Haruhiko Kuroda: Welcome to the "2 Percent" Club

Speech by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at the meeting of Councillors of Nippon Keidanren (Japan Business Federation), Tokyo, 25 December 2014.

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Introduction

It is a great honor to have this opportunity to address such a distinguished gathering of business leaders in Japan today.

There is only one week left this year. This year, Japan's economy has continued to recover moderately as a trend, albeit with fluctuations due to the front-loaded increase in demand prior to the consumption tax hike and the subsequent decline. Corporate profits have been improving significantly, and, as a whole, have maintained a favorable level around the peak before the global financial crisis (Chart 1). On the back of those, firms have become active on making business fixed investment and on employment. The active job openings-to-applicants ratio was 1.10 times, marking the highest level in 22 years – that is, since 1992 – and the unemployment rate has declined to around 3.5 percent, which is roughly the same level as the structural unemployment rate (Chart 2). Reflecting such tightening in labor market conditions, wages have been increasing moderately.

On the price front, the year-on-year rate of increase in the consumer price index (CPI, all items less fresh food), excluding the direct effects of the consumption tax hike, has been around 1¼ percent since the end of last year (Chart 3). The underlying price developments have continued to improve, and inflation expectations have been rising on the whole from a somewhat longer-term perspective. Since the summer, somewhat weak developments in demand following the consumption tax hike and a substantial decline in crude oil prices have exerted downward pressure on prices. In that situation, the year-on-year rate of increase in the CPI has been slowing, and the rate was 0.9 percent in October. 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, the Bank of Japan decided at the end of October to expand quantitative and qualitative monetary easing (QQE).

Japan's economy is steadily en route to overcoming prolonged deflation and to achieving the price stability target of 2 percent. However, it is true that not a few have voiced that they cannot benefit from the economic recovery. In particular, we have been hearing that "those who are benefitting from the QQE seem to be only large firms and wealthy households that hold financial assets, thus the benefits do not seem to be spreading through the whole economy" and "even if deflation is overcome, making a living might actually become difficult unless wages rise in accordance with a price increase."

Japan's economy is currently in the process of transition from a shrinking equilibrium under deflation to an expanding equilibrium under the 2 percent inflation. In the process in which such a major change occurs at a relatively high speed, it is inevitable that its effects arise differently depending on the sector, the firm size, and the income bracket. Even so, it is without question that Japan's economy is heading for the better. I believe that none of those unsatisfied with the current economic situation thinks that the situation during the deflationary period was better.

Today, I will elaborate as clearly as possible on what the economic state the Bank of Japan aims at would be like in comparison with the deflationary state. On that basis, I will explain how far we have proceeded and what challenges are left to be dealt with, going forward. I should say that overcoming deflation and achieving the price stability target of 2 percent will benefit not only some firms and financial asset holders, but also a wide range of sectors and a variety of people.

I. What does the deflationary economy look like?

In Japan, deflation – a situation in which prices keep declining – continued for 15 years since the latter half of the 1990s. In that situation, firms and households behave on the assumption that prices will not increase, or that prices will fall moderately. As a result, their spending behavior has become passive.

Since firms could not expect an increase in sales, the top priority of management was to ensure profits and stabilize firms' financial conditions by cost reduction – such as reducing the number of employees, wages, or expenses for materials – and by compressing business fixed investment as much as possible. However, cost reduction or investment reduction was nothing but equivalent to a decline in demand for goods and services of other firms, and as a result, the corporate sector as a whole could not increase profits.

Firms' cost reduction resulted in a decline in wages for households. Households were able to avert facing a surge in unemployment against the background of a tradition in Japan that people prioritize job security, but had to change their employment status from regular employment to non-regular employment or accept declines in wages (Chart 4). In that situation, the practice of an annual rise in base pay was lost. Salary increases every year were taken for granted among *salarymen* (corporate employees) through the first half of the 1990s, but younger people in their thirties or below have never experienced such an increase. Many households tried to restrain consumption as they could not expect an increase in income in the future. As the view that prices of goods gradually decline takes hold, there is an increasing tendency to postpone consumption. Against the background of those firms' and households' spending behavior, a vicious cycle of a decline in prices, a decrease in sales and profits, a restraint in wages, a slump in consumption, and a decline in prices continued.

Although such a phenomenon under deflation can be analyzed from various aspects, from the perspective of macroeconomic policy, it can be understood as follows. The key is that monetary conditions did not become sufficiently accommodative since low inflation expectations took hold, coupled with an actual price decline, and thereby real interest rates remained high. As you understand, under deflation, although nominal interest rates in Japan have long been at a low level, firms must not have been willing to make fixed investment by borrowing money. When firms were forecasting that general prices or sales prices of their own products would decline, firms' burden of paying interest rates remained large because, whatever low the nominal interest rates might become, the real interest rates would become higher than the nominal interest rates (Chart 5). By contrast, real rates of return on cash and deposits increased when prices were on a declining trend, since nominal interest rates of the deposits could not become negative (Chart 6). Under such circumstances, accumulating retained earnings mainly by cost reduction and hoarding them in cash and deposits became relatively more advantageous for firms as a form of "investment" than taking risks and making fixed investment. That was a rational behavior in a deflationary environment. In fact, cash and deposits held by firms increased substantially from 185 trillion yen in fiscal 1995 to 243 trillion yen in fiscal 2013.

If expected real rates of return on fixed investment had been sufficiently high, extremely low nominal interest rates could have been still attractive for businesses. However, in Japan, with the potential growth rate declining rapidly since the middle of the 1990s, firms' growth expectations declined substantially (Chart 5). In economic terms, the natural rate of interest, which is the real interest rate neutral to economic activity, declined. Standard economic theory implies that the degree of monetary accommodation is determined by to what extent real interest rates are lower than the natural rate of interest. In Japan, real interest rates remained high due to deflation expectations while the natural rate of interest declined due to a decline in the potential growth rate. As a result, despite the low nominal interest rates, monetary accommodation remained insufficient and could not sufficiently stimulate the economy. Firms' unwillingness to invest despite low interest rates represented such a situation. The breakthrough to that is either decreasing real interest rates by increasing inflation expectations or raising firms' expected returns and the natural rate of interest by enhancing the growth potential. Japan is now tackling both of them. The former corresponds to the QQE that the Bank has been pursuing and the latter corresponds to what firms have been tackling under the government's growth strategy.

II. Achieving the price stability target of 2 percent and transforming Japan's economy

Next, let me talk about the QQE. The mechanism of the QQE starts from showing the Bank's strong and clear commitment to achieve the price stability target of 2 percent at the earliest possible time, and converting people's deflationary mindset. Concurrently, the Bank has put downward pressure on the entire yield curve including longer-ends through its massive purchases of Japanese government bonds (JGBs) and has lowered nominal interest rates further. As a result, real interest rates have declined, which has generated a situation in which you must come to recognize that financial conditions are accommodative in not only nominal terms but also real terms. In such financial conditions, coupled with the effects of other policies, private demand has increased, the output gap has improved, and actual prices have increased. If firms and households experience actual price increases, they will come to realize that prices will increase and thus inflation expectations are expected to increase further.

In the economy, in which the price stability target of 2 percent is achieved by pursuing this mechanism, the rational behavior of firms and households should not be to hoard cash and deposits, but to invest and consume. In a situation in which prices rise moderately, the real return on cash hoardings is negative. If firms accumulate retained earnings gained by cost reductions and hold them simply in cash and deposits, the value of those firms is impaired. It is imperative for firms to undertake strategic initiatives such as improving their production system, carrying out research and development, or securing and developing human resources. Capital management policies such as those related to dividend payments or share buybacks are also important. In short, the economy will revert to a normal economic environment in which a priority for business management is to explore the opportunities for investing and gaining profits that would exceed the costs of capital, and thereby to generate a firm-specific value-added. Such behavioral change for Japanese firms to become proactive will also lead to an increase in the growth rate of Japan's economy from a medium- to long-term perspective.

We have often heard a question why the inflation that the Bank aims to achieve is 2 percent, although it appears to be understood that deflation should be overcome. In a nutshell, most advanced economies regard as price stability the situation in which price indices annually rise by about 2 percent on average (Chart 7). Let me ask you a question. What was the average of the year-on-year rates of change in the CPI during the 15-year deflation period (fiscal 1998–2012)? The answer is merely minus 0.3 percent. Many people may feel that prices of goods and services should have declined more substantially. Although I am not going into a detailed discussion in the interest of time, the CPI has an upward bias and indicates inflation higher than the true inflation rate. Given that fact, people tend to recognize being in a considerably deflationary environment when the year-on-year rate of increase in the CPI has been around zero. By the same token, on the contrary to the common belief, the situation in which the CPI records a 2-percent increase on a year-on-year basis in a stable manner is not at all a situation in which prices are rising substantially. Rather, in such a situation, people would recognize that prices are more or less flat on the whole or that prices are rising very moderately.

On the exchange rate front, given that the annual inflation of around 2 percent was achieved in other major countries in accordance with global standards while Japan continued to experience a deflationary situation, the yen continued to appreciate in nominal terms (Chart 8). It is in sharp contrast to the fact that, in the United Kingdom and Canada, where moderate price increases continue in the same degree as in the United States, the levels of the purchasing power parity – which reflects the difference of price increases between a country and another – remain almost constant and the exchange rates against the U.S. dollar remain around those levels. There is another view that the trend of the yen appreciation consistent with the difference in inflation rates between Japan and other countries is not a problem for firms, since firms' competitiveness is, in theory, affected by the real exchange rates which take into account the difference in inflation rates. However, since what matters for businesses in terms of difference in costs between Japan and abroad is not differences in general prices, it would be close to firms' recognition that even such an appreciation of the yen in nominal terms leads to difficulties in making business plans. If 2 percent inflation is achieved in Japan as in trading partners going forward, at least a risk of the appreciation of the yen brought about by the differences in inflation rates between Japan and abroad will become smaller. Under those circumstances, firms can make global investment plans from a viewpoint of the optimal allocation of management resources on the assumption that the exchange rates remain stable to some extent.

III. Emerging from the deflationary economy

Where are we in the process of the transition – from a shrinking equilibrium under deflation to an expanding equilibrium under the 2 percent inflation? Let me summarize the current situation of Japan's economy again.

In the corporate sector, profits have been improving, and firms' positive stance on making fixed investment has been maintained in spite of a decline in demand after the consumption tax hike. Business plans, shown in the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) released last week, indicate that fixed investment is planned to be increased steadily, with an upward revision in profits in a wide range of firms regardless of sector or size. Other survey results show that, as the excessive appreciation of the yen was corrected, there have been some developments that firms put more emphasis on domestic business fixed investment (Chart 9). In the household sector, nominal wages have been rising reflecting the tightening in labor market conditions. The year-on-year rate of increase in nominal wages in the first half of fiscal 2014 was 1.1 percent, and it is roughly the same level as the year-on-year rate of increase in the CPI for the same period excluding the direct effects of the consumption tax hike, which was 1.3 percent. Nevertheless, an increasing number of people argue that wage increases have failed to keep pace with inflation and the year-on-year rate of change in real wages has been negative. Such argument is based on the calculation using the CPI inflation including the consumption tax hike as a deflator of real wages. However, the effects of the consumption tax hike on the year-on-year rate of increase in prices will disappear in April 2015. Based on that, it is more reasonable to assess underlying developments in real wages by excluding the effects of the consumption tax hike. Since, on an aggregated basis, wages have been increasing and the number of employees has been rising, employee income has continued to increase at the pace around 2.0 percent on a year-on-year basis. Reflecting the steady improvement in the employment and income situation, private consumption has remained resilient as a trend, and the effects of the decline in demand following the front-loaded increase have been waning on the whole. Stock prices have increased substantially, exerting positive effects on firms' fixed investment and households' spending behavior.

Conversion of the deflationary mindset has been progressing steadily, which has influenced firms' wage setting and pricing strategy. At annual wage negotiations between management and labor this spring, an increase in wages was demanded taking into account actual inflation, and the practice of rises in base pay returned for the first time in more than a decade. Firms' price-setting strategy has been shifting from a low-price strategy under deflation to that of raising sales prices while increasing value added. Moreover, some labor unions have decided to demand an about 2 percent increase in base pay for wage negotiations toward spring 2015. That is a landmark event in that the Bank's price stability target is taken into consideration in labor-management wage negotiations. The Bank will continue to pay close attention to the progress in the negotiations with strong interest.

In this economic and price situation, the Bank decided to expand the QQE at its Monetary Policy Meeting held on October 31 (Chart 10). Specifically, the Bank decided that it will accelerate the pace of increase in the monetary base from "an annual pace of about 60–70 trillion yen" to "an annual pace of about 80 trillion yen." The annual pace of increase in the amount outstanding of the Bank's holdings of JGBs will be raised by about 30 trillion yen to "about 80 trillion yen" and as for exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs), the increases in the amount outstanding of the Bank's holdings will be tripled. Let me reiterate the background to the expansion. The year-on-year rate of increase in the CPI slowed after its peak in April this year. The background to this is somewhat weak developments in demand following the consumption tax hike and the substantial decline in crude oil prices since the summer. To avoid any misunderstanding, let me be clear that the additional easing was not a response to the decline in crude oil prices itself. Japan, a commodity-importing country, gains a large advantage from the decline in crude oil prices, especially when the decline is caused mainly by supply-side factors such as developments in oil-producing countries as it is this time. On the price front, while the decline in crude oil prices put downward pressure in the short term, it will lead to an improvement in the output gap and to an increase in underlying prices from a somewhat longer-term perspective.

The reason for deciding on the additional easing despite this is that the Bank judged that we are still in the midst of converting the deflationary mindset and there is a risk that a slowdown in the actual rate of increase in the CPI might delay this conversion. Two engines have so far brought the conversion of the deflationary mindset. The first is the Bank's strong commitment to achieve the price stability target of 2 percent at the earliest possible time and in a stable manner, and the second is the actual inflation that has been realized under the commitment. Although the decline in crude oil prices is desirable over time, if a pause in the actual price increase becomes protracted, the latter engine may be weakened. If this raises doubts on the achievement of 2 percent inflation, there may be a risk that the mechanism of the QQE as a whole will be weakened. Therefore, the Bank decided to pursue monetary easing more powerfully under the QQE, and to reiterate its unwavering resolution to achieve the price stability target of 2 percent at the earliest possible time through its "action."

Looking at responses in financial markets, it appears that the Bank's resolution to achieve the price stability target of 2 percent at the earliest possible time has been well understood. I believe that many of you also understand it very well. I strongly expect that there will be positive effects of the expansion of the QQE on wage negotiations next spring and on firms' price setting. If it is the case, conversion of the deflationary mindset under the QQE will keep going forward. That is the intended effect of the expansion of the QQE. Under those circumstances, the positive effects of the decline in crude oil prices will become clear. With the conversion of the deflationary mindset progressing, the decline in crude oil prices will gradually push up economic activity and the trend inflation, and the actual inflation rate will also increase as the short-term downward pressure on prices will dissipate.

As I have mentioned earlier, the Bank aims to achieve the price stability target of 2 percent in a stable manner. In the economy in which the Bank's aim is achieved, firms and households make decisions and take action based on the assumption of moderate inflation of 2 percent. We will pay close attention to how the conversion of the deflationary mindset will progress from such viewpoint in assessing developments in crude oil prices and their effects on inflation expectations.

The Bank's stance of monetary policy has been consistent since the introduction of the QQE. 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 make adjustments without hesitation if necessary to achieve the price stability target.

Concluding remarks

Before ending my speech, I will talk about what next year will be like as today is almost the end of the year. Firms can expect that corporate profits will be favorable on the back of the decline in commodity prices and the depreciation of the yen. Households can expect that nominal wages will increase. Real wages are also expected to recover since the inflation rate is likely to be at around the current level for the time being and the increase in prices attributable to the consumption tax hike will disappear in April 2015 on a year-on-year basis, although the year-on-year rate of increase in prices is affected by the future developments in crude oil prices. There seems to be a tailwind to Japan's economy. In this situation, the challenge for next year is, as Chairman Sakakibara often mentions, that firms should change by taking advantage of such a favorable environment, so that the next virtuous cycle in the economy will be firmly in place.

The "pie" that the entire economy can share is getting bigger. At this stage in which we are in the midst of the transition process, however, the pieces of the "pie" are unevenly distributed in favor of globally operating firms or financial asset holders. The fact is that profits of small- and medium-sized enterprises and household income are also becoming larger, compared with those during the period of deflation, and many people are gaining some benefits, but the size of benefits that firms and households gain differs, depending on the firm size, sector, and household income bracket. The issue is not simply a distribution of the "pie." Whether the next virtuous cycle can be generated depends critically on how the "pie" is shared. If the spending propensity of economic entities which got a large piece of the "pie" is low, the next cycle will not operate. In this context, firms making high profits should use them to generate the next virtuous cycle.

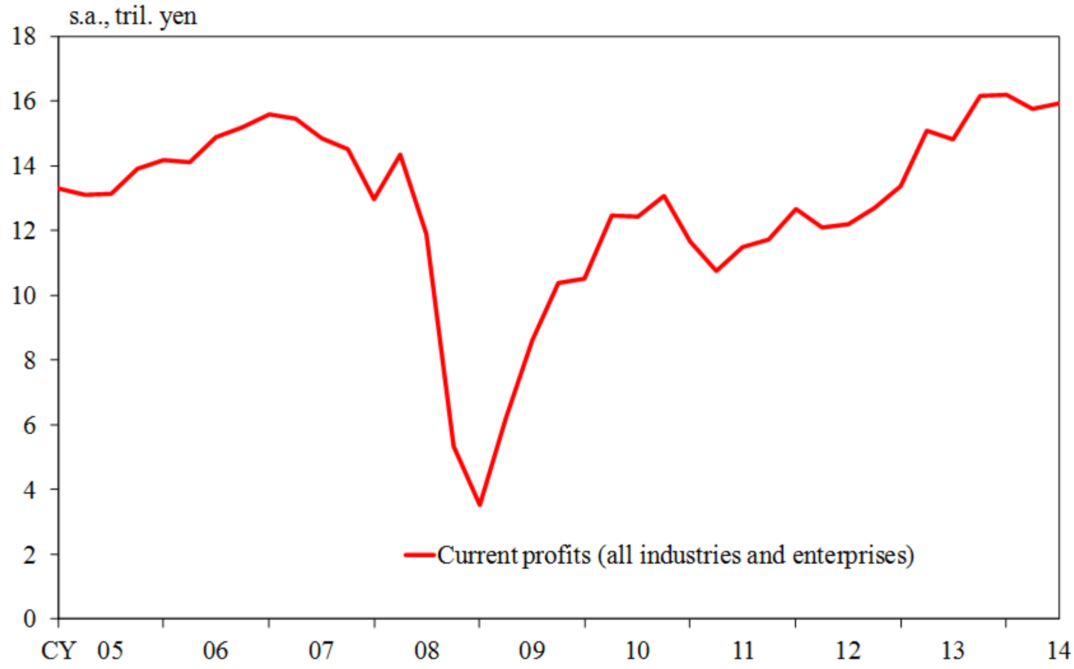
What I emphasize here is that firms' using of profits in that manner not only has a positive impact on Japan's economy, but also benefits themselves. Under the current financial conditions, for those who think that the price stability target of 2 percent will be achieved, real interest rates are extremely low and the expected return on fixed investment must be favorable. By contrast, for those who believe deflation will be here to stay, real interest rates remain high and their spending behavior will be restrained. After overcoming deflation, since those in the latter camp will become eager to spend, the competition for securing the labor force, for example, will become intensified. In addition, as a matter of course, financial conditions will be sooner or later neutral to the economy as 2 percent inflation is achieved in a stable manner.

In sum, the favorable financial conditions in the transitional period will not be forever. This is a great chance, on a first-come-first-served basis. The environment surrounding firms is totally different between the economy in a shrinking equilibrium under deflation and the economy in an expanding equilibrium under the 2 percent inflation. The rule book for business will be rewritten. As widely believed, Charles Darwin, who claimed the theory of evolution, said "it is not the strongest of the species that survives, but the one that is the most adaptable to change." Firms that are able to get ahead of a change in the environment promptly and to adapt to the economy in an expanding equilibrium will become the winners of the competition and enjoy prosperity in the new era.

Thank you very much for your attention. I sincerely wish you a Happy New Year.

Chart 1

Corporate Profits



Note: Finance and insurance are excluded.
Source: Ministry of Finance.

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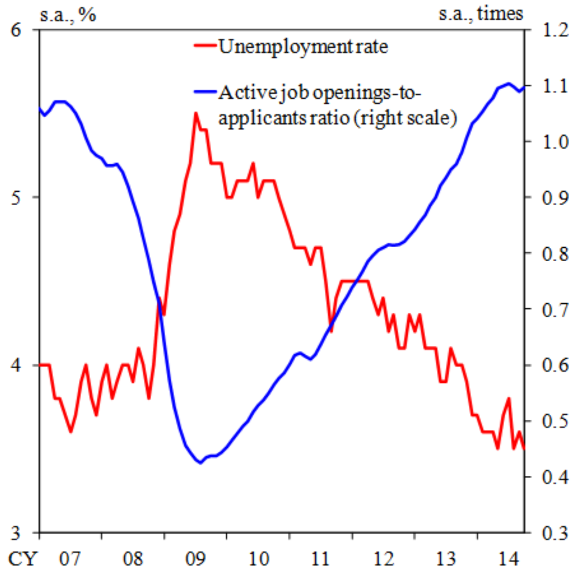
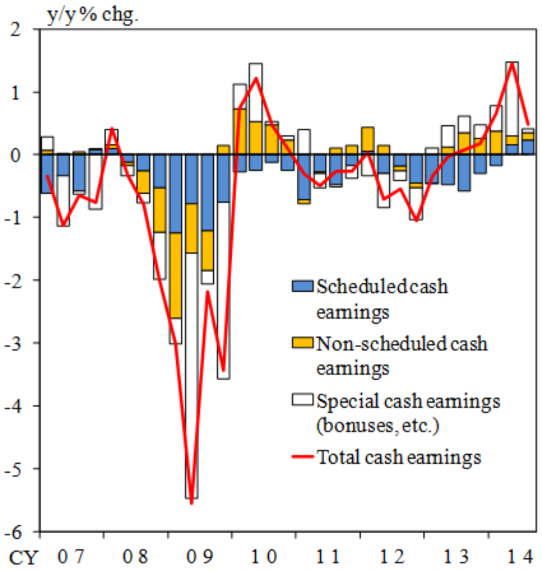
Chart 2

Employment and Income Situation

Labor Market Conditions



Cash Earnings



Note: The followings apply to cash earnings: Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. Figures for 2014/Q3 are those of September-October averages.
Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

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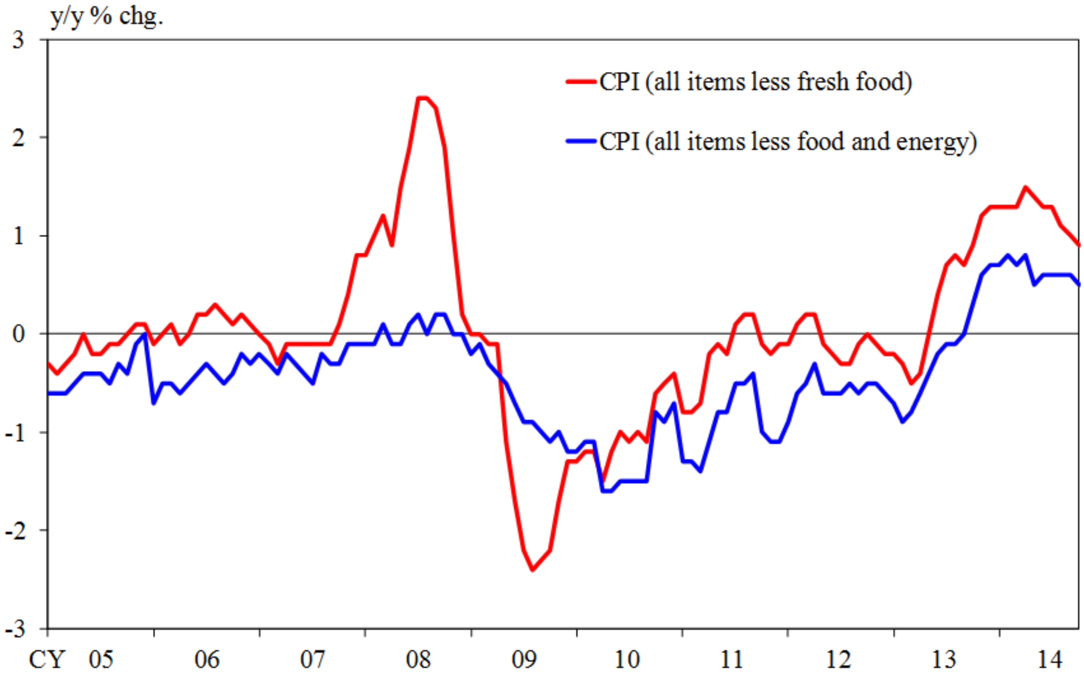
Chart 3

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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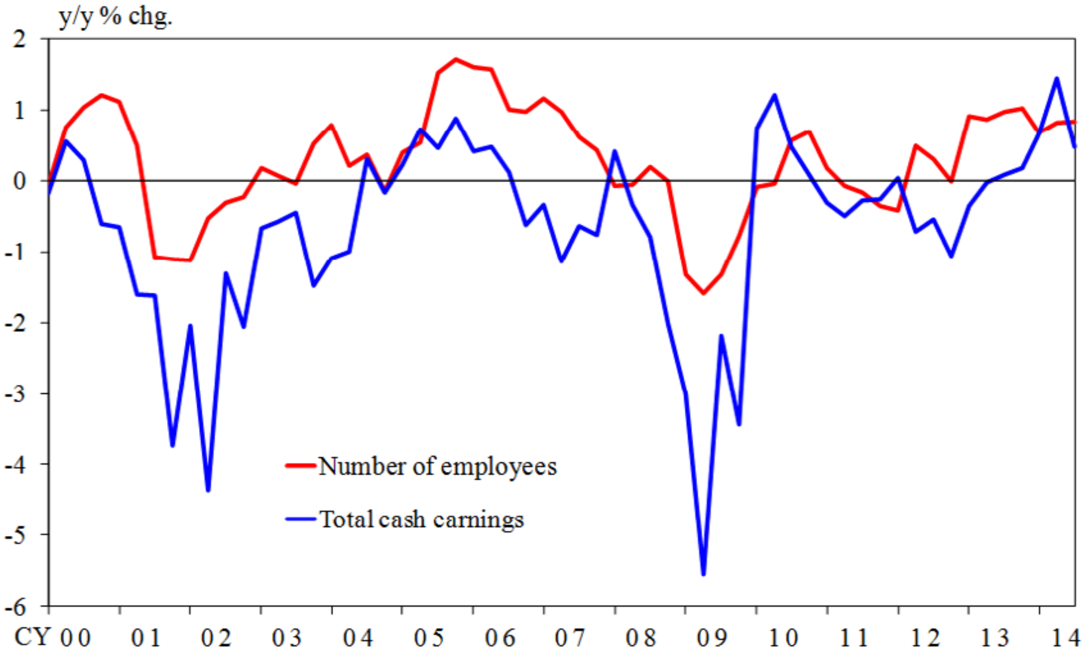
Chart 4

Employment and Wages



Note: Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
Figures for 2014/Q3 are those of September-October averages.
Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

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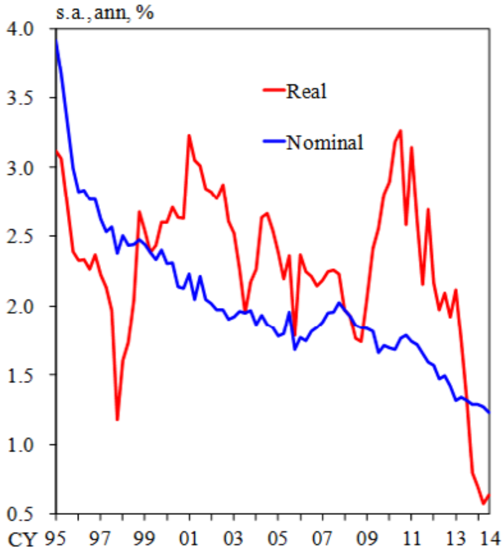
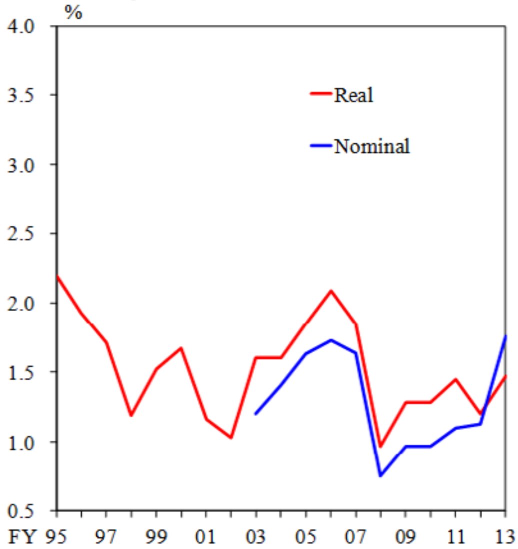
Chart 5

Firms' Funding Costs and Growth Expectations

Interest Rates for Firms' Funding



Expected Growth Rates for the Next 5 Years



Notes: 1. Nominal interest rate = interest expense / interest-bearing debt. Interest-bearing debt is the sum of long- and short-term borrowings, corporate bonds, and bills receivable discounted outstanding.
2. Figures for the real interest rate are calculated by subtracting the year-on-year rate of change in the CPI (all items less food and energy), adjusting the direct effects of the consumption tax hike, from the nominal interest rate.
3. Expected growth rates are taken from "Annual Survey of Corporate Behavior."

Sources: Ministry of Finance; Ministry of Internal Affairs and Communications; Cabinet Office.

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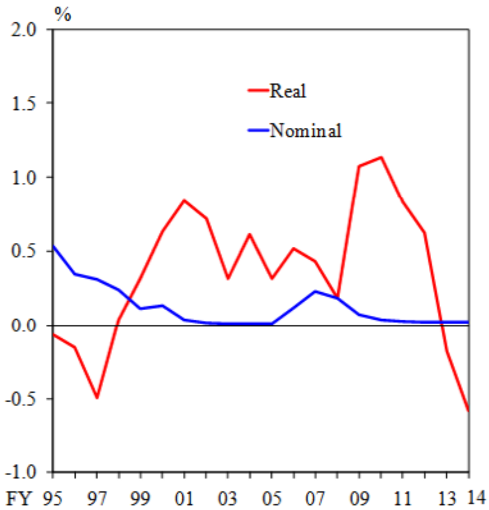
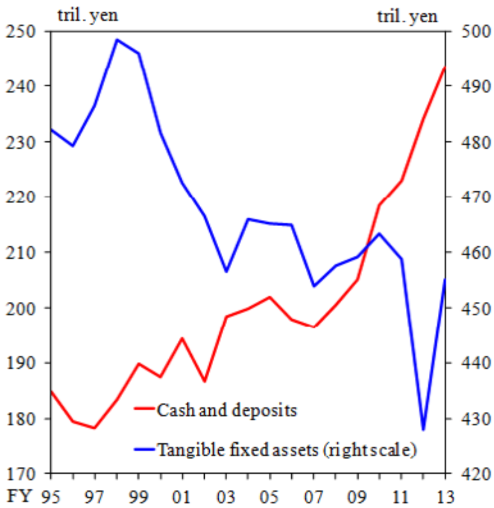
Chart 6

Cash Hoarding by the Corporate Sector

Returns on Cash and Deposits



Cash and Deposits and Tangible fixed assets



Notes: 1. Nominal returns on cash and deposits are the weighted averages of interest rates on deposits (that on cash is regarded as zero) by amounts outstanding of cash and deposits of nonfinancial corporations in the "Flow of Funds." Figures for real returns are calculated by subtracting the year-on-year rate of change in the CPI (all items less food and energy), adjusting the direct effects of the consumption tax hike, from nominal returns. Returns for fiscal 2014 are calculated using data for the April-September period.
2. Figures for the amount outstanding of cash and deposits are based on nonfinancial corporations in the "Flow of Funds." Figures for tangible fixed assets are based on all industries and enterprises excluding finance and insurance in the "Financial Statements Statistics of Corporations by Industry, Annually."

Sources: Bank of Japan; Ministry of Finance.

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Chart 7

Price Stability in Various Economies

Country/Region	Expression	Reference Indicator	Numerical Definition
Japan	Price stability target	CPI (all items)	2%
United States	Longer-run goal	PCE inflation (all items)	2%
Euro area	Quantitative definition	HICP (all items)	Below, but close to, 2%
United Kingdom	Target	CPI (all items)	2%
Canada	Target	CPI (all items)	2% (midpoint of 1-3%)
Australia	Target	CPI (all items)	2-3%
New Zealand	Target	CPI (all items)	Near 2% (midpoint of 1-3%)
Sweden	Target	CPI (all items)	2%
Switzerland	Definition	CPI (all items)	Less than 2%

Note: "PCE" stands for Personal Consumption Expenditures, and "HICP" stands for Harmonized Index of Consumer Prices.

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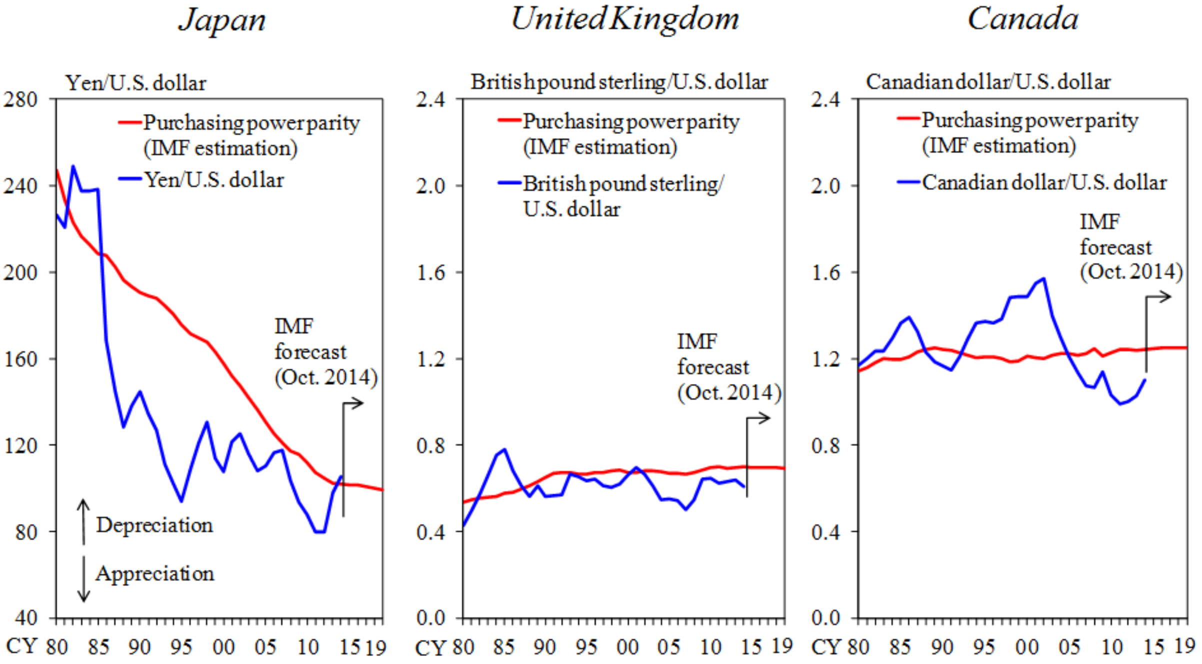
Chart 8

Foreign Exchange Rates and Purchasing Power Parity



Sources: IMF; Bloomberg.

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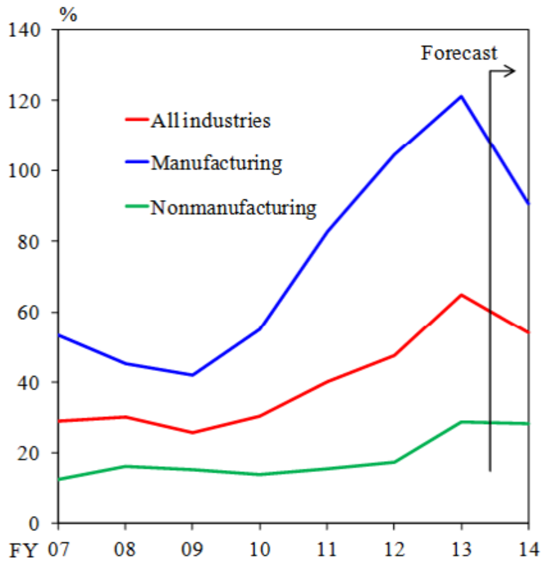
Business Fixed Investment

Tankan: Business Fixed Investment Plans

y/y % chg.

		FY2013	FY2014 (Forecast)
Large Enterprises	Manufacturing	- 0.8	+ 12.2
	Nonmanufacturing	+ 4.4	+ 6.3
	All industries	+ 2.6	+ 8.3
Small Enterprises	Manufacturing	+ 17.1	+ 10.2
	Nonmanufacturing	+ 19.6	- 6.5
	All industries	+ 18.7	- 0.9
All Enterprises	Manufacturing	+ 1.1	+ 12.9
	Nonmanufacturing	+ 7.7	+ 3.2
	All industries	+ 5.3	+ 6.5

Overseas/Domestic Ratio



Notes: 1. Figures for business fixed investment plans of the *Tankan* include software investment but exclude land purchasing expenses.
2. Figures for overseas/domestic ratio are the ratio of overseas business fixed investment on a consolidated basis to domestic business fixed investment on a non-consolidated base.

Sources: Bank of Japan; Development Bank of Japan.

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Chart 10

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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