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, Nagoya, 25 November 2014.

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Introduction

It is my great pleasure to have the opportunity today to exchange views with administrative, financial, and business leaders in the Chubu region. I would like to take this opportunity to express my sincerest gratitude for your cooperation with the Bank of Japan's Nagoya Branch.

In April last year, the Bank introduced the 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 2 years. The introduction of the QQE aimed at changing the deflationary mindset, which has taken root amid prolonged deflation, and at converting the economy from being in a deflationary shrinking equilibrium to being in an expanding equilibrium through creating a situation where people base their behavior on the assumption that prices rise moderately. During the year and a half since then, conversion of the deflationary mindset has been progressing steadily. The economy has continued to see moderate recovery, and the year-on-year rate of change in the consumer price index (CPI) has moved from negative territory to around 1¼ percent. Nevertheless, the rate of increase in the CPI has slowed somewhat of late due, for example, to somewhat weak developments in demand following the consumption tax hike and a substantial decline in crude oil prices, and there has been a risk that conversion of the deflationary mindset might be delayed. The Bank's expansion of the QQE at the end of last month aims to preempt the manifestation of this risk and to maintain the improving momentum of expectation formation.

Today, I would first like to review Japan's economic and price developments, and then touch on the thrust of the expansion of the QQE.

I. Developments in economic activity and prices

To begin with, let me talk about developments in Japan's economic activity and prices.

Real economy

Some weakness in Japan's economy has remained, particularly on the production side, against the background of inventory adjustments brought by the effects of a decline in demand following the front-loaded increase prior to the consumption tax hike. The real GDP growth rate declined substantially in the April-June quarter and was minus 1.6 percent in the July-September quarter on an annualized quarter-on-quarter basis (Chart 1). However, as an underlying trend, a virtuous cycle in which an increase in households' and firms' incomes leads to an increase in their spending seems to be operating firmly.

First, with regard to the household sector, labor market conditions have been improving steadily, as seen in the unemployment rate declining to around 3.5 percent, which is roughly the same level as the structural unemployment rate (Chart 2). In this situation, the rate of increase in wages has climbed moderately, registering around 1 percent (Chart 3). With an increase in the number of employees, employee income has been rising in the 2–3 percent range. Amid the steady improvement in the employment and income situation, private consumption has been resilient as a trend, and the effects of the decline in demand following the front-loaded increase have been waning on the whole.

Moving on to the corporate sector, some weakness in production has remained, but there are prospects for further progress in inventory adjustments – mainly in industries relating to the production of durable consumer goods including automobiles, as well as to housing – by the end of the year. Moreover, business sentiment has generally stayed at a favorable level (Chart 4). As seen in firms' business plans in the September 2014 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), plans for sales and profits were revised upward and there also were plans to increase business fixed investment (Chart 5).

On this basis, the Bank has judged that Japan's economy has continued to recover moderately as a trend.

Prices

Let me turn to prices. The year-on-year rate of change in the CPI excluding fresh food, which was minus 0.5 percent in March 2013, immediately before introducing the QQE, subsequently turned positive and has risen to around 1¼ percent excluding the direct effects of the consumption tax hike (Chart 6).

The determinants of the underlying trend of prices are the output gap and inflation expectations. Since the current economic recovery is led by domestic demand, which tends to have large stimulative effects on employment, the output gap has been steadily improving, particularly on the labor front, and has recently been around zero, which is the past long-term average (Chart 7). Judging from indicators obtained from the markets and various survey results, inflation expectations appear to be rising from a somewhat longer-term perspective, albeit with fluctuations (Chart 8). Such developments in inflation expectations have been influencing firms' wage setting and price strategies. Namely, labor unions requested an increase in wages, taking into account a rise in the inflation rate, at the labor-management wage negotiations this spring, and rises in base pay were revived for the first time in more than a decade. Another example is a shift in firms' price-setting strategy, from a low-price strategy to one of raising sales prices while increasing value-added. The conversion of the deflationary mindset has been steadily progressing.

II. The expansion of the QQE

However, the year-on-year rate of increase in the CPI excluding fresh food, which peaked at 1.5 percent in April 2014, slowed to 1.0 percent in September. Weakness in demand following the consumption tax hike and the substantial decline in crude oil prices since summer has been exerting downward pressure on prices. It should be noted that the effects of the decline in demand following the front-loaded increase prior to the consumption tax hike have already started to wane and that the decline in crude oil prices will have positive effects on the economy of Japan, which is a commodity-importing country and will push up prices from a somewhat longer-term perspective. Nevertheless, if the current downward pressure on prices remains, albeit in the short term, there is a risk that conversion of the deflationary mindset might be delayed. On this point, in countries like the United States where inflation expectations already have been anchored around the price stability target, medium- to long-term inflation expectations are less susceptible even if actual inflation rates change to some extent due to temporary factors such as developments in crude oil prices. This is because people believe that the inflation rate will eventually revert to the price stability target under a central bank's monetary policy management. In Japan, by contrast, we are in the middle of trying to drastically change the deflationary mindset through the QQE, and medium- to long-term inflation expectations have been en route to 2 percent. Therefore, in contrast with countries like the United States, we should assume that inflation expectations in Japan are more susceptible to changes in the actual inflation rate.

Inflation expectation formation is an essential part of the transmission mechanism of the QQE that the Bank envisages. Namely, the starting point of its effects is to convert people's deflationary mindset and raise their inflation expectations with the Bank showing its strong and clear commitment to achieving the price stability target of 2 percent. At the same time, the Bank tries to lower real interest rates by exerting downward pressure across the entire yield curve through massive purchases of Japanese government bonds (JGBs), thereby stimulating private demand such as business fixed investment, private consumption, and housing investment. If private demand increases and the output gap improves, prices will rise and inflation expectations will be further pushed up. As illustrated, there are two engines that will raise inflation expectations. One is the Bank's strong commitment to achieving the price stability target of 2 percent, and this has changed inflation expectations in a forward-looking manner. The other is the fact that, as a consequence, the actual inflation rate has risen to around 1¼ percent from negative territory. This has raised inflation expectations in a backward-looking manner. In this sense, if a pause in the actual price increase becomes protracted as a result of the decline in crude oil prices, which is a desirable phenomenon over time, the momentum of backward-looking expectation formation might lose steam. Consequently, if achievement of the 2 percent inflation is questioned, there is a risk that the transmission mechanism of the QQE might be weakened on the whole. Therefore, the Bank has considered it necessary to pursue monetary easing more powerfully under the QQE, as well as to reiterate its unwavering resolution to achieving the price stability target of 2 percent at the earliest possible time through its action.

Based on this line of thought, the Bank decided to expand the QQE at its Monetary Policy Meeting held on October 31 (Chart 9).

Specifically, the Bank decided upon the following measures. First, it will accelerate the pace of increase in the monetary base by about 10–20 trillion yen, from "an annual pace of about 60–70 trillion yen" to "an annual pace of about 80 trillion yen."

Second, the Bank will increase its asset purchases in order to accelerate the pace of increase in the monetary base. As for JGBs, the amount outstanding of the Bank's holdings will be increased by about 30 trillion yen from "an annual pace of about 50 trillion yen" to "an annual pace of about 80 trillion yen." The average remaining maturity of the Bank's JGB purchases will be extended by about 3 years at maximum to "about 7–10 years." The decision this time is expected to exert further downward pressure across the entire yield curve.

Third, as for exchange-traded funds (ETFs), the increase in the amount outstanding of the Bank's holdings will be tripled from "an annual pace of about 1 trillion yen" to "an annual pace of 3 trillion yen," and also tripled for Japan real estate investment trusts (J-REITs) from "an annual pace of about 30 billion yen" to "an annual pace of about 90 billion yen." In addition, the Bank will make ETFs that track the JPX-Nikkei Index 400 eligible for purchase.

These measures aim to preempt the manifestation of a risk that conversion of the deflationary mindset might be delayed, and to maintain the improving momentum of expectation formation. Going forward, the Bank will continue with the 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. It will examine both upside and downside risks to economic activity and prices, and if it is judged necessary for achieving the price stability target, the Bank will make adjustments without hesitation. This policy stance remains unchanged.

III. Outlook for economic activity and prices under the expansion of the QQE

Let me now turn to the Bank's outlook for economic activity and prices under the expansion of the QQE, based on the *Outlook for Economic Activity and Prices* (Outlook Report) released at the end of October.

On the real economy front, while the Bank steadily carries out the recently expanded QQE, a virtuous cycle from income to spending is expected to be maintained in both the household and corporate sectors as domestic demand, such as private consumption and business fixed investment, is likely to remain firm and exports are expected to head for a moderate increase. Therefore, Japan's economy is likely to continue growing at a pace above its potential growth rate, which is estimated to be around 0.5 percent or lower, as a trend. Put in terms of the median of nine board members' forecasts of the real GDP growth rate, this was 0.5 percent for fiscal 2014, 1.5 percent for fiscal 2015, and 1.2 percent for fiscal 2016 (Chart 10).

On the price front, as I just explained, with Japan's economy continuing to grow at a pace above its potential, the output gap is expected to stay on its improving trend and continue to advance within positive territory. Due partly to the Bank's measures decided on October 31, medium- to long-term inflation expectations are expected to gradually converge to around 2 percent – the price stability target. On the back of developments in the output gap and inflation expectations, the year-on-year rate of increase in the CPI (excluding fresh food and the direct effects of the consumption tax hikes) is likely to be at around the current level for the time being, subsequently accelerate gradually, and reach around 2 percent – the price stability target – in or around fiscal 2015. This outlook for prices has not changed from the one in the April 2014 Outlook Report. In terms of the median of the board members' forecasts of the year-on-year rate of increase in the CPI excluding fresh food, this was 1.2 percent in fiscal 2014, 1.7 percent in fiscal 2015, and 2.1 percent in fiscal 2016 (Chart 10).

Concluding remarks

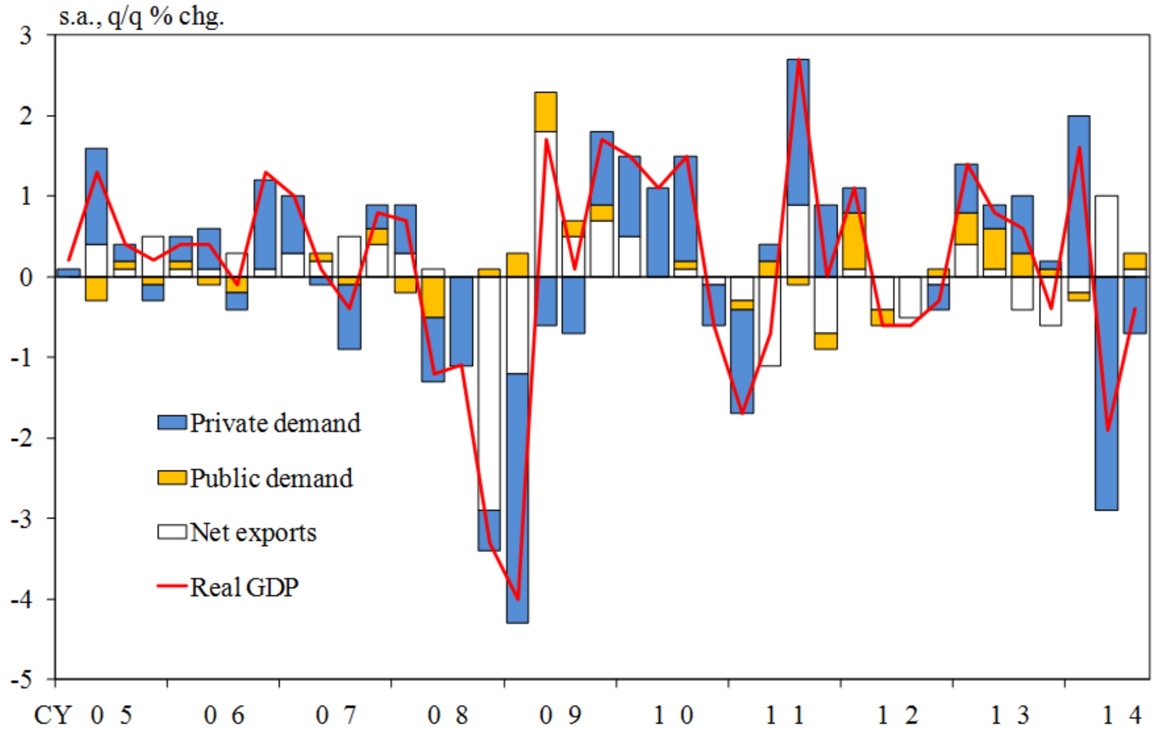
The most important point I want you to understand with regard to the expansion of the QQE is that the Bank strongly commits itself to achieving the price stability target of 2 percent at the earliest possible time and maintaining it in a stable manner. Against this background, I expect firms to make decisions and engage in economic activity based on the assumption of 2 percent inflation. Conversion of the deflationary mindset and the rise in inflation expectations, which the Bank is trying to achieve through the QQE, do not only mean a rise in figures of the markets' break-even inflation rates or of economists' survey results. Rather, such changes should also occur in the minds of business leaders like you and be reflected in actual decision-making and behavior. After the protracted deflation, such changes have gradually started to take place and, in my view, this is what you recognize the most. What you likely have in mind as firms' price-setting strategy and employment and wage management must be quite different from two years ago. The rise in base pay this spring, which was made for the first time in many years, is a prime example of this. In this sense, I have great interest in developments in wages and price settings through spring of next year.

Moreover, in the process of converting the deflationary mindset, hoarding cash and deposits will become costly. As a corporate strategy, using their profits in a more productive manner is imperative. Among others, investment in facilities and human resources, as well as reestablishment of supply chains including subcontractors are possible options. At the same time, this would be a part of the process of having the fruits of the correction of the yen appreciation and of overcoming deflation spread through the whole economy. Such progress should not be stopped now. To achieve the price stability target, the Bank has been taking "action" and will continue to do so. I would like to conclude my speech by expressing my expectations for your "action" that looks toward the situation for the economy after overcoming deflation.

Thank you for your attention.

Chart 1

Real GDP



Source: Cabinet Office.

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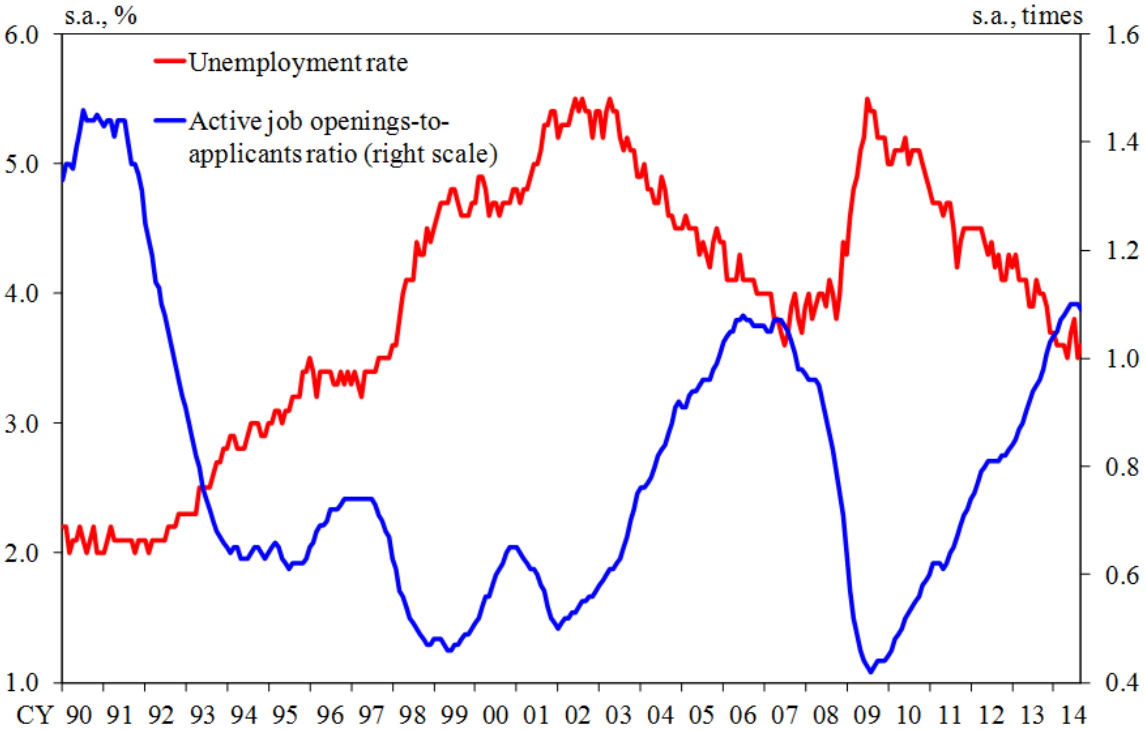
Chart 2

Labor Market Conditions



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

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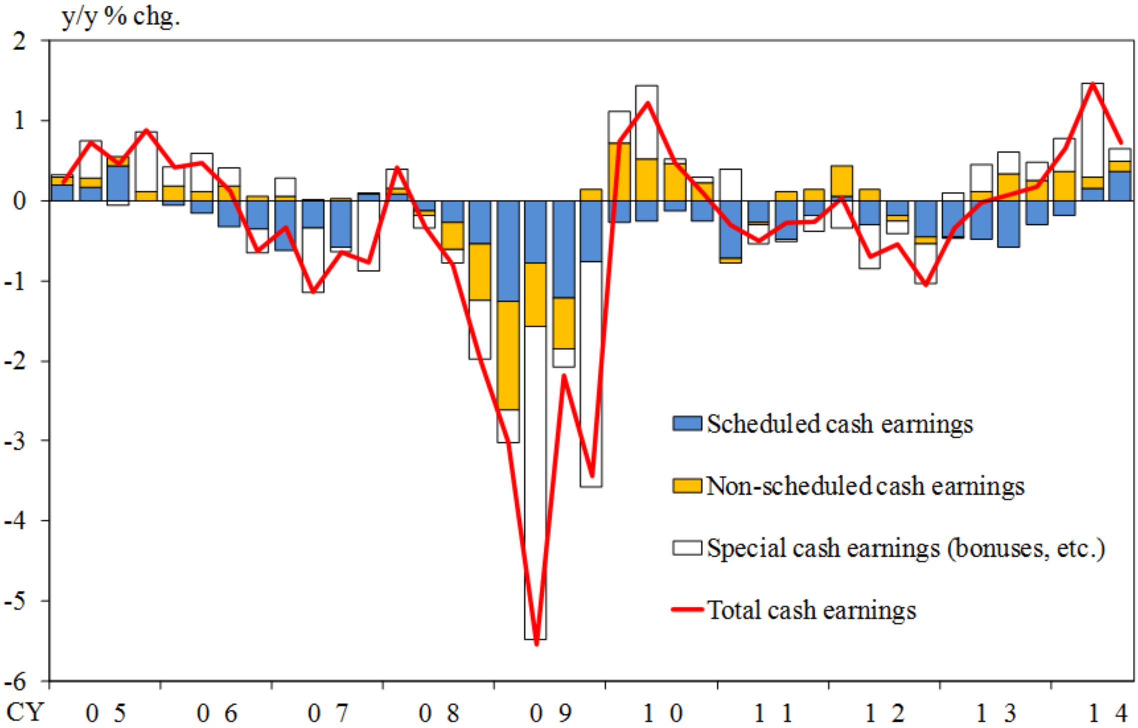
Chart 3

Cash Earnings



Note: Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
Figures for 2014/Q3 are those of September.
Source: Ministry of Health, Labour and Welfare.

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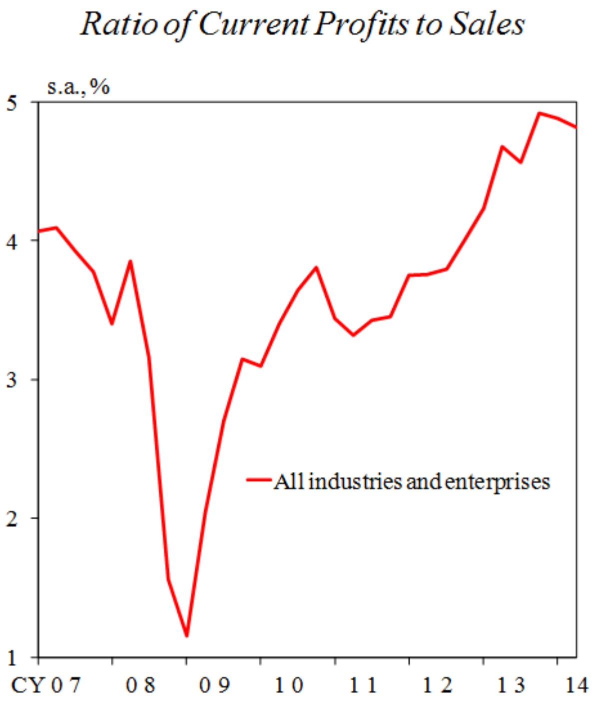
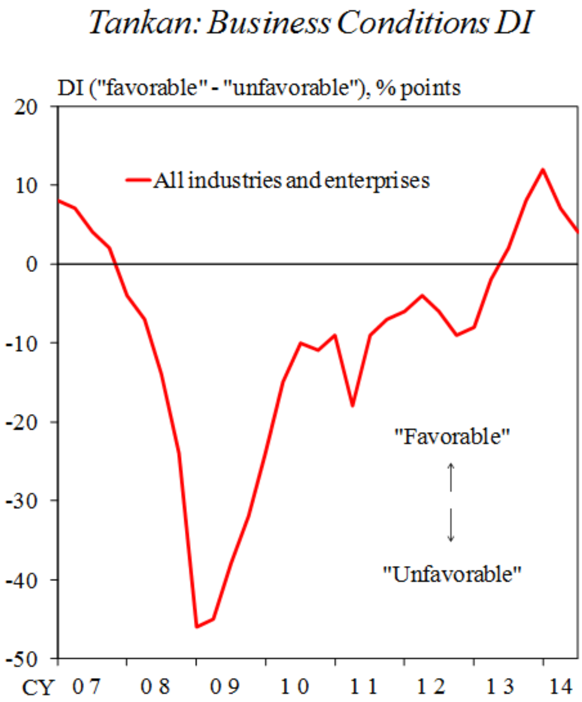
Chart 4

Corporate Profits and Business Sentiment





Sources: Ministry of Finance; Bank of Japan.

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Chart 5

Tankan: Business Plans

Sales

y/y % chg.

	FY2013	FY2014 (Forecast)	Revision rate
Manufacturing	6.2	1.3	0.0
Nonmanufacturing	5.2	0.9	0.2
All industries	5.5	1.0	0.2

Fixed Investment

y/y % chg.

	FY2013	FY2014 (Forecast)	Revision rate
Manufacturing	1.1	12.9	1.1
Nonmanufacturing	7.7	2.6	1.4
All industries	5.3	6.1	1.3

Current Profits

y/y % chg.

	FY2013	FY2014 (Forecast)	Revision rate
Manufacturing	40.9	-2.6	0.9
Nonmanufacturing	20.8	-5.1	1.8
All industries	28.4	-4.0	1.4

Notes: 1. September 2014 Survey. All enterprises. Revision rates are calculated as the percentage change of the figures between the current and the previous survey (June 2014).
2. Figures for fixed investment include software investment but exclude land purchasing expenses.
Source: Bank of Japan.

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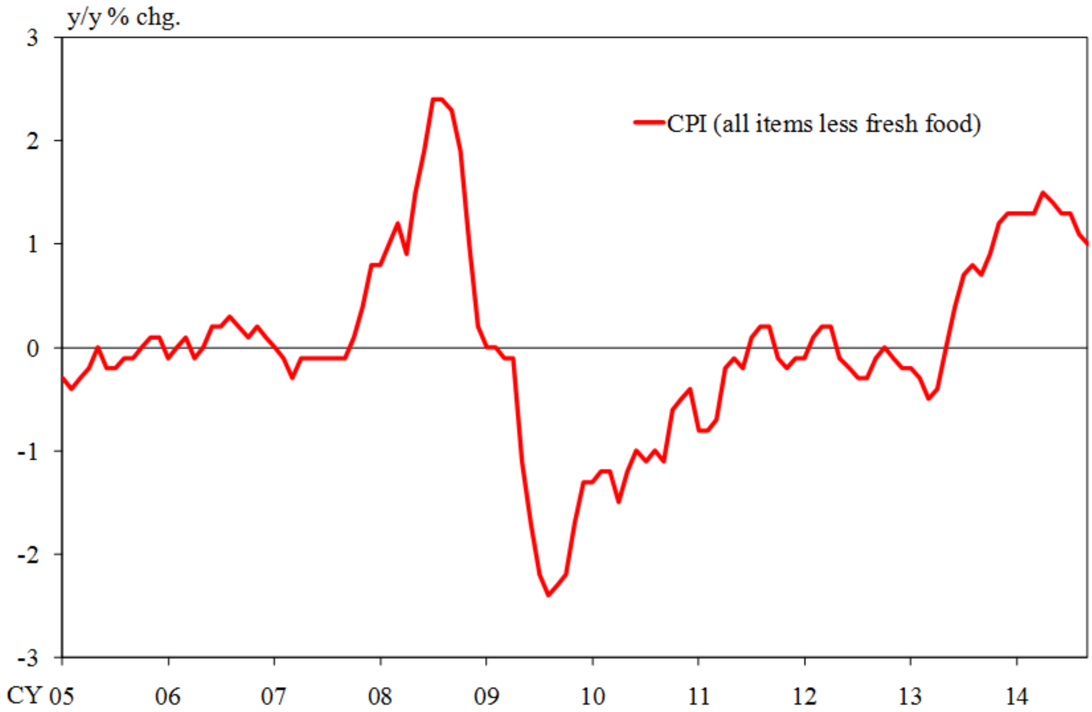
Chart 6

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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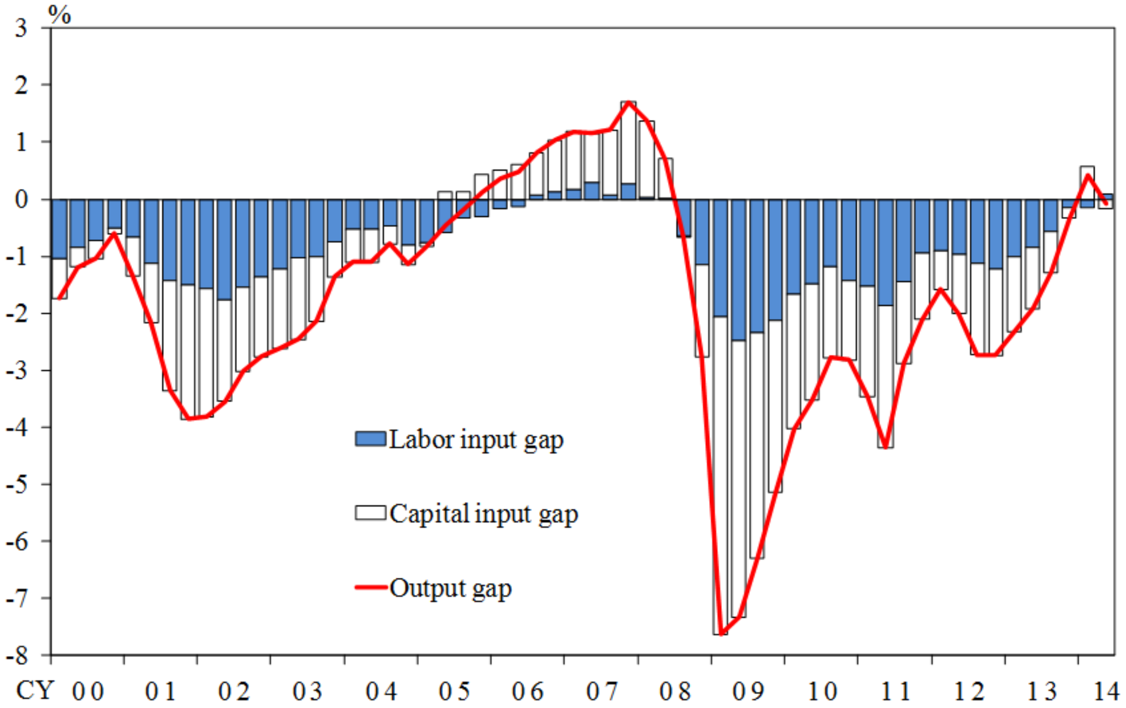
Chart 7

Output Gap



Note: 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.
Sources: Cabinet Office; Bank of Japan, etc.

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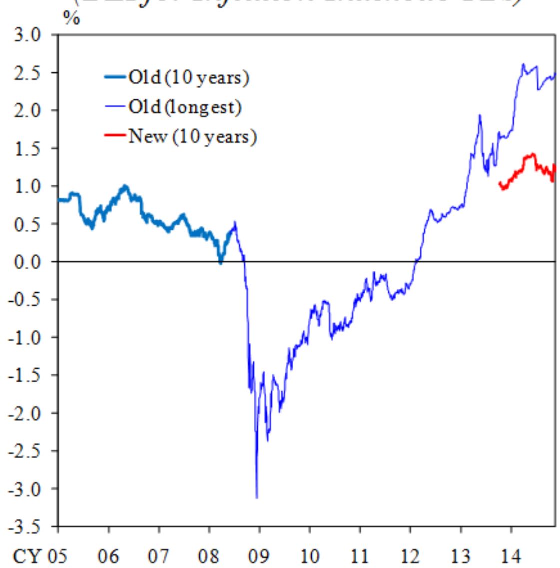
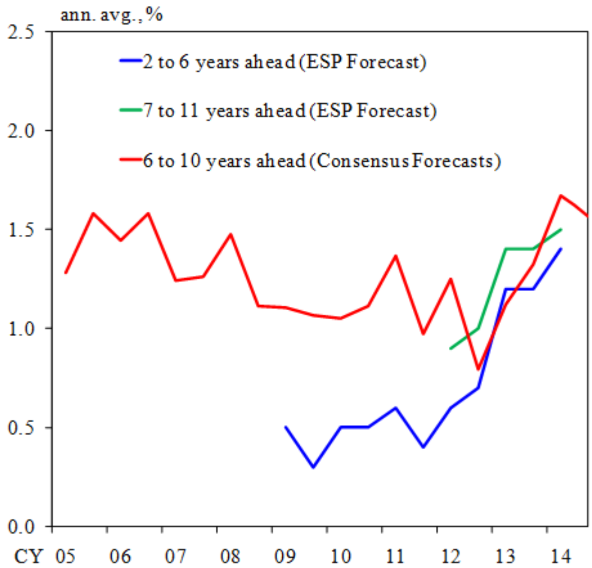
Chart 8

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 are designated as "old." Figures for "old (longest)" are calculated using yield data for issue No.16 of the inflation-indexed JGBs, which matures in June 2018.
2. Figures for the Consensus Forecasts are compiled every January, April, July, and October. Those up through April 2014 are compiled every April and October.
3. Figures for the ESP Forecast are compiled every June and December, and exclude the effects of the consumption tax hikes.

Sources: Bloomberg; Consensus Economics Inc.; JCER.

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Chart 9

Expansion of the Quantitative and Qualitative Monetary Easing

Accelerating the annual pace of increase in the monetary base from about 60-70 trillion yen to **" 80 trillion yen "**

Increasing the Bank's JGB holdings at an annual pace of about **80 trillion yen**: **" + 30 trillion yen "**

Extending the average remaining maturity of JGB purchases to **about 7-10 years**: **" + 3 years "**

Accelerating the pace of purchases of ETFs and J-REITs: **" Tripled "**

- Pre-empt manifestation of a risk that conversion of deflationary mindset, which has so far been progressing steadily, might be delayed
- Maintain the improving **momentum of expectation formation**

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Chart 10

Outlook for Economic Activity and Prices (as of October 2014)

y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2014	+0.5	+3.2	+1.2
Forecasts made in July 2014	+1.0	+3.3	+1.3
Fiscal 2015	+1.5	+2.4	+1.7
Forecasts made in July 2014	+1.5	+2.6	+1.9
Fiscal 2016	+1.2	+2.8	+2.1
Forecasts made in July 2014	+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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