

Toshihiko Fukui: Developments in economic activity and prices and the Bank of Japan's conduct of monetary policy

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at a meeting with business leaders, Nagoya, 3 December 2007.

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Introduction

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. In addition, I would like to touch upon the issues currently facing Japan's financial system.

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

I would first like to talk about the current situation and the outlook for economic activity and prices.

Japan's economy as a whole has continued to expand moderately, although the pace of improvement in the household sector has remained slow relative to the strength in the corporate sector. At the end of October, we released the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), and presented the projection through fiscal 2008. The gist of the Outlook Report is that although there are uncertainties regarding overseas economies and global financial markets, Japan's economy is likely to continue its sustained expansion under price stability. In terms of the rate of real GDP growth, we projected that this is likely to register around 2 percent on average, somewhat higher than the potential growth rate. I would now like to elaborate on the mechanisms that form the basis for the outlook as well as some associated risk factors.

Within the corporate sector, exports have remained on the increase, reflecting the widening base of continuing world economic growth. Business fixed investment is likely to keep rising steadily, supported by high corporate profits. The rate of growth is, however, likely to be lower than it was up until fiscal 2006, since capital investment has continued to increase at a rapid pace for the last several years.

The positive influence of the strength in the corporate sector has been feeding through into the household sector slowly but steadily. With the number of employees rising, employee income has been increasing moderately, and growth in household income has continued to be further supported via various other channels, for example, increased dividends. Meanwhile, wages have been somewhat weak recently, reflecting labor cost restraint by firms in the face of greater exposure to global competition and capital market discipline, and increased materials prices. The change in the composition of the workforce due to the retirement of the high-salaried baby-boomer generation and increases in part-time workers has also contributed to the weakness in wages. However, given the further tightening of labor market conditions and firms' growing sense of labor shortage, upward pressure on wages is expected to increase gradually. Against this background, private consumption is likely to follow a moderate upward trend.

In assessing wages and other flows of income from the corporate to the household sector, business conditions at small firms are especially relevant because small firms account for a large share of Japan's total employment. Since its inception, the current economic expansion has coincided with continued progress in globalization, and thus there has been disparity in business conditions depending on the extent of involvement with economies abroad. Recently released surveys indicate that business sentiment at small firms is weakening. Factors behind this include the deterioration in small firms' terms of trade, resulting from the

surge in materials prices, and the fact that production remained virtually flat in the first half of 2007. Although production has been increasing since the summer, future developments in business conditions at small firms continue to warrant attention.

Regarding prices, while the domestic corporate goods price index (CGPI) has been rising mainly due to higher international commodity prices, the year-on-year rate of change in the consumer price index (CPI, excluding fresh food) has remained at around 0 percent. This seems to reflect the fact that fierce competition due partly to progress in deregulation has not allowed firms at the retail level to pass increased materials prices on to consumers to the extent that has been possible at the wholesale level. Looking ahead, however, as economic growth is expected to continue at a rate somewhat higher than the potential growth rate, the level of utilization of resources, namely in labor and production capacity, should rise further, and unit labor costs (labor costs per unit of output) are likely to stop falling. Given this, 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.

II. Positive and negative deviations

As I have outlined, the scenario we consider the most likely is that Japan's economy will continue its sustained expansion with a virtuous circle of growth in production, income, and spending in place. However, it should be noted that such projections are always subject to upside and downside risks, which warrant close attention.

The first risk concerns developments in overseas economies. In the United States, housing investment has been decreasing, and, with inventory levels high, the correction in the housing market is expected to continue for a while. Banks are becoming increasingly cautious in extending loans in view of disruptions in financial markets due to subprime mortgage problems. Nevertheless, to date, other parts of the economy seem not to have been harmed significantly, and private consumption and business fixed investment are continuing their moderate upward trend, although the pace of increase is decelerating. Employment has also continued increasing. Given these developments, it seems likely that the U.S. economy will register relatively low growth rates in the short run but will eventually realize a soft landing and move toward sustainable growth. However, if the correction in the housing market intensifies or the negative effects of disruptions in financial markets become unexpectedly widespread, private consumption and business fixed investment may fall below expectations through negative wealth effects, credit tightening, and deterioration in business and consumer sentiment, thereby leading to further deceleration in U.S. economic growth. Meanwhile, the European economy has continued to expand, but the possible adverse effects on financial conditions of global financial market disruptions may pose a downside risk. If downside risks related to the U.S. and European economies were to materialize and have significant adverse effects, growth in other parts of the world may be hampered and this could cause global economic growth to be weaker than expected.

At the same time, attention should also be paid to the risk of inflation, since the world economy, taken as a whole, has been expanding at a rapid pace. In the United States, underlying inflationary pressures do not seem to have subsided, reflecting continued high levels of resource utilization as well as developments in crude oil prices. In China, with signs of overheating, especially in fixed asset investment, economic growth and inflation may exceed expectations. Meanwhile, given the currently elevated prices of crude oil and grains such as wheat and soybeans, possible shifts in international commodity prices may also influence the outlook for the global economy and the price situation.

In global financial markets, disruptions due to subprime mortgage problems have continued to be observed. In the United States and Europe, the functioning of markets for securitized products has deteriorated significantly, while money markets are still in the process of recuperating. Stock prices and foreign exchange rates have been unstable across the world. The recent volatility in global financial markets seems to reflect a reversal of the previous

laxity in risk evaluation that had developed during the long period of benign economic and financial conditions. This adjustment is therefore expected to require some time to work itself out, and during the process financial institutions will have to bear a certain amount of losses. Still, there is a degree of uncertainty as to how the global economy will be influenced by future developments in global financial markets and conditions at financial institutions.

If such disturbances to overseas economies and global financial markets should indeed materialize, Japan's economy may be adversely influenced through, for example, changes in exports and imports, corporate profits, and financial market conditions. Attention should continue to be paid to this potential risk.

The second risk concerns possible larger swings in financial and economic activity under continuing accommodative financial conditions. In terms of their impact on Japanese financial conditions, the adverse effects of subprime mortgage problems and the consequent volatility in global financial markets have so far been limited: the lending attitude of financial institutions has been positive; and the issuing environment for CP and corporate bonds has continued to be favorable. Meanwhile, with extremely accommodative financial conditions continuing, there is a risk of 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 lead to later downward adjustments and hamper the sustainability of economic growth.

III. Conduct of monetary policy

I would now like to explain the Bank's thinking regarding the conduct of monetary policy based on the above-mentioned assessment of economic activity and prices.

As I have just said, Japanese financial conditions have been extremely accommodative, and if Japan's economy is to follow a path of sustainable growth under price stability, the level of interest rates is to be raised. We have no predetermined view regarding the timing or the pace of increase in interest rates, and will determine these in light of our assessment of the future path of the economy and prices and its likelihood, as well as a careful consideration of both upside and downside risks. Our outlook suggests that Japan's economy will realize sustainable growth under price stability. But still, we need to examine the likelihood of this scenario. We are also aware of the importance of examining risk factors that may influence the outlook, and in this respect we should not focus merely on immediate downside risks, but should be attentive to both upside and downside risks. It is vital for monetary policy to adopt a wide-ranging perspective that takes due account of the various factors influencing economic activity and prices. This is something we bear in mind in our efforts to ensure the appropriate conduct of monetary policy.

IV. Issues facing Japan's financial system

As the last topic of my speech today, I would like to touch upon the recent volatility in global financial markets and its implications for Japan's financial system.

As subprime mortgage problems have intensified and become more widespread in financial markets abroad, the impact on Japanese financial institutions has been gradually increasing and is greater than originally expected. For instance, the decline in the market value of investment products has resulted in losses at some Japanese financial institutions, and some financial institutions have posted losses from revaluation on unsold products arranged as part of their overseas securitization business. However, since Japanese financial institutions' exposure to credit markets is relatively small, it seems that so far each financial institution or financial group is able to absorb losses incurred sufficiently within its earnings for the period or its buffer capital. We will keep our eyes on developments in U.S. and European financial

markets, but it currently seems unlikely that this particular problem will pose any significant threat to the stability of Japan's financial system.

Based on the assessment I have just made, let me now turn to current issues relating to risk management by market participants.

First, market participants, including financial institutions, need to assess the risks pertaining to financial products more precisely.

It cannot be denied that the current disruptions in financial markets are due partly to lax risk assessment by market participants caught out by the rapid expansion of markets for securitized products as well as the increased market penetration of complex financial products whose riskiness is difficult to assess. Innovative new financial products, in particular, have only a limited amount of accumulated historical data, for example on price fluctuations, and they also have complex risk profiles and relatively low market liquidity. For this reason, market participants should seek to quantify risks as accurately as possible, subject to very strict stress testing, and should then conduct appropriate risk management accordingly.

Second, market participants should further involve themselves in enhancing market transparency.

As seen in recent events, once a significant shock has occurred, the market as a whole tends to suffer anxiety and it can take some time for the proper functioning of financial markets to be restored. Furthermore, market reaction seems to become larger where financial products traded incorporate more advanced financial technologies. From the viewpoint of minimizing market over-reactions and facilitating the prompt recovery of market functioning, initiatives by market participants to further enhance information disclosure are highly desirable. Greater market transparency could be achieved, for instance, through the disclosure by financial institutions of the outstanding amounts of their investments and information concerning their profits and losses, as well as the provision by rating agencies of detailed information relevant to credit ratings.

I would like to emphasize that we do not view the recent development of financial markets, especially for securitized products, in a negative light. Risk diversification using new financial products has broadened the range of participants in financial markets, and has contributed significantly to the growth of the world economy. The problem has been that the techniques to assess and manage the associated risks have not kept up with the pace of product innovation. What we need is to improve those techniques. At the Bank of Japan, we will continue to closely monitor developments in global financial markets and to assess their implications for the Japanese financial system. At the same time, we will study and analyze in greater depth the various risk management issues I have discussed today, and so contribute to the enhancement of risk management by Japanese financial institutions.

Closing remarks

Amid intensifying global competition, Chubu, which has an industrial sector that is highly competitive at the international level, has been pulling the Japanese economy forward. I feel confident that the Chubu region will make use of the advanced technological expertise it has built up to take advantage of new business opportunities, and to enjoy further breakthroughs. I believe this will in turn lead to the sustained and dynamic growth of Japan's economy.