# Haruhiko Kuroda: Toward overcoming deflation

Speech by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at the Annual Tokyo Conference, hosted by the Center on Japanese Economy and Business (CJEB), Columbia Business School, Tokyo, 15 May 2014.

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*Accompanying charts can be found at the end of the speech.*

## Introduction

It is my great honor to deliver a speech at this conference hosted by the Center on Japanese Economy and Business of Columbia Business School.

The topic of this conference – "Restoring the Japanese Economy" – is of considerable significance and I have no doubt that the proposals presented here will be of benefit to Japan's economy in the future.

In my speech, I will talk about the Bank of Japan's initiatives toward overcoming deflation and the outlook for economic activity and prices. In closing, I will touch on Japan's growth potential, which is a key issue for "Restoring the Japanese Economy".

## I. Effects of quantitative and qualitative monetary easing and outlook for economic activity and prices

In April last year, the Bank introduced quantitative and qualitative monetary easing, dubbed QQE, aiming to achieve a price stability target of 2 percent at the earliest possible time, with a time horizon of about two years. About a year has passed since then and QQE has been having the intended effects. Through a clear commitment to promptly achieving the price stability target and large-scale monetary easing, people's inflation expectations have been rising on the whole. On the other hand, massive purchases of government bonds by the Bank have kept 10-year interest rates at a low level, which is currently about 0.6 percent. As a result, real interest rates have been negative and have continued to decline, thereby stimulating economic activity. Japan's economy has continued to grow, led by domestic demand, and the year-on-year rate of change in the consumer price index (CPI) excluding fresh food has risen from minus 0.5 percent in March last year to plus 1.3 percent in March this year (Chart 1).

Going forward, it is likely that a virtuous cycle of economic activity will be maintained as domestic demand will continue to remain firm and exports are expected to increase, albeit moderately. Therefore, Japan's economy is likely to continue growing at a pace above its potential as a trend, although it will be affected by fluctuations in demand associated with the two rounds of consumption tax hikes. According to the projections in the recently released *Outlook for Economic Activity and Prices* (Outlook Report), real GDP is expected to grow by 1.1 percent in fiscal 2014, 1.5 percent in fiscal 2015, and 1.3 percent in fiscal 2016 (Chart 2).

With regard to the outlook for the CPI excluding fresh food, the year-on-year rate of increase after eliminating the direct impacts of the consumption tax hikes is likely to be around 1¼ percent for some time. The reason is that upward pressure from import prices – mainly from energy prices – will wane through around summer while trend inflationary pressure – due mainly to an improvement in the output gap – will increase, and these two factors will likely more or less offset each other. Subsequently, as trend inflationary pressure continues to grow, the year-on-year rate of increase is expected to follow a rising trend again from the second half of this fiscal year, and reach around 2 percent around the middle of the projection period, which is from fiscal 2014 through fiscal 2016. Thereafter, the rate of increase is likely to edge up as medium- to long-term inflation expectations will converge to around 2 percent and the output gap is expected to continue expanding in positive territory. According to the Outlook Report, the year-on-year rate of change is expected to be plus 1.3 percent in fiscal 2014, plus 1.9 percent in fiscal 2015, and plus 2.1 percent in fiscal 2016 (Chart 2).

Hence, Japan's economy is likely to achieve an inflation rate of around 2 percent, and thereafter gradually shift to a growth path that sustains such inflation in a stable manner.

## II. Issues regarding the outlook for economic activity

Let me next talk about issues concerning the outlook for the real economy and prices – specifically, two concerning the real economy and two concerning prices.

### *Effects of the consumption tax hike and the sustainability of domestic private demand*

With regard to the real economy, the first issue – and perhaps the one of immediate interest for you – is the effects of the consumption tax hike. The front-loading of demand prior to the tax hike through the end of March was quite substantial (Chart 3). When the consumption tax was last raised in April 1997, the economy subsequently fell into recession. There are some concerns that this might happen again. However, looking back at the economic situation at the time, following the decline in demand after the tax hike, the economy showed signs of recovery in the July–September quarter. What moved the economy back into recession was the outbreak of the Asian currency crisis in the summer of that year and the failure of a number of Japan's major financial institutions in November. Unlike then, emerging economies today are much more resilient to adverse shocks and Japan's financial system is stable. In addition, this time around, the economic recovery maintains its momentum as shown in favorable business sentiment, and the employment situation, as measured in terms of the unemployment rate, is also firm. This will have a positive effect on both current labor income and the outlook for future labor income – and hence permanent income – and is therefore expected to underpin private consumption. According to interviews with firms, the decline in consumption following the front-loading of demand has been broadly in line with expectations so far. Therefore, real GDP growth is expected to show a clear decline in the April–June quarter, but the effects of the decline in demand after the tax hike will dissipate thereafter, and the economy is expected to return to a growth path above its potential from summer.

### *Recovery in exports*

The next issue is developments in exports. Since exports have been lacking momentum despite the correction of the excessive appreciation of the yen, some have argued that Japanese firms' global competitiveness has declined (Chart 4). However, recent developments in exports have basically been due to cyclical factors such as the sluggishness in emerging economies with close economic ties with Japan, such as the ASEAN countries, although structural factors such as the acceleration in the relocation of production overseas by Japanese manufacturers are likely to have also played a certain role. In addition, especially in the first quarter, temporary factors have likely put downward pressure on exports. Examples include the fact that firms placed priority on domestic shipments in response to the front-loading of demand prior to the consumption tax hike and the effects of the unusually severe winter weather in the United States. Therefore, once growth in overseas economies rises and the effects of these temporary factors diminish, exports are likely to start increasing again, albeit moderately.

Meanwhile, the correction in the appreciation of the yen might slow the pace of the relocation of production overseas in the future, given that there is a considerable lag between the decision to relocate production and the actual start of production overseas. Therefore, concerning this structural factor, too, developments may move in the direction of underpinning exports.

## III. Issues regarding the outlook for prices

As I explained, Japan's economy is likely to continue growing above its potential. However, growth in fiscal 2013 and 2014 is likely to turn out somewhat lower than previously expected due to the delay in the recovery in exports. Despite these downward revisions, the year-on-year rate of change in the CPI for fiscal 2013 turned out as projected and the outlook remains unchanged. The output gap has been steadily narrowing mainly due to the tightening of labor market conditions as projected, and the rise in medium- to long-term inflation expectations seems to have started to influence actual wage and price settings. Let me elaborate on these two points.

### *The output gap and prices*

First, on the output gap. The current recovery has been led by domestic demand, and business conditions in nonmanufacturing in particular have been improving. As domestic demand tends to have large stimulative effects on employment, this has led to a further tightening in labor market conditions. For example, the unemployment rate is approaching the structural unemployment rate and the active job openings-to-applicants ratio is now at the same level as the peak reached before the global financial crisis (Chart 5). The employment conditions DI in the Bank's *Tankan* survey revealed that more and more firms feel that there is a labor shortage. This tightening of labor market conditions has started to influence wages. In the regular annual wage negotiations this spring, the number of firms that raised not only bonuses but also base pay increased substantially.

In addition, more and more firms, especially in nonmanufacturing, feel that they have insufficient capacity. While estimates of the output gap are subject to a considerable margin of error, the gap seems to have narrowed to close to 0 percent, which is the past long-term average, reflecting the increased utilization of labor and capital (Chart 6).

As for the outlook, it is likely that the tightening of labor market conditions will become more pronounced as the economy continues to grow above its potential, and inflationary pressure from wages and the output gap is likely to steadily strengthen. I will touch on what implications this might have in the last part of my speech.

### *Medium- to long-term inflation expectations*

Next, according to various surveys and market indicators, medium- to long-term inflation expectations appear to be rising on the whole (Chart 7).

As I mentioned at the outset, the year-on-year rate of change in the CPI excluding fresh food has been plus 1.3 percent for four consecutive months. Except for the period after the previous consumption tax hike in 1997 and the surge in global commodity prices around 2008, this is the first time since 1993 that the CPI has risen by more than 1.0 percent year-on-year several months in a row. With firms and households experiencing these price increases, their inflation expectations are changing in an adaptive manner. In this situation, medium- to long-term inflation expectations are likely to follow an increasing trend and gradually converge to around 2 percent – the price stability target.

These developments seem to have started to influence actual wage and price settings. As mentioned earlier, an increasing number of firms are raising base wages and some firms recently have changed from a strategy that puts first priority on low prices to one that aims at raising sales prices while increasing value-added. Regarding the CPI for April, an issue of key interest has been whether firms have been able to pass on the consumption tax hike by raising sales prices in line with the tax hike, and the index for Tokyo, which is released ahead of the nationwide index, suggests that this is indeed the case.

### *The Phillips curve*

Let me summarize this price rise mechanism in terms of the Phillips curve, which illustrates the relationship between the output gap and inflation.

This relationship is shown in Chart 8, with the red dots representing the four positions observed over the past year. While it is difficult to gauge the shape and position of the Phillips curve on a real-time basis, we find that the red dots lie above the Phillips curve based on observations for the past 18 years. Thus, taking into account the aforementioned rises in various indicators of inflation expectations and changes in wage- and price-setting behavior, the chart suggests that two things appear to have happened: we seem to have moved upward along the Phillips curve, reflecting a boost in inflation due to the improvement in the output gap, and the Phillips curve appears to have shifted upward due to a rise in inflation expectations. It is likely that these developments will continue and the inflation rate will follow a path toward achieving the price stability target of 2 percent.

## IV. Monetary policy management and the growth potential of Japan's economy

As I have mentioned, QQE has been having the intended effects. Therefore, I believe it is important to continue with QQE as long as it is necessary for maintaining the price stability target of 2 percent in a stable manner. On that basis, should the outlook change due to certain risk factors the Bank, if necessary, will make adjustments without hesitation in order to achieve the price stability target.

What I would like to emphasize here is our strong commitment to achieving the price stability target of 2 percent. If Japan's economy follows a path toward the 2 percent target as we have projected, we will steadily pursue the current QQE. If not, we will make adjustments so as to achieve the 2 percent.

In closing, let me briefly touch on the growth potential of Japan's economy. The Bank's QQE policy aims at escaping from a protracted deflationary equilibrium and achieving an economy in which people act on the assumption of inflation of about 2 percent. What has been happening in Japan's economy for the past 15 years is that declines in product prices led to a decline in firms' sales, which led to a further decline in prices through compressed wages and stagnant consumption, resulting in a vicious cycle. In such a deflationary economy, it is only rational for individual firms or persons to maintain the status quo, or to prefer cash, and therefore they did not consider it worth the risk, relative to the potential rewards, to embark on new business ventures. What we are aiming at is to break through this "coordination failure" and revive people's animal spirits. This will be an important element in raising growth expectations and the growth potential.

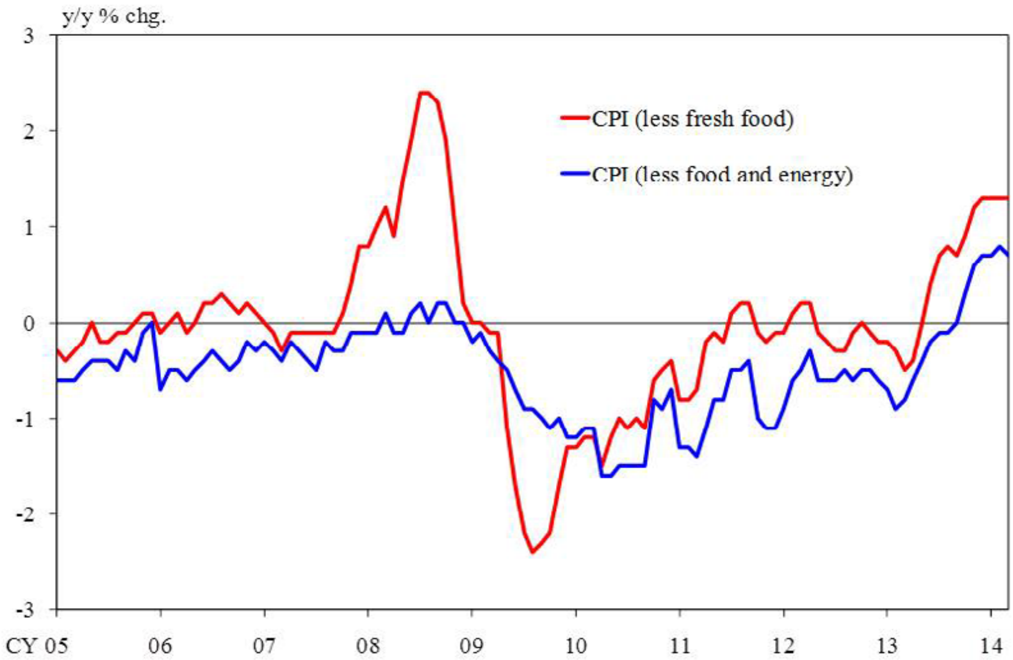
However, there is another important element to consider. As mentioned earlier, given that slack in the economy has shrunk, as seen in the tightening of labor market conditions, it also has become clear that it is imperative to strengthen supply capacity in order for Japan's economy to grow in the medium to long term. Growth in the aggregate supply capacity of Japan's economy has been declining due partly to a declining trend in population and aging, as well as the slowing accumulation of capital stock under deflation. These trends, however, did not manifest themselves in the form of labor shortages or supply capacity constraints because demand had been weak. Yet, in the past year or so, with the increase in demand thanks to large-scale monetary easing, fiscal spending, and the rejuvenation of private-sector activities, the supply capacity constraints that were lurking below the surface have now become apparent.

In my view, with the supply capacity constraints having surfaced, this will be a golden opportunity to resolve the medium- to long-term challenges facing Japan's economy. These challenges, of which the public is well aware, include enhancing productivity through regulatory and institutional reforms, raising the labor participation of women and the elderly as well as utilizing high-skilled foreigners, and putting public finances and the social security system on a sustainable footing. However, even though these challenges are well understood, it was difficult to gather sufficient momentum to address them. When there is excess labor and job security is at issue, it is difficult to win support for policy measures to enhance labor participation. Even though people knew that raising labor participation would eventually become an issue due to demographic trends, they tended to think that there was no need to tackle it immediately. Since the serious labor shortages that have now become evident in some industries are due to temporary phenomena such as the high level of public works and the effects of the front-loading of demand, it may not be appropriate to regard the current labor shortages as entirely linked to medium- to long-term challenges. Having said that, given the demographic trends, there is no doubt that labor supply will be an issue in the near future in various forms. Therefore, we should use the ongoing problem of labor shortages as an impetus for a broader discussion on how to raise Japan’s growth potential. In fact, the government has put forward a growth strategy covering a wide range of areas and has been making efforts to accelerate its implementation. I believe that this is the final and most important element in addressing Japan’s challenges and the one that links the topic of my speech, “Overcoming Deflation”, and the topic of this conference, “Restoring the Japanese Economy”.

Thank you for your attention.

Chart 1

# Consumer Prices




Source: Ministry of Internal Affairs and Communications.

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Chart 2

# Outlook for Economic Activity and Prices (as of April 2014)

y/y % chg.

| | Real GDP | CPI (all items less fresh food) | Excluding the effects of the consumption tax |
|---|---|---|---|
| Fiscal 2013 (Actual) | +2.3 | +0.8 | |
| Forecasts made in January 2014 | +2.7 | +0.7 | |
| Fiscal 2014 | +1.1 | +3.3 | +1.3 |
| Forecasts made in January 2014 | +1.4 | +3.3 | +1.3 |
| Fiscal 2015 | +1.5 | +2.6 | +1.9 |
| Forecasts made in January 2014 | +1.5 | +2.6 | +1.9 |
| Fiscal 2016 | +1.3 | +2.8 | +2.1 |

Note: Figures indicate the median of the Policy Board members' forecasts (point estimates).
Source: Bank of Japan.

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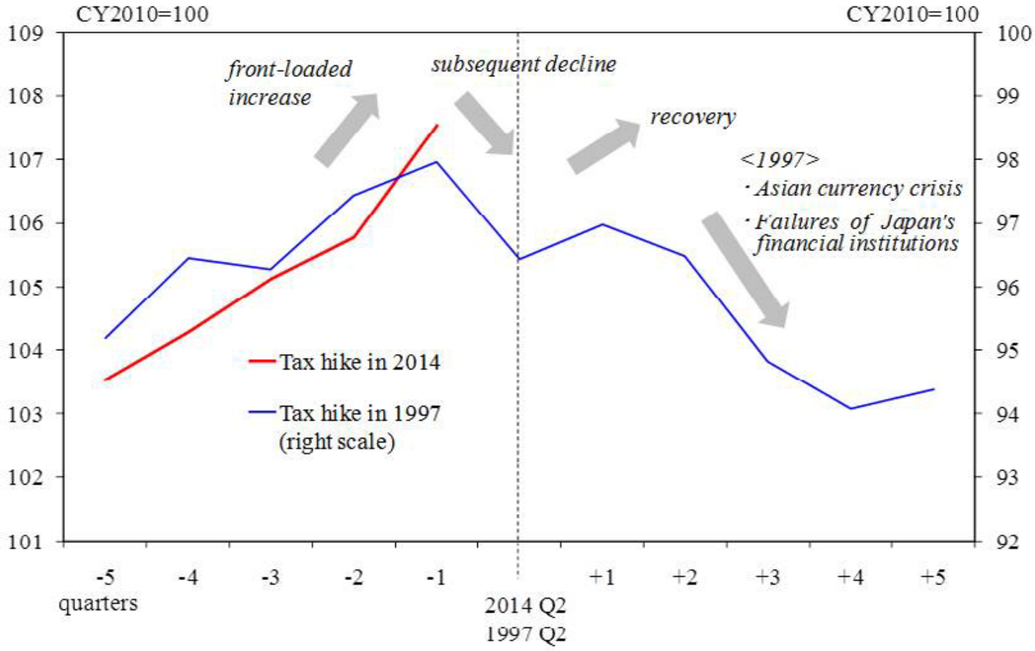
Chart 3

## Domestic Demand prior to and after the Consumption Tax Hikes




Note: Figures are based on real GDP.
Source: Cabinet Office.

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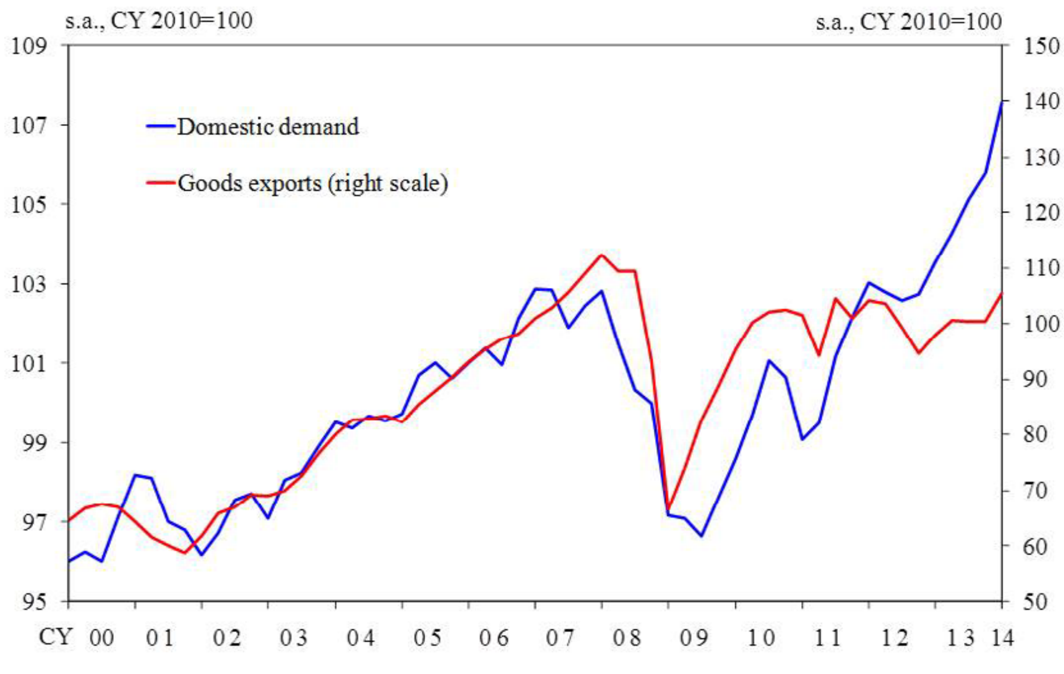
Chart 4

## Domestic Demand and Exports




Note: Figures are based on real GDP.
Source: Cabinet Office.

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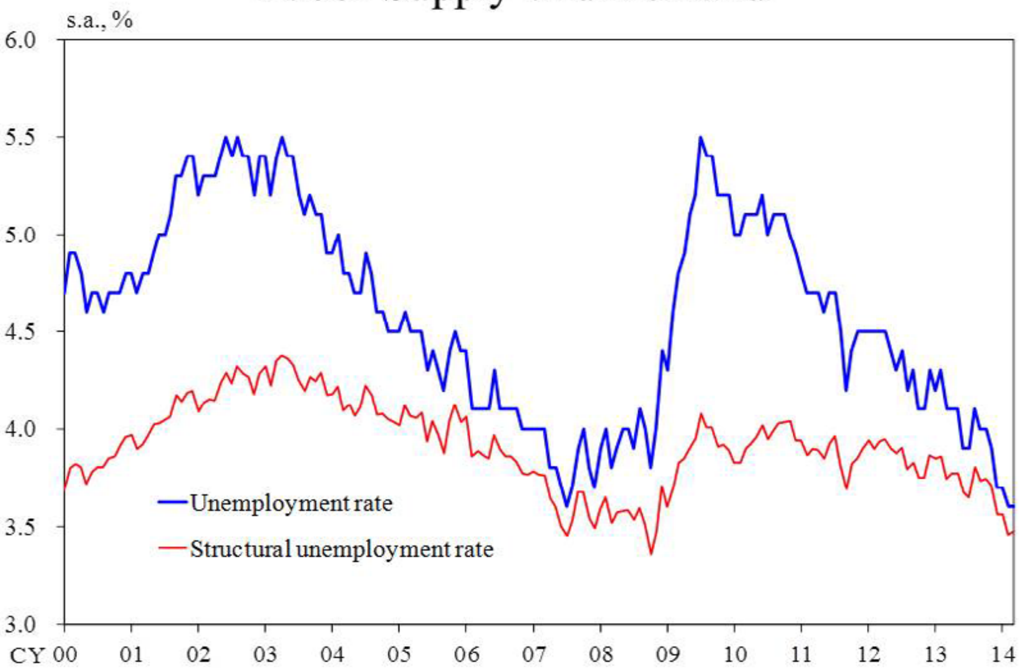
Chart 5

## Labor Supply and Demand



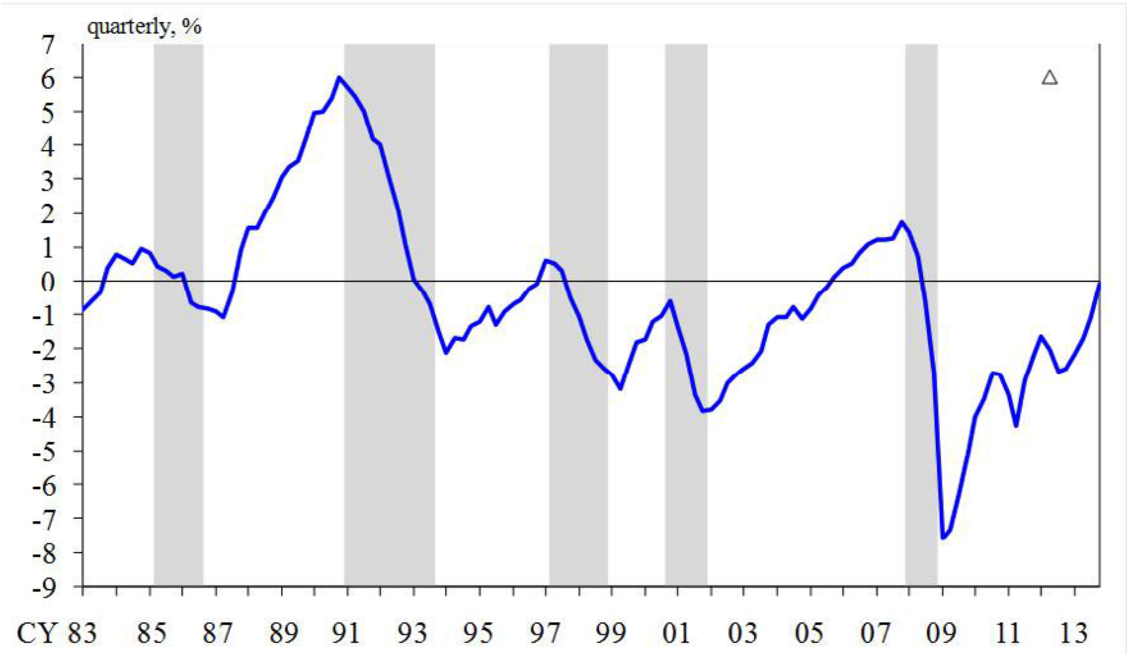

Note: The structural unemployment rate is defined as the level of the unemployment rate where the number of vacancies equals that of the unemployed, given the empirical relationship between job vacancies and unemployment (estimation by the Research and Statistics Department, Bank of Japan). It captures frictional unemployment and unemployment caused by the mismatch between supply and demand in the labor market.

Source: Ministry of Internal Affairs and Communications.

5

Chart 6

## Output Gap




Notes: 1. For the estimation procedures of the output gap estimated by Bank of Japan, see "The New Estimates of Output Gap and Potential Growth Rate," Bank of Japan Review Series, 2006-E-3.

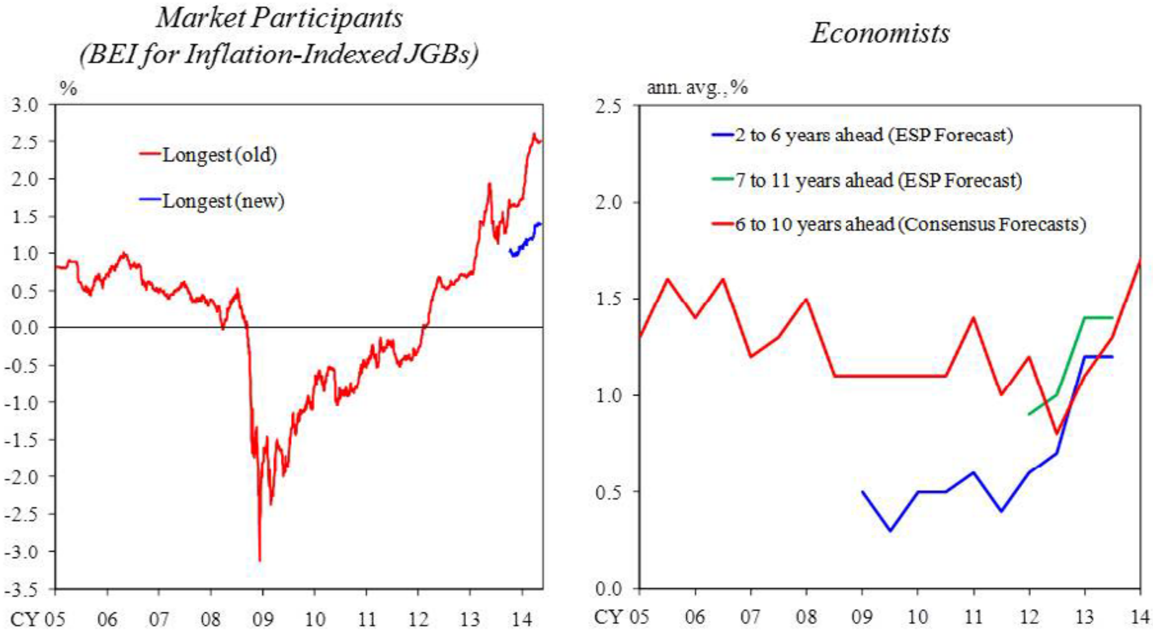
2. Shaded areas indicate recession periods. Triangle shows the latest peak.

Source: Bank of Japan, etc.

6

Chart 7

# Inflation Expectations




Notes: 1. BEI (break-even inflation) rates are yield spreads between fixed-rate coupon-bearing JGBs and inflation indexed JGBs. Inflation-indexed JGBs issued since October 2013 are designated as "new," while the rest of them are designated as "old." Figures for "longest" are calculated using yield data for the inflation-indexed JGBs that have the longest maturity at each period, which currently correspond to those maturing in June 2018 for "old" and March 2024 for "new."

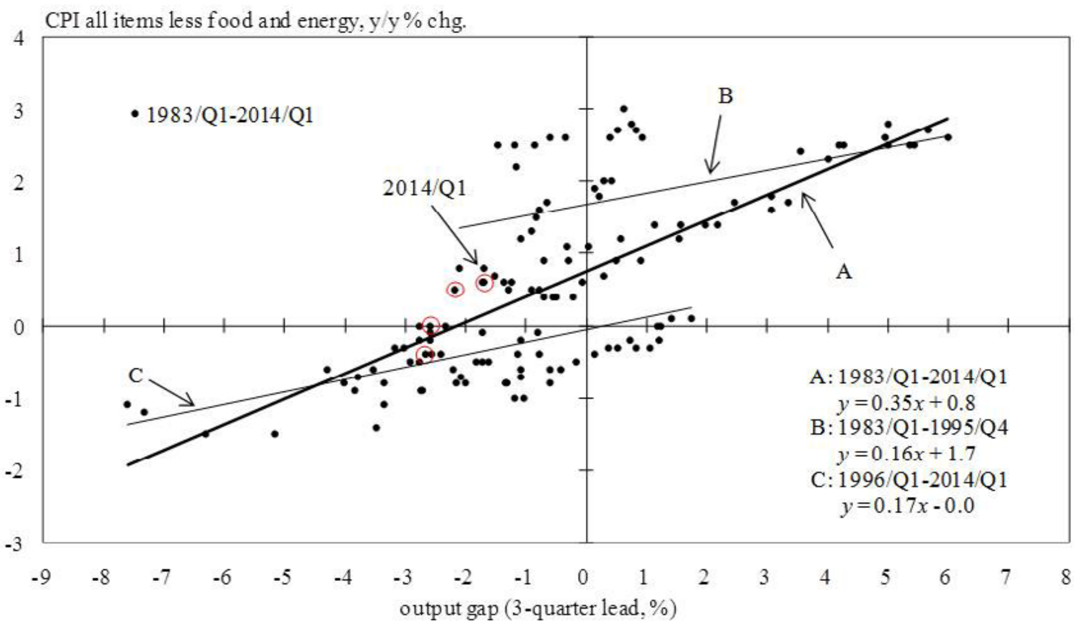
2. Figures for the ESP Forecast exclude the effects of the consumption tax hikes.

Sources: Bloomberg; Consensus Economics Inc.; JCER.

7

Chart 8

# Phillips Curve




Notes: 1. The red circled marks are the latest four positions.

2. Figures for the CPI are adjusted to exclude the effect of changes in the consumption tax rate.

3. The output gap is estimated by the Research and Statistics Department, Bank of Japan. For the estimation procedures, see "The New Estimates of Output Gap and Potential Growth Rate," Bank of Japan Review Series, 2006-E-3.

4. The number of lags is chosen so that the cross-correlation between the output gap and the CPI is maximized.

Sources: Ministry of Internal Affairs and Communications; Cabinet Office; Bank of Japan, etc.

8