

## Toshihiko Fukui: Recent developments in economic activity in Japan

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at a meeting with business leaders, Osaka, 27 November 2006.

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### Introduction

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### I. The current situation and the outlook for economic activity and prices

Japan's economy has been expanding moderately. The current phase of economic recovery began in January 2002. By the end of November, the economy will have experienced a long economic expansion that has lasted for four years and ten months. This sustained period of economic expansion is likely to continue.

Recent economic indicators have shown mixed developments. For example, while the results of the *Family Income and Expenditure Survey* and machinery orders were weak, the preliminary estimate of real GDP growth turned out to exceed market expectations, recording 2.0 percent in the July-September quarter on an annualized quarter-on-quarter basis. These mixed results seem to have introduced some volatility into market participants' view of the current economic situation. The important point at this juncture is to examine whether these indicators as a whole suggest any changes in the fundamental mechanisms underlying economic activity and prices.

In the latest *Outlook for Economic Activity and Prices* (the Outlook Report), which was released at the end of October, the Bank made public its projection for the next two years or so. The Bank projected that the economy was 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. Although economic indicators have shown mixed developments since the Bank released its projection, the Bank considers that they do not suggest a change in the mechanisms underlying the economy. The Bank will continue to confirm this by carefully assessing various relevant economic indicators as well as microeconomic information.

Let me touch upon a few important factors in this regard. The first factor is developments in overseas economies, especially the U.S. economy. The pace of U.S. economic growth has been decelerating recently due mainly to the decrease in housing investment. The advance estimates of real GDP for the July-September quarter increased at an annual rate of 1.6 percent on a quarter-on-quarter basis. Business fixed investment has continued to increase against the background of high corporate profits, and the deceleration in the growth of private consumption has been moderate supported by the increase in household income and the drop in gasoline prices. Therefore, the U.S. economy is likely to realize a soft landing and to move toward sustainable growth. However, it is important to continue to pay attention to the extent of adjustment in housing prices and whether this affects private consumption, as these factors could impact on production and exports in Japanese industries, for example, in the IT-related industry. Upside risks should also be watched closely, such as the risk of inflation expectations rising in the U.S. economy, given that the rate of resource utilization is high.

Taking a look at the global economy as a whole, the Chinese economy continues to expand strongly, and in the euro area, the momentum of economic recovery is becoming more evident. Oil-producing countries, such as those in the Middle East, continue to experience an economic boom. The global economy is likely to keep expanding even in the face of a modest slowdown in the U.S. economy, as expansion in other economies may be expected to offset it.

The second factor is whether strong corporate performance will continue. Corporate profits continue to be high as indicated in the semiannual book closings for the first half of fiscal 2006, and business fixed investment continues to increase. Although machinery orders, a leading indicator of business fixed investment, declined substantially in the July-September quarter, this does not indicate a change in the underlying trend of business fixed investment, because the decline was partly a reaction to the sharp increase in the previous quarter and is largely attributable to the fall in orders for cellular phones. The uptrend in corporate profits and business fixed investment is evident in the September *Tankan* (Short-Term Economic Survey of Enterprises in Japan) as well as in the results of various surveys conducted on small firms. However, the Bank does not consider the current state of business fixed investment indicative of overheating. The recent growth in business fixed investment has been supported by the fact that firms are factoring the ongoing rapid growth of the global market into their business strategies, and at the same time are still displaying a strong tendency to evaluate investment profitability strictly. Given that financial conditions continue to be extremely accommodative, however, attention should be paid to the risk of a further acceleration of firms' investment leading to an excessive build-up of capital stock. Whatever the case, the Bank will further examine developments in the corporate sector based on data such as the upcoming December *Tankan*.

The third important factor is the extent to which the positive influence of the strength in the corporate sector continues to feed through into the household sector. The number of employees has been rising at an annual rate of 1.0-2.0 percent driven by the strength in corporate activity. Looking at developments in wages per worker, while regular payments have been flat year on year, special payments and overtime payments continue to rise, and as a result wages per worker have been rising moderately. In this situation, private consumption, especially outlays for services and durable consumer goods, continues to trend upward. The preliminary estimates of real GDP for the July-September quarter indicated a decrease in private consumption by 0.7 percent on a quarter-on-quarter basis, but this seems to have been attributable to the substantial decline in consumer spending reported in the *Family Income and Expenditure Survey*, which provides the basic statistics for consumer spending. It should be noted that figures in the *Family Income and Expenditure Survey* were considerably weaker than sales statistics and other statistics related to consumption. Still, even allowing for this, private consumption was somewhat weak in the July-September quarter, and therefore the Bank will watch closely developments in private consumption from the autumn onward so as to check whether this weakness was due to temporary factors, such as unfavorable weather and the tax rise in tobacco products.

Lastly, in relation to this point, developments in wages and prices are important factors that need to be watched closely. The Bank expects the year-on-year rate of increase in the consumer price index (CPI; excluding fresh food, on a nationwide basis) to rise gradually with the output gap remaining positive and expanding at a moderate pace while downward pressure from declining unit labor costs (labor costs per unit of output) weakens.

If, in contrast with past experience, productivity keeps rising with wage increases lagging behind in spite of the prolonged economic expansion, there may be no upward shift in the inflation rate. Despite the steady tightening of labor market conditions, the rate of increase in wages has remained moderate so far because, while employers faced with intensified global competition are maintaining their restraint on labor costs, employees, having experienced a severe employment situation, continue to prefer stable employment to a wage increase. Although the population of those 15 years old and over has been leveling off, the number of employees has been increasing steadily. If the number of employees keeps increasing in line with the continuing economic expansion, a further tightening of labor market conditions will become inevitable. In this situation, it is natural to assume that upward pressure on wages including regular payments will increase gradually. However, since the point at which this will happen is not clear, developments in wages and the underlying trend in prices continue to require close monitoring.

## **II. Conduct of monetary policy**

I would like to touch on the Bank's thinking regarding the conduct of monetary policy based on the assessment of economic activity and prices I have just referred to.

With regard to the future course of monetary policy, as long as economic activity and prices are expected to develop in line with the Bank's projection in the Outlook Report, the Bank will 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. As I have stated repeatedly, the adjustment process will proceed gradually. This will avoid impeding the expansion of Japan's economy, and will instead facilitate the realization of sustainable economic expansion.

The specific timing of the move will be decided based on careful assessment of developments in economic activity and prices and thorough discussion of the issue among members at each Monetary Policy Meeting. In making such decisions, the Bank will carefully examine individual economic indicators as well as other relevant information in light of the mechanisms underlying economic activity and prices indicated in the October Outlook Report and assess whether economic activity and prices will develop in line with the Bank's projection.

### **III. Issues facing Japan's financial system**

Next, let me turn to Japan's financial system.

Japanese financial institutions have finally overcome the nonperforming-loan (NPL) problem they had been wrestling with since the bursting of the asset price bubble in the 1990s. In addition, the capital base of Japanese financial institutions has strengthened and Japan's financial system has regained its stability.

In such circumstances, financial institutions are ever more focused on developing and offering a wider range of financial services closely tailored to customer needs. For example, banks have increased the variety of financial products offered over the counter, such as investment trusts and private pension policies in addition to conventional bank deposits, and sales of such products have expanded. They have also been more innovative in designing new types of residential mortgage loan products, and as a result, residential mortgage loans have come to account for about a quarter of all bank loans, up from around 10 percent in the 1990s. Finally, the variety of commercial loan products has increased. Banks have increased their syndicated loans and have started to offer small-sized non-collateralized business loans to small and medium-sized firms using the so-called "credit scoring model," a statistical credit examination method.

Along with efforts to overcome the NPL problem, financial institutions have been preparing themselves to develop innovative lines of business. Smooth implementation of such new business lines requires financial institutions to accurately identify and assess the risks inherent to each new business and then to manage those risks accordingly. Specifically, financial institutions will need to employ the advanced risk management techniques that have been rapidly developed in recent years so as to appropriately manage the various risks involved in each new business area, for example, credit risks, market risks, and operational risks, and thereby achieve sound business management and enhance profitability.

Competition among financial institutions to provide various financial services and develop advanced risk management techniques will not only strengthen financial institutions' ability to provide value-added services but also enhance the functioning of financial markets, thus leading to increased financial system stability. Enhancing the functioning of financial markets is also very important for firms. This will not only increase the efficiency with which firms can raise and invest funds, but will also promote business restructuring, which has been increasing among Japanese firms, as well as facilitate balance-sheet adjustments. The U.S. economy has been growing for some time now - a fact due in no small part to the increased productivity accompanying innovations in information and communication technology and the improved flexibility in the business management of firms made possible by the deepening and expansion of financial markets. Similarly in Japan, strengthening the business management of financial institutions and further enhancement of the functioning of financial markets are essential in invigorating the economy.

The Bank will continue to make full use of occasions such as its on-site examinations, off-site monitoring, and various seminars hosted by the Center for Advanced Financial Technology to support the initiatives of financial institutions to strengthen their business management. Through such activities, we intend to promote financial institutions' initiatives to develop and offer new financial services, thus making a greater contribution to regional economies.

### **Closing remarks**

As I have explained, Japan's economy is expanding moderately. Looking at the economic situation in the Kansai region, corporate activity has increased due partly to strong exports, and a resulting

improvement in corporate profits is being observed, not only at large firms but also at small firms. In order for Japan's economy to continue sustainable growth in the face of various challenges including the declining population, it is crucial for all regions and industries to persist with their efforts to innovate. Since, along with the Tokai and Kanto regions, the Kansai region is pulling Japan's economy forward, I fully anticipate that your originality and inventiveness will continue to play a leading role. As for the Bank, it will continue to support the economy from the monetary side to achieve sustainable economic growth with price stability.