Koji Ishida: Economic activity and prices in Japan and monetary policy

Summary of a speech by Mr Koji Ishida, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Aomori, 11 September 2013.

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I. Monetary Policy

A. Introduction of the "Price Stability Target" and the joint statement by the government and the Bank of Japan

First, I would like to describe the status of the Bank of Japan's monetary policy conduct at the beginning of this year. At the Monetary Policy Meeting (MPM) held on January 21 and 22, 2013, the Bank decided to introduce the price stability target of 2 percent in terms of the year-on-year rate of change in the consumer price index (CPI). At the same time, it released a joint statement with the government, which clearly stated that the government and the Bank would strengthen their policy coordination and work together to overcome deflation early and achieve sustainable economic growth with price stability. In the statement, the Bank announced that, under the price stability target, it would pursue monetary easing and aim to achieve this target at the earliest possible time. Concurrently, the government announced that it would not only flexibly manage macroeconomic policy but also formulate measures for strengthening the competitiveness and growth potential of Japan's economy, and promote them strongly. The government also announced that it would steadily promote measures aimed at establishing a sustainable fiscal structure with a view to ensuring the credibility of fiscal management.

B. Quantitative and Qualitative Monetary Easing (QQE)

Now I would like to talk about the Bank's current monetary policy measures, which aim at overcoming deflation.

At the MPM held on April 3 and 4, 2013, the Bank introduced QQE to achieve the price stability target of 2 percent in terms of the year-on-year rate of change in the CPI at the earliest possible time, with a time horizon of about two years. The features of this new monetary policy measure are as follows. First, with a view to pursuing quantitative monetary easing, the Bank changed the main operating target for money market operations from the uncollateralized overnight call rate to the monetary base, which is the total amount of money the Bank directly supplies to the economy. On this basis, the Bank increases the monetary base – defined as the sum of banknotes in circulation, coins in circulation, and current account deposits held by financial institutions at the Bank – at an annual pace of about 60–70 trillion yen. Second, the Bank purchases Japanese government bonds (JGBs) as the primary means of increasing the monetary base, so that their amount outstanding will increase at an annual pace of about 50 trillion yen. Moreover, the average remaining maturity of the Bank's JGB purchases has been extended from slightly less than three years to about seven years – equivalent to the average maturity of the amount outstanding of JGBs issued. Third, in addition to JGBs, with a view to lowering risk premiums of asset prices, the Bank purchases exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their amounts outstanding will increase at an annual pace of about 1 trillion yen and 30 billion yen, respectively. And fourth, the Bank will continue with QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary to maintain that target in a stable manner. It will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate.

So far, I have explained the basic framework of QQE. More than five months have passed since QQE was introduced at the beginning of April. The amount outstanding of the monetary base has increased from 146 trillion yen at the end of March to 177 trillion yen at the end of

August, and has been accumulating smoothly toward 200 trillion yen, the amount projected at end-2013. The amount outstanding of JGBs has also been accumulating smoothly toward 140 trillion yen, the amount projected at end-2013, increasing from 91 trillion yen at the end of March to 123 trillion yen recently.

C. Loan support program

In addition to implementing QQE, the Bank has been employing the Loan Support Program in order to make the effect of aggressive monetary easing further permeate the economy.

The Loan Support Program consists of two measures: 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). With the Growth-Supporting Funding Facility, the Bank supplies long-term funds at a low interest rate to private financial institutions in accordance with their efforts in terms of lending and investment to strengthen the foundations for economic growth. With the Stimulating Bank Lending Facility, on the other hand, the Bank provides long-term funds at a low interest rate to financial institutions that have increased their lending, at their request, up to an amount equivalent to the net increase in their lending, with a view to encouraging them to take more aggressive action and helping stimulate the proactive credit demand of firms and households. In addition, there is no upper limit to the total amount of funds provided by the Bank under this facility. The outstanding balance of the total loans provided through both facilities of the Loan Support Program has exceeded 7 trillion yen, supporting financial institutions' efforts to tap firms' proactive demand for funds.

D. Developments in financial markets

Reflecting such aggressive monetary easing measures, financial conditions in Japan have been substantially accommodative. As for firms' funding costs, financial institutions' lending rates have been significantly low. CP issuance rates have declined to around 0.1 percent – equivalent to the interest rate applied to excess reserve balances at the Bank – and yield spreads between corporate bonds and JGBs have remained narrow on the whole. With regard to credit supply, firms have continued to see financial institutions' lending attitudes as being on an improving trend.

From end-2012 until the beginning of April 2013, long-term interest rates in Japan declined significantly, reflecting heightened expectations for large-scale monetary easing by the Bank and some anticipation of abolishment of the payment of interest on excess reserve balances. However, since the introduction of QQE at the beginning of April, the entire yield curve has risen, reflecting (1) the correction of the level of interest rates on instruments with medium-term maturities due to a drop in anticipation of abolishment of interest payments as well as (2) the phenomenon of "buying on rumors and selling on facts." Moreover, since the middle of May, a rise in U.S. long-term interest rates stemming from speculation about possible changes in quantitative easing in the United States has been exerting strong upward pressure on Japan's long-term interest rates. At present, yields on 10-year JGBs have been in the range of 0.7–0.8 percent, which in absolute terms are higher than those before QQE was introduced at the beginning of April. It should be noted, however, that while the rise in U.S. long-term interest rates has actually caused interest rates in Germany and the United Kingdom to follow suit, interest rates in Japan have recently been more or less flat at a low level. This is evidence that the Bank's aggressive monetary easing has been working strongly to contain the upward pressure on Japan's long-term interest rates.

Reflecting such extremely accommodative financial conditions in Japan, the yen has been depreciating, albeit with some fluctuations, and stock prices have been trending upward. The year-on-year rate of increase in the amount outstanding of bank lending has been rising in recent months, as major banks' lending stance has become active. According to the money stock statistics for August 2013, released on September 10, 2013, the year-on-year growth rate of broadly-defined liquidity was 3.5 percent, the highest since March 2007, and among its components, the growth rates of pecuniary trusts and investment trusts have been accelerating in particular since the turn of fiscal 2013. Although economic entities have just started to rebalance their portfolios, the monetary easing seems to have gradually taken effect. I would therefore like to continue close monitoring of future developments.

II. Economic activity and prices

A. The current situation of Japan's economy

1. Economic activity

Next I will talk about economic activity and prices.

The Bank currently assesses Japan's economy as recovering moderately. According to the second preliminary estimates of real GDP statistics released on September 9, 2013, Japan's economy grew at an annualized rate of 3.8 percent in the April-June quarter, showing positive growth for the third consecutive quarter. The rate was largely revised upward from the first preliminary estimate of 2.6 percent as a result of increases in business fixed investment and inventory investment. As for domestic demand, private consumption showed relatively high growth while public investment continued to increase, and business fixed investment turned positive for the first time since the October-December quarter of 2011. External demand also made a positive contribution, with exports rising due to factors such as the depreciation of the yen.

Other economic indicators have also been improving on the whole. Among various statistics on private consumption, the Synthetic Consumption Index, which combines demand-side and supply-side statistics, has been firm recently. Real exports, despite monthly fluctuations, have been gaining upward momentum from developments in foreign exchange rates and a moderate recovery in the U.S. economy. In particular, those of motor vehicles and related goods as well as of capital goods and parts have recently been moving toward a pick-up. Industrial production is also increasing moderately, reflecting these developments in demand both at home and abroad.

Looking at corporate profits, listed firms expect to see large increases in their profits for fiscal 2013, which they forecast to recover close to the levels of the post-fiscal 2000 peak marked in fiscal 2007. Earnings of listed firms for the April-June quarter of 2013, announced in late July to early August, showed that corporate results of firms in domestic demand-oriented sectors were favorable on the whole, and that many firms reported increased sales and profits due to the effects of developments in foreign exchange rates and greater demand for motor vehicles, smartphones, and related goods. In this environment, firms are planning to increase business fixed investment for fiscal 2013, and supply and demand conditions in the labor market continue to improve moderately, as seen, for example, in a rise in the active job openings-to-applicants ratio.

2. Prices

The year-on-year rate of change in the CPI (all items less fresh food) had turned positive in June 2013 for the first time in 14 months, and in July it rose to 0.7 percent. The CPI for the Tokyo metropolitan area rose to 0.4 percent in August year on year, showing a marginal increase from 0.3 percent in July.

Looking at the components of Japan's CPI reveals that rises in prices of energy-related goods, such as gasoline prices and electricity charges, are pushing up the CPI. In addition, some firms in the food products industry are passing their higher costs arising from the rise in import prices on to sales prices. The recent rise in the CPI is attributed to not only the increase in prices of energy-related goods but also rises in prices of a wide range of items as a result of resilient private consumption. This is evident from the fact that the decline in the CPI excluding food and energy is gradually coming to a halt.

3. *Outlook for economic activity and prices, and challenges for Japan's economy*

(a) Outlook

I will now turn to the outlook for economic activity and prices in Japan. Japan's economy is expected to continue a moderate recovery against the background of firm domestic demand and the pick-up in overseas economies. Specifically, exports are expected to increase moderately due to a gradual pick-up in overseas economies, mainly in the United States, and the definite, cumulative effects of developments in foreign exchange rates since last year. Looking at domestic demand, public investment is expected to continue trending upward supported by the supplementary budget for fiscal 2012 under the emergency economic measures, the budget for fiscal 2013 with higher weight on public investment, and the increased budget for reconstruction-related spending. Housing investment showed negative growth in the April-June quarter in the GDP statistics. However, the number of housing starts, a leading indicator of housing investment, increased clearly by 9.3 percent in the April-June quarter from the previous quarter. It is expected that actual implementation of housing investment will start rising firmly as (1) reconstruction of houses struck by the earthquake disaster in 2011 continues and (2) lower interest rates on loans and a surge in consumer spending prior to the consumption tax hikes are likely to encourage housing investment. Business fixed investment is projected to follow a moderate increasing trend as corporate profits continue to improve. Private consumption is expected to remain resilient, supported by improvement in the employment and income situation. Under these circumstances, industrial production is expected to continue increasing moderately.

As for prices, the year-on-year rate of increase in the CPI is likely to continue rising. In a situation where the effects of the improvement in the supply and demand balance are expected to become clear with an economic recovery, a rise in petroleum product prices – reflecting the recent developments in foreign exchange rates and crude oil prices – and a further rise in electricity charges by electric power companies are likely to exert upward pressure on overall prices. Therefore, for the time being, the CPI is expected to continue to rise clearly on a year-on-year basis. I mentioned earlier that some firms in the food products industry are passing their higher costs on to sales prices, and wholesale and retail prices of imported goods, such as personal computers and handbags, are also being raised in some cases. In forecasting price developments, close watch should be kept on changes in firms' price-setting behavior. Price increases could spread gradually if private consumption remains resilient and firms are encouraged to raise prices.

(b) Challenges for Japan's economy

In order for the economy to move in line with the outlook I have described, it is necessary for production levels to rise firmly. The sluggish pace of increase in exports appears to have caused industrial production for the first half of 2013 to remain lower than a year earlier. As a result, business fixed investment remains lackluster, restraining growth in production.

In the past, exports were usually the driving force of economic recovery in Japan. The present recovery, however, is being led by domestic demand, such as private consumption, housing investment, and public investment. It is time for exports to take the lead. The cause of the current slow recovery in exports can be partly attributed to structural factors, such as declining competitiveness of firms in some industries and a greater shift to overseas production and local procurement of goods since the earthquake disaster. In order for Japan's economy to return to a stable growth path, exports must rise, and thus developments in overseas economies hold the key.

B. Overseas economies

1. *Europe*

Economic activity in the euro area deteriorated due to the European debt problem that engulfed Greece, Portugal, and Spain. More recently, however, the economy has finally bottomed out and is now showing signs of heading toward a pick-up with an improvement in consumer and business sentiment. Although some countries are still subject to factors that might lead to instability, investors have become less risk-averse and the financial conditions of financial institutions have been improving. While economic activity in the euro area cannot be expected to improve significantly for the time being, the situation there will no longer exert a large negative impact on the global economy.

2. The United States

The U.S. economy has been on a moderate recovery trend against the backdrop of steady private demand, despite downward pressure from the fiscal side. Private consumption remains on a moderate increasing trend as the employment situation follows an improving trend and prices of houses and other assets rise. The U.S. economy is expected to remain on a recovery trend. In view of this, the Federal Reserve is planning to gradually reduce the size of its asset purchases, and long-term interest rates have started to rise. Given the possibility of a further increase in interest rates, it is necessary to monitor how this will affect housing investment, which has been the engine of U.S. economic growth, just as automobile sales have been.

3. Emerging and commodity-exporting economies

Economic growth in China, which has been the driving force of global economic growth, has decelerated due to sluggish economic activity in Europe, an important trade partner, and slower growth in China's manufacturing sector activity owing to excess capital stock. The Chinese economy is currently aiming for a soft landing followed by stable growth led by domestic demand. Other emerging and commodity-exporting economies have been benefiting thus far from China's robust economy and monetary accommodation in advanced economies; however, deceleration in the Chinese economy and speculation about possible changes in quantitative easing in the United States are currently exerting strong downward pressure on their financial markets, trade, and commodity prices.

4. Challenges for overseas economies

Action by the Federal Reserve to gradually reduce the size of its asset purchases is sensible for the U.S. economy since it is showing signs of recovery, and it would be a natural policy decision for the United States. An ensuing rise in U.S. long-term interest rates, however, could trigger a rise in long-term rates in other countries, which would restrain their economic growth.

In emerging economies, growth has been propelled in part by a large inflow of funds caused by the quantitative easing policy in the United States. However, an outflow of these funds from emerging economies could lead to depreciation of their currencies, declines in stock and bond prices, and to higher inflation, thereby exerting negative effects on economic growth. It is necessary to continue close monitoring of whether these negative effects will be offset by the positive effects to be generated by growth in the U.S. economy. Close monitoring is also required of developments in capital flows, since they would influence whether emerging economies can eliminate their twin deficits, draw up effective measures to stem inflation, and implement structural reforms.

III. Overcoming deflation

A. Outlook for Japan's economic activity and prices

From fiscal 2014 toward fiscal 2015, Japan's economy is expected to follow the baseline scenario presented in the April 2013 *Outlook for Economic Activity and Prices*, released by the Bank. That is, the economy is expected to continue growing at a pace above its potential, as a trend. As for prices – excluding the direct effects of the scheduled consumption tax hikes – the year-on-year rate of change in the CPI is expected to follow a rising trend, reflecting factors such as the improvement in the aggregate supply and demand balance as well as the rise in medium- to long-term inflation expectations. It is likely to reach around 2 percent – the price stability target – toward the latter half of the projection period, spanning from fiscal 2014 through fiscal 2015.

B. Overcoming deflation

As I have explained, the Bank is implementing the aggressive monetary easing policy to achieve the price stability target of 2 percent in terms of the year-on-year rate of change in the CPI, and thereby achieve sustainable economic growth with price stability as stated in the joint statement with the government released in January 2013.

Many people believe that economic activity will pick up and the quality of people's lives will improve when the economy overcomes deflation. Economic growth, however, will be temporary and unsustainable if price increases following the efforts to overcome deflation are not accompanied by increases in income; a decline in households' real purchasing power would dent private consumption and lead to economic deterioration. If this turns out to be the case, it is meaningless to aim at overcoming deflation.

Japan's economy has finally started to recover moderately, and it is at an extremely important stage where a virtuous cycle has just begun to operate. Given that the year-on-year rate of increase in the CPI is likely to rise from fiscal 2014, it is essential for nominal income to increase steadily so that the present recovery enters a stable growth path.

For this to happen, it is necessary that the current positive momentum of the economy is maintained and that the overall level of corporate profits rises sufficiently. Furthermore, it is necessary to dispel concerns about the outlook for Japan's economy and secure growth expectations. To this end, as specified in the joint statement, it is vital for the Bank to vigorously implement aggressive monetary easing measures to achieve the price stability target – and for the government, for its part, to be flexible in its public spending, steadily implement growth strategies, and ensure the credibility of its fiscal management.

In order to realize effectively a steady expansion of consumption expenditures, increases in nominal income made in the form of increases in scheduled cash earnings – which comprise about three-fourths of nominal wages and are considered to be stable and less variable – would be superior to increases in special cash earnings, which are considered to be more variable. In this context, it is crucial that from fiscal 2014 onward base levels of salaries, which have hardly increased since the beginning of the 21st century, are once again raised on an annual basis in a wide range of industries.

In Japan, the deflationary mind-set has taken hold as a result of years of sluggish income and prices. However, an actual steady increase in income as a result of economic growth accompanied by a rise in prices will change this mind-set, thereby helping Japan's economy to overcome deflation.