Yoshihisa Morimoto: Economic activity and prices in Japan and monetary policy

Speech by Mr Yoshihisa Morimoto, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Kochi, 20 February 2013.

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I. Recent financial and economic developments

A. Overseas developments

1. Global financial markets

I would like to start with developments in global financial markets and overseas economies, which affect Japan's economy.

Against the backdrop of the European debt problem, some nervousness continued to be seen in global financial markets through summer 2012, but the tail risk of a potential disintegration of the euro, which some had feared at one time, has receded since the autumn. This is because gradual progress has been made in discussions and measures for further strengthening and restructuring the euro area to form an economic and financial union with greater stability. Steps include (1) the introduction of the modalities for undertaking Outright Monetary Transactions (OMTs) by the European Central Bank (ECB), which have created a safety valve in government bond markets, especially in peripheral countries such as Spain and Italy; and (2) an agreement to establish a single banking supervisory mechanism in Europe to ensure the stability of the European financial system. More recently, it emerged that the amount of early repayments under the ECB's 36-month longer-term refinancing operations (LTROs), implemented in early 2012 in response to the crisis, turned out to be larger than markets expected, suggesting that the financial system is regaining stability. Meanwhile, in the United States the "fiscal cliff" has been avoided and investors' risk aversion has been abating. Nevertheless, as these factors contain numerous inherent uncertainties, market developments require continued attention.

2. Overseas economies

Under these circumstances, the extent of deceleration in many overseas economies became more pronounced through summer 2012 due in part to the anxiety in global financial markets reflecting concern over the European debt problem. Overseas economies remained in a deceleration phase thereafter, but at present, while the euro area economy remains stagnant, the U.S. and Chinese economies show some positive developments. As for the outlook, assuming that global financial markets remain stable on the whole, overseas economies are expected to gradually emerge from the deceleration phase and turn to a moderate recovery.

3. Euro area economy

By region, economic activity in the euro area has been receding slowly. Given the continued adverse feedback loop in peripheral countries among the fiscal situation, the financial system, and economic activity, business and household sentiment has become cautious. Because fiscal austerity measures will continue, economic activity is expected to continue receding slowly for the time being. However, while tensions in financial markets have been easing, business sentiment has shown signs of improvement in core countries such as Germany. Regarding the outlook, as economies outside the euro area pick up, economic activity in the euro area – particularly in the core countries – is likely to gradually emerge from the deceleration phase, led by exports.

4. U.S. economy

The U.S. economy continued to recover at a moderate pace, particularly in the household sector, supported by accommodative financial conditions. Although some weakness can be seen in household sentiment due to the effects of the expiration of the payroll tax cut at the beginning of 2013, the employment situation has been improving, albeit modestly, and private consumption has been firm, as evidenced by continued brisk car sales. Housing-related investment has also continued to show signs of picking up, albeit at a depressed level. Because the fiscal cliff was avoided, reducing the risk of a sharp fiscal tightening, business sentiment has been improving, and consequently, the deceleration in business fixed investment is coming to a halt. The U.S. economy is likely to continue recovering, supported by accommodative financial conditions. Nevertheless, the pace of recovery is likely to remain only moderate for the time being, reflecting the lack of momentum in external demand as well as continued downward pressure from the fiscal side.

5. China's economy, and the NIEs and the ASEAN economies

With regard to emerging countries, the Chinese economy has been regaining stability on the back of firm domestic demand. Domestic demand as a whole has been firm, as evidenced by the uptrend in infrastructure investment and retail sales. There are also signs of a bottoming out in exports and imports. Reflecting these developments in demand at home and abroad, industrial production has also been stabilizing. As for the outlook, domestic demand is expected to remain firm, partly due to the effects of policies taken since mid-2012 such as monetary easing and the front-loading of public works projects. Under these circumstances, as inventory adjustments make progress and exports gradually pick up, the recovery of the Chinese economy is likely to become more pronounced. However, since China's new administration has launched a policy emphasizing "quality-based" growth and targeting well-balanced growth, the pace of economic growth in China is expected to be restrained relative to the high growth in the mid-2000s. The NIEs and the ASEAN economies are picking up only moderately, led by the corporate sector, but are expected to gradually regain momentum underpinned by firm private consumption.

B. Japan's economy and prices

1. Economic activity

I will now explain the current state of, and outlook for, Japan's economy given the overseas economic developments I have just outlined. Japan's economy picked up rapidly following the plunge caused by the Great East Japan Earthquake, which struck just as the economy was recovering from the Lehman shock, and it posted relatively high growth in the first half of 2012. In the second half of 2012, however, the economy as a whole was relatively weak as exports and industrial production dropped sharply due to the effects of the deceleration in overseas economies. However, this downward momentum has recently been coming to an end. Specifically, the pace of decrease in exports has been moderating in a situation where some signs of picking up have been observed in overseas economies, particularly in the United States and China. In addition, private consumption has been resilient, and the effects of the decline in car sales due to the ending of subsidies for purchasers of environmentally friendly cars have fallen off. Meanwhile, public investment has continued to increase, and housing investment has generally been picking up.

With regard to the outlook, as the effects of various economic measures underpin domestic demand and overseas economies emerge from the deceleration phase, exports and industrial production are likely to start picking up, and these improvements are likely to feed through into business fixed investment and private consumption. In addition, recent movements in foreign exchange rates are likely to contribute to the underpinning of exports and corporate profits. Under these circumstances, Japan's economy is likely to more or less level off for the time being and subsequently return to a moderate recovery path toward mid-year.

The economic growth rate in fiscal 2013 is expected to be relatively high, mainly owing to the effects of various economic measures and foreign exchange rate movements. Although the economic growth rate is likely to decrease mainly due to a decline in demand following the front-loading of consumption prior to the consumption tax hike, growth is expected to remain above potential in fiscal 2014. In the Bank of Japan's interim assessment in January 2013, the median of the Policy Board members' forecasts for Japan's real GDP growth rate is 2.3 percent for fiscal 2013 and 0.8 percent for fiscal 2014.

2. Prices

Next, I will talk about price developments. The year-on-year rate of change in the consumer price index (CPI) for all items less fresh food is around 0 percent. For the time being, it is expected to turn negative due to the reversal of the previous year's rise in energy prices and of the movements in durable consumer goods, and thereafter, it is likely to be around 0 percent again. However, in the somewhat longer term, the rate of change is likely to turn positive as the aggregate supply and demand balance improves due to the recovery of Japan's economy, and is expected to gradually rise in fiscal 2014. In the Bank's interim assessment in January 2013, the median of the Policy Board members' forecasts for the year-on-year rate of increase in the CPI (all items less fresh food; excluding the direct effects of the consumption tax hike) is 0.4 percent for fiscal 2013 and 0.9 percent for fiscal 2014.

C. Uncertainty surrounding the outlook

The baseline scenario for Japan's economy described thus far is subject to both upside and downside risks. Risk factors that particularly warrant close attention are developments in overseas economies and uncertainty with regard to firms' and households' medium- to long-term growth expectations. With regard to overseas economies, remaining uncertainty over the European debt problem and future developments in the relations between Japan and China require due attention. As for the Chinese economy, whether it will succeed in making a smooth transition to stable growth is a key issue. The economy is likely to face various structural changes, including in labor supply and demand conditions following the reduction of excess capacity in the manufacturing sector and surplus labor in rural areas, as well as in the supply and demand conditions for resources. Attention therefore needs to be paid to the risk that these changes will impose constraints on the Chinese economy. On the other hand, the so-called shale revolution in the United States may buoy up the U.S. economy through declines in energy and materials prices. With regard to the Japanese economy, various economic measures will likely boost its growth rate for the time being; in the meantime, however, there is uncertainty over the extent to which the economic measures can promote a virtuous circle in which firms' and households' medium- to long-term growth expectations rise as a result of progress in regulatory reforms. As for prices, attention needs to be paid to the possibility that materialization of the aforementioned risks to economic activity could exert considerable effects on developments in prices, including the supply and demand balance.

II. Monetary policy under the "price stability target"

Next, I would like to turn to the Bank's conduct of monetary policy under the current economic and price situation.

In order for Japan's economy to overcome deflation as early as possible and return to a sustainable growth with price stability, the Bank has been pursuing aggressive monetary easing. At the Monetary Policy Meeting held on January 21 and 22, 2013, the Bank took decisive additional steps to provide monetary accommodation. Specifically, the Bank decided to introduce (1) the "price stability target" in place of the "price stability goal in the medium to long term", and (2) the "open-ended asset purchasing method" under the Asset Purchase Program. Furthermore, the Bank released "Joint Statement of the Government and the Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth" with the government. In addition, by providing strong support to lending by financial institutions, the Bank is making efforts to ensure that firms and households make use of the accommodative financial conditions.

In what follows, I will explain the aim of, and thinking behind, the Bank's policy measures.

A. Introduction of the "Price Stability Target" of 2 percent

1. What is "price stability"?

I would now like to explain the details of the "price stability target". The Bank conducts monetary policy based on the principle that monetary policy shall be aimed at "achieving price stability, thereby contributing to the sound development of the national economy". On this basis, I would like to explain the price developments under which the Bank perceives "price stability" and the reasons for setting the target at 2 percent in terms of the year-on-year rate of change in the CPI.

"Price stability" is defined conceptually as a state where various economic agents may make decisions regarding such economic activities as consumption and investments without being concerned about the fluctuations in the general price level, and this must be achieved on a sustainable basis. The Bank considers "price stability" to be a situation in which the economy improves in a balanced and sustainable manner, accompanied by increases in employment, wages, and corporate profits, and prices rise moderately as a result. To put it simply, what the Bank is aiming to achieve with the "price stability target" is to create an environment in which corporate profits and wages rise in a sustainable manner that primarily reflects increases in productivity. For example, when import prices rise, this may push up the inflation rate, but such an increase in inflation is not accompanied by an improvement in the economy because the terms of trade will deteriorate and real income of households and firms will fall. This is not the type of inflation the Bank aims to achieve.

In Japan, given that inflation has been hovering at a low level of close to 0 percent year on year for a prolonged period, low inflation expectations have become entrenched in firms' and households' decision making. Given this, the "price stability target" of 2 percent may be seen as somewhat high. However, as I explained earlier, the year-on-year rate of change in the CPI is projected to move closer to 1 percent through fiscal 2014 supported by a recovery in the economy. If, in this situation, efforts by a wide range of entities to raise the competitiveness and growth potential of Japan's economy bear fruit and firms' and households' inflation expectations rise as a result, the inflation rate consistent with price stability on sustainable basis will rise as well after fiscal 2014. The Bank will continue to provide support from the financial side through measures to pursue aggressive monetary easing and support strengthening the foundations for economic growth in order to underpin the signs of recovery currently seen. The Bank will do its utmost so that the CPI will rise steadily to the target of 2 percent and that the target will be achieved at the earliest possible time.

2. Inflation mechanism

Now, I would like to briefly explain the mechanism through which the inflation rate rises. From a somewhat long-term perspective, there is a mild positive correlation between the rate of increase in the CPI and the aggregate supply and demand balance. If, as a result of an improvement in the economy, aggregate demand in the economy as a whole increases relative to production capacity and, therefore, the balance between aggregate supply and demand improves, the rate of increase in the CPI will rise with a time lag of several quarters.

Since the mid-1990s, Japan's economy has tended to face a shortage of aggregate demand and the rate of change in the CPI (all items less fresh food) has been on a moderate declining trend since the latter half of the 1990s, with the exception of 2007 and 2008. The aggregate supply and demand balance reached nearly minus 8 percent after the Lehman shock, and although it has recently narrowed to about minus 2 to 3 percent, upward momentum on prices has not been sufficiently strong. This shortage of demand reflects not only cyclical factors but also structural ones. As a result of globalization and the unparalleled decline in the birth rate and aging of the population, the environment surrounding Japan's economy has changed dramatically but economic structures have been slow to adapt. As a consequence, economic growth has declined as a trend, lowering growth expectations, which in turn has led to a chronic shortage of demand. Due to this shortage, many firms have cut costs, mainly by reducing wages. Despite these efforts, however, corporate profits have not increased because fierce price competition has prevented firms from raising prices on their goods. Consequently, unable to foresee a clear improvement in profits, firms have inevitably turned cautious about increasing fixed investment, employment, and wages.

3. Importance of strengthening the growth potential

In order to overcome this situation, it is essential to strengthen the growth potential of the economy to raise firms' and households' medium- to long-term growth expectations and to resolve the chronic shortage of demand. Because it is impossible to halt the decline in the birth rate and the aging of the population in the short run, a prerequisite for strengthening the growth potential of the economy is to secure the labor force and raise the value added per worker (value-added productivity).

In order to secure the labor force, it is important to (1) make the labor market more flexible, and (2) make it easier for labor to move from one industry to another and for women and the elderly to participate in the labor market. If the situation remains unaddressed and the labor force continues to decline, this will push down Japan's annual economic growth rate in the 2010s by approximately 0.6 percentage point. This population issue is not unique to Japan. China's labor force also started to decline in 2012, giving rise to a sense of crisis. A shrinking labor force is a problem that many other advanced and emerging countries will face in the near future. In Japan, it is estimated that if the labor force participation rate of women were to rise to the level of Sweden by 2030 and that of the elderly (those aged 60 and over) were also to rise, the Japanese labor force would increase at an annual rate of 0.2 percent in the 2010s. As for the employment of the elderly, in view of the gradual rise in the pensionable age of the national pension to 65, starting in April 2013 it will be mandatory for firms to provide employment to elderly workers who wish to keep working. Given that Japan succeeded in shifting from a retirement age of 55 to 60 toward the 1980s, it should be possible to create a society in which it is normal to work until the age of 65 or beyond through institutional reforms and changes in the way people work.

To raise value-added productivity, it is necessary to build an economic environment where innovations in a broad sense – including the development of new business models – can be achieved more easily. Recently, firms have been making active efforts in a wide range of areas to capitalize on social changes, including business focusing on the elderly, the environment and energy, and information and telecommunications. If firms accelerate efforts on these fronts and reorient their strategies from concentrating on price competition to competition based on new goods and services, and if this is accompanied by increases in the labor force and value-added productivity, firms' and households' medium- to long-term growth expectations should rise amid vigorous economic activity.

B. Fostering more accommodative financial conditions: maintaining a virtually zero interest rate policy and increasing asset purchases

I will now explain the Bank's powerful monetary easing measures to achieve the "price stability target" of 2 percent. The Bank is pursuing aggressive monetary easing through its commitment to continue with a virtually zero interest rate policy and purchases of financial assets for as long as the Bank judges appropriate. Through the Asset Purchase Program established on its balance sheet, the Bank purchases various financial assets – such as Japanese government securities (JGSs), CP, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs) – and conducts the fixed-rate funds-supplying operation against pooled collateral. The program is aimed at encouraging declines in longer-term interest rates and various risk premiums to foster more accommodative financial conditions for firms and households to raise sufficient funds at low interest rates.

The size of the Asset Purchase Program, which was set at about 35 trillion yen at the time of its establishment in October 2010, has successively been increased, and the amount outstanding of the program was about 65 trillion yen at the end of December 2012. The Bank will continue to significantly increase the amount outstanding of the program until it reaches about 101 trillion yen by the end of December 2013. In addition, the Bank decided at the Monetary Policy Meeting held on January 21 and 22, 2013 to introduce, after completing the current purchasing method, a method of purchasing a given amount of financial assets every month without setting any termination date. Specifically, from January 2014, the Bank will conduct purchases of financial assets totaling about 13 trillion yen each month for some time. As a result, the amount outstanding of the Asset Purchase Program will be increased further by about 10 trillion yen in 2014 – to about 111 trillion yen – and is expected to be maintained thereafter.

C. Strengthening policy coordination between the government and the bank

On January 22, 2013, the Bank released "Joint Statement of the Government and the Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth". The Bank announced that it was setting the "price stability target" at 2 percent in terms of the year-on-year rate of change in the CPI, and that, under this target, it would pursue monetary easing and aim to achieve this target at the earliest possible time. The Bank stated that it would ascertain whether there was any significant risk to the sustainability of economic growth, including from the accumulation of financial imbalances. The government, on the other hand, announced that it would formulate and strongly promote measures for strengthening the competitiveness and growth potential of Japan's economy, and steadily promote measures aimed at establishing a sustainable fiscal structure with a view to ensuring the credibility of fiscal management.

The government plays a crucial part in strengthening the growth potential of the economy. Specifically, strengthening the growth potential hinges on the cumulative efforts of firms and financial institutions to create and expand new business. In this context, the government plays a pivotal role in fostering, through regulatory and institutional reforms, an environment that encourages the private sector to take on new challenges.

While the Bank continues to pursue aggressive monetary easing through measures such as large-scale purchases of JGSs, Japan's fiscal imbalances – among the most serious in the world – could hamper the effects of monetary easing. If the credibility of Japan's fiscal management were to falter, interest rates would likely rise, thereby making fiscal management more difficult and undermining the effects of monetary easing. In order to fully ensure the effectiveness of monetary easing, it is important for the government to ensure market credibility of fiscal consolidation. In this regard, the joint statement has profound significance in showing that the government and the Bank have clearly acknowledged each other's roles and that they will work together to overcome deflation and achieve sustainable economic growth.

D. Making use of accommodative financial conditions: providing a boost through the loan support program

Given the Bank's aggressive monetary easing I described earlier, financial conditions in Japan are extremely accommodative both in historical and international comparison. To be specific, in terms of firms' funding costs, both short- and long-term average interest rates on new loan contracts have hit 1 percent – an unprecedented level. In terms of households' borrowing costs, variable mortgage rates are below 1 percent and even 35-year fixed mortgage rates are around 2 percent. Moreover, financial institutions' lending attitude remains accommodative, issuing conditions for CP and corporate bonds remain favorable on the whole, and an environment has been maintained in which households and firms can feel secure that they can gain access to funds. Meanwhile, even at a time when there were strong headwinds generated by the Great East Japan Earthquake and the European debt problem, extremely accommodative financial conditions have been firmly maintained.

In order for Japan's economy to achieve sustainable growth with price stability, it is important that firms and households actually make use of the accommodative financial conditions for funding and increase investment and spending, which in turn will lead to an improvement in the aggregate supply and demand balance. As for recent developments in credit demand, although firms have shown signs of increasing their demand mainly for working capital and funds related to mergers and acquisitions, business fixed investment has been financed from cash flows, indicating that accommodative financial conditions have not been used to the fullest possible extent. To promote full use of the accommodative financial conditions, the Bank has established the Loan Support Program, consisting of the fund-provisioning measure to support strengthening the foundations for economic growth (hereafter the Growth-Supporting Funding Facility) and the fund-provisioning measure to stimulate bank lending (hereafter the Stimulating Bank Lending Facility). These facilities are offered for your use.

1. The growth-supporting funding facility

The Growth-Supporting Funding Facility was introduced with the aim of supporting the flow of funds to areas with growth potential. With this facility, the Bank provides long-term funds at a low interest rate to financial institutions for their lending and investment to areas that are expected to contribute to strengthening Japan's growth potential, such as medical and nursing care; environment and energy; agriculture, forestry, and fisheries; and tourism. In addition to the lending arrangement under the main rules, the Bank has established special rules for a lending arrangement through which it extends loans to financial institutions for their equity investments and asset-based lending (ABL). In ABL, assets such as accounts receivable and inventories are used as eligible collateral. Moreover, the Bank has established special rules for another lending arrangement for small-lot investments and loans as well as for a U.S. dollar lending arrangement of 12 billion U.S. dollars – equivalent to 1 trillion yen – using the U.S. dollar reserves already held by the Bank, for foreign currency-denominated investments and loans. The total size of these lending arrangements making up the Growth-Supporting Funding Facility was set at about 5.5 trillion yen, of which nearly 4 trillion yen has already been disbursed by the Bank. The amount of lending and investment actually provided by financial institutions using this facility greatly exceeds the amount of loans disbursed by the Bank. This indicates that the Bank's measures have been producing positive effects as a catalyst.

2. The stimulating bank lending facility

In October 2012, the Bank introduced the Stimulating Bank Lending Facility with the aim of prompting financial institutions to take a more active stance and stimulating greater proactive credit demand of firms and households. With this facility, the Bank will provide long-term yen-denominated funds at a low cost to financial institutions that have increased their lending, at their request, up to an amount equivalent to the net increase in their lending for a period of 15 months until the end of March 2014. The lending, based on which the net increase is calculated, can be either yen-denominated or foreign currency-denominated. While it may be extraordinary for a central bank to support lending – particularly foreign-currency denominated lending – to firms located overseas or lending by domestic financial institutions' overseas offices, Japanese firms' international operations as well as financial institutions' activities to provide funds for such operations are essential in capturing global demand, so that the Bank's measure to support such lending contributes to strengthening Japan's growth potential. Based on recent lending data, the amount of funds provided through the Stimulating Bank Lending Facility is expected to reach more than 15 trillion yen by the end of March 2014.

E. Quantitative aspects of monetary easing

The Bank will provide a massive amount of funds exceeding 50 trillion yen by the end of March 2014 under the Asset Purchase Program and the Loan Support Program, and the amount outstanding of these programs will exceed 120 trillion yen. Looking at the amount of funds disbursed by the Bank in terms of the monetary base, the ratio relative to nominal GDP in Japan is currently about 27 percent, the highest level among the advanced economies. When considering the additional funds of more than 50 trillion yen to be provided, the ratio will rise further by more than 10 percentage points to almost 40 percent. As these figures show, the Bank will proceed with unprecedentedly massive monetary easing this year. On this basis, it will continue to closely examine the financial and economic environment, and make policy decisions in a timely and appropriate manner.

If the large amount of funds provided at low cost on the basis of these accommodative financial conditions is utilized effectively and invigorates corporate activity, this should bring an improvement in firms' profit prospects and an increase in the expected rate of return on new investment. Once such a virtuous circle has taken hold, the accommodative financial conditions will have even stronger effects, and the virtuous circle will become more sustainable.

As mentioned earlier, "price stability" is achieved in a situation in which the economy improves in a balanced and sustainable manner, accompanied by increases in employment, wages, and corporate profits, and prices rise moderately as a result. The Bank will do its utmost to fulfill its responsibility to achieve the "price stability target".