

Toshihiko Fukui: The current situation and outlook for Japan's economy

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, to the Board of Councillors of Nippon Keidanren (Japan Business Federation), Tokyo, 22 December 2005.

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Introduction

There is now only one week remaining in 2005. The year has been marked by steady progress toward a new path of growth for Japan's economy, with the completion of adjustments that had been ongoing since the bursting of the bubble. Today, I will focus on the path of Japan's economy in 2006 and onward, talking about the current situation and immediate outlook for economic activity and prices, as well as the challenges facing the economy over the longer term.

I. Current economic situation

Japan's economy has regained its momentum for recovery, having emerged from the temporary deceleration in economic growth from the second half of 2004. Real GDP in the July-September quarter of 2005 has posted positive growth for the third straight quarter. Japan's economy is likely to experience a sustained period of expansion, albeit at a moderate pace.

The current economic expansion has lasted almost four years since January 2002, based on the Cabinet Office's reference dates for business cycles. This already makes it the third longest expansion phase in the post-World War II period, and in the coming year it is appearing increasingly likely to surpass the two other long postwar economic expansion phases, namely the Heisei boom (four years and three months during 1986-91), and the Izanagi boom (four years and nine months during 1965-70).

Japanese stock prices have been increasing in response to the economic recovery. The Nikkei 225 Stock Average recovered to the 15,000 yen level at the beginning of December 2005, its record high for about five years, and even reached the 16,000 yen level temporarily yesterday, December 21. Since the beginning of 2005, the Nikkei 225 Stock Average has risen by more than 30 percent, marking the largest increase among major industrial countries. In the meantime, the net purchase of Japanese stocks by foreign investors has increased substantially.

In analyzing business conditions, differences across regions, industries, and firm sizes should of course be taken into consideration. The Bank of Japan collects information via its network of branches spread throughout the country so as to accurately grasp regional developments. Recent information indicates that most regions in Japan have been recovering, although notable differences remain in the degree of improvement: regions with a concentration of high-tech businesses show strength, while those that are highly dependent on public investment remain in relatively severe circumstances.

II. Factors behind the moderate and sustainable economic recovery

As I mentioned earlier, Japan's economy is likely to experience a sustained period of expansion albeit at a moderate pace in 2006. There are several factors underlying this economic outlook.

The first factor is that overseas economies are likely to continue expanding. Japan's exports are expected to continue increasing against the background of this overseas economic expansion.

The second factor is that the corporate sector is finally reaching the end of the long path of the post-bubble adjustments. Firms have almost resolved their "three excesses" in production capacity, employment, and debt. For example, the recently released December *Tankan* (Short-Term Economic Survey of Enterprises in Japan) shows that both the number of firms perceiving their production capacity to be insufficient and the number perceiving their holdings of labor to be insufficient have simultaneously exceeded the numbers perceiving them to be excessive for the first time since the bursting of the bubble. Furthermore, ratios of firms' outstanding debt to total assets and to sales have been declining not only at large firms but also small and medium-sized firms.

While making adjustments in the "three excesses," firms have responded to economic globalization by reallocating their production bases so as to take advantage of the international division of labor. On the domestic side, they have been reviewing their business lines based on the "selection and concentration" strategy and improving their ability to create high-value-added products and services. As a result, current profits at Japanese firms of all industries and sizes increased for fiscal 2004, with profits and the ratio of current profits to sales exceeding those recorded at the height of the bubble era. Corporate profits are likely to continue to increase for the fourth straight year in fiscal 2005, while absorbing the cost resulting from high crude oil prices.

Reflecting high corporate profits, business fixed investment is likely to continue to increase across a wide range of industries. According to the December *Tankan*, not only have large manufacturing firms substantially increased their business fixed investment plans for fiscal 2005, but small and medium-sized firms have also steadily revised their plans upward. As a result, business fixed investment is expected to increase for the third straight year for firms of all industries and sizes.

Financial institutions have mostly resolved their nonperforming-loan problems, which are inextricably linked with firms' excessive debt, and financial institutions' profits have been improving markedly. As a result, financial institutions' lending attitude has become more accommodative, and their lending has been recovering. Financing in capital markets through, for example, issuance of CP and corporate bonds has continued to be favorable, indicating that firms' financing demand is being sufficiently met. These extremely accommodative financial conditions are supporting private demand.

The third factor supporting the ongoing economic recovery is the positive interaction which has started to operate between the corporate and household sectors: the positive effects stemming from the increased corporate profits have gradually spread to household income, feeding back to the corporate sector via increased private consumption.

Looking at the employment situation, the number of employees has been increasing since 2004, with the number of full-time employees also increasing recently. Regular payments have been increasing steadily, and winter bonus payments are expected to have registered a steady increase. Moreover, increases in receipts of dividends and wealth effects stemming from higher stock prices have started to contribute to the steady developments in private consumption.

Reflecting the improvement in the employment and income situation, consumer confidence continues to be favorable on the whole and private consumption is likely to remain steady. Housing investment has shown some strength, as evidenced in housing for sale and housing for rent, reflecting low interest rates.

The fourth and last factor supporting the economic recovery, relating back to its moderate pace, is that corporate behavior has remained cautious so that an excessive buildup of stocks, such as production capacity and inventory, is unlikely to occur. The current levels of business fixed investment appear modest relative to the historically high level of current profits. Since cautious corporate behavior will help prevent large economic fluctuations, the economy is likely to experience a sustained period of recovery at a moderate pace.

III. Uncertainty over the outlook for economic activity

Japan's economy continues to recover steadily and is unlikely to fall into recession due to domestic factors. Nevertheless, in discussing the outlook for Japan's economy, it is necessary to maintain a close watch on the rise in crude oil prices and its impact on developments in overseas economies, including the United States.

Crude oil prices have softened somewhat since marking a record high around the end of August 2005, but they still remain at high levels. The high crude oil prices are mainly due to increased global demand, reflecting the expansion of the global economy. But another factor, highlighted by the two hurricanes that recently struck the United States and revealed supply-side weaknesses, particularly in refining capacity, is the risk that the supply of crude oil will fail to meet growing global demand. If crude oil prices rise further due to supply-side constraints, the global economy will be affected by a decline in real purchasing power in non-oil-producing countries, or by rising concerns over increasing inflationary pressures worldwide.

In the United States, the Federal Reserve has gradually raised the targeted federal funds rate to above 4 percent. Partly due to these monetary policy actions, the rise in the core consumer price index (CPI) has been contained. However, concern about inflationary risks is emerging due to such factors

as the surge in crude oil prices. The current U.S. economic growth has been supported by relatively low long-term interest rates, which have been underpinned by well-contained long-term inflation expectations due to the appropriate conduct of monetary policy. Should, however, price stability be undermined and the financial environment become destabilized, not only would growth in the United States slow, but the global economy could also be affected by abrupt changes in the international flow of funds.

Another issue that every country should address in an effort to achieve sustainable global economic growth from a slightly longer-term perspective is increasing global imbalances. At the meeting of the G-7 countries held at the beginning of December in London, the view was shared that each country was taking steps to address these imbalances but more vigorous, mutually reinforcing action was needed.

IV. Developments in prices

The environment influencing prices has been improving as the economy continues to recover. The output gap is likely to continue narrowing moderately, as the economy continues to recover at a pace slightly above its potential. The decline in unit labor costs is likely to slow along with the increases in wages, despite continued downward pressure from the rise in productivity. Various survey results show that firms' and households' expectations regarding prices are gradually being revised upward.

As for the potential growth rate, some argue that it is higher than previously estimated, and thus that the output gap is unlikely to narrow much. It should be noted, however, that a rise in productivity tends not only to expand production capacity but also to stimulate demand via increases in firms' expected growth and households' expected income. Thus, the overall effect on prices of the rise in the potential growth rate varies depending on how these opposing mechanisms work over time.

The impact of the expansion of emerging market economies on price developments is increasingly significant. It has been pointed out that the expanding production capacity of emerging market economies, particularly China, has been containing upward pressure on prices. Recently, however, attention is also being paid to another aspect of increased production capacity in these economies, namely, the upward pressure being exerted on crude oil and other raw materials prices. Therefore, in assessing underlying price developments, the effect of relative price changes at the global level should be taken into consideration.

Looking at individual price indicators, domestic corporate goods prices are increasing, due mainly to the effects of the rise in crude oil and other international commodity prices and the depreciation of the yen, and they are expected to continue increasing. The year-on-year rate of change in consumer prices (excluding fresh food) had been slightly negative thus far, but posted 0.0 percent in October. The year-on-year rate of change is expected to record a slight increase and remain positive thereafter.

As for the outlook, a reduction in electricity charges and other special factors are likely to exert downward pressure on consumer prices from April 2006, the beginning of the next fiscal year. At the same time, there will be other special factors placing upward pressure on consumer prices, so that the net effect remains uncertain. The Bank, however, thinks it unnecessary to change its view that the year-on-year change in the CPI is expected to remain positive in view of the gradual narrowing of the output gap.

Land prices on the whole continue to decline, but those in some parts of Tokyo and other major metropolitan areas have started to rise. These developments are notable as they suggest a gradual upturn in people's expectations regarding the future course of the economy.

V. Challenges for the future: the declining population

The Japanese economy continues to recover steadily, as I mentioned. Looking toward the near future, however, Japan will enter an era of population decline as a result of the declining birthrate of its aging society.

According to population statistics, the working-age population (15-64 years old) has already started to decline after peaking in 1995. The total population is projected to peak in 2006, according to the medium variant projection of the National Institute of Population and Society Security Research. It has also been pointed out that the total population is likely to start decreasing earlier than projected.

It is assumed that the decline in population will significantly affect the Japanese economy. Supposing that the labor force participation rate remains unchanged, a decline in the total population will cause a decrease in the labor force population. Without substitution of capital for labor or an increase in the rate of technological progress, this decline in the labor force population will lower economic growth. Focusing on the near future, as the baby-boomers reach retirement age between 2007 and 2009, the trend of a decreasing labor force population may accelerate. With a decreasing total population, an increase in the proportion of the aged may also lower the savings rate and lead to deceleration in capital accumulation.

In spite of the continued decline in the labor force, I would argue that it is quite possible not only to maintain the current level of per capita income but also to realize a new stage of economic development, if technological progress accelerates and/or economic efficiency is improved.

In this regard, economies have the flexibility to respond to demographic changes such as a population decline or population aging. A shortage of labor supply will be at least partly neutralized by increases in the labor force participation rate, induced by, for example, rises in wages. The Japanese industrial structure will change by shifting to capital-intensive industries, transferring the production bases of labor-intensive industries overseas. The Japanese industrial structure will also change in response to the demand for new goods and services accompanying the aging of the population, including nursing care for the elderly.

To enable the economy to respond in this way, some crucial adjustments need to be made to the economic and social system as a result of demographic changes. For example, in response to an increase in average life expectancy, it is important to provide reemployment opportunities for people reaching retirement age, ensuring that they are able to work for a longer proportion of their lives. This viewpoint seems important in addressing the problems relating to the retirement of the baby-boomer generation. Furthermore, in order to increase the labor force participation rate for women, it is important to develop social and working environments conducive to balancing work with family life, including public support for childcare. Efforts to improve these environments are expected to neutralize the decline in the labor force. Meanwhile, on the financial side, initiatives taken by financial institutions to accommodate households' portfolio requirements, which are becoming more diversified due to demographic changes, will contribute to greater risk tolerance.

Another extremely important point is how we improve productivity in the economy. In addition to increasing the flexibility of the economic structure to allocate limited resources more efficiently, it is deemed necessary to expand the frontiers of Japan's economy by encouraging innovation: technological progress, knowledge creation, and the combination of the two. It should be noted that these efforts will contribute not only to strengthening the supply side of the economy, but also to generating sustainable demand. In other words, by using innovation as a lever to reallocate production resources dynamically to growing sectors, the demand and supply sides of the economy may be expected to expand in a mutually complementary manner.

Needless to say, corporate executives, including many of you here today, have already begun to actively engage with these ongoing demographic changes. If, as a result of such efforts, the dynamism of Japan's economy is fully exploited, I think it entirely feasible that the potential of the economy will be enhanced even in the face of a declining labor force.

VI. Conduct of monetary policy

In closing, let me touch upon the Bank's conduct of monetary policy.

The Bank's monetary policy is aimed at contributing to the balanced and sustainable growth of Japan's economy through the pursuit of long-run price stability.

As for the conduct of monetary policy in the near future, the Bank will aim to achieve its stated goal by maintaining the framework of the quantitative easing policy based on the clear commitment in terms of the CPI. With the economic recovery likely to remain highly sustainable and the year-on-year changes in the CPI expected to remain positive, the possibility of a departure from the unprecedented framework of the quantitative easing policy, which was introduced to stave off a deflationary spiral, is likely to increase over the course of fiscal 2006. In making this decision, the Bank will judge whether the policy commitment has effectively been fulfilled, that is, whether the year-on-year rate of change in the CPI is registering zero percent or higher on a sustainable basis, by monitoring developments in economic activity and prices.

Since, at present, the effects of the quantitative easing policy are increasingly coinciding with the effects of short-term interest rates being at practically zero percent, a change of the policy framework does not in itself imply any major change in policy effects. Such a change is likely to encourage smoother formation of the yield curve in financial markets, thereby invigorating the economy. Although the level of interest rates after such a change of policy framework will of course depend on developments in economic activity and prices, an accommodative financial environment is likely to be maintained, as long as upward pressure on prices continues to be contained and the economy follows a sustainable and balanced growth path.

Conclusion

Japan's economy is now entering a robust recovery phase, having gone through an adjustment period of more than a decade since the bursting of the bubble. Structural reform of the economy is aimed at stimulating activity in the private sector while managing the economy in a more market-oriented manner. Thanks to deregulation and other government policy measures and private-sector initiatives, the economy is on the threshold of a new growth phase. It is important to make the best of private-sector dynamism by establishing clear prospects for fiscal consolidation while at the same time gaining credibility among the public.

The Bank is determined to contribute to the new growth phase of Japan's economy, through its efforts to achieve long-run price stability by the appropriate conduct of monetary policy.