

## **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, at the Kisaragi-kai meeting, Tokyo, 7 November 2006.

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### **Introduction**

At the Monetary Policy Meetings at the end of April and October, the Policy Board of the Bank of Japan approves the text of the *Outlook for Economic Activity and Prices*, or the Outlook Report as we call it for short, and makes it public. Today, I would like to discuss the Bank's view on the current state of and outlook for the domestic economy and overseas economies as well as the Bank's thinking behind its conduct of monetary policy, with reference to the October 2006 Outlook Report, which was released last week.

### **I. Developments in overseas economies**

Let me first touch upon recent developments in the global economy.

In the United States, deceleration in the pace of economic expansion is becoming clearer, as seen, for example, in the decrease in housing investment. However, business fixed investment and production continue to increase, and the pace of deceleration in private consumption has been moderate so far. Meanwhile, in the euro area, the momentum of economic recovery is becoming more evident. The increases in production and the recovery in corporate profits observed so far have contributed to an improvement in the employment situation and increases in business fixed investment. In China, strong expansion in both domestic and external demand is continuing. The rate of growth in fixed asset investment remains high, although the pace of growth has been slowing slightly as a result of measures taken by the Chinese government and the People's Bank of China to contain the overheating of the economy. Oil-producing countries, such as those of the Middle East, continue to experience an economic boom supported partly by the significant improvement in the external balance resulting from the rises in crude oil prices. Other emerging economies also continue to expand. Thus, the global economy as a whole continues to expand strongly, with the slowing growth in the U.S. economy being offset by high growth in other economies. The global economy is expected to continue expanding steadily across a broader range of regions.

According to the International Monetary Fund (IMF), the global economy has registered high growth rates of around 5 percent for two consecutive years: 5.3 percent in 2004 and 4.9 percent in 2005. The global economy is expected to continue expanding at around the same pace, at 5.1 percent in 2006 and 4.9 percent in 2007. This is the first time since the early 1970s that the global economy has registered and is expected to continue to register high growth of around 5 percent over a period of some years. Looking at the growth rates of individual countries, the developed economies have not necessarily been growing faster than in the past; rather, the countries contributing to the current high growth are the emerging economies that have taken off, one after another, as economic globalization progressed. These countries have increased their overall presence in the global economy and have contributed greatly to the high global growth rate. Asian emerging economies in particular have enjoyed high growth rates for many years, and their share in the global economy has increased so much that they have become an engine of global economic growth. This is evident from the IMF's latest projection of world economic growth, which was revised in September. Based on a substantial upward revision of the growth projection for Asian emerging economies, the projected growth rate of the world economy has been pushed up despite the downward revision of the growth projection for the U.S. economy.

### **II. The current state of the Japanese economy**

I would now like to turn to the current state of the Japanese economy.

The current phase of economic recovery began in January 2002. In November, it will have lasted for four years and ten months, exceeding the *Izanagi* boom, the longest postwar economic expansion (57 months during 1965-70).

Looking at recent economic developments, exports have continued to increase against the background of the expansion of overseas economies, which I have just outlined. By destination, exports to the United States have maintained their steady growth as a whole, although growth in automobile-related goods has slowed somewhat. Exports to Europe and East Asia have continued their solid increases, and those to other regions, particularly the oil-producing countries, have registered high growth.

Corporate profits have been high despite the surge in prices of raw materials such as crude oil. Large manufacturing firms in particular have made successive upward revisions to their profit estimates due to the increase in exports coupled with the depreciation of the yen. In this situation, business sentiment remains favorable and business fixed investment continues to increase. According to the September *Tankan* (Short-term Economic Survey of Enterprises in Japan) conducted by the Bank's Research and Statistics Department, if firms' business plans for fiscal 2006 are realized, current profits will register growth for the fifth consecutive year (since 2002), and business fixed investment will record an increase for the fourth consecutive year (since 2003).

The current strong business fixed investment continues to be led by the manufacturing sector, although nonmanufacturers as well as small firms have started to step up their fixed investment. The acceleration in business fixed investment reflects the fact that firms are seeking to reinforce their capacity to supply goods and services by increasing capital equipment as they look to capture profit opportunities in overseas markets. In the 1990s, when Japan was undergoing severe adjustments after the bursting of the bubble economy, there was a view that the increasing supply capacity of emerging economies was a threat that would deprive Japanese workers of job opportunities. This view, however, is one-sided, and the rapid development of emerging economies has in fact been playing a significant role in establishing the foundation of Japan's economic development toward a new era. It is very beneficial to the development of Japan's economy that Japan and emerging economies - especially strongly growing Asian emerging economies - have established a new system of international division of the production process and interdependent relations in a constructive manner.

For example, goods requiring a relatively high degree of processing, such as IT-related machinery, have been gradually increasing their share in Japan's imports from other Asian economies, replacing labor-intensive goods, such as clothing and other light manufactured goods. This is mainly because Japan's direct investment in other Asian economies has been increasing as Japanese firms optimize their production processes. As a result of the creation of production bases and employment opportunities with the increased direct investment, Asian economies have been increasing their presence in the global economy, not only as global suppliers but also as markets with high growth potential. Asian economies are becoming one of the driving forces of the ongoing expansion of the global economy, and this in turn is spurring Japan's exports.

One of the notable characteristics of the current recovery phase of Japan's economy is that many Japanese firms continue to scrutinize investment profitability. They are not only increasing investment to boost production capacity but also accelerating the replacement of obsolete capital equipment to improve efficiency. Such corporate behavior can be interpreted as reflecting the fact that the management of firms, amid intensifying global competition and greater exposure to the discipline of the capital market, is becoming more attentive to increasing corporate value.

The positive influence of the strength in the corporate sector has fed steadily through to the household sector, albeit at a moderate pace. Labor market conditions have been tightening as the ratio of job offers to applicants has increased and the unemployment rate has been on a downtrend. The number of employees has been increasing steadily, partly due to the recovery in the hiring of new graduates. Yet, even in this situation, wage increases have remained moderate so far. We believe that this is because, while employers continue to restrain labor costs, employees, having experienced a severe employment situation, continue to prefer stable employment to a wage increase.

However, further tightening of labor market conditions seems inevitable if the number of employees continues to increase when growth in the labor force levels off. For example, wages of part-time and temporary workers have already started to increase and large firms are planning to increase significantly the number of employees, including regular employees. In this environment, the pattern of behavior of employers and employees is likely to change gradually, and upward pressure on wages,

including regular payments, is expected to strengthen accordingly. Sales at department stores and supermarkets were relatively sluggish from spring to around July, partly due to the unfavorable weather conditions, but picked up in August and September. Sales of electrical appliances and outlays for services have continued to be favorable. Given that changes in regular payments are usually considered to constitute changes in permanent income, an increase in regular payments is likely to ensure a sustainable rise in private consumption, especially spending on durable goods and services.

In sum, Japan's economy has been expanding moderately with a virtuous circle of production, income, and spending in operation. The current recovery has certainly been driven strongly by expansion in external demand, but it is not accurate to say that the recovery has been brought about by external demand alone.

Against this background of the ongoing economic expansion, the environment surrounding prices has been gradually changing. First, the utilization of resources such as production capacity and labor has been rising. According to the *Tankan*, the perception among firms of having excess production capacity has dissipated for the first time in more than a decade. In terms of employment, firms are increasingly feeling a shortage of labor due to improving labor market conditions. An estimate of the output gap, which represents the difference between aggregate demand and potential aggregate output in the economy, suggests that the conditions of persistent excess supply have been dispersed and the output gap seems to have become positive. Second, wages are rising, albeit moderately, as labor market conditions are improving and firms are feeling a shortage of labor in a relatively wide range of industries. In contrast, unit labor costs, that is, the labor costs incurred to produce one unit of product, are still decreasing due to the increase in productivity, but the pace of decrease has clearly slowed, reflecting the moderate uptrend in wages. And third, as suggested by various survey results, inflation expectations of firms and households are shifting up. The September *Tankan* showed that an increasing number of firms in a wide range of industries answered that their output prices had risen compared with three months ago. Retailers are considered to have a strong influence on consumer prices, and the number of retailers expecting a rise in output prices exceeded the number expecting a fall. According to the most recent issue of the *Opinion Survey on the General Public's Views and Behavior*, which is conducted by the Bank's Public Relations Department and covers a nationwide sample of 4,000 individuals, about 60 percent of respondents felt that prices had risen from a year earlier, and about 80 percent of respondents expected prices to rise in the one-year period ahead.

### **III. The Bank's outlook for economic activity and prices**

In the April Outlook Report, the Bank presented the projection that, from fiscal 2006 through fiscal 2007, Japan's economy was likely to experience a sustained period of expansion, with the positive influence of the strength in the corporate sector feeding through into the household sector and the corporate and household sectors well in balance. Comparing the recent developments in economic activity and prices to the April projection, developments in the corporate sector have been somewhat stronger, as evidenced in corporate profits and business fixed investment, while those in the household sector have been somewhat weaker, as evidenced in wages and private consumption. On the whole, however, economic developments have generally been in line with the April projection.

Given these developments, the Bank, in the October Outlook Report, projected that economic developments in the near future are likely to follow in general the path projected in the April Outlook Report. That is, from the second half of fiscal 2006 through fiscal 2007, the economy is likely to experience a sustained period of expansion, with domestic and external demand increasing and the positive influence of the strength in the corporate sector feeding through into the household sector. As the economic expansion lengthens and matures, growth in business fixed investment is likely to moderate. As a result, the economic growth rate is likely to slow gradually from around 2.5 percent for fiscal 2006 to around 2 percent for fiscal 2007, approaching the potential growth rate.

On the price front, the domestic corporate goods price index has been exceeding the April projection, mainly reflecting the rises in crude oil and other international commodity prices. The index is likely to continue to be on an uptrend, although the projection is subject to developments in crude oil and other commodity prices and foreign exchange rates. The year-on-year increase in the consumer price index (CPI; excluding fresh food, on a nationwide basis) is likely to gradually rise from the 0.0-0.5 percent range in fiscal 2006 to around 0.5 percent in fiscal 2007.

The CPI was rebased in August 2006, with the base year being changed to 2005 from 2000, and year-on-year figures as far back as January 2006 were revised retroactively. Accordingly, the Bank used

the 2005-base CPI in the October Outlook Report while it used the 2000-base CPI in the April Outlook Report. At the time of the April Outlook Report, the Bank estimated that the extent of the negative divergence caused by the rebasing was likely to be slightly less than 0.3 percentage point, approximately the same as that at the previous rebasing of the CPI from the 1995 base to the 2000 base. In fact, the negative divergence turned out to be greater, around 0.5 percentage point on average during January and July 2006, but this was due to the effects of changes in the calculation of indices for existing items in the CPI basket, such as mobile telephone charges. Since such effects disappear after the first year, the divergence is likely to be reduced. Thus, the basic view on the CPI in the current projection remains the same as that in the April projection, which used the 2000-base CPI, and the Bank's projection that the year-on-year increase in the CPI is likely to gradually rise continues to be valid as the Bank's main scenario.

#### **IV. Factors causing positive and negative deviations in economic activity**

Economic activity has so far been generally in line with the April projection. However, any kind of projection is subject to upside and downside risks. It should be noted that the following factors could cause positive and negative deviations from the baseline projection of economic activity.

The first risk concerns the growth path of the global economy.

The latest outlook is based on the following environment surrounding exports: although the pace of expansion in the U.S. economy has been decelerating recently, the economy is likely to realize a soft landing and to move toward sustainable growth; and overseas economies as a whole are likely to keep expanding across a broader range of regions. These views are generally comparable with the IMF's *World Economic Outlook* and forecasts by other international organizations and private research institutes. Global economic growth is likely to remain robust even with a modest slowdown in the U.S. economy, as the growth of emerging economies has increasingly become self-sustained. Recent developments in Japan's exports show that goods, particularly capital goods and automobiles, in which Japanese firms have a competitive edge, are being exported to an increasing number of countries. According to the September *Tankan*, firms perceived overseas demand for Japanese products as exceeding supply in the current period and continuing to do so in the future. This implies that at this point firms do not feel that the slowdown in U.S. economic growth will substantially affect overseas demand for Japanese products.

However, if a greater-than-expected downward adjustment in housing prices occurs in the United States, it may lead to lower growth rates in the U.S. economy via, for example, a deceleration of growth in private consumption. If the pace of U.S. economic growth decelerates unexpectedly, adjustment pressure may build up in the IT-related sector. Global demand for IT-related goods has so far been on a steady uptrend due partly to the rapid growth in emerging economies, such as the BRIC economies (Brazil, Russia, India, and China). However, the pace of global increase in the supply of IT-related goods has also been rapid, and thus if downside risks to the outlook of the U.S. economy materialize, the balance between supply and demand of IT-related goods may be disturbed. In addition, inflation expectations may rise, if the U.S. economy does not slow considerably in a situation where resource utilization, namely in production capacity and labor, is high. One of the factors supporting the sustained expansion of the global economy is the continuing stable financial conditions and generally subdued inflationary pressures due at least in part to the appropriate conduct of monetary policy in countries around the world. Any changes to the picture may adversely affect the global economy, and be accompanied by shifts in international capital flows and repricing in financial markets. With the fall in crude oil prices, it is becoming increasingly likely that inflation pressures in the United States will gradually ease as economic growth decelerates moderately. However, risks in the United States of a slowdown in economic growth or an acceleration in the inflation rate still require attention because if either occurs, the impact on the global economy will be large.

In the euro area, the European Central Bank has been raising its policy interest rate amid appreciation of the euro, and the sustainability of economic recovery should be watched carefully. In Germany, full-scale fiscal consolidation has started; for example, the value-added tax rate will be raised from January 1, 2007, and such measures may place downward pressure on the economy in the short term. In China, the economy continues to expand strongly, and there is a possibility that this growth will accelerate during the projection period, influenced by developments in fixed asset investments and exports. Even though administrative measures will probably help to contain the rise in the growth rate of investment for some time, the risk of a further acceleration of the economy and subsequent repercussions cannot be ruled out, since the financial environment continues to be accommodative.

Global economic developments may also be influenced by international commodity prices, such as crude oil prices, depending on their future movements.

The second risk is a further acceleration of business fixed investment.

Although firms, especially manufacturers, have been stepping up their business fixed investment, an excessive build-up of capital stock has not so far been observed in the economy overall. Since firms are very careful in choosing their investment projects, business fixed investment as a whole has, despite recent acceleration, generally been kept within cash flow and the pace of increase in capital stock is moderate. In evaluating whether the growth in capital stock is excessive or not, developments not only in the moderately growing domestic market but also in strongly growing overseas markets need to be taken into account.

With the economy continuing to expand moderately, financial conditions remain extremely accommodative. Short-term interest rates have been very low relative to the state of economic activity and prices. The yen has been depreciating against other major currencies. The real effective exchange rate is currently as low as that recorded in the period immediately after the conclusion of the Plaza Accord in 1985. Given such extremely accommodative financial conditions, firms may further accelerate investment based on optimistic assumptions of future profitability, such as favorable expectations regarding the growth rate, financing costs, and foreign exchange rates. Such acceleration may push up overall growth in the short run, but may lead in turn to an excessive build-up of capital stock that could precipitate an economic slowdown.

The upturn in land prices, particularly in major cities, is becoming more broad-based. Such a recovery in land prices basically indicates that people's view on future economic activity has improved and they are increasingly expecting higher returns from investment in real estate projects. There seems no need at present to be concerned about possible excessive rises in land prices, but a rise in asset prices is likely to push up private demand.

## **V. Factors causing positive and negative deviations in prices**

Regarding the outlook for prices, attention needs to be paid to factors that may cause prices to deviate either upward or downward from the projection. Developments in the prices of crude oil and other commodities are an example of such factors. Another important factor is to what extent consumer prices will change in response to economic developments, especially changes in the output gap.

Turning to the outlook for the CPI, the year-on-year rate of increase is expected to rise gradually, reflecting increasing upward pressure on wages and the moderate widening expected in the positive output gap. This outlook, however, assumes that the rate of increase in the CPI will not noticeably accelerate, since it takes into account the possibility that prices may be less sensitive to changes in the output gap than in the past.

This decline in sensitivity is attributable to deregulation, advances in information and communication technology, the robust global economic growth, and economic globalization reflecting such growth. For example, if competition between domestic goods and imported goods from emerging economies intensifies, upward pressure on prices may be contained even when the domestic output gap turns positive. Likewise, if intensifying global competition is pushing firms to raise corporate value, upward pressure on prices may be contained as firms try to increase wage restraint despite tight labor market conditions and to raise productivity.

The sensitivity of prices to changes in the output gap, however, may be subject to substantial variation as it differs depending on how it is influenced by deregulation, advances in information and communication technology, and economic globalization. If sensitivity to the output gap is not as weak as assumed, prices may rise more than expected. Similarly, even if prices are less sensitive to changes in the output gap in the short term, the rate of wage and price increases might accelerate at some point accompanied by an increase in inflation expectations. On the other hand, if the sensitivity of prices to the output gap is weaker than assumed, prices will not respond even if economic activity is stronger than expected. Our projection assumes that as the economic expansion lengthens, productivity increases will slow and wages will rise. However, if the pattern of employers' and employees' behavior that I mentioned - firms maintain their restraint on labor costs, while employees continue to prefer stable employment to a wage increase - persists for longer than expected and rises in wages lag behind, upward pressure on prices may continue to be contained.

Changes in prices of international commodities, such as crude oil, also affect price developments. Crude oil prices had declined after posting a record high in the summer, but they are still at a high level. They may either surge or plunge in the future depending on, for example, developments in geopolitical risks.

## **VI. Conduct of monetary policy**

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

In March 2006, when the quantitative monetary policy implemented in 2001 was terminated, the Bank introduced the "New Framework for the Conduct of Monetary Policy," with the aim of ensuring the transparency of monetary policy from a relatively long-term viewpoint. In line with the new framework, the Bank assesses economic activity and prices from two perspectives, taking account of the "understanding of medium- to long-term price stability," which is expressed as approximately 0 to 2 percent in terms of the year-on-year rate of change in the CPI, and outlines and makes public its view on the future course of monetary policy.

The Bank's assessment from the first perspective, which is the outlook that it deems most likely for economic activity and prices through fiscal 2007, is that Japan's economy is likely to continue expanding with domestic and external demand increasing and that the year-on-year rate of increase in the CPI (excluding fresh food, on a nationwide basis) is expected to rise gradually through fiscal 2007, as the level of excess demand in the economy (the positive output gap) is increasing at a moderate pace and downward pressure from declining unit labor costs is weakening. In sum, Japan's economy is likely to achieve sustainable growth under price stability. This outlook is based on the assumption that market participants and firms have, to some extent, factored future changes in monetary policy into their decisions. Therefore, for economic activity and prices to develop in line with the above outlook, adjustment in the level of the policy interest rate seems necessary.

The assessment from the second perspective - in which the Bank assesses the risks considered most relevant to conducting monetary policy, looking over a longer time horizon and taking account of the cost incurred should risks materialize, however improbable they might be - is that although at present there seem to be no signs of overinvestment, the stimulative effect of monetary policy on economic activity and prices may be amplified with corporate profitability high and prices on a positive trend. For instance, if the expectation takes hold that interest rates will remain low for a long time regardless of economic activity and prices, there is a risk in the medium to long term of larger economic swings, resulting in large fluctuations in the rate of inflation, channeled, for example, via financial behavior and investment activity.

Meanwhile, depending on future developments, the economic expansion and rising prices may stall. However, Japan's economy seems more resilient to such shocks, since the financial system has regained stability and the economy has now cast off excesses in production capacity, employment, and debt. In fact, the economy recovered its momentum shortly after entering a soft patch due to adjustments in IT-related industries in the summer of 2004. Unlike in the past, the risk of the economy falling into a vicious circle of declining prices and deteriorating economic activity seems small, even if the economic expansion and rising prices stall.

With regard to the future course of monetary policy, as a result of the assessment of economic activity and prices from the two perspectives, it seems appropriate to adjust the level of interest rates gradually in the light of developments in economic activity and prices, while maintaining the accommodative financial conditions ensuing from very low interest rates for some time.

Such an adjustment in the policy interest rate, in our view, will contribute to ensuring price stability and achieving sustainable economic growth in the medium to long term. Should a large disturbance in the price and economic situation occur, a drastic policy change may become necessary, which would potentially carry the danger of causing large economic swings. In order to avoid this happening, it is important for the Bank to take a forward-looking approach in its conduct of monetary policy. Such forward-looking policy is not intended to stifle growth potential, but rather to steer the economy toward a sustained period of expansion. As I have emphasized repeatedly, the Bank does not have a predetermined view regarding a future increase in the policy interest rate. The Bank will adjust the level of interest rates gradually, carefully assessing economic activity and prices.

## Conclusion

Under the new framework for the conduct of monetary policy, it is very important for the Bank to carefully explain its assessment of the state of the economy and financial developments and its thinking regarding the conduct of monetary policy. The Bank has been communicating with the public through, for example, the Outlook Report, the minutes of Monetary Policy Meetings, the *Monthly Report of Recent Economic and Financial Developments*, press conferences and speeches, and by enriching the content of its web site. In July this year when the Bank brought the zero interest rate environment to an end after five years, financial markets remained calm, a fact that has been lauded by overseas central banks and international organizations. The calm response of financial markets can be regarded as evidence that the Bank's message to market participants was well understood and the new framework for the conduct of monetary policy functioned effectively in communicating with market participants. Ensuring transparency with the new framework is important not only in terms of better communication with market participants, but also in terms of increasing the effectiveness of monetary policy. The Bank will continue to conduct monetary policy appropriately and to contribute to achieving sustainable economic growth under price stability.