

## **Koji Ishida: Economic activity and prices in Japan and monetary policy**

Speech by Mr Koji Ishida, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Kanagawa, 26 February 2015.

\* \* \*

### **I. Developments in economic activity and prices**

#### **A. Overseas**

I would like to start my remarks with a look at developments in economic activity and prices, in and outside Japan.

On overseas economies – mainly advanced economies – the Bank of Japan's current assessment is that they have been recovering, albeit with a lackluster performance still seen in part. The average of real GDP growth rates of major countries and regions, weighted by value of exports from Japan, has been posting higher growth, due mainly to a pick-up in the U.S. economy, after decelerating to 1.7 percent in the January-March quarter of 2014.

As for the outlook, the projections of global economic growth, released by the International Monetary Fund (IMF), have been revised downward repeatedly, but the projection of the growth rate gradually accelerating toward 2016 is unchanged. The Bank likewise expects that the overall global economy will moderately increase its growth rate, as advanced economies will continue to enjoy a recovery and the positive effects will gradually spread to emerging economies.

Taking a closer look at developments by region, the U.S. economy has continued to see solid recovery, led mainly by private demand. According to U.S. employment statistics for February 2015, the number of employees has been increasing by more than 200 thousand people on a seasonally adjusted month-on-month basis for eleven consecutive months, and the unemployment rate has been hovering at a low level. In this situation, consumer sentiment has been on an improving trend. Although wage increases have been somewhat weak, the economy is likely to continue to see solid recovery, as private consumption continues to increase on the back of the improvement in the employment situation and of low gasoline prices.

The euro area economy has maintained its moderate recovery, as seen in the fact that the real GDP growth rate has been positive for seven consecutive quarters, and the slowdown in its growth momentum observed since spring 2014 has come to a halt. As for the outlook, the economy is likely to maintain its recovery, albeit at a moderate pace, mainly because the depreciation of the euro and monetary easing by the European Central Bank (ECB) are likely to contribute to underpinning the economy, although close attention should continue to be paid to factors such as the risk of low inflation becoming protracted and the effects of the situation in Ukraine and Russia.

As for the Chinese economy, the year-on-year growth rate of real GDP for the October-December quarter of 2014 was 7.3 percent, unchanged from the previous quarter. The economy has generally maintained its stable growth, although its momentum has somewhat slowed due to downward pressure associated with structural reforms. As for the outlook, the Chinese economy is likely to basically continue to grow stably, although attention should be paid to an overhang in supply capacity in the manufacturing sector and to the adjustment pressure in the real estate market, mainly in local cities.

Emerging economies as a whole have remained lackluster in terms of growth. Looking at developments in the East Asian region, which is closely tied with Japan's economy, while the NIEs have been improving on the whole, mainly due to a pick-up in domestic demand, the ASEAN economies have been lacking growth momentum. As for the outlook, emerging

economies as a whole are likely to gradually increase their growth rates as advanced economies, particularly the United States, have positive effects on them, triggering a pick-up in domestic demand.

## **B. Japan**

### **1. Current situation**

Now I will discuss developments in economic activity and prices in Japan.

The Bank's current assessment is that the economy has continued its moderate recovery trend. The growth rate of real GDP for the October-December quarter turned positive, registering 2.2 percent on an annualized quarter-on-quarter basis, following the negative growth for two consecutive quarters after the consumption tax hike in April 2014, mainly due to the decline in demand following the front-loaded increase prior to the tax hike and to adverse weather conditions. A look at developments in each demand component shows that business fixed investment has been on a moderate increasing trend, while exports have been picking up noticeably and private consumption has remained resilient in a situation where the effects of the decline in demand following the front-loaded increase have been dissipating. Given these developments, I hold the view that, having emerged from the pause in the first half of fiscal 2014, the economy has started to show signs of returning to a moderate recovery path.

Although a limited number of economic indicators has been released with regard to developments since the beginning of 2015, real exports for January showed a clear pick-up of 5.0 percent from the previous month, mainly due to an increase in exports of automobiles to the United States. Meanwhile, as for private consumption, the number of new passenger-car registrations for January declined slightly, while indicators of consumer sentiment, which had been relatively weak since 2014, have been bottoming out recently.

With regard to prices, the year-on-year rate of increase in the consumer price index (CPI) for all items less fresh food, excluding the direct effects of the consumption tax hike, is around 0.5 percent. The rate of increase has recently been slowing, mainly due to a fall in the prices of petroleum products caused by the decline in crude oil prices. On a basis excluding food and energy, the rate of increase in the CPI had been slowing marginally, mainly reflecting the weakness in consumption during the summer of 2014, but for December, it is unchanged from the previous month.

### **2. Outlook**

Japan's economy is expected to continue its moderate recovery trend. On the price front, the year-on-year rate of increase in the CPI is likely to slow for the time being, reflecting the decline in energy prices. Meanwhile, risks to the outlook include developments in the emerging and commodity-exporting economies, the prospects regarding the debt problem and the risk of low inflation rates being protracted in Europe, and the pace of recovery in the U.S. economy.

The Bank compiles and releases the Policy Board members' forecasts for economic activity and prices on a quarterly basis. Looking at the medians of the members' forecasts released in January 2015, the real GDP growth rate is projected to be minus 0.5 percent for fiscal 2014, 2.1 percent for fiscal 2015, and 1.6 percent for fiscal 2016. The year-on-year rate of increase in the CPI (all items less fresh food), excluding the direct effects of the consumption tax hike, is projected to be 0.9 percent for fiscal 2014, 1.0 percent for fiscal 2015, and 2.2 percent for fiscal 2016. Compared with the forecasts made in October 2014, real GDP growth will likely be lower for fiscal 2014, but higher for fiscal 2015 and 2016, due mainly to the positive effects from the substantial decline in crude oil prices and the government's economic measures. With regard to the CPI, the outlook for the underlying trend is unchanged; the year-on-year rate of increase will likely be lower toward fiscal 2015, due to

the significant decline in crude oil prices, but that for fiscal 2016 will likely be more or less unchanged at above 2 percent, due mainly to the waning of downward pressure.

### 3. *Keys to assessing the outlook*

Thus far, I have briefly outlined the current situation of and outlook for economic activity and prices. In what follows, I will discuss the three keys to assessing the outlook.

#### a. *Effects of the decline in crude oil prices*

The first is the effects of the decline in crude oil prices on the global economy and prices. Although crude oil prices have been rising slightly recently, they have generally been at a level substantially below their peak observed around June 2014. The following factors have been pointed to as the background to the substantial decline in crude oil prices: oil supply factors, such as the decision of a group of major oil-exporting countries to maintain their production levels despite the rise in production of other oil, such as shale oil in the United States; and a decline in demand for crude oil due to economic deceleration in emerging and European economies, for example. These factors combined are likely to have had an impact on the decline in crude oil prices.

In terms of the effects of the decline in crude oil prices on Japan's economy, as is being discussed widely, I believe that the net effect of this is likely to be positive in terms of economic activity, brought about by an improvement in corporate profits and a rise in households' real purchasing power. On the price front, the price declines in energy – including the drop in the price of crude oil – are likely to exert downward pressure on general prices in the short term. From a relatively longer-term perspective, however, they are likely to push up general prices through an improvement in the output gap. In other words, I basically consider that the decline in crude oil prices will bring about positive effects on both economic activity and prices over time, but at the same time, I also consider that attention should be paid to its effects on certain areas of the economy.

I mentioned earlier that the projections of global economic growth released by the IMF have been revised downward repeatedly, and I consider that this itself suggests the existence of vulnerable areas in the world economy despite the global recovery trend. In this situation, the decline in crude oil prices is likely to exert adjustment pressure on capital investment by the energy and resources sector, which is said to account for approximately 40 percent of such investment on a global basis. Attention should be paid to the possibility that this in turn will exert downward pressure on orders, production, and exports of Japan's capital goods, in which the country has a competitive edge.

#### b. *Developments in real wages*

The second key is developments in real wages. Since the turn of fiscal 2014, the year-on-year rate of change in real wages has been negative, due in part to the substantial increase in the rate of change in the CPI including the effects of the consumption tax hike. Meanwhile, there has been a somewhat weak recovery in consumption from the decline following the front-loaded increase prior to the consumption tax hike. I believe that the decline in real wages, in addition to the effects of irregular weather, largely accounted for the weak recovery. Therefore, for private consumption to pick up clearly and maintain an increasing, albeit moderate, trend in fiscal 2015 and beyond, I consider it necessary that nominal wages rise firmly and that wages in real terms – adjusted for inflation – start rising on a year-on-year basis.

On this point, let us look at recent developments in Japan's economy. Corporate profits as a whole have been increasing, with some differences observed in the business performance between exporting firms – which benefit from the yen's depreciation – and domestic demand-oriented firms – against which the yen's depreciation acts as a headwind. In view of the continued tight employment situation and of developments in prices, it is my consideration that the conditions are being prepared for wages to start rising in the form of increases in base pay and bonus payments. Household income, I believe, will be a great driving force for

supporting a virtuous cycle in the household sector from fiscal 2015 if, as a result of wage negotiations in spring 2015, nominal wages improve to an extent that will bring about a rise in real wages; however, attention should be paid to the effects, for example, of the introduction of the macroeconomic slide formula to the pension system in Japan from fiscal 2015.

*c. Developments in exports*

The third key is developments in exports. Real exports had been sluggish despite the substantial depreciation of the yen since the introduction of quantitative and qualitative monetary easing (QQE) in April 2013. A range of factors have been pointed to regarding the slow emergence of the J-curve effects; namely, cyclical factors such as the sluggishness in emerging economies and structural factors such as the increase in the relocation of production overseas by Japanese manufacturers. Given these circumstances, unlike in the past, it has become quite difficult for exports to act as the driving force of Japan's economy even amid the situation of the yen's depreciation.

It must be noted, however, that real exports have started to rise noticeably recently. Moreover, an increasing number of firms has announced plans to expand domestic business, as some manufacturers have been shifting their production back to Japan and making import substitutions. Amid the situation of the yen's depreciation, developments that will yield a virtuous cycle in the economy are beginning to be observed steadily, and I believe they will continue to gradually strengthen as the yen stabilizes. In determining the outlook for production and exports, it is also necessary to observe such changes in corporate behavior.

## **II. The Bank's monetary policy**

### **A. Expansion of QQE**

Next, I would like to discuss the Bank's monetary policy.

At the Monetary Policy Meeting held on October 31, 2014, the Bank decided to expand QQE, which it introduced in April 2013. The specific measures of the expansion were as follows. First, the Bank decided to accelerate the pace of increase in the monetary base it provides from "an annual pace of about 60–70 trillion yen" to "an annual pace of about 80 trillion yen." Second, it decided to raise the pace of increase in the amount outstanding of the Bank's holdings of Japanese government bonds (JGBs) from "an annual pace of about 50 trillion yen" to "an annual pace of about 80 trillion yen." At the same time, the Bank decided to extend the average remaining maturity of its JGB purchases from "about seven years" to a flexible range of "about seven to ten years." And third, it decided to purchase exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their amounts outstanding would be tripled to annual paces of "about 3 trillion yen" and "about 90 billion yen," respectively.

Around the time of the Bank's expansion of QQE in October 2014, somewhat weak developments in demand following the consumption tax hike and the substantial decline in crude oil prices had been exerting downward pressure on prices. The Bank considered that, if such downward pressure remained, albeit in the short term, there was a risk that the emergence from the deflationary mindset, which had been progressing steadily, might be delayed. To preempt the manifestation of this risk and to maintain the improving momentum of expectation formation, the Bank decided on the expansion of QQE.

### **B. Enhancement of other fund-provisioning measures**

Prior to the introduction of QQE, the Bank established – on its balance sheet – the Loan Support Program, with the aim of making the effect of monetary easing permeate the entire economy. The program consists of two measures – namely, the fund-provisioning measure to support strengthening the foundations for economic growth (hereafter the Growth-Supporting Funding Facility) and the fund-provisioning measure to stimulate bank lending

(hereafter the Stimulating Bank Lending Facility) – and had been providing support for private financial institutions' efforts to these ends.

In January 2015, the Bank decided to extend the application period of the program by one year. It also decided, with regard to the Growth-Supporting Funding Facility, to increase the maximum amount of funds that it can provide to each financial institution from 1 trillion yen to 2 trillion yen, and also to increase the maximum amount outstanding of its fund-provisioning as a whole from 7 trillion yen to 10 trillion yen. Moreover, the Bank further enhanced the program by introducing a new framework for enabling financial institutions that do not have a current account at the Bank to use the Growth-Supporting Funding Facility and the Stimulating Bank Lending Facility through their central organizations.

The Bank also decided, in January 2015, to extend the application period of the funds-supplying operation to support financial institutions in disaster areas affected by the Great East Japan Earthquake by one year.

Through these enhancements of the existing measures, the Bank will further promote financial institutions' lending, as well as stimulate firms' and households' demand for credit and continue to support the efforts of financial institutions in disaster areas toward rebuilding.

### **C. Financial Conditions**

As I have described, the Bank has been implementing large-scale monetary easing through various measures. In this situation, interest rates in financial markets have been hovering at extremely low levels. Yields on 10-year JGBs are currently in the range of 0.3–0.4 percent, although there have been relatively large fluctuations recently. While the U.S. dollar/yen rate has been moving within a narrow range of 115–120 yen, the Nikkei 225 Stock Average has been in the range of 18,000–19,000 yen.

Financial conditions have continued to be accommodative. The average contract interest rates on new loans and discounts and the issuance rates for CP and corporate bonds have been at low levels. Firms' perception of financial institutions' lending attitudes and financial positions of firms, including those for small firms, have been improving.

### **D. Future Conduct of Monetary Policy**

#### *1. The decline in crude oil prices and the conduct of monetary policy*

Next, I would like to highlight two points regarding the Bank's future conduct of monetary policy and then conclude my remarks.

The first is the relationship between the decline in crude oil prices and the conduct of monetary policy. In the Bank's interim assessment in January 2015 of the October 2014 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), the forecasts for the year-on-year rate of increase in the CPI (all items less fresh food) have been revised downward toward fiscal 2015 from those presented in the October 2014 Outlook Report. From a somewhat longer-term perspective, the decline in crude oil prices – the main factor behind this downward revision – will exert upward pressure on the underlying trend in prices by producing stimulus effects on the economy. In a situation where medium- to long-term inflation expectations among households and firms have been stable according to a number of surveys, as long as the path for the year-on-year rate of increase in the CPI to rise again toward around 2 percent is in sight, the decline in crude oil prices should not pose any particular concern in terms of the conduct of monetary policy.

In terms of grasping price developments, it has become difficult to determine the underlying trend of the CPI, due to the large fluctuations in crude oil prices. The basic approach to assessing this trend is to make a comprehensive examination of a range of indicators – particularly the CPI for all items less fresh food. Given the current situation, it is appropriate for the time being to make an assessment by also taking account of the contribution of energy items to the year-on-year rate of increase in the CPI (all items less fresh food). The

Bank's decision to release an estimate of this contribution for the price outlook through fiscal 2016 was based on such thinking.

On this point, one view is to examine the year-on-year rate of increase in the CPI for all items less food and energy, or the core-core CPI, in particular. However, when identifying the underlying trend in prices, I personally consider that it also is important to examine the price index that includes food, given that food expenditures in Japan account for a larger proportion of household expenditures than in other countries – such as the United States – and that the rise in the prices of daily necessities has been weighing on consumer sentiment since 2014.

Furthermore, I place importance on the CPI for all items less imputed rent, which is used in the calculation of such items as real wages. Imputed rent is an expenditure that is not actually paid in the market. It has long been on a declining trend, and if this trend continues, this will exert strong downward pressure on the CPI for all items, particularly in the phase when the rate of increase in the prices of goods and services accelerates. If this turns out to be the case, various problems may arise from a gap between the rise in prices perceived by households and the rise in the CPI, or in assessing the rate of wage increase.

## 2. *The continuation of QQE*

The second point is the continuation of QQE. Almost two years have passed since the Bank introduced QQE in April 2013. So far, the Bank has committed to continuing with QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary to maintain the target in a stable manner. It also has committed to examining both upside and downside risks to economic activity and prices, and making adjustments as appropriate.

As for the Bank's outlook for prices, looking at the medians of the Policy Board members' forecasts, the year-on-year rate of increase in the CPI (all items less fresh food) is projected to remain at 1.0 percent for fiscal 2015 due to the substantial decline in crude oil prices, but to reach 2.2 percent for fiscal 2016. If economic activity and prices develop as projected, the achievement of the price stability target of 2 percent will become more in sight over time. Although it is premature to discuss an exit strategy at this stage, if the year-on-year rate of increase in the CPI accelerates in accordance with the Bank's forecast I just mentioned, the Bank at some point will need to gradually slow the pace of QQE from the current full-speed operation. From this viewpoint, it will become all the more important for the Bank to carefully grasp and assess prevailing economic developments and the underlying trend in prices, and thereby accurately determine their outlook, in the process of preparing the Outlook Report every April and October, and of conducting the interim assessment thereof every July and January.

With respect to the wording "make adjustments as appropriate" used to describe the Bank's monetary policy stance, my understanding is that these adjustments will only be made in response to, from a longer-term perspective, a heightening of risks to achieving sustainable economic growth with price stability, such as an emergence of economic and financial imbalances, and should not be made in response to changes in the timing for achieving the 2 percent price stability target or in the pace at which this target will be achieved.