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, Wakayama, 20 February 2014.

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I. Recent economic and price developments

A. Japan's economy and prices

1. Current state of and outlook for Japan's economy

I will begin by explaining the current state of, and outlook for, Japan's economy. Economic activity had stopped weakening after the turn of 2013. The economy then returned to a moderate recovery path around mid-year as domestic demand remained resilient, mainly due to the effects of monetary easing and various economic measures. Japan's economy has since continued to recover moderately as domestic demand has remained firm, although exports have somewhat lacked momentum. Business sentiment has been improving in a wide range of industries, including those of small firms, and in regional terms economic recovery has been spreading on a national basis. Taking a closer look at developments in demand, exports showed relatively high growth in the first half of 2013 but have somewhat lacked momentum since the second half amid somewhat sluggish movements in some emerging and commodity-exporting economies. As for domestic demand, private consumption has remained resilient as a trend, with improvement in the employment and income situation, and a front-loaded increase in demand prior to the consumption tax hike has been observed mainly in durable consumer goods, as suggested particularly by the recent noticeable rise in new car sales. Housing investment has been increasing. Public investment has been trending upward, mainly reflecting the effects of various economic measures implemented thus far. Business fixed investment has been picking up, as the aggregate supply of capital goods – a coincident indicator of machinery investment – has recently shown relatively high growth with improvement in corporate profits, and as machinery orders – a leading indicator of machinery investment – have been improving as a trend even in the manufacturing sector, albeit with fluctuations. Taking these developments as a whole, the employment and income situation has been improving, supported by resilient domestic demand, indicating that a virtuous cycle among production, income, and spending is being maintained.

As for the outlook, while Japan's economy will be affected by the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike, it is likely to continue growing at a pace above its potential, which is estimated to be around 0.5 percent, as a trend, as the virtuous cycle will continue to operate. Japan's exports are expected to increase moderately as overseas economies – mainly advanced economies – recover moderately. Meanwhile, business fixed investment is likely to follow a moderate increasing trend, with improvement in corporate profits. Private consumption and housing investment, albeit with some fluctuations, are expected to remain resilient as a trend, as improvement in employee income is expected to gradually become evident. Public investment is expected to trend upward for the time being, supported partly by the effects of the implementation of the supplementary budget for fiscal 2013, and then remain at a high level. In the Bank of Japan's January 2014 interim assessment of the October 2013 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), the median of the Policy Board members' forecasts for the economic growth rate was 2.7 percent for fiscal 2013, 1.4 percent for fiscal 2014, and 1.5 percent for fiscal 2015.

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 turned positive in June 2013 and rose to 1.3 percent in December. The year-on-year rate of change in the CPI, excluding prices of food and energy-related goods such as petroleum products, was 0.7 percent in December, and improvement in prices is spreading across a wide range of items amid the improvement in the aggregate supply and demand balance, with the number of items for which prices have risen exceeding that for which prices have declined. As for the outlook, 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 likely to be around 1–1/4 percent for some time as the effects of the upward pressure from prices of petroleum products subside. Thereafter, it is likely to rise, reflecting factors such as the improvement in the aggregate supply and demand balance due to the recovery of Japan’s economy as well as the rise in medium- to long-term inflation expectations in response to fundamental changes in the public’s expectations. The rate of increase in the CPI is likely to reach around 2 percent – the price stability target – toward the latter half of the projection period, through fiscal 2015. Specifically, in the Bank’s interim assessment in January of the October 2013 Outlook Report, the median of the Policy Board members’ forecasts for the year-on-year rate of increase in the CPI (all items less fresh food; for fiscal 2014 and fiscal 2015, excluding the direct effects of the consumption tax hikes) was 0.7 percent for fiscal 2013, 1.3 percent for fiscal 2014, and 1.9 percent for fiscal 2015.

B. Major issues surrounding economic activity and prices

I would now like to talk about the key issues concerning assumptions related to the outlook for Japan’s economic activity and prices. Japan’s economy is expected to achieve sustainable growth as the virtuous cycle among production, income, and spending – including wage increases and a recovery in business fixed investment – continues to operate. However, Japan’s working-age population has been on a downtrend due to the aging population and declining birth rate. For the economy to achieve a higher growth rate, it is important to step up efforts to secure a sufficient labor force and raise productivity, allowing firms and households to raise their optimism about future income and demand. Positive developments have recently been observed, such as progress in the labor force participation of women and the elderly, as well as firms’ efforts in growth sectors. In the future, if growth expectations gradually rise as active efforts by the government and firms to strengthen Japan’s growth potential bear fruit, this in turn will eventually lead to a rise in Japan’s potential growth rate. At this point, I will discuss recent developments in overseas economies and Japan’s exports, business fixed investment, the employment and income situation, and inflation expectations, all of which are likely to have a significant effect on the outlook for economic activity and prices.

1. Developments in overseas economies and Japan’s exports

I will first examine current developments in overseas economies to assess those in Japan’s exports. Overseas economies – mainly advanced economies – are starting to recover, although the performance remains lackluster in some parts of emerging and commodity-exporting economies.

As for the outlook, overseas economies – mainly advanced economies – are likely to continue recovering. In January 2014, the International Monetary Fund (IMF) revised upward its projections for global economic growth in its *World Economic Outlook*, forecasting that the global economy would moderately accelerate its pace of growth from 3.0 percent in 2013 to 3.7 percent in 2014 and 3.9 percent in 2015. Looking at respective regions, the recovery of the U.S. economy has gradually become widespread as the employment and income situation continues on an improving trend, with firmness in household spending spreading to the corporate sector and boosting production, although some effects of a winter snowstorm are still being observed. The benefits of the shale revolution are also being felt by the economy. Looking ahead, the U.S. economy is expected to gradually see an acceleration in its pace of recovery, led mainly by private demand, partly because the fiscal drag will gradually fade as uncertainties surrounding the economy abate somewhat, mainly due to progress in the fiscal debate. In the European economy, business and household sentiment has been on an improving trend as financial markets have regained stability. In such circumstances, private consumption has been picking up, albeit moderately, and production is starting to pick up. Further developments regarding the European debt problem, efforts to restore financial soundness, and the disinflationary trend warrant attention. Nevertheless, the economy is likely to continue picking up, as domestic demand is expected to do so as well and as exports are likely to recover moderately. The Chinese economy continues to see stable growth on the back of firm domestic demand including private consumption and fixed asset investment, although the pace of growth has decelerated somewhat. It is likely to maintain stable growth, as the government – while progressing with reforms to address structural problems – is expected to pursue policy measures that take due account of economic activity, although some uncertainties remain including the effects of excess production capacity and debt. Regarding some of the other emerging and commodity-exporting economies, in a situation where they are facing structural problems such as fiscal deficits and current account deficits, there have been outflows of funds against the background of the U.S. Federal Reserve's reduction of the pace of its asset purchases. Thus, continued attention is warranted on developments in these economies, including the effects on economic activity. Emerging economies other than China and commodity-exporting economies as a whole will likely lack growth momentum for the time being, but from a longer-term perspective, positive effects of the recovery in advanced economies will spill over to them.

Amid these developments in overseas economies, Japan's exports have generally been picking up but continue to lack some momentum. This may be partly attributable to structural factors including the shift of Japanese firms' production sites to overseas accompanying increased local procurement of parts by Japanese manufacturers. Fundamentally, however, the lack of momentum is considered to be largely due to the sluggishness in the emerging economies, particularly the ASEAN economies, which are closely linked to Japan's economy. As for the outlook, exports as a whole – including indirect exports via Asian economies such as China and the NIEs – are likely to increase moderately, as the growth rates of advanced economies such as those of the United States and Europe increase.

2. *Developments in business fixed investment*

Turning to the corporate sector, it is important that increases in corporate profits and demand lead to growth in business fixed investment. Corporate profits have been recovering on the back of firm domestic demand and developments in the foreign exchange market. Business fixed investment has been picking up on the whole, including the manufacturing sector, which had been lagging behind.

Going forward, business fixed investment is likely to follow a moderate increasing trend against the backdrop of an improvement in corporate profits and the effects of monetary easing. In the context of investment profitability, profitability from business fixed investment is likely to improve and the extent of the monetary easing stimulus to encourage investment is likely to strengthen, owing to a rise in the rate of return on capital due to economic recovery combined with the decline in real interest rates mainly reflecting a rise in inflation expectations. As to the objects of investment, latent demand for the maintenance and replacement of equipment has built up, reflecting past restraints on firms' investment, and has become more likely to materialize. Investment related to disaster prevention and energy is also expected to increase. Furthermore, firms' medium- to long-term growth expectations are likely to rise moderately, due partly to the positive initiatives to strengthen the competitiveness and growth potential of Japan's economy, such as the government's regulatory and institutional reforms and various tax reduction measures, as well as firms' restructuring efforts. In such an environment, if business fixed investment continues on an uptrend and firms' efforts to accumulate capital in growth sectors and increase labor productivity make headway, the potential economic growth rate – the real strength of the economy – should also rise moderately.

3. Employment and income situation

I would now like to talk about the employment and income situation, which is one of the key factors in achieving a sustainable recovery in domestic demand. Private consumption has recently been resilient thanks to continued active spending by the elderly – the baby-boom generation in particular – and is underpinned by the wealth effects of the rise in stock prices. While active spending by the elderly is expected to continue as firms work to capture demand, the key to economic improvement in a well-balanced manner lies in improvement in income supporting private consumption.

Looking at the current employment and income situation, supply and demand conditions in the labor market continue to improve steadily, with the active job openings-to-applicants ratio having risen to the level observed prior to the Lehman shock of just over 1.0 and with the unemployment rate similarly having fallen to the pre-Lehman shock level of 3.7 percent, mainly due to resilient domestic demand. Firms are increasingly experiencing a shortage of labor, as suggested by the fact that the employment conditions diffusion index (DI) (the proportion of firms responding that employment is "excessive" minus the proportion of those responding that it is "insufficient") in the latest *Tankan* (Short-Term Economic Survey of Enterprises in Japan) is deeper in negative territory, particularly in the nonmanufacturing sector. Reflecting these supply and demand conditions in the labor market, a growing number of firms, especially among industries increasingly experiencing a shortage of labor, have eased or made more flexible their hiring criteria, or have adopted the "hire-and-nurture" recruiting method, which involves supporting their workers' efforts to obtain the qualifications necessary for their jobs. At the same time, firms are making progress in terms of actively employing women, the elderly, and foreign nationals, and in increasing the diversity of their employment methods. This has resulted in more active job searches by women and those who had been out of the workforce, resulting in the recent growth of the labor force population. If these diverse employment styles gradually become established with a sustained economic recovery, this will help secure a sufficient labor force despite the declining trend of the working-age population, underpinning the medium- to long-term growth potential of Japan's economy.

The improvement in supply and demand conditions in the labor market is influencing nominal wages. Specifically, the year-on-year rate of change in nominal wages per full-time employee has become slightly positive, reflecting increases in overtime pay and winter bonuses. In addition, hourly nominal wages per part-time employee remain on a modest increasing trend year on year. Looking at workers as a whole, scheduled wages per employee have remained slightly negative year on year, due partly to the increase in the proportion of part-time workers, whose wage levels are relatively low. Still, the employment and income situation has been improving on the whole, with employee income – wages per employee multiplied by the number of employees – continuing to register year-on-year increases.

Going forward, as the improvement in supply and demand conditions in the labor market continues, nominal wages are expected to be put under upward pressure gradually. Regarding the wage negotiations to be held this spring, labor unions are demanding wage hikes, including an increase in workers' base wages. At the same time, a growing number of firms appear to be indicating their willingness to allow for a certain rise in wages in terms of total remuneration, including base wages. Amid increasing corporate profits, close attention will be paid to whether firms carry out wage hikes to some extent, including an increase in scheduled wages.

4. Developments in prices and inflation expectations

I will now turn to price-related issues. Japan's economy has been following the path toward achieving the 2 percent price stability target, as expected, and we can say that the year-on-year rate of change in the CPI (all items less fresh food) has been somewhat higher than market expectations thus far. Inflation expectations of firms and households have also risen on the whole, and are likely to remain on an increasing trend under the Bank's quantitative and qualitative monetary easing (QQE), due in part to a rise in the actual inflation rate. However, since the year-on-year rate of increase in the CPI is expected to be around 1–1/4 percent for some time, close attention still needs to be paid to whether medium- to long-term inflation expectations will rise as expected. In addition, it is important that a virtuous cycle between price rises and wage increases operates effectively in order for prices to rise in a sustainable fashion. Discussions on efforts to raise productivity and on price developments in the upcoming wage negotiations will therefore be monitored closely.

II. Conduct of monetary policy

A. Quantitative and qualitative monetary easing (QQE)

1. Framework of QQE

Next, I would like to turn to the Bank's conduct of monetary policy.

In order for Japan's economy to overcome deflation as early as possible and achieve sustainable growth with price stability, the Bank introduced in January 2013 the price stability target of 2 percent in terms of the year-on-year rate of change in the CPI. Then, in April the Bank introduced QQE to achieve the price stability target at the earliest possible time, with a time horizon of about two years.

Specifically, the Bank decided upon the following. First, with a view to pursuing quantitative monetary easing, the Bank decided to increase the monetary base – which is the total amount of currency it directly supplies to the economy (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, thus doubling it in two years. Second, to achieve this, the Bank has been purchasing Japanese government bonds (JGBs) so that their amount outstanding increases at an annual pace of about 50 trillion yen. In doing so, the Bank has aimed at working on interest rates across the yield curve – including longer-term ones – extending the average remaining maturity of its JGB purchases to about seven years. And third, the Bank has been purchasing exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their amounts outstanding increase at an annual pace of about 1 trillion yen and about 30 billion yen, respectively. The Bank will continue with QQE – consisting of these measures – aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate. In order to achieve the price stability target, it is important to create a virtuous cycle in which prices rise moderately along with a balanced and sustainable improvement in economic activity that is accompanied by increases in corporate profits, employment, and wages.

2. Effects of QQE

Now I will talk about developments since the introduction of QQE. The monetary base has been increasing at an annual pace of about 60–70 trillion yen – in line with the Bank's guideline for money market operations – owing to progress in the Bank's large-scale JGB purchases, and reached its initial projection of 200 trillion yen at end-2013. The Bank intends to increase its monetary base to 270 trillion yen – corresponding to as much as approximately 60 percent of Japan's nominal GDP – toward end-2014. Despite some instability observed in the JGB market soon after the introduction of QQE last April, the market gradually regained stability as the Bank implemented detailed money market operation measures while maintaining a close dialogue with market participants. QQE has thus been exerting its intended effects, with favorable developments spreading to economic activity and financial markets.

The Bank conducts QQE keeping in mind two key transmission channels, that is, routes by which the effects of QQE are expected to carry through the economy: (1) lowering real interest rates by exerting downward pressure on nominal long-term interest rates and raising inflation expectations; and (2) the portfolio rebalancing effect. In lowering real interest rates, the Bank first applies strong downward pressure on nominal long-term rates by tightening JGB market conditions through the massive purchases of JGBs. Then, through a clear explanation of its determination to achieve the price stability target at the earliest possible time and the continuation of massive purchases of assets underpinning this determination, it aims to raise inflation expectations by boosting people's expectations that the economy will become revitalized. Consequently, real interest rates could be lowered if the extent of a pick-up in nominal rates is contained within the extent of a rise in inflation expectations. As the spending behavior of firms and households is influenced by real interest rates, a decline in such rates would help to increase firms' and households' investment and consumption. As for recent developments, in a situation where nominal long-term interest rates have been stable at low levels, real interest rates appear to be on a declining trend on the back of a rise in inflation expectations as a whole. Real interest rates are expected to continue on a declining trend given that the Bank's large-scale JGB purchases will put strong downward pressure on nominal long-term rates and as inflation expectations rise in line with an increase in the actual inflation rate.

Next, the portfolio rebalancing effect can be described as the effect produced by the Bank's asset purchases, in which they encourage financial institutions and institutional investors to shift their asset portfolio toward lending and investment in risk assets such as stocks. The aggregate flow of investment – including by households – confirms that investments in stocks and investment trusts as well as in corporate bonds, in addition to lending, have been increasing, while the amount of JGB holdings has been decreasing. The increases are partly attributable to the rise in stock prices, and the increase in the amount of lending is still small compared with that of the monetary base. Nevertheless, portfolio rebalancing – mainly characterized by the shift in investment to risk assets – is likely to gradually gather momentum as firms' demand for funds continues to strengthen and given that business fixed investment is expected to continue on a moderate increasing trend. With these channels acting together, it is likely that the aggregate supply and demand balance will improve and that the actual inflation rate will rise further.

3. Developments in financial markets

Meanwhile, financial conditions remain accommodative. Firms' funding costs have been hovering at low levels, with long-term average contract interest rates on new loans and discounts having declined to the 0.8–0.9 percent level, reaching a historical low. Firms see financial institutions' lending attitudes as being on an improving trend. The DI of financial positions of small firms has been recovering, reaching the most recent peak level seen around 2006. In addition, the number of corporate bankruptcies has been at a low level, with figures for January 2014 at the lowest for a January since 1991. The amount outstanding of bank lending has been at around 2.5 percent, with lending to small firms extended to those across a wider range of industries and a climb observed in the year-on-year rate of increase in the amount outstanding of such lending. Issuing conditions for CP and corporate bonds have continued to be favorable. In these circumstances, the year-on-year rate of growth in the money stock (M2) has been high at around 4.5 percent. Looking at financial markets, money market rates have been below the 0.1 percent level for all maturities. Long-term interest rates have been stable at a historically very low range of 0.6–0.8 percent, even at a time when overseas interest rates rose on the whole, with U.S. long-term interest rates reaching around 3.0 percent, mainly against the backdrop of an economic recovery. In addition, stock prices have risen substantially and a correction in the yen's appreciation has been taking place in the foreign exchange market.

Regarding economic activity, a front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike are expected. In making future monetary policy decisions, it is important to assess whether Japan's economy is following the path toward achieving the 2 percent price stability target as expected, after smoothing out related fluctuations in demand. At present, the virtuous cycle continues to operate as the effects of QQE on economic activity are becoming pronounced. Nevertheless, it is important to continue to carefully examine economic developments and the effects of monetary policy.

Furthermore, in order to fully ensure the effectiveness of monetary easing, it is essential for the government to ensure the market credibility of fiscal consolidation. Japan faces serious fiscal imbalances, even by international standards. If the credibility of its fiscal management were to decline, long-term interest rates would likely rise in a manner inconsistent with economic and price developments. The government has indicated that it aims to halve the primary deficit-to-GDP ratio by fiscal 2015 and achieve a surplus in the primary balance by fiscal 2020. Based on these targets, it is expected that the government will continue making efforts toward fiscal consolidation.

B. Loan support program

Next, I will discuss the Bank's Loan Support Program. To support full use of the accommodative financial conditions by firms and households, the Bank – in addition to implementing aggressive monetary easing measures – has established the Loan Support Program. The program consists of two measures: the fund-provisioning measure to stimulate bank lending (hereafter the Stimulating Bank Lending Facility) and the fund-provisioning measure to support strengthening the foundations for economic growth (hereafter the Growth-Supporting Funding Facility). At the Monetary Policy Meeting held on February 17 and 18, 2014, the Policy Board decided to double the scale of the two facilities and to extend the application period for them, both of which were due to expire shortly, by one year. It also decided to extend the duration of loans, enabling financial institutions to borrow funds at a fixed rate of 0.1 percent per annum for four years instead of the current one to three years.

Let me elaborate on the framework of and the recent enhancements made to these facilities. First, the Stimulating Bank Lending Facility aims to prompt financial institutions to take a more active lending stance and stimulate firms' and households' demand for credit. With this facility, the Bank provides long-term yen-denominated funds at a low interest rate to financial institutions, at their request, up to an amount equivalent to the net increase in their lending. There is no upper limit to the total amount of funds provided by the Bank under this facility. Under the enhanced framework, the Policy Board decided to double the maximum amount of its fund-provisioning to each financial institution – formerly set to the net increase in its lending – allowing it to borrow funds from the Bank up to an amount that was twice as much as the net increase in its lending. Moreover, the duration of loans was extended from the former period of one to three years with a fixed interest rate of 0.1 percent per annum to four years with a fixed rate of 0.1 percent per annum. The amount outstanding of fund-provisioning under the Stimulating Bank Lending Facility is about 5 trillion yen as of end-2013. Based on the assumption that the growth rate of bank lending and the utilization rate of the facility will remain more or less at current levels, the amount outstanding of fund-provisioning under the enhanced framework is estimated to be around 30 trillion yen.

I will now move on to the Growth-Supporting Funding Facility, which aims to support the flow of funds to growth sectors. With this facility, the Bank provides long-term funds – both yen-dominated and foreign currency-denominated – 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. Before the enhancements, the Bank set the maximum amount of its fund-provisioning to financial institutions under the main rules and special rules as follows: 3.5 trillion yen under the main rules for financial institutions' investments and loans amounting to 10 million yen or more; 500 billion yen under the special rules for financial institutions' equity investments and asset-based lending (ABL) – the latter of which uses assets such as accounts receivable and inventories as eligible collateral; 500 billion yen under the special rules for financial institutions' small-lot investments and loans; and 12 billion U.S. dollars – equivalent to 1.2 trillion yen – under the special rules for a U.S. dollar lending arrangement using the U.S. dollar reserves already held by the Bank. In the recent enhancement of the facility, the Policy Board decided to double the maximum amount of the Bank's fund-provisioning under the main rules, which had almost reached its limit, to 7 trillion yen, and increased the maximum amount of its fund-provisioning to each financial institution from 150 billion yen to 1 trillion yen. It was decided that the duration of all loans – excluding those made under the U.S. dollar lending arrangement – would be extended from the former period of one to two years with a fixed interest rate of 0.1 percent per annum to four years with a fixed rate of 0.1 percent per annum.

In order to maintain the virtuous cycle, 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 and further to the strengthening of the economy's growth potential. The recent enhancement of the two facilities, and the extension of their application period, will likely promote such movements. The corporate sector has accumulated 230 trillion yen worth of cash and deposits amid firms' persistent tendency to invest only as much as their cash flow allows. Recently, however, firms have increasingly shown a willingness to take the opportunity to start new investment using external funds. Through the measures I have just explained, the Bank will continue to provide firm support enabling them to meet their challenges.

I hope that these measures, together with steady progress in the implementation of the Japan Revitalization Strategy – aimed at strengthening the government's competitiveness – will prompt financial institutions to take a more active lending stance and stimulate firms' and households' demand for credit, with a view to encouraging banks' lending and strengthening the foundations for economic growth.