Kai (Research Institute of Japan), Tokyo, 28 February 2005.

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For Japan, this year is a crucial one, which may set the future direction of the country's economy. With the full removal of blanket deposit insurance scheduled for April 2005 now imminent, it is important to ensure that the financial system remains stable, the functioning of financial markets is further enhanced, and that the economy is brought firmly onto a sustainable growth track. Today, I will talk about the Bank of Japan's assessment of the economic and financial situation and the thinking behind its conduct of monetary policy.

I. Recent economic developments

The Bank releases its assessment of the economy as "The Bank's View" in the *Monthly Report of Recent Economic and Financial Developments* following discussions at Monetary Policy Meetings (MPMs). In "The Bank's View" for February, the Bank's assessment was that "Japan's economy continues a recovery trend, although there seem to be somewhat weak movements mainly in production."

In other words, the economy is at a temporary pause: production has been weak reflecting exports, which have been more or less flat. Production in the IT-related sector has been weak due to continued inventory adjustment reflecting lower-than-expected growth in demand for digital appliances and the decline in global demand for PCs and mobile phones. In addition, production in the materials-related industry is lackluster, as spare production capacity is limited. For example, with the surge in demand, especially in exports to other Asian economies, steel and chemical industries have been producing close to full capacity and find it difficult to raise their production levels immediately. In the processing and assembly industries, such as automobiles, it has been reported that firms may not be able to increase production due to the limited availability of materials such as steel plates. Although these firms cannot increase production significantly, they have been able to raise profitability by expanding margins and improving productivity.

Corporate profits are at high levels across most industries, although some IT-related firms have revised their profit forecasts downward. The ratio of current profits to sales in fiscal 2004 for firms of all sizes in all industries is likely to exceed not only the peaks recorded during the recovery phases of the 1990s but also the high point of the bubble period in the late 1980s. Given such improvements in corporate profits as well as a decline in structural adjustment pressures arising from excessive production capacity and debt, many firms are revising upward their business fixed investment plans for fiscal 2004. According to interviews with corporate management, firms seem likely to continue increasing business fixed investment in fiscal 2005. In the household sector, the employment situation continues to improve, and recently the figures for income appear to have bottomed out. Private consumption has been steady, although developments have lacked upward momentum due partly to adverse weather conditions.

Adjustments in the IT-related sector are likely to be completed in or after spring 2005, while trend expansion of overseas economies, particularly the United States and China, is expected to continue. Against this background, Japan's economy will gradually emerge from its current temporary pause and move onto a sustainable growth path.

II. Current economic situation in relation to the inventory cycle

Some hold the view that the Bank's outlook for the economy is a little too optimistic. They maintain that, in the expansion and contraction of the business cycle, an economy which has lost its upward momentum will inevitably enter a downturn. These views focus on the short-term business cycle mainly caused by cyclical fluctuations in inventories.

As the economy recovers, increases in product sales boost shipments, and thus cause inventories to decline. Firms then increase production to restore depleted inventories. However, if firms become bullish about the economic outlook and continue increasing production, at some point the pace of increase in production will exceed that of shipments and production will need to be curtailed to prevent inventories from accumulating. When shipments fall short of firms' projections, production will also need to be cut to reduce accumulated inventories. Although fluctuations in GDP caused by changes in firms' inventories tend to average out and so can generally be ignored, changes in inventory investment can be seen to have had a considerable impact on the business cycle in Japan, especially during periods of recession.

During the past two recessions of 1997-98 and 2001-02, the fall in final demand caused substantial inventory accumulation, and the subsequent inventory adjustment placed strong downward pressure on the economy. Current inventory levels are, however, low, and few firms perceive their inventories to be in excess. The general background to this is that many firms continue to keep a tight lid on inventories so as to increase their balance-sheet efficiency. By industry, while inventory adjustment pressure remains in the IT-related sector, inventory conditions in the materials and machinery industries have actually tightened with firms in these industries unable to produce fast enough to meet increases in shipments. Inventory adjustment in the IT-related sector is expected to be relatively mild since IT-related manufacturers have promptly reduced their pace of production. In this situation, it is unlikely that inventory adjustment will cause the economy to deteriorate.

III. Developments in overseas economies

There have been periods when developments in external demand rather than domestic demand have posed greater downside risks to Japan's economy. For example, the Asian currency crisis of 1997 and the bursting of the IT bubble in 2001 had a considerable impact on Japan's economy. Business cycles across economies worldwide have become more closely correlated as globalization has progressed. In the recent recovery phase, uncertainty has attended the outlook for external demand due to factors such as the unpredictability of geopolitical developments and the surge in crude oil prices.

Despite persistently high crude oil prices, there is less concern about the sustainability of overseas economic growth, and particularly the United States and China continue to expand steadily. In the United States, components of domestic private demand, such as household spending and business fixed investment, continue to increase, and the number of employees has been on an improving trend. Market attention has been focused on the sustainability of the U.S. twin deficits. The U.S. economy, however, seems unlikely to experience difficulty in financing its current account deficit for the time being, given that it continues to provide a high-growth, low-inflation environment and attractive opportunities for both domestic and foreign investors. Its fiscal deficit, the expansion of which is due partly to large-scale tax cuts, is expected to decline in line with the increase in tax revenues that will accompany the anticipated sustainable economic expansion. In China, overheating investment and an infrastructural bottleneck arising, for example, from the paucity of the electricity supply, are pointed out as potential sources of risk, and policy measures have been implemented to address these issues. Meanwhile, the Chinese economy continues to expand strongly, underpinned by firm domestic and foreign demand. These developments in overseas economies suggest that the associated downside risk is smaller than it was up to and including 2004.

IV. Relationship between business cycles and structural problems

It was thought that a greater degree of correlation between business cycles in economies worldwide would result in more volatile economic fluctuations. Recent economic fluctuations among major industrialized countries, however, seem to be displaying less volatility. The following are suggested as possible reasons for this: (1) changes in the economic structure which have resulted in a greater weight on less volatile components of demand such as consumption of services; (2) smaller fluctuations in the inventory cycle due to improved inventory management by firms; and (3) increased central bank credibility and the resulting stability of inflation expectations which have allowed central banks to avoid substantial tightenings of monetary policy that cause sharp economic downturns. In Japan, however, troughs in the two post-1990 recessions have been extremely deep. While these three factors have operated to some extent, excesses in production capacity, holdings of labor, and debts, along with the corresponding weakness in the financial system, have combined to place strong downward pressure on the economy.

Structural adjustment has progressed considerably in the current recovery phase. As mentioned earlier, corporate profits are likely to exceed not only the peaks recorded during the past two economic recovery phases but also that recorded during the bubble period. Since firms' success in dealing with their structural problems is reflected in their profitability, firms are judged to be approaching the end of a prolonged adjustment phase. In this situation, the pace of decline in land prices, which was substantial, has started to slow. While land prices have continued to plunge in regional areas, specific parts of some metropolitan areas have experienced surging prices. Land price developments such as these, as well as the factors causing them, require monitoring.

Turning to the financial system, considerable progress has been made toward restoring the system to soundness, particularly in dealing with the nonperforming-loan problem. Financial institutions have therefore been less concerned about the availability of liquidity. Under these circumstances, financial institutions have become less inclined to increase their current account balances at the Bank - a phenomenon reflected in undersubscription during the Bank's funds-supplying operations. Financial institutions are expected to continue further improving their business performance even after the full removal of blanket deposit insurance in April, as this will contribute both to the soundness and to the further revitalization of the financial system. The stronger the financial system, the easier it is for a virtuous cycle to operate, whereby improved profits and ongoing structural adjustment keep driving firms to even greater heights of activity. Economic fluctuations in Japan are also expected to exhibit less volatility, coming into line with the trend in other major industrialized countries.

The economic environment in which Japan finds itself is basically robust: factors such as inventories, which can cause imbalances in the domestic economy, are currently insignificant; overseas economies are likely to continue expanding; and there has been progress in structural adjustments. The economy is likely to emerge from the current temporary pause and continue to recover. With time, the economic outlook visualized by the Bank will gradually take more concrete shape, as the economy moves more clearly onto a sustainable recovery path.

V. Assessment of the decline in prices

Japan's economy is experiencing its third recovery phase since the 1990s, during which period the Bank has been conducting an accommodative monetary policy. In the four years between 1991 and 1995, the official discount rate was cut from 6 percent to 0.5 percent (it currently stands at 0.1 percent). Faced with continuing weakness in the economy, however, and with prices still falling, the Bank embarked on the zero interest rate policy in 1999. Now, in a situation where short-term interest rates are constrained by the zero bound, the Bank is providing more ample liquidity to financial institutions through its "quantitative easing policy," and has made a commitment to continue with this policy until the year-on-year rate of change in the consumer price index (CPI; excluding fresh food, on a nationwide basis) registers zero percent or higher on a sustainable basis. By implementing drastic monetary easing, the Bank has sought to avert the risk that a vicious cycle, involving the translation of price declines into reduced corporate profits, depressed economic activity, and hence further price declines, could impair the monetary policy goal of price stability over the medium to long term.

When general prices, which are the yardstick for evaluating individual prices, fluctuate on a large scale, households and firms have difficulty in accurately distinguishing a price fluctuation caused by changes in the supply and demand balance of an individual good/service from a fluctuation caused by a change in the general price level. This results in distortions in the efficient allocation of resources in the economy as well as increasing uncertainty about the future. Moreover, a decline in prices generates the following three problems. First, real wages adjust slowly when there is downward rigidity in nominal wages, and this impacts negatively on corporate profits and unemployment. Second, a rise in deflationary expectations produces an equivalent rise in real interest rates. Typically, nominal interest rates would be reduced to counteract this rise in real interest rates, but when an economy comes up against the zero bound on nominal interest rates, it is possible for real interest rates to rise above their optimal level and thus depress economic activity. Third, higher real interest rates and the fall in asset prices that tends to accompany a price decline cause financial institutions' asset quality to deteriorate. As these problems intensify, the operation of a negative cyclical mechanism between falling prices and declining economic activity generates significant costs for the macroeconomy.

The Bank has continued to implement drastic monetary easing to prevent the economy from being caught up in this negative cyclical mechanism, i.e., from falling into a deflationary spiral. The year-on-year rate of change in the CPI, which had fallen for a time to as low as minus 1 percent, has recently recovered to around minus 0.2 to minus 0.3 percent in line with improvements in the output gap. A breakdown by components shows that the year-on-year rate of decline in the prices of goods, which are sensitive to economic developments, is gradually diminishing, and is currently at virtually zero percent. Excluding the effects of the rise in petroleum prices and the decline in rice prices and public utility charges, the pace of decline in the CPI is seen to be slowing moderately. The corporate goods price index continues to increase year on year, and the year-on-year rate of decline in the corporate service price index is diminishing. Various surveys also suggest that households' and firms' expectations for deflation, which have important implications for the economy, have been improving steadily since around 2001.

In this situation, the problems arising from the downward rigidity of nominal wages and the zero bound on nominal interest rates are unlikely to be too serious, and the risk of a negative cyclical mechanism operating between falling prices and declining economic activity is therefore correspondingly small. In fact, the economy has been on a recovery trend in spite of the continuing decline of consumer prices year on year. This suggests that the current decline in prices is qualitatively very different from that experienced during 2001-02 when the fall in demand triggered anxiety about the economy falling into a deflationary spiral.

VI. Effects of quantitative easing

The economic and price conditions confronting a central bank change with time. Under normal circumstances, the role of monetary policy is to respond to these shifting phases by making the appropriate adjustments to the tightness/easiness of the monetary policy stance. Since June 2004, the U.S. Federal Open Market Committee has made six cautious 0.25 percent adjustments to the federal funds rate target, producing a cumulative rise of 1.5 percent. The Bank of Japan, however, 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 registers zero percent or higher on a sustainable basis. The Bank has made this commitment to prevent the economy from once again falling into a downward spiral in which falling prices and declining economic activity could be negatively reinforcing. This policy framework is expected to more strongly support private-sector activity as the economy recovers. Explaining this in a little more detail, the policy commitment to continue with the quantitative easing policy ensures that, even during phases of economic recovery, expectations of short-term interest rates remain stable as long as prices themselves are not rising. In terms of the current situation, this has allowed firms to continue to enjoy low funding costs. Firms are better able to take advantage of these lower interest rates to carry out forward-looking investment since they have been highly successful in their efforts to raise profitability. When firms are more confident about the future, a financial environment such as this makes it easy for them to raise necessary funds and execute their spending plans more aggressively.

Yet when pursuing an unprecedented quantitative easing policy such as this, it does not do to be complacent about "excessive movements" - that is, phenomena which are not consistent with the sustainable growth of the economy. In the United States, low interest rates over a protracted period have generated remarkably high levels of liquidity. There is now discussion over whether this may be contributing to signs of potentially excessive risk taking, which seem to be reflected in relatively narrow credit spreads and the speculative demand becoming apparent in the housing market. Reduced credit spreads are a worldwide phenomenon, which is becoming slightly more marked in Japan than in other economies, and we cannot ignore the possibility that market participants have begun to take less notice of risk. Similarly, attention now needs to be paid to whether or not low long-term interest rates are consistent with the likely duration of accommodative monetary policy. It goes without saying that such matters will need to be taken duly into account in conducting monetary policy in the future.

VII. Firms' positive commitments and their adaptability to change

Even if some parts of the economy are moving forward aggressively, this is not to say that the whole economy is characterized by similar vigor. Some firms are starting to adopt a more positive stance as evident in the increase in business fixed investment. However, such cases are still limited, with a large number of firms placing priority on reducing interest-bearing liabilities by using their increased profits, and taking a "wait-and-see" attitude toward investment commitments. Although many firms are increasing business fixed investment, this is being kept within the limits of their cash flow. As pointed out earlier, firms have been cautious about increasing inventories during this recovery phase. The persistent decline in bank lending is also indicative of firms' hesitancy about making forward-looking commitments.

Firms became concerned about business risk and financial risk management, having experienced highly volatile economic conditions during the 1990s and financial system instability during the second half of that decade. Their incentives to reduce interest-bearing liabilities and increase their capital bases as much as possible are therefore understandable. Expanding business lines is not so easy for firms in the current situation where, faced with price-sensitive consumers, they have difficulty in raising product prices in order to pass on the rise in materials and intermediate goods prices caused by the surge in commodity prices at home and abroad. There may also exist some concern about the impact of changes in the economic environment, such as those caused by the low birth rate and rapidly aging society. However, corporate management will not continue to appeal to uncertainty about the economic outlook to justify its hesitancy in making positive commitments for long. Amid rapidly changing technology and increasing competition, firms know that they need to maintain high profitability in the medium term by continuously and swiftly reallocating their management resources while continuing to invest in highly profitable areas.

The economic environment surrounding firms is now well suited to encourage such commitments. In the labor market, deregulation and changes in people's attitudes and lifestyles have combined with firms' need to adapt to changes in the industrial structure and to improve profitability, with the result that the number of non-regular employees has increased. Although indicative of firms' unwillingness to commit themselves to hiring longer-term regular employees, such developments, in so far as they illustrate the increased flexibility of the labor market, also suggest that firms have become better able to adapt to change. In addition, some firms have started to invest in highly profitable areas. They have been studying consumer needs so as to provide attractive new products and new services, and this has contributed greatly to private consumption, which has continued to be firm despite sluggish growth in income. A breakdown by household 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. The evidence suggests that firms' efforts in various areas have been gradually bearing fruit. Furthermore, there are signs that the effects of monetary easing have been feeding through into the corporate financing situation. In the December *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the number of firms that perceived financial institutions' lending attitudes as "accommodative" exceeded those that perceived them as "severe," even among small firms.

In such a setting, firms will be more likely to use their free cash flow, not to pay down debts, but to increase business fixed investment and financing for other research or investments aimed at increasing growth. Alternatively, they may prefer to buy back their own stock or increase dividend payments. Gradually, more firms will start to make use of the accommodative financial environment to raise funds in the markets and execute more aggressive spending plans. As the economy achieves a balanced recovery path, this kind of positive forward-looking behavior should become more widespread. Meanwhile, financial institutions are making more efficient use of their capital to devise new financial services that more closely meet the needs of firms and households. At the same time, they are maintaining efforts to further enhance their risk management and increase profitability by adopting new financial engineering techniques, as well as by making better use of financial markets. As the efforts of industries and financial institutions combine and reinforce one another, the economy will escape the current confines of the short-term business cycle and enjoy longer periods of sustainable recovery.

The Bank will continue to conduct monetary policy so as to offer vigorous support for the positive efforts being made by the private sector.