Toshihiko Fukui: The outlook for Japan's economy and the conduct of monetary policy

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, to the Naigai Josei Chousa Kai (Research Institute of Japan), Tokyo, 15 May 2006.

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Introduction

Japan's economy has been recovering for more than four years since the trough in January 2002. The Bank of Japan projected in its *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) released on April 28, 2006 that from fiscal 2006 through fiscal 2007 the economy was likely to experience a sustained period of expansion, with domestic and external demand and also the corporate and household sectors well in balance.

Today, I will focus on the Bank's view concerning future developments in economic activity and prices given the projection in the Outlook Report, and I will explain its future monetary policy conduct.

I. Developments in the world economy

I will first touch on developments in the world economy, which underlie developments in Japan's economy. The world economy has been expanding steadily since 2003, recording a growth rate of around 5 percent in 2005, and is projected to maintain high growth into the future. At the G-7 meeting held in Washington, D.C., in April 2006, finance ministers and central bank governors agreed that the outlook for the world economy remained favorable, although risks remained from factors such as oil market developments and global imbalances. They also agreed that inflation remained contained despite high oil prices and that global trade growth was buoyant.

Economic developments among Japan's main trading partners indicate that the U.S. economy continues to expand steadily, at a pace around its potential growth rate, led mainly by business fixed investment and household spending, although there are signs of a slowdown in some parts of the economy, specifically in the housing market. The Chinese economy continues to expand strongly as a whole despite some imbalance in the pace of growth between industries and regions. The NIEs and ASEAN economies continue to expand at a moderate pace on the whole, although the negative effects of high energy prices can be seen in some areas of economic activity.

II. Current situation and outlook for Japan's economy

Turning to Japan, the economy continues to recover steadily. One of the characteristics of the current economic situation is that domestic and external demand and also the corporate and household sectors are well in balance. Exports continue to increase against the backdrop of global economic expansion and trade expansion resulting from further progress in international division of the production process. As for domestic private demand, corporate performance continues to be strong. The Bank's *Tankan* (Short-Term Economic Survey of Enterprises in Japan) indicates that corporate profits increased for the fourth consecutive fiscal year, and firms expect their sales and profits to rise in fiscal 2006. Business fixed investment plans for fiscal 2006 are relatively strong. As for the household sector, the employment and wage situation has been improving and private consumption has been on an increasing trend. Japan's economy is likely to continue to show balanced growth.

Another characteristic is that the sustained economic recovery has resulted in a higher level of utilization of resources such as capital and labor. The current recovery has already lasted for over four years, and if it continues much longer, in October 2006 it will equal the *Izanagi* boom (1965-70), which is the longest postwar economic expansion to date. As a result of the sustained recovery, according to the *Tankan*, for the first time in more than a decade firms are no longer perceiving excess capacity but have started to feel more strongly that their labor holdings are insufficient. The ratio of job offers to applicants, below 1.00 from 1992 until recently, has now exceeded 1.00 since the end of 2005. Furthermore, the conditions of persistent oversupply have been dispersed and the output gap, the difference between actual and potential output, which had long been negative, seems now to have closed. This indicates that demand and supply capacity in the economy are well balanced.

Given these characteristics of the current economic situation, the following are considered to be the three core elements of the most likely projection for economic activity and prices two years into the future.

The first element is that the household sector is expected to be the main driving force behind firm domestic private demand.

Strong corporate performance has been benefiting the household sector, and this positive influence is likely to become more evident from now on. Employment and wages have been improving against the background of favorable corporate profits and rises in labor shortages. The number of part-time employees and bonus payments are rising, and the number of full-time employees and regular payments are also on an uptrend. These developments suggest that households can expect the increase in their income to be more permanent, and this has contributed to the improvement in consumer sentiment. Households' average propensity to consume is likely to remain at its current elevated level, and private consumption is expected to follow an increasing trend. Housing investment is likely to continue to trend moderately upward, supported by the improvement in household income and the view that interest rates will only rise from current levels, as land prices are starting to rise particularly in major metropolitan areas. Increases in household spending will feed back to the corporate sector via increases in sales and profits, and thus, a virtuous circle between the household and corporate sectors is likely to keep operating.

The second element is that there is likely to be a cyclical slowdown in the economic growth rate as the recovery has already lasted for over four years and is likely to mature.

Given the high level of corporate profits and the expansion in domestic and external demand, the momentum driving increases in business fixed investment is likely to be maintained. However, considering that there is a stable relationship in the long term between the capital stock and aggregate demand, the pace of increase in business fixed investment will probably slow eventually. Business fixed investment has steadily increased for the third consecutive year since fiscal 2003, and this has resulted in high growth in the capital stock relative to the projected increase in aggregate demand. Therefore, unless firms can make stronger forecasts for the economic growth rate and the rate of return on investment, it is becoming unlikely that they will keep up the current pace of increase in business fixed investment. In this situation, the growth rate of Japan's economy is likely to slow toward the potential growth rate, which the Bank estimates to be in the 1.5-2 percent range. The forecast is around 2.5 percent for fiscal 2006 and around 2 percent for fiscal 2007.

The third element is that, as the economic recovery matures, a slowdown in the growth in productivity and upward pressure on wages are expected to exert upward pressure on prices.

At an early stage of economic recovery, firms usually retain surplus labor and capacity and are therefore able to increase productivity by raising their rate of resource utilization. With the maturing of the economic recovery, however, firms have less scope to increase productivity in this way. As I have already explained, the output gap has closed, and as the economy is likely to continue expanding at a pace above its potential through fiscal 2007, the output gap is likely to become positive and then to widen moderately.

Moreover, in a situation of improving labor market conditions and with labor shortages being observed in a relatively wide range of industries, wages are likely to continue rising moderately. The rise in wages and the slowdown in the growth in productivity will together put upward pressure on unit labor costs (labor costs per unit of output). Through fiscal 2007, unit labor costs are likely to show smaller declines, and to start increasing slightly at some point.

One of the factors holding back upward pressures on prices during the economic recovery phase has been declining unit labor costs. As the effect of this factor diminishes, prices will be more inclined to rise than before. As for the year-on-year rate of change in the consumer price index (CPI; excluding fresh food), which has been positive since November 2005, we estimate that this will gradually rise to around the middle of the range between zero and 1 percent in fiscal 2006 and to slightly below 1 percent in fiscal 2007.

III. Upside and downside risks to the outlook for economic activity

In the above sections, I have outlined the core elements of the most likely projection for economic activity and prices. However, the economy constantly faces various risks and it should be noted that, should particular risks materialize, economic activity and prices may deviate from this projection.

As downside risks to the outlook for economic activity, the April 2006 Outlook Report raises the following factors: slowdown in the growth of the world economy; and inventory adjustments, for example, in IT-related sectors. As for the first risk factor, developments in crude oil prices, which have been rising, and their impact on the world economy warrant attention. In relation to this, there is also a risk of a change in the situation where stable financial conditions are durable and inflationary pressures generally subdued which has been supporting the ongoing global economic expansion. With regard to the second factor, it should be borne in mind that inventory adjustments may be triggered as the economic recovery matures. Even if inventory adjustment occurs, it is unlikely that inventory adjustment carried out in some industries would seriously affect overall economic activity, since Japanese firms as a whole have completed adjustments in various excesses and their profitability has been recovering.

As an upside risk to the outlook for economic activity, there is a possibility of further acceleration of business fixed investment. If firms accelerate investment, there may be a positive impact on overall growth. On the other hand, such acceleration may lead to an excessive build-up of the capital stock relative to the level of expected growth in demand, which may precipitate an economic slowdown via adjustments. Given that the output gap has already closed, if economic activity accelerates further and as a result the positive output gap widens rapidly, this will increase the risk of a subsequent compensatory correction. However, large economic swings can be avoided, thereby realizing sustainable economic expansion, if firms' investment stance does not become too aggressive.

On this point, firms so far continue to increase business fixed investment based on favorable projections for sales and profits. However, overall, the value of fixed investment is being kept within the amount of firms' cash flow, and this suggests that they remain relatively cautious about accelerating fixed investment. The outlook for economic activity described earlier assumes that firms will maintain this cautious stance regarding investment.

However, the current conditions point to further acceleration in investment by firms. Looking at corporate finances, firms' risk-taking capacity has increased as a result of the reduction of their debt excesses and the strengthening of their capital bases. Levels of return on assets are comparable to those recorded during the bubble era of the late 1980s. Since interest rates are extremely low, this favorable financial environment is likely to stimulate firms' investment. A turnaround in land prices in major metropolitan areas and a rise in stock prices may also accelerate firms' investment partly through increases in household spending boosted by the wealth effect.

If firms were to further accelerate investment in this situation, overall economic growth would increase for a while, although this would generate the risk of a subsequent correction.

IV. Upside and downside risks to the outlook for prices

The following are considered to be key upside and downside risks to the outlook for prices: the path of international commodity prices including crude oil prices; and the degree of sensitivity of the rate of increase in the CPI to economic developments, that is, changes in the output gap.

The April outlook does not assume that the rate of increase in the CPI will accelerate noticeably even when the output gap becomes positive, i.e., actual output exceeds potential output. This takes account of the weaker sensitivity of the rate of increase in the CPI to changes in the output gap, which is a tendency that has been observed in recent years not only in Japan but also worldwide. This is because prices of goods and services as well as wages have been under downward pressure due to industrialization of emerging economies as well as to firms in industrial countries shifting production facilities to overseas locations. Upward pressure on overall prices seems to have been restrained by increased productivity and intense competition both as a result of deregulation and advances in information and telecommunication technology. Additionally, in Japan unit labor costs have been able to fall considerably due to the relatively low rate of resource utilization. However, unit labor costs are expected to start increasing. Furthermore, as the output gap becomes positive, the sensitivity of prices to changes in economic activity may increase at some point, reflecting changes in firms' price-setting stance and higher inflationary expectations among the public, and thus prices may increase faster than anticipated.

V. The impact of an increase in the potential growth rate

I have thus far outlined the Bank's outlook for economic activity and prices for the next two years. I will next explain in more detail a point touched on in the projection described earlier, namely, the impact of the change in the potential growth rate on the Bank's conduct of monetary policy.

The potential growth rate seems to have been increasing recently, as a result of firms' efforts in reducing excesses in production capacity and employment and their reallocation of capital and labor to areas likely to generate higher profitability and growth in demand. The Bank estimates that the potential growth rate has recovered to the 1.5-2 percent range recently, from its previous estimate of approximately 1 percent.

When considering the impact of a rise in the potential growth rate on the conduct of monetary policy, the important point is to assess how such a rise affects aggregate supply and demand and hence prices. On the supply side, an increase in the potential growth rate gives rise to downward pressure on prices. More concretely, a rise in the potential growth rate acts to increase the supply capacity of the economy and thus exerts downward pressure on prices. Furthermore, since a rise in the potential growth rate tends to be accompanied by an increase in productivity, downward pressure may also be exerted on prices by the decrease in unit labor costs that can occur if wage rises lag behind the increase in productivity.

On the demand side, however, a rise in the potential growth rate acts to boost aggregate demand. Therefore, a rise in the potential growth rate does not necessarily exert downward pressure on prices. The recent rise in the potential growth rate stems from firms' efforts to reallocate their resources to areas likely to generate higher profitability and growth in demand, and this implies an improvement in the overall economy's ability not only to produce goods but also to increase profits and income by selling those goods. Such real economic improvements brighten firms' and households' expectations regarding future income, and this brighter outlook, together with the wealth effect stemming from the rise in stock prices, is likely to stimulate aggregate demand by bolstering their spending. Moreover, since the expected rate of return on investment increases when the potential growth rate is rising, monetary easing effects become stronger at any given level of the real interest rate. The result is to further increase investment demand, triggering upward pressure on prices.

In terms of the time frame, a rise in the potential growth rate often causes an increase in production capacity in the relatively short term, while in the longer term it seems to bring about an increase in demand and to strengthen monetary easing effects. Such a picture, however, is inevitably attended by uncertainty, since individual economic agents may increase demand in advance, taking account of increases in their expected future income and in response to the wealth effect. Whatever the case, a rise in the potential growth rate warrants close attention as it may give an expansionary push to the economy not only from the supply side but also from the demand side, and because its effect on prices can be both upward and downward.

VI. Conduct of monetary policy

I would now like to talk about the Bank's conduct of monetary policy, based on the outlook for economic activity and prices.

At the Monetary Policy Meeting held on March 8 and 9, 2006, the Bank decided to terminate the quantitative easing policy, which had been maintained during the five years since March 2001. It decided to change the operating target of money market operations from the outstanding balance of current accounts at the Bank to the uncollateralized overnight call rate. The new target for the uncollateralized overnight call rate was set at effectively zero percent.

Under the new guideline for money market operations, the volume of short-term funds-supplying operations by the Bank has been decreasing. Accordingly, the outstanding balance of current accounts at the Bank has now declined to around 16 trillion yen. So far, the short-term money market remains stable and there is gradually more activity being seen in the interbank market. The Bank will continue to closely monitor conditions in the short-term money market in reducing the outstanding balance of current accounts at the Bank. As long as the short-term money market remains stable, the reduction in the outstanding balance will be completed in line with the projection the Bank made when it terminated the quantitative easing policy in March. However, completing the reduction of the outstanding balance of current accounts at the Bank and raising the target interest rate, which is effectively zero percent, are two different issues. While the reduction in the outstanding balance of current accounts at the Bank is carried out taking full account of conditions in the short-term money market, the level of the target interest rate is to be set based on the Bank's assessment of economic activity and price developments.

With regard to the future conduct of monetary policy based on the new operating target of money market operations, namely, the uncollateralized overnight call rate, the Bank introduced a new framework. The Bank announced that, under this framework, it would assess economic activity and prices from two perspectives, taking account of the "understanding of medium- to long-term price stability," which is expressed as an approximate range between zero and 2 percent in terms of the rate of year-on-year change in the CPI. In light of this assessment, it would outline and release its current view on monetary policy. The April Outlook Report was compiled under the new framework.

In the Outlook Report, the Bank examined, from the first perspective, whether the outlook deemed most likely by the Bank for economic activity and prices two years into the future is that the economy will follow a path of sustainable growth under price stability. The Bank judged that Japan's economy is likely to achieve sustainable growth under price stability as long as the economy develops in line with the outlook described earlier.

From the second perspective, the Bank examined the risks that are most relevant to conducting monetary policy, looking over a longer time horizon.

As a result, the Bank came to the conclusion that, as an upside risk, it should pay attention in the medium to long term to larger economic swings, resulting in large fluctuations in the rate of inflation, mainly due to acceleration of business fixed investment reflecting the accommodative financial conditions.

As for downside risks, the Bank examined the possibility of economic activity and the rate of inflation deviating downward from its projection due to various factors. The Bank's judgment was that even if economic activity is less robust and the inflation rate lower than expected, the risk of the economy falling into a vicious circle of declining prices and deteriorating economic activity has become smaller, since the Japanese financial system has regained stability and the economy has now cast off excesses in production capacity, employment, and debt.

With regard to the future course of monetary policy, based on the assessment of economic activity and prices from the two perspectives, it seems probable that the accommodative financial conditions ensuing from very low interest rates will be maintained for some time following a period in which the uncollateralized overnight call rate is at effectively zero percent. Through and beyond this stage, the Bank will adjust the level of the target interest rate gradually in the light of developments in economic activity and prices.

The Bank will continue to support the economy so as to achieve sustainable growth under price stability through the appropriate conduct of monetary policy.