

## **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, 10 May 2007.

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### **Introduction**

In the year since I last spoke to you here, Japan's economy has continued to expand moderately. Semiannually in April and October, the Bank of Japan explains its projection for the nation's economy in its *Outlook for Economic Activity and Prices*, or the Outlook Report for short. In the latest Outlook Report, which was released at the end of April, the Bank projected that from fiscal 2007 through fiscal 2008, the economy is likely to continue its sustained expansion, growing at a rate slightly above its potential. Today, I will focus on the Bank's view concerning developments in economic activity and prices based on the projection in the Outlook Report, and I will also explain the basic thinking regarding future monetary policy conduct.

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

I would first like to touch upon developments in overseas economies, which form the basis for the Bank's outlook for Japan's economy. Overseas economies taken as a whole continue to expand, with momentum being gained across a wide range of economies, and are likely to keep expanding. In the United States, although the pace of economic growth has recently been decelerating due mainly to ongoing adjustments in the housing market, the economy is likely to realize a soft landing and move onto a growth path at a rate near its potential as adjustments, particularly in household spending, become less severe. In the euro area, economic recovery has been solid, as the increase in production and improvement in corporate profits have led to recovery in business fixed investment and private consumption. Looking at East Asia, the Chinese economy continues to expand strongly with both exports and business fixed investment showing high growth, and the NIEs and ASEAN economies continue to expand at a moderate pace on the whole as domestic demand remains firm, despite a lull in exports. It was also the consensus view among delegates at the G-7 meeting in April that the global economy continues to expand robustly and is becoming more balanced.

### **II. Current situation of Japan's economy**

Against the background of the generally favorable developments in overseas economies, Japan's economy has continued to expand moderately. Although exports to the United States are somewhat weak, overall exports continue to increase steadily reflecting the expansion of overseas economies. Business fixed investment continues to increase as corporate profits remain high. Production decreased in the January-March quarter of 2007 in reaction to the high growth in the previous quarter led by production in automobile-related goods, but it seems to be on a trend of 1 percent quarter-on-quarter growth.

As for the household sector, although growth of wages per worker has been somewhat sluggish due mainly to weak regular payments, employee income has continued to rise moderately supported by the increase in the number of employees. Property income such as dividends is also increasing. In this situation, growth in private consumption has recently resumed its upward movement, after sluggish growth over the summer of 2006 due to unfavorable weather conditions and consumers' reluctance to buy before the introduction of new products.

In sum, although the pace of improvement in the household sector has been somewhat slow relative to the strength in the corporate sector, Japan's economy as a whole is expanding moderately.

On the price front, domestic corporate goods prices have recently been about the same as their levels of three months earlier. The year-on-year rate of change in the consumer price index (CPI) excluding fresh food has recently been around 0 percent due to the drop in crude oil prices.

### III. Characteristics of the current economic expansion

Let me now review the characteristics of the current economic expansion, in order to project the future course of the economy. The economic recovery began in January 2002, and its most distinctive feature is that the economy has been growing amid rapid globalization. Japanese firms – which have regained competitiveness as adjustment of excesses in production capacity, employment, and debt proceeds – have been increasing exports, against the background of global economic expansion and growing prevalence of international division of the production process. They have increased exports of a wide variety of goods – including capital goods and parts, automobiles, IT-related goods, and consumer goods – to an increasing number of countries. This strong performance of Japanese firms in the global market has led them to expect higher demand growth, thus accelerating business fixed investment.

Economic growth achieved in this way has affected the distribution of the profits of economic growth to households. Faced with intensifying global competition and greater exposure to the discipline of the capital market, firms have changed the way they distribute profits. In an ever-changing competitive environment, they have been constraining increases in fixed costs and thus have continued to be cautious about increasing wages, particularly regular payments. Meanwhile, employees, having experienced a severe employment situation and currently facing intensifying global competition, have tended to prefer stable employment to a wage increase. Wage growth has therefore remained moderate despite the continuing high corporate profits.

Nonmanufacturing firms, which have relatively little access to the global market, are also experiencing a severe market environment. In the nonmanufacturing sector, not only has deregulation led to increased supply with new entrants into the market, but also the decline in public expenditure has reduced demand. Given that changes in wages have become more closely linked to the level of corporate performance, the pace of increase in wages has been slower among nonmanufacturing than among manufacturing firms, reflecting their lower profits.

In order to maintain competitiveness in the severe market environment, firms have continued to restrain labor costs. As a result, the pace of recovery in the household sector seems to be slower than people's expectations, despite the strength in the corporate sector.

These features of the current economic expansion may also be affecting the environment surrounding prices. As firms have been restraining wages and also increasing productivity, upward pressure on prices seems to have been contained. Also, given that the driving force of current economic growth has been the corporate sector, especially globally active firms, and that the positive influence of the strength in the corporate sector has been relatively slow in feeding through into the household sector, supply and demand conditions for consumer goods and services are likely to improve more slowly than overall supply and demand conditions. In other words, while, from the demand side, growth in consumer demand is likely to be moderate given the slow pace of the flow of income from the corporate sector to the household sector, supply is likely to increase given the rise in imports due to economic globalization coupled with new entrants coming into the market as a result of deregulation. Looking at firms' perception of resource utilization, an indicator for supply and demand conditions, the weighted average of the diffusion indices of production capacity and employment conditions in the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) suggests that the pace of improvement in resource utilization in consumption-related industries, such as retailing and services, is slower than the average for all industries. In recent years, the sensitivity of consumer prices to a rise in the utilization of resources such as production capacity and labor, or to changes in the output gap, has been declining, and this seems to have been due not only to deregulation and technological innovation but also to economic globalization.

Another characteristic of the current economic expansion is that the financial environment has continued to be extremely accommodative, and this has been supporting private demand. This accommodative financial environment, together with the expansion of the global market and the progress in adjustment of excess production capacity mentioned earlier, has also underpinned the increase in business fixed investment. Interest rates have been very low relative to economic activity and price conditions. For instance, comparison of the real GDP growth rate with the real short-term interest rate – although the latter varies depending on how the expected inflation rate is estimated – shows that while the GDP growth rate has been around 2 percent, the real short-term interest rate has been in the range of around 0-0.5 percent if the actual year-on-year change in the CPI is used as the expected inflation rate. The lending attitudes of financial institutions have been positive reflecting expansion of risk-taking capacity as a result of improvement in their financial condition, and in this

situation, the amount outstanding of lending by private banks has been increasing. In sum, the financial environment continues to be accommodative, both in terms of interest rates and availability of funds. The yen in terms of the real effective exchange rate has been moving at around its lowest level since the 1985 Plaza Accord, and this has been supporting growth in Japan's exports. Increases in asset prices, such as a more widely observed upturn in land prices, particularly in major cities, also seem to be exerting upward pressure on private demand.

#### **IV. Outlook for Japan's economy**

Next, I would like to elaborate on the outlook for Japan's economy based on the assessment of the current economic situation that I have described. From fiscal 2007 through fiscal 2008, Japan's economy is likely to continue its sustained growth of around 2 percent, somewhat above its potential. Given that the expansion of the global market and the accommodative financial environment – the two distinctive features of the current economic expansion – are likely to continue, the virtuous circle of production, income, and spending is expected to remain intact.

In the corporate sector, business fixed investment is expected to keep increasing as exports continue to rise and corporate profits remain high. According to the March *Tankan*, firms' business fixed investment plans for fiscal 2007 are strong for initial estimates. As for the household sector, household spending is expected to follow a moderate upward trend as the positive influence of the strength in the corporate sector feeds through into the household sector slowly but steadily. Although firms are likely to continue to restrain labor costs, upward pressure on wages is likely to increase gradually as firms feel a growing shortage of labor. In fact, wages for temporary and part-time workers are rising, and an increasing number of firms are planning, for the first time in many years, to raise their starting salaries for new graduates. In this spring's wage negotiations, labor unions demanded slightly larger wage increases than hitherto and firms' management tended to accommodate them, at least to a certain extent. Firms may become more eager to hire or retain skilled workers in order to maintain and enhance their quality control expertise and their ability to provide value-added goods and services, both of which will give them a competitive edge in the long term. Acceleration in wage growth, coupled with the ongoing rise in the number of employees, will likely lead to a more firmly established uptrend in employee income. Property income of households is also expected to continue to increase due mainly to the rise in dividends, since households have been increasing their investments in financial instruments such as stock investment trusts. Furthermore, how baby boomers, who have started to retire, will spend their retirement benefits and savings should be watched closely. Thus, private consumption is likely to follow a moderate upward trend as the positive influence of the strength in the corporate sector feeds through into the household sector via various channels.

In this situation, the environment surrounding prices is expected to gradually improve. If the economy continues to grow at a rate exceeding its potential for the next two years, the rate of utilization of resources such as production capacity and labor will further increase. In other words, the output gap will continue to indicate tighter supply and demand conditions. As the strength in the corporate sector leads to further increases in employee income, it is natural to expect that supply and demand conditions for consumer goods and services will improve and that this will exert upward pressure on consumer prices. Moreover, unit labor costs (labor costs per unit of output), although currently still declining with the growth rate of wages hovering around 0 percent, are likely to stop falling and start showing modest increases reflecting gradual rises in wages. Although inflation expectations in the private sector have shifted down due mainly to past falls in the prices of petroleum products, prices in general are still expected to increase moderately.

Taking these developments into account, the year-on-year rate of change in the CPI is likely to be around 0 percent in the short run depending on developments in crude oil prices, but is expected gradually to rise in the longer run. However, the pace of increase is likely to be moderate, given that the sensitivity of prices to changes in the output gap is declining due to factors such as economic globalization and deregulation. The year-on-year rate of increase in the CPI is expected to be slightly above 0 percent in fiscal 2007 and around 0.5 percent in fiscal 2008.

#### **V. Upside and downside risks to the outlook for economic activity**

I have so far outlined the most likely projection for the next two years or so. However, the economy constantly faces various risks, and due attention should be paid to the possibility that economic activity and prices might deviate from this projection should particular risks materialize.

In the April 2007 Outlook Report, we pointed out the following as upside and downside risks to the outlook for economic activity: developments in the global economy; supply and demand conditions for IT-related goods; and possible larger swings in financial and economic activity. Let me elaborate on each risk.

The first risk concerns developments in the global economy, which is expected to keep expanding with momentum being gained across a wide range of economies. In the United States, adjustments in the housing market, including problems in the market for subprime mortgage debt, are still ongoing, and some leading indicators of business fixed investment have been showing somewhat weak developments. If adjustments in the housing market turn out to be greater than expected or business fixed investment weakens, economic growth may decelerate further. On the other hand, there is a risk that inflationary pressures in the United States may persist longer than expected, given that the rate of change in the core CPI has been somewhat elevated reflecting higher utilization of resources. If inflationary pressures do not subside, there is a risk that not only the U.S. but also the global economy and financial markets may be adversely affected, for instance, through the reaction of long-term interest rates and foreign exchange rates to this situation. In China, there is an upside risk of the economy growing faster than expected, particularly fixed asset investments and exports. Whether this risk can be reduced and the Chinese economy can realize stable growth even after the 2008 Olympic Games in Beijing should be the focus of attention.

The second risk concerns supply and demand conditions for IT-related goods. Inventory adjustments of IT-related goods are continuing, and this seems to be the result mainly of specific domestic factors, namely, the slow improvement in the balance of inventories and shipments for electronic parts, particularly those related to cellular phones. Global demand for IT-related goods has so far been on an upward trend due partly to the rapid growth in emerging-market economies, such as the BRICs, and thus inventory adjustments should basically come to an end in or after the middle of 2007. However, if expected global demand is revised significantly downward in response to, for instance, a deceleration in the global economy, there is a possibility that adjustment pressures on inventories may intensify, since the pace of increase in global supply tends to be rapid in the IT-related sector.

The third risk concerns possible larger swings in financial and economic activity based on optimistic assumptions regarding, for example, financial conditions. Japan's current economic circumstances, with the financial positions of both firms and financial institutions improving and real interest rates remaining very low, are such as potentially to encourage assertive financial and economic activity. As for foreign exchange rates, the real effective exchange rate is at the lowest level since the 1985 Plaza Accord, and the upward trend in land prices in major cities has become increasingly distinct as seen in the fact that commercial land prices in Tokyo and Osaka in March's *Land Price Publication* showed a double-digit increase from the previous year. These developments in foreign exchange rates and asset prices may also cause activity of both firms and financial institutions to accelerate. Should greater assertiveness be based on optimistic assumptions regarding future profitability, such as too rosy expectations for the growth rate, financing costs, foreign exchange rates, and asset prices, the result could well be a misallocation of resources in the long run as agents become over-extended in financial markets or pour funds and other resources into inefficient economic activities. Such behavior may push up economic growth and asset prices in the short run, but it can lead to later downward adjustments and hamper the sustainability of economic growth.

## **VI. Upside and downside risks to the outlook for prices**

These upside and downside risks to the outlook for economic activity may affect prices if they should materialize, but there are also upside and downside risks unique to price developments that could cause prices to deviate from the projection. In the April Outlook Report, two risks are noted: uncertainty concerning the sensitivity of prices to changes in the output gap, and developments in the prices of crude oil and other commodities.

The sensitivity of prices to changes in the output gap has been declining in recent years due partly to economic globalization. This tendency has been taken into account in the projection for prices mentioned earlier, but the sensitivity of prices may turn out to be lower than assumed in the projection. If, despite prolonged economic expansion, wage growth were to remain low relative to the pace of productivity gains, downward pressure on prices from labor costs would persist. Moreover, if the positive influence of the strength in the corporate sector feeds through into the household sector slower than expected due to sluggish wage growth, supply and demand conditions for consumer

goods and services may not improve in line with the diminishing slack in the economy. In such a situation, prices may not be responsive to the improvement in the economic situation.

On the other hand, if the economy continues to grow at a pace exceeding the potential through fiscal 2008, it is likely that the rate of utilization of resources such as production capacity and labor will rise further and the output gap will show further tightening of supply and demand conditions. Inflation expectation, which has been low and stable, may increase with higher resource utilization, particularly in labor. Moreover, although firms are likely to continue to restrain labor costs, they may change their attitude with the aim of hiring or retaining skilled workers. These potential changes would exert upward pressure on prices.

Prices of crude oil and other international commodities may deviate either upward or downward from the projection depending on factors such as geopolitical risks. Close attention should be paid to developments in these prices, since they will have a substantial effect on domestic corporate goods prices and consumer prices.

## **VII. Conduct of monetary policy**

Let me now explain how the Bank will conduct monetary policy based on the outlook for the economy and prices I have outlined, giving due regard to the possibility of upward or downward deviation.

In March 2006, when the quantitative easing policy was terminated, the Bank introduced the "New Framework for the Conduct of Monetary Policy." It consists of three elements. The first is releasing the "understanding of medium- to long-term price stability," the second, assessment of the economic and price situation from two perspectives taking account of the "understanding of medium- to long-term price stability," and the third, outlining the Bank's thinking on the future course of monetary policy.

The "understanding of medium- to long-term price stability" is the level of inflation that each member of the Policy Board understands, when conducting monetary policy, as being consistent with price stability over the medium to long term. Each member, with this understanding in mind, judges whether Japan's economy will achieve sustainable growth under price stability, and makes policy decisions based on this judgment. At the Monetary Policy Meeting at the end of last month, we conducted a review of the "understanding," in accordance with the decision that it should be reviewed, in principle, annually. First, the basic understanding concerning price stability was reviewed, and it was reaffirmed as follows.

- (1) Price stability is a state where various economic agents including households and firms may make decisions regarding economic activities without being concerned about fluctuation in the general price level.
- (2) Given that the effects of monetary policy take time to work through the economy and that the volatility of output may actually be amplified when attempts are made to absorb every short-term change in prices resulting from various shocks, the Bank should forecast developments in economic activity and prices from a sufficiently long-term viewpoint and strive to realize price stability over the medium to long term.

Furthermore, in examining the "understanding of medium- to long-term price stability," the following points were considered. First, the significance of measurement bias in the CPI. Second, the necessary extent of the "safety margin" that acts as a buffer against the risk of falling into a vicious circle of declining prices and deteriorating economic activity. And third, possible changes in the level of inflation perceived by households and firms as consistent with price stability. As for the first point, it seemed that measurement bias remained insignificant even taking into account last year's rebasing of the CPI. Regarding the second point, the "safety margin," the risk of the economy falling into a deflationary spiral seems to have further decreased, since the strength of the corporate sector and robustness of the financial system have further improved. Finally, on the third point, the level of inflation perceived by households and firms as consistent with price stability is unlikely to have changed much, since changes in the inflation rate have been small.

Based on these considerations, it was agreed, as was also the case a year ago, that the "understanding of medium- to long-term price stability" expressed in terms of the year-on-year change in the CPI, takes the form of a range approximately between 0 and 2 percent with most Policy Board members' median figures falling on one side or the other of 1 percent.

The next step, the examination from two perspectives, involves assessment of the outlook for the economy and prices from two standpoints – whether the main scenario leads to the attainment of our objective and how other relevant risks should be evaluated.

From the first perspective, we examine the prospects for economic activity and prices for one to two years ahead – this time, through fiscal 2008 – and assess whether the most likely outlook is for the economy to follow a path of sustained growth under price stability.

Through fiscal 2008, the economy, as I said earlier, is likely to continue its sustained expansion with a virtuous circle of production, income, and spending in place. The year-on-year rate of change in the CPI (excluding fresh food) is likely to be around 0 percent in the short run, but is expected gradually to rise in the longer run. Such developments can be regarded as in line with the "understanding of medium- to long-term price stability" that each member of the Policy Board has in mind. In sum, we judged that, through fiscal 2008, Japan's economy is likely to realize sustainable growth under price stability.

This outlook is based on the assumption that market participants and firms make decisions by factoring in future changes in monetary policy. Thus, adjusting the level of the policy interest rate will become necessary for the economy and prices to continue to follow the projection. The pace of necessary adjustment, however, will depend on the degree of future improvements in the economy and price situation. We do not, therefore, have any predetermined schedule.

The second perspective extends the time horizon and assesses the risks considered most relevant to the conduct of monetary policy. In this assessment, we take account of the cost incurred should risks materialize, even though the probability of this happening may be low. In this regard, both upside and downside risks need to be borne in mind. In terms of the upside risks, we need to be mindful of the stimulative effect of monetary policy being further amplified with the improved prospects for economic activity and prices. If, for instance, the expectation takes hold that interest rates will remain low for a long time regardless of developments in economic activity and prices, then firms and financial institutions may over-extend themselves based on such expectation, resulting in medium- to long-term risks of larger swings in the economy and inflation rate, and of misallocation of funds and resources.

On the other hand, if the downside risks mentioned earlier should materialize, the improvement in the economic situation may stall. It is also possible that prices will continue not to rise despite the improvement in economic conditions. Nevertheless, the risk of the economy falling into a vicious circle of declining prices and deteriorating economic activity seems to have further decreased, since the strength of the corporate sector and the robustness of the financial system have been enhanced.

Based on this outlook and assessment of risks, we have decided to maintain the current basic thinking regarding the conduct of monetary policy, employed since the termination of the quantitative easing policy in March 2006. The Bank adjusted the level of the policy interest rate in July 2006 and in February 2007. Adjustments were made in view of the outlook for the economy and prices, with the Bank judging that sustained economic growth would continue with a virtuous circle of production, income, and spending in place, and that consumer prices would be likely to increase moderately in the long run in line with the "understanding of medium- to long-term price stability." Based on this assessment, we have been realizing the idea of "adjusting the level of interest rates gradually in the light of developments in economic activity and prices." With inflationary pressures weak, the pace of adjustment has been slow and the accommodative financial conditions ensuing from very low interest rates have been maintained. The Bank's basic thinking in this regard will remain the same in the conduct of future monetary policy. In sum, while confirming that Japan's economy remains likely to follow a path of sustainable growth under price stability in light of the aforementioned "understanding" and assessing relevant risk factors, the Bank will adjust the level of interest rates gradually in accordance with improvements in the economic and price situations.

## **Concluding remarks**

Lastly, I would like to touch upon the Bank's communication of information concerning the conduct of monetary policy. The Bank will continue to explain carefully to the public its assessment of economic activity and prices and its basic thinking on the conduct of monetary policy in line with the "New Framework for the Conduct of Monetary Policy," through, for example, the Outlook Report.

In relation to this point, there are voices that call for the Bank to communicate information on the specific time schedule of a policy change, but we neither believe it possible nor consider it appropriate

to do so. The Bank considers that there are two key pieces of information that it should provide, namely, its assessment of economic activity and prices, and its basic thinking on the conduct of monetary policy. Taking into consideration such information provided by the Bank, market participants carry out transactions based on their views regarding economic activity and prices; the Bank in turn obtains information regarding market participants' views on economic activity and prices from interest rates formed in financial markets as a result of transactions carried out by market participants, and uses it in making its assessment of economic activity and prices. We think such a two-way communication process is important. If, however, the central bank were to indicate a specific time schedule for a policy change, market participants would carry out transactions based not on their own views regarding economic activity and prices but on the Bank's indication. Therefore, we think it is vital that the central bank's communication to the public should be limited to the extent I have just outlined for the market to fully perform its function of price discovery and allocating resources efficiently. The Bank will continue to conduct monetary policy appropriately and to contribute to achieving sustainable economic growth under price stability.