# Haruhiko Kuroda: Japan's economy and monetary policy

Speech by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at a meeting with business leaders, Osaka, 16 September 2014.

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

## Introduction

It is my great pleasure to have the opportunity today to exchange views with a distinguished gathering of business leaders in Osaka. I would like to take this opportunity to express my sincerest gratitude for your cooperation with the Bank of Japan's branches in Osaka, Kobe, and Kyoto.

In April last year, the Bank introduced quantitative and qualitative monetary easing (QQE) to achieve the price stability target of 2 percent at the earliest possible time, with a time horizon of about two years. When I spoke to you last November, I said that under QQE there was a positive turnaround in areas such as economic activity, financial markets, and people's sentiment and expectations. Since then, QQE has continued to steadily exert its intended effects. The year-on-year rate of change in the consumer price index (CPI, excluding fresh food) was minus 0.4 percent in April last year when QQE was introduced, but it has improved since then, recently registering 1.3 percent excluding the direct effects of the consumption tax hike. Japan's economy has thus been on a path suggesting that the 2 percent price stability target will be achieved as expected, although we are only halfway there.

Today, before exchanging views with you, I would like to explain the Bank's view on the current situation of and outlook for economic activity and prices as well as the Bank's monetary policy management.

## I. Economic activity in Japan and abroad

### *Current situation of and outlook for Japan's economy*

Let me start by discussing the current situation of and outlook for Japan's economic activity.

Japan's economy has continued to recover moderately as a trend, although a decline has been observed in demand following the front-loaded increase prior to the consumption tax hike. The GDP statistics (second preliminary estimates) released last week showed that real GDP in the April-June quarter of 2014 fell substantially at a rate of 7.1 percent on an annualized quarter-on-quarter basis (Chart 1). However, this decline followed the front-loading of demand in the January-March quarter, in which real GDP had grown significantly at a rate of 6.0 percent. To exclude such fluctuations, when we compare real GDP in the January-June period this year with that in the July-December period last year, the annualized growth rate was 1.0 percent. Therefore, on average, Japan's economy has continued to grow at a pace above its potential. More specifically, the employment and income situation has continued to improve steadily, and household sentiment has been improving, although the decline following the front-loaded increase prior to the consumption tax hike is still observed, and exports as well as industrial production have shown some weakness. Moreover, firms have maintained a proactive stance on investment due mainly to their favorable business performance. In this way, a virtuous cycle from income to spending has been operating steadily in both the household and corporate sectors. With this mechanism intact, Japan's economy is expected to continue its moderate recovery trend, and the effects of the decline in demand following the front-loaded increase are expected to wane gradually. Next I will discuss the household and corporate sectors, respectively.

### *Household sector: resilient private consumption*

In the household sector, private consumption has remained resilient as a trend with the employment and income situation improving steadily. With regard to durable goods such as automobiles and household electrical appliances, the recovery from the decline has dragged on reflecting the large degree of front-loading of purchases. On the other hand, sales at department stores and supermarkets have followed a recovery trend on average. Moreover, consumption of services has been resilient, as seen for example in food service and outlays for travel, where the effects of the consumption tax hike have been limited. Although developments in consumption after the consumption tax hike vary by item and bad weather may have adversely affected developments in some regions, the effects of the decline in demand following the tax hike have gradually begun to wane on the whole. Looking ahead, with the employment and income situation continuing to improve steadily, private consumption is expected to remain resilient.

With regard to the household sector, it is claimed that wage increases have failed to keep pace with inflation and real wages have declined, putting downward pressure on private consumption. On this point, it is important to distinguish between an increase in the inflation rate resulting from the consumption tax hike and trend inflation. With the year-on-year rate of increase in the CPI since April this year having been pushed up temporarily due to the consumption tax hike, the year-on-year rate of increase in nominal wages has been lower than that in the CPI. However, the consumption tax hike was scheduled in advance, and it is not an additional factor putting downward pressure on economic activity and prices. Even since before the tax hike in April this year, the Bank's outlook for economic activity and prices has factored in the two rounds of consumption tax hikes. While the hikes will adversely affect real income, such effects on households' spending behavior might be mitigated to some extent as confidence is enhanced in the sustainability in the government's fiscal conditions and the social security system.

Looking at the recent income situation of households, employee income has been increasing about 2 percent year on year, exceeding the inflation rate, which is hovering at around 1¼ percent excluding the direct effects of the consumption tax hike (Chart 2). Specifically, the year-on-year rate of change in scheduled cash earnings turned positive reflecting a rise in base pay by many firms – the first increase in many years. In addition, special cash earnings have clearly risen due mainly to an increase in summer bonuses. Furthermore, the number of employees has been growing. Looking ahead, with the economy recovering moderately, the employment situation is expected to maintain its improving trend, exerting further upward pressure on wages, and therefore employee income is likely to continue increasing moderately. Underpinned by this improvement in the employment and income situation, private consumption is expected to remain resilient, and the effects of the decline in demand following the front-loaded increase are expected to wane further.

### *Corporate sector: moderate increase in business fixed investment*

Turning to the corporate sector, industrial production has recently shown some weakness, particularly in durable goods, such as automobiles, and construction goods, both of which have been significantly affected by the decline following the front-loading of purchases. Exports have been lacking momentum due mainly to a delay in the recovery of overseas economies, as I will explain later in more detail. Even in this situation, corporate profits and business sentiment have been favorable, and firms have maintained their proactive stance on business fixed investment. In fact, the corporate profits of listed companies for the April-June quarter appear to have surpassed projections. Surveys point to favorable business sentiment, and firms are planning to increase their business fixed investment – mainly investment in Japan – from the previous year.

While it is claimed that growth in business fixed investment can no longer be expected due to Japanese firms' accelerated relocation of production overseas, I hold the view that we are now in an environment supporting an increase in such investment (Chart 3). The reasons are as follows. First, as a result of restrained investment for some years, capital stock has become outdated and this has hampered smooth production in some cases, prompting increasing demand for renewal investment. Second, wages have risen due to the labor shortage while interest rates for borrowing to finance business fixed investment have been at low levels. Therefore, it might have become more advantageous for some firms to invest in labor-saving machinery and equipment than to hire new employees. Third, nearly two years have passed since the correction of the excessive yen appreciation, and it appears that Japanese firms have started again to invest in improving the domestic bases of their businesses, particularly for research and development.

Against this backdrop, as corporate profits are expected to continue improving on the whole, the virtuous cycle from income to spending is likely to operate steadily, and business fixed investment is expected to continue its moderate increasing trend.

### *Exports and overseas economies*

As I just mentioned, domestic demand is expected to remain firm. On the other hand, external demand has continued to lack momentum (Chart 4). This is due not only to cyclical factors including sluggishness in global economies such as emerging economies, but also to structural factors such as the accelerated relocation of production overseas by Japanese manufacturing firms. Nevertheless, as the cyclical factors are expected to become favorable – particularly with the accelerating growth of overseas economies (mainly advanced economies) – exports are expected to head for a moderate increase, especially those of high-value-added products. In fact, there are signs of a pick-up in exports, with an uptrend in external demand for machinery orders – a leading indicator of exports of capital goods and parts – and an improving trend in the forecast diffusion index of overseas supply and demand conditions for products as shown in the *Tankan* (Short-Term Economic Survey of Enterprises in Japan).

Of course, such an outlook for exports is based on the assumption that overseas economies will continue to recover. While there are concerns including geopolitical risks in some parts of the world, the global economy is likely to continue recovering, led by advanced economies, since economic recovery in the United States has become increasingly evident. In the *World Economic Outlook Update* published in July by the International Monetary Fund, annual global economic growth – which slowed to 3.2 percent in 2013 – is projected to accelerate gradually to 3.4 percent in 2014 and 4.0 percent in 2015 (Chart 5). Looking at individual countries or regions, in the U.S. economy, firmness in the household sector has been spreading to the corporate sector and a pick-up in business fixed investment recently became evident. These developments are likely to lead to an increase in demand for some capital goods and parts – in which Japan enjoys a competitive advantage – and therefore deserve attention when we consider the outlook for Japan’s exports. In the euro area economy, a disinflationary trend – as seen in the decline in the year-on-year growth rate in consumer prices to 0.3 percent – is a matter of concern. However, international markets’ views on the European debt problem remain stable and the European Central Bank implemented a series of additional monetary easing measures in June and September. This background supports the view that the euro area economy will basically continue to recover, albeit moderately. In China, the economy is expected to maintain stable growth at around the current pace, since the government plans to give due attention to the economic recovery, such as by providing economic stimulus measures both on the monetary and fiscal fronts, although an adjustment in the real estate market has persisted. While other emerging economies and commodity-exporting countries have continued to lack growth momentum as a whole, positive effects of the recovery in advanced economies are expected to spread gradually. In the meantime, some geopolitical risks, including those in Ukraine and Iraq, still warrant attention.

Therefore, the Bank's baseline scenario is that overseas economies – mainly advanced economies – are likely to continue to recover, and Japan's exports are expected to head for a moderate increase.

## II. Price developments in Japan

Let me turn now to price developments in Japan.

As I mentioned at the outset, the year-on-year rate of increase in the CPI (excluding fresh food) – which was minus 0.4 percent in April last year when QQE was introduced – subsequently turned positive and increased further to around 1¼ percent recently (Chart 6). These developments reflect an improvement in the output gap and a rise in inflation expectations. The output gap has been improving at around 0 percent – the long-term average – with Japan's economy continuing to grow at a pace above its potential as a trend, although the effects of the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike have been observed. Inflation expectations appear to be rising on the whole, albeit with monthly fluctuations. With the year-on-year rate of increase in the CPI (excluding fresh food) continuing to exceed 1 percent, a shift is observed in firms' price-setting strategy, from a low-price strategy to one of raising sales prices while increasing value-added. As for wage setting, as seen in annual wage negotiations this spring, the rise in inflation is increasingly being taken into account in wage negotiations between management and labor.

This improvement in the output gap and the rise in inflation expectations are expected to continue. Therefore, the year-on-year rate of increase in the CPI, which is likely to be around 1¼ percent for some time, is expected to subsequently follow an uptrend again from the second half of this fiscal year and reach about 2 percent – the price stability target – around the middle of the current projection period from fiscal 2014 through 2016.

## III. Monetary policy management toward achieving the price stability target of 2 percent

Finally, let me discuss the Bank's monetary policy management.

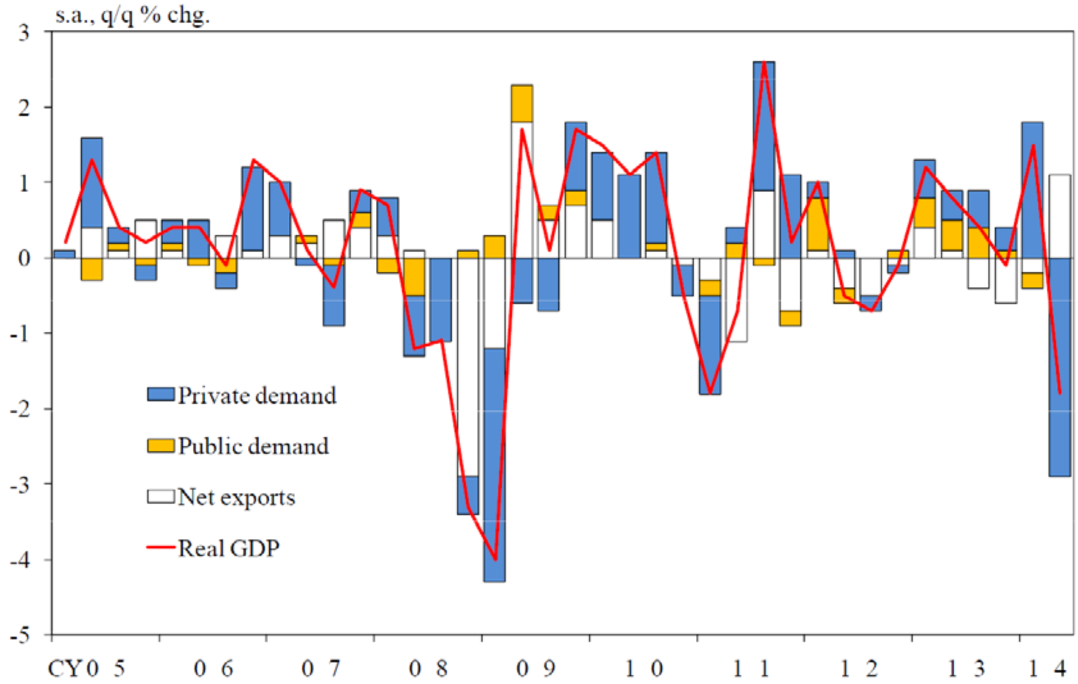
The Bank has been pursuing QQE, aiming to achieve a state in which the 2 percent inflation rate is maintained in a stable manner. In this state, the inflation rate will be around 2 percent when the economy is at a normal level. That is, firms will be able to base decisions on an assumption of about 2 percent inflation when they consider how to set prices and when management and labor negotiate wages. If such an economy is achieved, economic entities will act based on an expectation that inflation will return to about 2 percent sooner or later – even if the economy faces temporary downward pressure on prices and wages due to, for example, a downturn in economic activity. Therefore, the risk of falling into deflation, where prices and wages continue to decline, will be lowered.

As I mentioned, Japan's economy has been on a path suggesting that the price stability target of 2 percent will be achieved as expected. We are only halfway there, however, and the Bank will continue with QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. If the outlook changes due to the manifestation of risk factors and it is judged necessary for achieving the price stability target, the Bank will make adjustments without hesitation. I would like to conclude my speech today by assuring you that, through the Bank's monetary policy management, the prolonged deflation will be overcome and an economy based on a moderate inflation rate of 2 percent will be achieved.

Thank you.

Chart 1

# Real GDP




Source: Cabinet Office.

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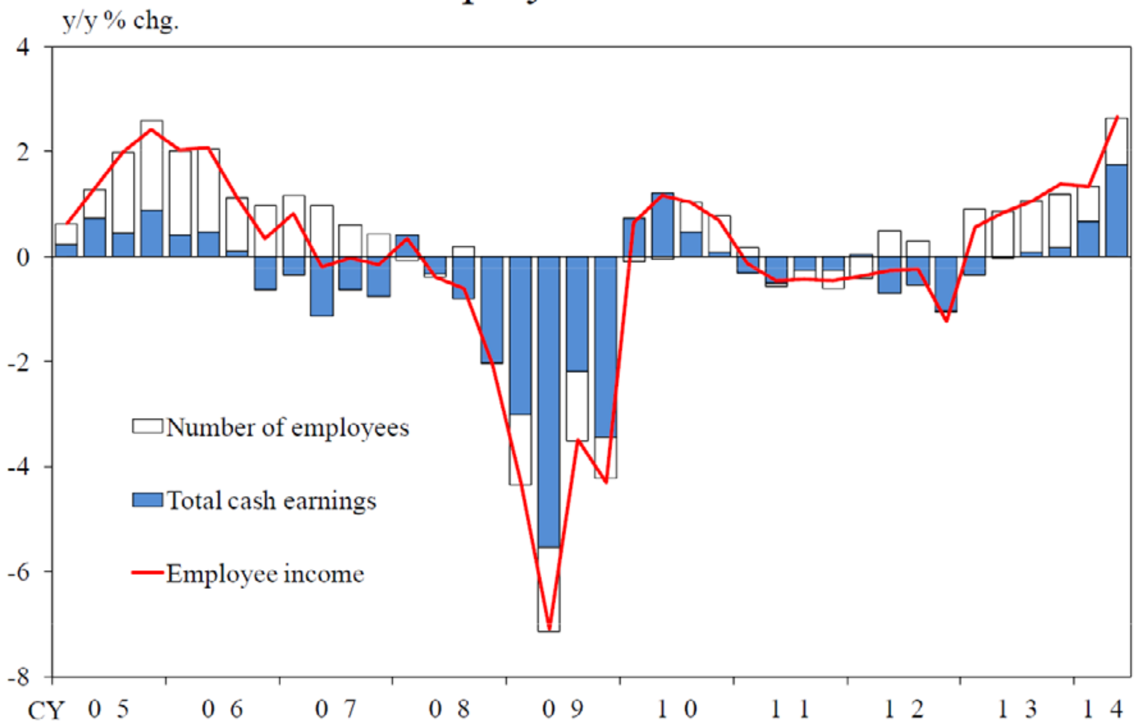
Chart 2

# Employee Income




Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. Figures for 2014/Q2 are June-July averages.
2. Figures for "employee income" are calculated as the "number of employees" (Labour Force Survey) times "total cash earnings" (Monthly Labour Survey).

Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

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Chart 3

## Environment surrounding Business Fixed Investment

Increased demand for "renewal investment"

Advantageous conditions for "labor-saving machinery and equipment investment"

Developments toward making "investment in improving the domestic bases of Japanese firms' businesses"

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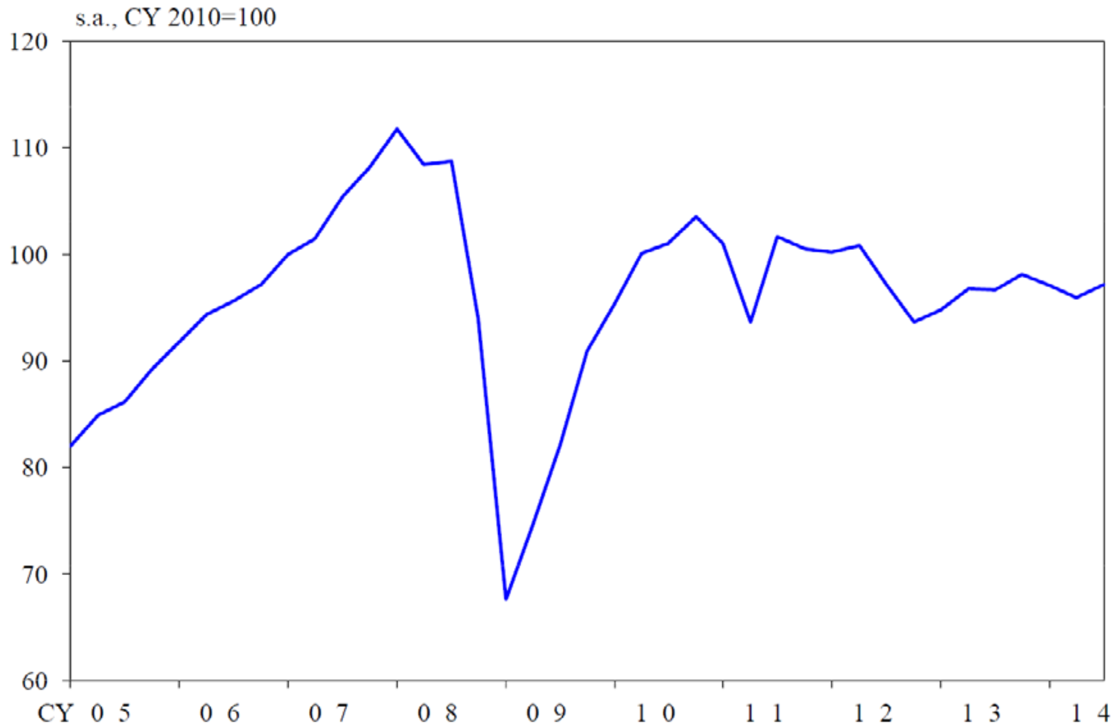
Chart 4

## Real Exports




Note: The figure for 2014/Q3 is that for July.
Sources: Ministry of Finance; Bank of Japan.

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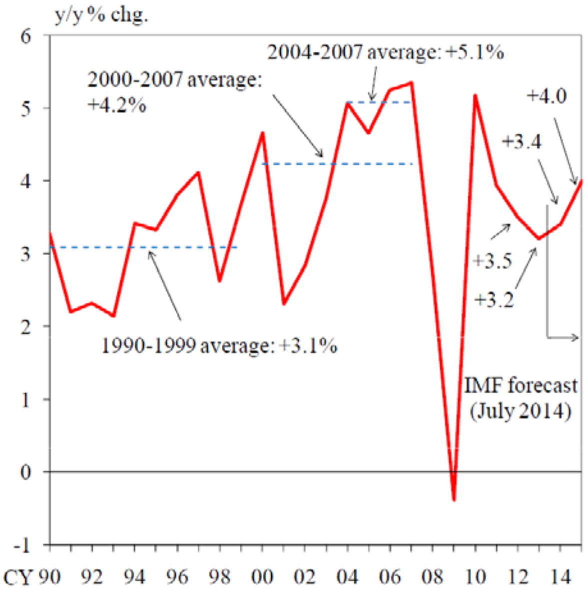
Chart 5

## World Economy

*Real GDP Growth Rate*




*Projections for Major Economies*

y/y % chg.

| | 2012 | 2013 | Projections 2014 | Projections 2015 |
|---|---|---|---|---|
| World | 3.5 | 3.2 | 3.4 (-0.3) | 4.0 (0.0) |
| Advanced Economies | 1.4 | 1.3 | 1.8 (-0.4) | 2.4 (0.1) |
| United States | 2.8 | 1.9 | 1.7 (-1.1) | 3.0 (0.1) |
| Euro Area | -0.7 | -0.4 | 1.1 (0.0) | 1.5 (0.1) |
| Japan | 1.4 | 1.5 | 1.6 (0.3) | 1.1 (0.1) |
| Emerging Market and Developing Economies | 5.1 | 4.7 | 4.6 (-0.2) | 5.2 (-0.1) |
| Developing Asia | 6.7 | 6.6 | 6.4 (-0.2) | 6.7 (-0.1) |
| China | 7.7 | 7.7 | 7.4 (-0.2) | 7.1 (-0.2) |
| ASEAN | 6.2 | 5.2 | 4.6 (-0.4) | 5.6 (0.2) |
| Latin America and the Caribbean | 2.9 | 2.6 | 2.0 (-0.5) | 2.6 (-0.3) |

Note: Figures in parentheses are the difference from the April 2014 WEO projections.
Source: IMF

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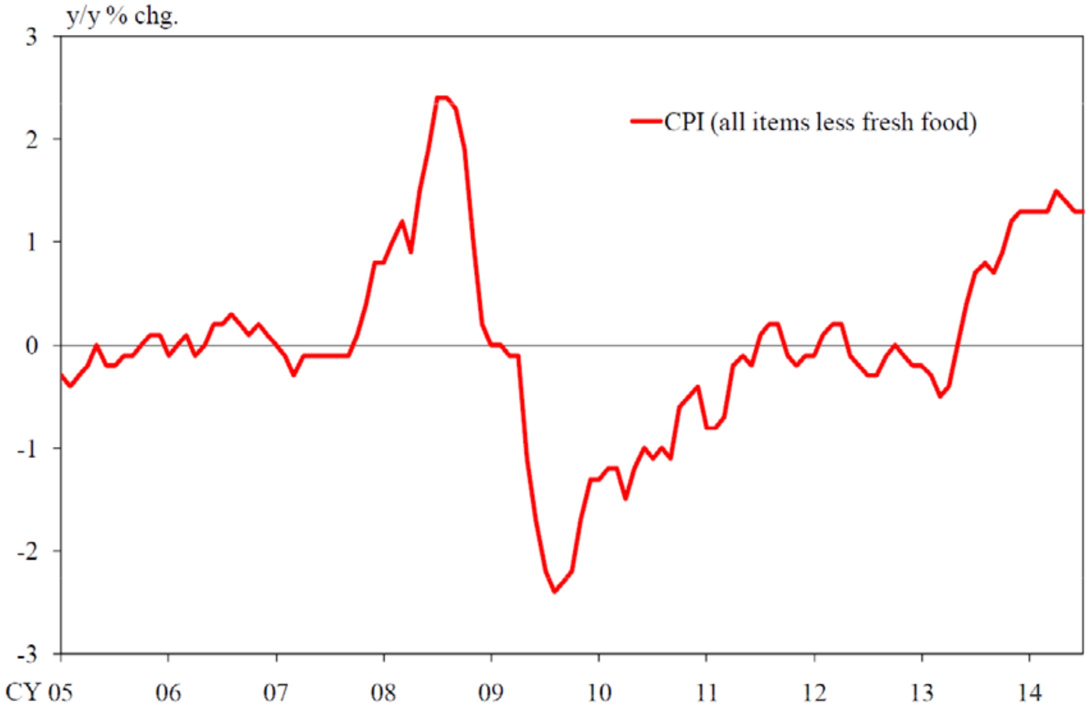
Chart 6

## Consumer Prices




Note: Figures from April 2014 onward are calculated to adjust the direct effects of the consumption tax hike.
Source: Ministry of Internal Affairs and Communications.

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