

Toshiro Muto: Bank of Japan's view regarding developments in economic activity and prices and the thinking behind its conduct of monetary policy

Summary of a speech by Mr Toshiro Muto, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Sapporo, 10 January 2008.

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Introduction

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

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.

The pace of growth in Japan's economy is currently slowing, mainly due to the drop in housing investment. The economy, for the time being, is expected to continue slowing, but is likely to resume moderate expansion thereafter.

The December *Tankan* (Short-Term Economic Survey of Enterprises in Japan) indicated that businesses have become somewhat more cautious. Factors behind this seem to include the following. First, small firms, in particular, are still unable to pass on higher costs to sales prices even though the steep rise continues in prices of materials such as crude oil and grains. Second, housing construction has decreased significantly, reflecting the coming into force of the revised Building Standard Law in June last year. And third, uncertainty regarding the future course of the world economy has increased due to subprime mortgage problems. However, overall, firms are maintaining their growth forecasts for income and profits for fiscal 2007 and their capital investment plans remain solid.

Production has started increasing again after staying flat during the first half of 2007. The adjustment in inventories of IT-related goods, which had been rising, has more or less come to an end, and levels of production, shipments, and inventories, including in the IT-related sector, are essentially well in balance. Despite increased uncertainty regarding the course of the global economy and especially the U.S. economy, exports to a broad range of regions, including the oil producing countries and emerging economies, and hence overall, are continuing to increase. In the December *Tankan*, large firms' annual projections for export sales have been revised upward.

Given these developments, it seems reasonable to conclude that the strength in corporate activity remains intact, although close attention should be paid to how the more cautious business sentiment will affect corporate spending activity.

Let me now turn to developments in the household sector. Nominal wages per worker have been somewhat weak. Labor cost restraint by firms is persistent, as they are facing greater exposure to global competition and capital market discipline. Recently, in particular, sluggish growth in corporate profits resulting from the surge in materials prices has been leading firms, especially small ones, to restrain wages. Moreover, the change in the composition of the workforce, resulting from the fact that the high-salaried baby-boomer generation started to retire in 2006 and from increases in the share of part-time workers, has also contributed to the weakness in wages. However, as the economic expansion continues, albeit at a moderate pace, many firms are feeling a shortage of labor, as suggested by the *Tankan* reports, and the number of employees continues to rise. If labor supply and demand conditions continue to tighten, it is likely that upward pressure on wages will gradually

increase. This implies that employee income, which is the product of the number of employees and wages, is likely to continue rising moderately.

Against this background, private consumption has been firm. Although weather conditions have caused sales at department stores and at supermarkets to stay virtually flat, sales of digital appliances have been strong and the number of new passenger-car registrations has picked up. Meanwhile, however, various survey results are indicating weaker consumer sentiment. Factors behind this seem to include rises in prices of daily necessities such as gasoline, kerosene, and food, while wages remain sluggish. Developments in private consumption, which may be influenced by the weaker consumer sentiment, should continue to be monitored carefully.

Meanwhile, housing investment has been showing substantial declines due to the delays in the confirmation of building applications after the revised Building Standard Law came into force. Going forward, it is expected that gradual recovery will take place as the delays in the confirmation process are resolved, but there are uncertainties regarding the pace and extent of the recovery because condominium sales are becoming sluggish due to the rise in real estate prices, especially in the Tokyo metropolitan area.

Regarding prices, 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), which had remained at slightly below 0 percent, posted an increase of 0.1 percent in October 2007, followed by a 0.4 percent increase in November. As prices of petroleum products and food are increasing, the rate of growth in the CPI is likely to rise further in the immediate future.

As I noted earlier, the pace of economic growth seems to be decelerating at present. Given this, the overall supply and demand conditions seem unlikely to tighten for the time being. However, from a longer-term perspective, prices are likely to continue their upward trend due to tighter supply and demand conditions as the economic expansion continues.

In sum, negative factors such as (1) the surge in materials prices, (2) the significant decline in housing investment, and (3) increased uncertainty regarding the course of the global economy are causing a deceleration in the growth of Japan's economy, which has been moderate to begin with. For this reason, the virtuous circle of growth in production, income, and spending is temporarily weakening, but we do not expect that it will break. The current economic expansion is attributable to the continuing growth in overseas economies and the progress in the adjustment of various excesses at firms and financial institutions in Japan. Export activity, which is supported by overseas economies, and production at present are continuing to increase, so that the driving force of the virtuous circle remains intact. The extent of progress in corporate restructuring varies depending on the industry and size of firms concerned, but looking at the corporate sector as a whole, firms are not under pressure to adjust production capacity, labor, and inventories. Under these circumstances, business fixed investment and private consumption are maintaining their upward trend. In addition, going forward, housing investment seems likely to gradually recover, since the sharp decrease in housing investment is mainly due to the procedural change following the coming into force of the new law. Given these circumstances, our current view is that Japan's economy will maintain its moderate upward trend.

II. Developments in overseas economies

It should be noted, however, that there are certain risks regarding the outlook I just mentioned. In particular, one important risk factor is whether the world economy will continue its sustained growth, since this is the basis for the virtuous circle driving Japan's economic expansion.

Since summer 2007, global financial markets have been volatile due to the U.S. subprime mortgage problems, and uncertainty regarding the future of the world economy, especially the U.S. economy, has been increasing.

The deceleration in the growth of the U.S. economy is becoming somewhat more pronounced. Housing investment continues to decrease substantially, and the drop in home sales and accumulation of unsold houses are becoming increasingly severe. According to survey results, banks are applying tighter terms and conditions not only on mortgage loans but also on real estate loans for business properties and on corporate and consumer loans. Recently released labor market statistics indicate that the pace of increase in employment has decelerated and the unemployment rate has risen.

In this situation, however, private consumption and business fixed investment are so far continuing their moderate upward trend, although the pace of increase is decelerating. It seems likely that the U.S. economy will register relatively low growth rates in the short run but will gradually return to a path with growth rates close to the potential rate as the housing market correction progresses. However, the risk should be borne in mind that depending on future developments in the housing market correction and in global financial markets, 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.

The European economy continues to expand, with business fixed investment and private consumption maintaining their upward trend. However, the possible adverse effects on financial conditions of global financial market disruptions may pose a downside risk. Meanwhile, emerging economies and oil producing countries have been expanding robustly and are playing a more significant role as pillars of world economic growth.

Thus, it seems reasonable to expect that thanks to the widening base of growth the world economy will continue to expand robustly. However, downside risks to this outlook are growing, reflecting intensified adjustment in the U.S. economy and in global financial markets.

At the same time, attention should also be paid to the risk of inflation. In the United States, inflationary pressures are remaining, reflecting continued high levels of resource utilization, namely in labor and production capacity. In China, the economy continues to expand strongly, and there are signs of overheating, especially in fixed investment, despite various measures taken by the authorities to cool down the economy. The strong growth of the global economy and other factors, such as geopolitical risks and the speculative inflow of funds to commodity markets, are causing international commodity prices to remain elevated, as evidenced by the fact that crude oil prices temporarily rose above 100 dollars per barrel at the beginning of the year. Thus, countries around the world face difficult monetary policy challenges in the presence of both downside risks to the economic outlook and upside risks to inflation.

III. Developments in global financial markets

Global financial markets remain unstable, reflecting the downgrading of securitized products and persistent concern about possible further losses at financial institutions. The functioning of markets for securitized products has remained impaired as evidenced, for example, by continued decreases in the amount outstanding of asset-backed commercial paper (ABCP) issued and sluggish trading of collateralized debt obligations (CDOs). Corporate bonds have been issued at a reasonable pace, but the corporate bond market is still undergoing adjustment as seen in increased issuance spreads. Stock markets are still unstable, and stock prices declined substantially around the turn of the year.

The volatility in global financial markets seems to reflect a market correction following the 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. Since summer 2007, organizations such as the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) have released their estimates of the size of losses incurred from financial products related to subprime mortgage loans, but it is difficult to accurately grasp the amount of final losses, since the correction in the housing market is ongoing. Financial institutions in the United States and Europe have been posting considerable losses, and many have announced measures to boost their capital to compensate for these losses. How successful these measures are in helping financial institutions and the financial system to restore their credibility will need to be monitored closely.

Short-term funding markets in the United States and Europe were under elevated pressures in late 2007 as financial institutions tried to secure end-of-year funds. To address this situation, on December 12 central banks in the major economies announced joint measures to ensure the stability of global financial markets. The Federal Reserve established a temporary Term Auction Facility. Under this facility program, the Federal Reserve can auction term funds against a wide variety of collateral, thereby providing funds with longer maturities to more financial institutions. Moreover, it established foreign exchange swap lines with the European Central Bank and the Swiss National Bank, and based on this, U.S. dollar auctions were carried out in Europe. The Bank of England and the Bank of Canada actively conducted operations to provide ample term funds with maturities beyond year-end.

The Bank of Japan and the Swedish Riksbank welcomed the action and issued a press release stating that they would also appropriately provide liquidity to money markets in their respective countries. The Bank of Japan did not make any particular changes to its framework of money market operations because we have been providing funds with various maturities against a wide variety of collateral and are able to gauge funding needs by monitoring market participants' daily financing activities, and we can thus fully address the situation under the current framework.

The joint action was based on the central banks' common understanding that, given the continued volatility in global financial markets, it was necessary to appropriately address elevated pressures in short-term funding markets and thereby facilitate the market adjustments in an orderly manner. Since the announcement of the measures, the central banks involved have been implementing market operations accordingly, and as a result interest rates on term instruments declined toward the end of 2007 in the United States and Europe. I believe these efforts will contribute to ensuring the stability of global financial markets.

IV. Conduct of monetary policy

I would now like to explain the Bank's thinking regarding the conduct of monetary policy based on the outlook for economic activity and prices and risk factors I have described.

As I have often noted in the past, the Bank has been taking monetary policy actions in accordance with changes in the economic and price situation and has no predetermined view regarding future actions. In making judgments on policy actions, we try to accurately forecast future developments in the economy and prices, taking account of the time lags until policy actions actually influence the economy and prices – the so-called transmission lag of monetary policy. This is the essence of a forward-looking monetary policy.

Let me explain this in the context of the current economic situation in Japan where, as I mentioned, the economy for the time being is likely to decelerate while the year-on-year rate of increase in the CPI will gradually rise due to increases in the prices of petroleum products and food. In conducting monetary policy, it is necessary to anticipate how these developments will affect future economic activity and prices. For example, in the current

context, monetary policy judgments should be made based on the careful analysis of the following issues, which will be incorporated in the future assessment of the economy and prices: (1) whether the slowdown is temporary and the economy can be expected to return to its growth path, or whether there is a possibility that it will last longer than expected; (2) whether price rises could exert a negative influence on the economy, leading to future downward deviations in the economy and prices; and (3) whether, on the contrary, price rises could push up future prices through their influence on households' inflation expectations or firms' price-setting behavior. It goes without saying that forecasts always entail uncertainty, making it all the more important to assess their likelihood as well as the risks of upward or downward deviations. We are determined to conduct appropriate monetary policy with the aim of achieving sustainable growth under price stability while carefully assessing our projections, their likelihood, and upside and downside risks.

If, as a result of such assessment, it is judged that Japan's economy will continue its sustained expansion under price stability, interest rates, which currently are extremely accommodative, will be adjusted gradually. It is conceivable that 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, there is a medium- to long-term risk of larger swings and an inefficient allocation of resources as firms and financial institutions over-extend themselves. However, with regard to specific policy actions, we would like to proceed with discretion based on an open-minded, forward-looking assessment of the economic and price situation.

Closing remarks

Thus far, I have explained the current situation and the outlook for Japan's economy as well as the Bank's thinking on the conduct of monetary policy. In closing, I would like to devote attention to the economy of Hokkaido.

The most notable characteristic of Hokkaido is its rich and boundless natural environment. However, as a consequence, Hokkaido's economy relies to a large degree on public works such as road construction and flood prevention. The reduction in these works as a result of the financial difficulties of the central and the local government means that economic growth has been sluggish relative to other parts of Japan.

However, promising initiatives that take advantage of Hokkaido's rich natural resources are currently underway. Primary industry accounts for a large share of Hokkaido's economy, and in agriculture, for example, the promotion of organic farming and the introduction of a certification system for "Hokkaido Brand" products are achieving progress against the background of rising concerns about food safety. Moreover, with numerous colleges and research institutions working on bio-technologies, there are moves to produce new products that combine Hokkaido's rich resources in agriculture, forestry, and fisheries with new bio-technologies.

Furthermore, the Hokkaido Toyako Summit will be held in July this year with environmental problems as one of the major themes. Hokkaido has already implemented a number of steps to take the lead in addressing environmental issues. For example, in the area of energy supply, work has been in progress in fields such as wind and solar power generation, biomass power generation in central Hokkaido – which has a large dairy farming industry – and the utilization of snow-ice cryogenic energy in regions with heavy snowfall, using snow and ice stored in winter for air-conditioning in summer. All of these efforts take full advantage of the region's distinguishing features and are friendly to the environment.

The summit is a perfect opportunity to showcase Hokkaido's industries and natural environment, not only domestically but also to the rest of the world. I hope this will bring about steady progress in the revitalization of the regional economy.