

## **Toshihiko Fukui: Bank of Japan's view on developments in economic activity and its conduct of monetary policy**

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at a meeting with business leaders, Osaka, 5 November 2007.

\* \* \*

### **Introduction**

In the year since I last spoke to you here, Japan's economy has continued to expand moderately, with a virtuous circle of growth in production, income, and spending in place. Although there are uncertainties regarding overseas economies and global financial markets, the economy is likely to continue its moderate but sustained expansion. In the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), released at the end of last month, we have provided an outlook that, toward fiscal 2008, our economy will grow, under stable prices, at an average pace of around 2 percent, which is somewhat above its potential growth rate.

Today, I would like to explain the Bank of Japan's view regarding developments in economic activity and prices and the basic thinking behind its conduct of monetary policy.

### **I. The current situation and the outlook for Japan's economy**

I would first like to touch upon the current situation of Japan's economy.

Japan's economy as a whole has continued to expand moderately, although the pace of improvement in the household sector has been somewhat slow relative to the strength in the corporate sector. Exports to the United States have been somewhat weak, but the overall exports have continued to increase steadily as overseas economies taken as a whole have kept growing. In this situation, firms have continued to reinforce their capacity to supply products by increasing fixed capital with a view to capturing profit opportunities in overseas markets. The increase in corporate activity driven by strong exports, coupled with the extremely accommodative financial conditions, has led to growth in business fixed investment among a wider range of industries, including domestic demand-oriented industries. However, since business fixed investment has continued to increase at a rapid pace for the last several years and the level of capital investment is already high, the pace of growth is likely to decelerate gradually. The September *Tankan* (Short-Term Economic Survey of Enterprises in Japan) indicated that steady growth in business fixed investment would continue, and the pace of increase would slow gradually. It also indicated that corporate profits have been high, and business sentiment has remained generally favorable although some cautiousness was reported in certain sectors.

The positive influence of the strength in the corporate sector is feeding through into the household sector slowly but steadily. Wages per worker have been somewhat weak mainly due to the following factors: firms, particularly small ones, have been restraining labor costs in the face of greater exposure to global competition and capital market discipline, and increased materials prices; and with the high-salaried baby-boomer generation retiring, an increasing number of relatively low-salaried workers, such as new graduates and part-time workers, have been recruited. Meanwhile, the number of employees has been increasing at a year-on-year rate of around 1 percent, and employee income has continued rising moderately. At the same time, strength in the corporate sector has been filtering through into the household sector via various channels, for example, increased dividends. While spending on clothes and other daily necessities has been somewhat weak, growth in spending in areas where firms have increasingly been providing new products and services designed to meet consumer needs has been high as evidenced by, for example, strong sales of digital

appliances. Spending behavior has thus varied with the type of goods and services, but private consumption, taken as a whole, has remained firm.

In sum, our economy is currently experiencing moderate expansion. The virtuous circle of growth in production, income, and spending is likely to remain intact against the background of the expansion of the global market and the extremely accommodative financial conditions, although there are uncertainties regarding overseas economies and global financial markets.

In this situation, upward pressures on prices are likely to build up gradually. Looking at recent developments in price indices, while the domestic corporate goods price index (CGPI) has been rising mainly due to increases in international commodity prices, higher materials prices have not been passed through to the retail level as much as at the wholesale level. This seems to indicate that with intensifying competition among firms due partly to globalization and deregulation, many firms are restraining increases in prices through improvements in productivity and various cost reduction measures. In this situation, the year-on-year rate of change in the consumer price index (CPI, excluding fresh food) has remained at around 0 percent. However, if the economy continues to grow at a rate exceeding its potential, resource utilization, namely in labor and production capacity, will increase further. In such a situation, it is expected that supply and demand conditions for consumer goods and services will further tighten and that this will exert upward pressure on consumer prices as more firms pass on higher costs to consumers. Moreover, unit labor costs (labor costs per unit of output), although currently still declining, are likely to stop falling as wages begin to show a gradual upward trend.

With these understandings, 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. 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 rate of increase is projected to be around 0 percent in fiscal 2007 and around 0.5 percent in fiscal 2008.

## **II. Developments in overseas economies**

I have so far outlined the most likely projection. However, any kind of projection is subject to upside and downside risks.

The first risk concerns developments in overseas economies.

The global economy has been expanding strongly, registering high growth of around 5 percent since 2004. It is the first time since the early 1970s that the global economy has registered such high growth over a period of this length: until 2003, the growth rate was around 3 to 4 percent. The high growth of the global economy is to a great extent attributable to the fact that emerging economies have taken off one after another and have been increasing their presence in the global economy.

In the U.S. economy, the correction in the housing market is continuing, but business fixed investment and private consumption continue to be on a moderate increasing trend although the pace of increase is decelerating. If the housing correction does not spread to other areas of the economy and the economic slowdown is only moderate, the global economy is likely to continue to expand steadily with the slowing of U.S. economic growth being offset by high growth in emerging economies such as the BRICs. This was also the consensus view among delegates at the G-7 and International Monetary Fund meetings in October.

As you all know, global financial markets have been volatile since the summer due to the heightening of concern about the U.S. subprime mortgage problem. This recent volatility in global financial markets could be regarded as laxity in risk evaluation in the continued benign global economic and financial environment being reversed by market forces of self-correction. However, if the correction in the U.S. housing market intensifies or the effects of

swings in financial markets become unexpectedly widespread, private consumption and business fixed investment may become weaker than expected due to the negative wealth effect, credit tightening, and deterioration in business and consumer sentiment, thereby leading to further deceleration in U.S. economic growth. Although the European economy is likely to expand steadily, growth may slow depending on the effect of volatile global financial markets on financial conditions. If these risks related to the U.S. and European economies were to materialize, this may, depending on the extent, affect growth of other economies such as emerging economies, and this could cause global economic growth to be weaker than expected.

In view of the high rate of growth that the global economy has maintained, attention should also be paid to inflationary pressures. In the United States, inflationary pressures may not subside as a result of higher resource utilization, namely in labor and production capacity, coupled with developments in crude oil prices. The Chinese economy continues to grow strongly, but there are signs of overheating, particularly in fixed asset investment, indicating that economic activity and prices may deviate upward from the expected path. Because of the strong growth of the global economy and geopolitical risks, international commodity prices such as crude oil prices remain elevated, and they may affect the global economy and the price situation depending on future developments in these prices.

Thus, there is a risk that disruptive changes in overseas economies or global financial markets may affect Japan's economy through changes in exports and imports, corporate profits, and financial market conditions such as foreign exchange rates and long-term interest rates.

### **III. Swings in financial and economic activity**

The second risk concerns possible larger swings in financial and economic activity as a result of a misallocation of resources under continuing accommodative financial conditions. Some argue that recent developments in yen carry trades are a sign of such a potential risk. In Japan, there have so far been only limited effects on financial conditions stemming from the U.S. subprime mortgage problem and the subsequent volatility in overseas financial markets, and the lending attitude of financial institutions has remained positive. The issuing environment for CP and corporate bonds has been favorable. 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. According to the Prefectural Land Price Survey released in September, the rate of increase in land prices in the three major metropolitan areas (Tokyo, Osaka, and Nagoya) has accelerated against the background of increases in redevelopment projects and steady demand for office space. These developments may also cause activity of both firms and financial institutions to accelerate. If greater assertiveness should be based on optimistic assumptions regarding future sales and profits, 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 developments may push up economic growth in the short run, but lead to later downward adjustments and hamper the sustainability of economic growth.

### **IV. Sensitivity of prices to changes in the output gap**

These upside and downside risks to the outlook for economic activity may affect prices should they materialize, but there are also upside and downside risks unique to price developments that could cause prices to deviate from the projection.

The sensitivity of prices to changes in the output gap has been declining in recent years. This tendency has been taken into account in our projection for prices mentioned earlier, but the

degree of decline is uncertain and the sensitivity of prices may turn out to be lower than assumed in the projection. If factors strongly restraining wage growth remain despite prolonged economic expansion, 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 more slowly than expected due to sluggish wage growth, supply and demand conditions for consumer goods and services may not improve as much as the output gap suggests. 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 its potential through fiscal 2008, it is likely that the utilization of resources such as labor and production capacity will rise further and the output gap will show further tightening of supply and demand conditions. Inflation expectations, which have been low and stable, may rise with higher resource utilization, particularly in labor, along with increased prices of crude oil and other international commodities. 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.

## **V. Conduct of monetary policy**

Next, I would like to elaborate on the future conduct of monetary policy, keeping in mind the projection for economic activity and prices and the possibility that they may deviate from the projection.

The Bank assesses the economic and price situation from two perspectives and then outlines its thinking on the future conduct of monetary policy, taking account of the "understanding of medium- to long-term price stability" (in numerical terms, a range approximately between 0 and 2 percent in the year-on-year rate of change in the CPI), which 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.

To further your understanding of the two perspectives, I would like to assess the developments in economic activity and prices that I have explained based on these two perspectives. The first perspective involves assessing whether the most likely outlook for economic activity and prices will remain on the path of sustainable growth under price stability. As I said earlier, it is likely that Japan's economy will continue its sustained expansion with a virtuous circle of growth in production, income, and spending in place, and this is the Bank's baseline scenario. 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. In sum, under the first perspective, we are of the view that, through fiscal 2008, Japan's economy is likely to realize sustainable growth under price stability.

The second perspective extends the time horizon and assesses the risks, taking account of the cost incurred should they materialize, even though the probability of this happening may be low. Since I have already referred to these risks as possible upward and downward deviations of the economy and prices, let me review these risks briefly. There are uncertainties regarding overseas economies and global financial markets and if their situation changes significantly, Japan's economy will inevitably be affected. There is also a possibility that prices will continue not to rise despite the improvement in economic conditions. Lastly, attention should continue to be paid to the risk that the stimulative effect of monetary policy may be 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, this may result in medium- to long-term risks of larger swings in the economy and inflation rate through misallocation of funds and resources.

I would now like to talk about the Bank's conduct of monetary policy, bearing in mind the assessment above. The Bank's basic thinking has been that (1) given the extremely accommodative financial conditions, the level of interest rates is to be raised if Japan's economy is to follow a path of sustainable growth under price stability, and (2) the pace of increase in interest rates should be determined in accordance with improvements in the economic and price situation without any predetermined view. So far, weak inflationary pressures have given the Bank latitude in conducting monetary policy. The actual interest rate adjustments have therefore been slow based on a thorough assessment of the future path of the economy and prices and its likelihood, as well as both upside and downside risks. The Bank's basic thinking in this regard will remain the same in the conduct of future monetary policy. That is, while confirming that the Japanese economy remains likely to follow a path of sustainable growth under price stability and assessing relevant upside and downside risk factors, the Bank will adjust the level of interest rates gradually in accordance with improvements in the economic and price situation. We believe that, from the long-term perspective, the conduct of monetary policy in such a manner will prevent the risk of larger swings in economic activity and prices from materializing and will help to realize sustainable growth under price stability.

## **Conclusion**

Japan's economy is expanding moderately. Corporate activity has been increasing due partly to strong exports, as can be seen here in the Kansai region, and the positive influence is clearly spreading throughout the wider economy as evident in the declining unemployment rate. 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 Kanto and Tokai 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, we will continue to support your efforts through our conduct of monetary policy.