Haruhiko Kuroda: Overcoming deflation – the Bank of Japan's challenge

Speech by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at the Council on Foreign Relations, New York, 10 October 2013.

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Introduction

Good morning. I am honored to be given an opportunity to speak this morning at the long-established Council on Foreign Relations.

Today, I will talk about what Japan's deflation is all about and what challenges Japan is faced with, followed by how the Bank of Japan is trying to overcome deflation.

I. Deflation that Japan has been experiencing

Japan has been mired in deflation for the past 15 years. Let me bring up some figures. In Tokyo, the minimum fare for the subways of 160 yen, or 1.6 dollars, has not changed since 1995. During the same period, the fare in New York increased from 1.5 dollars to 2.5 dollars. As fees for public services are not likely to be reduced as a rule, the minimum fare for the subways in Tokyo has not declined, but prices as a whole have declined moderately for a long period in Japan.

The feature of Japan's deflation is that it is moderate but persistent. This is a phenomenon quite different from the deflation seen in the days of the Great Depression. In the period of deflation that occurred in the United States during the Great Depression, prices plunged in a short period. Prices declined significantly in the two years of 1931 and 1932, by almost 10 percent annually, but deflation continued for only four years. In contrast, Japan's consumer prices have fallen 4.1 percent in the past 15 years from fiscal 1998 to fiscal 2012. That is merely a 0.3 percent decline on an annual average basis. However, the deflation in Japan has been extremely persistent. Young Japanese people have been born into a life of carrying the recognition that prices either will be constant or decline.

The continuation of price declines, albeit moderate ones, for a protracted period has deprived Japan's economy of vitality. In a state of deflation, the holding of cash or deposits will become a relatively better investment. In fact, cash and deposits held by Japanese firms have reached 230 trillion yen, close to 50 percent of nominal GDP. Persistent deflation has created an environment in which the status quo is better than making investment in new initiatives, and has brought a sense of stagnation to Japan. In an economy with few new challenges and investment, growth potential will decline gradually. Therefore, it is necessary to overcome deflation this time around and enhance people's willingness to take on new challenges.

There were economic cycles during the past 15 years. However, even when the economy recovered, prices did not increase in a sustainable fashion. The major reason for this is that, due to prolonged deflation, persistent deflationary expectations – that is, the recognition that it is natural for prices not to increase – have become entrenched among people, and they took actions based on such expectations. In such a situation, firms, households, and even labor unions will act on the assumption that prices will not increase, and thus it has become intrinsically difficult to increase prices.

In the past, the Bank of Japan (BoJ) took a variety of initiatives, including the adoption of unconventional measures ahead of other central banks, such as a zero interest rate policy, quantitative easing, and – in the latest wording – forward guidance. Nevertheless, while those policies were effective in terms of stimulating economic activity, they could not change people's persistent deflationary expectations. The greatest challenge in overcoming deflation this time is to raise people's inflation expectations.

II. Introduction of quantitative and qualitative monetary easing

The BoJ introduced the quantitative and qualitative monetary easing (QQE) in April. The new policy aimed at working directly on inflation expectations, with the goal of increasing inflation to the global standard of 2 percent. The question is: how?

The conclusion we reached was, first, to show our clear commitment to achieving the 2 percent price stability target in a stable manner as soon as possible, and, second, to underpin this determination by launching massive monetary easing that clearly differed from the past policies. Specifically, we declared that there would be a doubling in two years of the monetary base the BoJ provides. With this QQE, Japan's monetary base two years from now will become 270 trillion yen, or 2.78 trillion dollars, reaching 56 percent of nominal GDP. For reference, the current monetary base in the United States is 329 trillion yen, or 3.39 trillion dollars, which is 20 percent of nominal GDP.

To build the monetary base, on the asset side of the BoJ's balance sheet, the holdings of Japanese government bonds (JGBs) would be doubled. An associated massive purchase of JGBs would alter supply and demand conditions in the JGB market and put strong downward pressure on long-term interest rates.

However, there was a problem. The 10-year government bond yield in Japan was less than 1 percent. How could we make additional room for monetary easing? The point was the real interest rate, which is the nominal interest rate minus the expected inflation rate. In this regard, the situation facing Japan, in which expected inflation rates were stagnant, fortunately provided a breakthrough to this question. By raising inflation expectations while containing a rise in nominal interest rates, we would be able to lower real interest rates, which affect decision-making with respect to business fixed investment and private consumption.

Let me elaborate on this. In the United States and Europe, amid stagnant growth, observed inflation rates have been hovering around central banks' targeted inflation rate of 2 percent, and firms' and households' medium- to long-term expected inflation rates have also been stable at around 2 percent. In other words, expected inflation rates are anchored at around targeted inflation rates. In such cases, central banks cannot afford to raise expected inflation rates further. Therefore, to lower real interest rates, nominal interest rates need to be lowered. When long-term interest rates fall to the historic low level of less than 2 percent, room to further lower real interest rates becomes limited, as there is not much room to further lower nominal interest rates.

By contrast, in Japan, expected inflation rates have been anchored at too low of a level compared with the 2 percent price stability target, and thus there is sufficient room to raise them. If a rise in nominal interest rates can be contained to a lesser extent than an increase in inflation expectations, then real interest rates can be lowered by that extent. With such a decline in real interest rates, business fixed investment and private consumption are expected to be stimulated, thereby elevating economic activity. Observed prices are also expected to increase gradually. In addition, a rise in observed inflation will lead to an increase in inflation expectations.

There is little time today to explain all the transmission channels of the QQE, but I have covered the core part. Through its effects, it is our aim to stimulate the economy, improve the output gap and, above all, shift inflation expectations upward, and achieve the 2 percent price stability target as soon as possible.

III. Achievements under QQE and perspective on overcoming deflation

Now that six months have passed since the QQE was introduced, is it working? As it turns out, there have been improvements in financial markets, economic activity and prices, and people's expectations, and the QQE has been powerfully exerting its effects. Let me point out some examples.

In the financial markets, stock prices have risen by more than 30 percent since the beginning of the year. This substantially exceeds the rate of increase not only in Europe, of around 13 percent, but also in the United States, of around 16 percent.

On the real economy front, real GDP has marked high growth since the turn of the year of around an annualized 4 percent for two consecutive quarters. The unemployment rate has recently declined to the levels seen prior to the Lehman shock of around 4 percent.

People's expectations have also changed. Consumer confidence indicators clearly have tilted upward since around the end of last year. Looking at business confidence indicators, according to the BoJ's business survey, called the *Tankan* survey, the diffusion index (DI) for business conditions bottomed at minus 9 percentage points in the last December survey and has improved to plus 2 percentage points in the latest September survey – the same level as that in December 2007, prior to the Lehman crisis.

Turning to price developments, expected inflation rates have increased as a whole, according to market indicators and various surveys. The break-even inflation rate (BEI) has increased to close to 1.7 percent, from around 0.70 a year ago. In the Opinion Survey on the General Public's Views and Behavior conducted by the BoJ, in which consumers are asked their views on the inflation rate one year from now, the proportion of consumers who answered that prices would increase was just over 50 percent in the last December survey, but increased to above 80 percent in the September survey. In addition, the DI for selling prices in the *Tankan* survey, which is calculated based on a question firms were asked of developments in selling prices of their own products and services, have improved for large firms from minus 15 percentage points in the last December survey to zero in the September survey.

Looking at the observed inflation rates, the CPI inflation rate turned positive in June for the first time in 14 months, and accelerated to 0.8 percent in August.

As explained, stock prices have been rising and the real economy has been improving steadily. The inflation rate has turned positive and inflation expectations have risen. Such improvements in economic activity, prices, and people's expectations could be factors in increasing interest rates. Nevertheless, thanks to strong downward pressure stemming from the BoJ's JGB purchases, Japan's long-term interest rates have been slightly lower than those of a year ago, with 10-year JGB yields hovering at less than 0.7 percent. In addition, while long-term interest rates have been rising since May in the United States and other overseas economies, those in Japan have been more or less flat or slightly declining. Commercial banks' lending rates on new loans – an average of loans to firms and individuals – have declined to a historic low of below 1 percent.

Meanwhile, as people's inflation expectations have been increasing gradually on the whole, real interest rates have been declining. Thus, the situation we have aimed for has been generated. This decline in real interest rates is likely to stimulate business fixed investment, housing investment, and private consumption, thereby bolstering the economy. In addition, the QQE and various measures by the government seem to have been gradually improving people's sentiment, making them proactive and igniting their animal spirits. In fact, there are signs that firms' funding is becoming active. The year-on-year rate of increase in bank lending, which once declined to below 0.5 percent in the first half of fiscal 2012, has since been moderately expanding to slightly over 2 percent. The amount of corporate bonds issued in the April-June quarter reached a high level for the first time since the July-September quarter of 1998, which was coincidentally the quarter when deflation began. Initial public offerings by firms have also become active recently.

So far, the QQE has been exerting its intended effects, which is quite encouraging. By continuing to pursue the QQE with a strong determination to achieve the 2 percent price stability target, we are convinced that we will definitely overcome deflation.

Concluding remarks

Japan has a solid growth base. It has first-class technology and human resources. What has been lacking is positive sentiment – both the confidence in our ability to succeed and in our animal spirits – which were lost amid the sense of stagnation under persistent deflation. The overcoming of deflation will progress in line with a dispelling of this sense of stagnation. I am a firm believer that Japan will regain confidence and grow with vigor again.

There is another tail wind for Japan. The recent decision to hold the 2020 Olympics in Tokyo is boosting the level of people's sentiment. At the time of the Olympics, seven years from now, we will welcome you to a Japan that has regained its brightness. However, I am afraid that you may not be able to ride subways in Tokyo at a minimum fare of 160 yen at that time.

Thank you for your attention.