Japan's Economic Recovery in the Global Context

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It is a great pleasure for me to speak at the Annual Meeting of the International Manganese Institute here in Tokyo. The Institute has contributed greatly to facilitating the exchange of information among its members and with outside experts.

Today, I would like to talk about Japan's economic recovery in the global context.

Global Economic Outlook

The global economic outlook is bright, because the four main engines of the world economy, the United States, the Euro area, Japan, and China, are likely to maintain or accelerate their growth in 2004 and beyond.

By far the largest of these engines is the U.S. economy, which accounts for more than 30% of global GDP. The U.S. economy is expected to grow by about 4.5% this year and to continue to grow by around 4% next year. Employment has been increasing despite extensive outsourcing by U.S. corporations to China and India. Although headline inflation has recently reached 2.3%, the core rate of inflation is still below 2%. The fundamental causes of the economy's strong performance have been rapid productivity growth and greatly improved corporate profits. This strong trend should continue beyond 2004.

The Euro economy, whose share in the global GDP is about 20%, has been steadily recovering. Even the German economy, which had lagged behind the recovery trend in the Euro area, recorded 1.8% annual growth in the first quarter of 2004. Consequently, the Euro economy is expected to grow around 2% this year. The recovery is still very much supported by government expenditure and exports, but it is hoped that consumption will soon start to recover. Then, economic growth may accelerate to around 3% in 2005.

The Japanese economy, whose GDP is about 13% of the global GDP, started to recover in late 2002, and recorded 2.5% growth in 2003. In the first quarter of 2004 the economy grew by annualized 5.6%, of which roughly one third was from corporate fixed investment, one third from consumption, and one third from net exports. The contribution of net exports is expected to shrink in the next few quarters, so that this year's growth rate will probably be around 3.5%. Hopefully, the trend of around 3% growth will be maintained in the years to come. I will speak more about this in a moment.

The most dynamic engine of the global economy now is undoubtedly the Chinese economy. Although its share in the global GDP is still only about 4%, its average growth rate of 9% over the past ten years easily makes its contribution to global growth next to that of the United States. Currently the Chinese economy is overheating, as shown by the rapidly rising real estate prices and the annual growth rate close to 10% in the first quarter of 2004. The government and the central bank have already adopted measures to cool down the overheating, but it will take a year or so before the growth rate slows down to anywhere near to the 7% targeted by the government.

Causes of and Prospects for Japan's Economic Recovery

The two proximate causes of Japan's economic recovery are strong growth in corporate fixed investment and the recent rebound in consumption. The former is based on significantly improved corporate profits, brought about by substantial restructuring in the corporate sector, particularly the manufacturing sector, and various innovations, such as hybrid cars, flat TVs, DVD players, and digital cameras. The latter may be due to the improved employment situation and the reduced saving ratio owing to the better economic climate.

Whether the current economic recovery will be sustained or not will critically depend on two sets of factors, external and internal. As far as external factors are concerned, with the three main engines of the global economy outside Japan booming, Japan's economic recovery is likely to be supported and sustained. On the other hand, internal factors are much more mixed.

The restructuring of Japan's manufacturing sector is almost complete; however, restructuring of the non-manufacturing sector has only begun. There are still many inefficient and unprofitable general contractors in the construction sector. With the largest supermarket chain and department store being subject to Chapter 11 type treatment, the distribution sector is beginning to be restructured, but there is still much more to be done. The financial sector has undergone significant restructuring and M&As, and now comprises only four big financial groups, but it will require further efforts to become internationally competitive and profitable.

In the public sector, a far more serious situation exists, and much more substantial reforms will be needed. The public debt has reached nearly 150% of GDP, and must be consolidated in the coming years; the government has decided a medium-term scenario for fiscal consolidation, according to which the primary balance is to be restored by the early 2010s. Currently, significant pension reform is being discussed by the Diet, but further reform, including the integration of pension systems, will be needed in view of the rapidly aging population. Privatization of public agencies is another important issue. The government has already decided to privatize the four highway corporations and intends to privatize the Post Office soon.

Deregulation is well underway. The airline and telecommunication sectors have been substantially deregulated, resulting in large decreases in airfares and telecommunications costs coupled with equally large increases in the number of airline travelers and mobile phone/PC users. Recently, thousands of "Special Deregulation Zones" have been allowed in hitherto heavily regulated areas, such as education, medical care, and welfare services, in order to promote innovation, and such zones will be expanded nationwide if successful. It is hoped that the privatization of certain government agencies and the deregulation of regulated services will increase the efficiency and growth potential of the economy.

Global Risk Factors

Despite the generally bright outlook, there are a number of risks which could have a negative effect on the global economy, including the Japanese economy.

First and foremost are the extremely high oil prices; the WTI index of more than $40 per barrel is certainly much too high. If this price level is maintained for more than six months, it is bound to seriously affect the global economic outlook by increasing inflation and significantly lowering growth. Concerned about the implications of the high price of oil, the Finance Ministers who met a week ago to prepare for this year's G8 Economic Summit called on oil producers to "provide adequate supplies to ensure that world oil prices return to levels consistent with lasting global economic prosperity and stability."

Since not only the cut in production by OPEC, but also many other factors, such as the gasoline shortage in the United States, the generally bright prospects of the four engine countries, and increased geopolitical risks in the Middle East, have been influencing oil prices, the high prices may continue for some time. It should, however, be noted that the Japanese economy, being one of the least oil-dependent of the OECD countries and the only country still facing deflation, may be relatively safe as far as the direct impact of high oil prices is concerned, although the indirect effect of the global economic slowdown could overwhelm it.

The second global risk factor is the likelihood of higher interest rates in coming months. The Federal Reserve has already indicated that it might raise interest rates in the near future. It would be quite natural for the Fed to raise the FF rate, which at 1% may be too low in view of the very strong growth and signs of price increase in the United States. Interest rates are likely to rise in the coming months not only in the United States but also in many other countries.

I do not think that an increase in interest rates will constitute a risk to the global economy, however. Higher interest rates reflecting stronger economic prospects are appropriate, and will result in sustained economic growth. In addition, since the core rate of inflation in the United States is still below 2%, any increase in the interest rate will be small. In any case, Japan, still facing persistent deflation, will continue to have a "zero interest rate policy," and even long-term interest rates are unlikely to rise anytime soon.

The third risk for the global economy may come from the Chinese economy, which could experience a sharp slowdown unless there is a successful soft landing from the overheating. The basic causes of the overheating seem to be twofold; first, the undervalued currency necessitated huge exchange market interventions releasing excess domestic liquidity, which fueled the economy in general and the real estate sector in particular, and second, the last year's reshuffle of local government leaders resulted in euphoria and competition for ever-increasing investment for development.

If the Chinese economy remains overheated, not only monetary tightening and exchange rate changes, but also measures to regulate overinvestment will be necessary. If the necessary policy actions are delayed too long, the economy will overheat further, creating a huge asset price bubble which will eventually burst or double-digit inflation which will have to be thrashed by severe fiscal and monetary tightening; either way, the economy will experience a sharp slowdown. Fortunately, neither of these outcomes is likely this year, and hopefully the Chinese government will take appropriate action to achieve a soft landing in a timely manner.

Specific Risks to the Japanese Economy

On top of those global risk factors, the Japanese economy could face various risks that are specific and unique to it; in some cases these risks could be even more serious.

The first and most serious risk is persistent deflation. The Consumer Price Index still shows a small decline, −0.2% in April, compared to last year's −0.4%. The Corporate Goods Price Index has recently turned positive, 0.5% this April, reflecting the higher prices of commodities, including oil. In contrast, the GDP deflator continues to be negative around −2.5% over the past four quarters. This is worrisome.

With a reduced GDP gap and improved economic prospects, deflation was supposed to disappear, but it has not, possibly because of some deep-rooted deflationary expectations in the economy. Deflation in terms of the CPI began in 1999, in the GDP deflator in 1995, and in the CGPI well before the 1990s. This persistent deflation has enormously increased the real debt burden for the corporate and public sectors, and destabilized the economy. Unless deflation is completely eradicated by proactive monetary policy and CPI inflation shows a stable 1 to 2% annual increase, this risk will continue to haunt the economy.

The second risk to the Japanese economy is the financial sector, which is still struggling to reduce non-performing loans. Thanks to strenuous efforts by banks and to generally improved economic conditions, non-performing loan ratios among the major financial groups are likely to be halved to around 4% by the end of next March, meeting the target set by the government. However, if deflation persists or worsens, it will be more difficult to attain the target, and this will create uncertainty in the financial markets. Already, the demise of the UFJ, one of the big four financial groups, affected the markets a few weeks ago.

The third potential risk is another round of yen appreciation, which could create a vicious cycle of appreciation and deflation, although at this stage such a risk appears rather unlikely. After appreciating from around ¥120 to the dollar last September to ¥105 this January, the yen gradually declined to ¥115 in May and is currently about ¥110. In view of the stronger U.S. economic growth and widening interest rate differentials, the yen is likely to decline slightly or remain close to the current level for the time being.

Political Factors

Until now, I have not mentioned political factors which might affect global economic prospects, except for the reference to geopolitical risks in the context of high oil prices. This does not mean that political factors have little effect on the global economy or the Japanese economy. On the contrary, political factors play a major role in determining the fate of our economies, and so must be carefully considered. However, since political factors are so difficult to predict, at least in economic theory, what I am going to say must be viewed as tentative and speculative.

2004 is an election year in many Asian countries; already we have seen spectacular election results in Malaysia, Korea, Indonesia, Taiwan, the Philippines, and India, and we will have the result of the Japanese election in July. After the elections in Taiwan and India, their stock markets declined sharply, indicating market participants' fear about the implications for the economies and financial markets. If Prime Minister Koizumi's coalition parties should reduce their majority in the Upper House, the financial markets might overreact, because he has promoted structural reform in the past three years and has just brought about economic recovery.

Of course, the most important election from a global standpoint this year is the U.S. presidential election, and its result could affect the global financial markets in many ways. But prudence prohibits me from making any prediction.

More seriously, the geopolitical risks for the global economy as well as the Japanese economy could increase in coming years. The situation in the Middle East might further deteriorate or the nuclear issue in the Korean Peninsula might continue to pose a threat. However, at this stage, nothing sure can be said, and the financial markets, which tend to discount any potential risk in evaluating financial assets, have not shown any sign of distress so far, unlike during he aftermath of 9/11.

Concluding Remarks

In conclusion, I am confident that Japan's economic recovery is robust in the global context and that the world economy is likely to record its highest growth in the last 15 years. While there are a number of potential risks facing the world economy and the Japanese economy, carefully monitoring our economy and forcefully implementing the right macroeconomic policies and structural reforms, we may be able to avoid those risks, and put the economy firmly back on a path of sustainable growth.

Thank you.