Kikuo Iwata: Japan's economy and monetary policy

Speech by Mr Kikuo Iwata, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Sapporo, 27 May 2015.

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

Introduction

It is my pleasure to have the opportunity today to exchange views with administrative, financial, and business leaders in this region. I would like to take this chance to express my sincerest gratitude for your cooperation with the activities of the Bank of Japan, particularly of the Sapporo Branch and the local office in Asahikawa.

Today, I would like to have your views on the actual situation of the local economy as well as your candid opinions about the Bank's policies and activities.

Before exchanging views with you, I will briefly explain the recent economic developments at home and abroad, and then touch on some points regarding the conduct of monetary policy.

I. The current situation of and outlook for Japan's economy

Japan's economy has continued to recover moderately in a situation where a virtuous cycle from income to spending has been operating in both the corporate and household sectors. In the following, I would like to elaborate on the background to this assessment and on the outlook for Japan's economy in terms of the corporate sector – including exports and production – and then in terms of the household sector – such as the employment and income situation and private consumption.

A. Corporate sector

Exports have been picking up recently owing to the recovery in overseas economies and support from the effects of the depreciation of the yen (Chart 1). In particular, exports to the United States have continued to see a marked increase since capital goods and parts have increased, reflecting the recovery in business fixed investment in the United States, and since motor vehicles and their related goods have picked up.

The global economy, which is the key to projecting the outlook for exports, is expected to moderately increase its growth rate as advanced economies continue to see firm recovery and its positive effects gradually spread to emerging economies. According to the April 2015 World Economic Outlook (WEO) released by the International Monetary Fund (IMF) last month, global economic growth is projected to accelerate moderately on the whole: after registering 3.4 percent in 2014, it is projected to be 3.5 percent in 2015 and 3.8 percent in 2016 (Chart 2).

Looking specifically at the developments by region, in the United States, which is expected to be the driving force of global growth, the real GDP growth rate for the January-March quarter has decelerated considerably, due in part to effects of adverse weather conditions. Nevertheless, the economy continued its robust recovery trend supported by household spending – as seen in private consumption rebounding from a fall in winter – against the background of the favorable employment and income situation in particular. The U.S. economy is expected to continue to see growth led mainly by private demand, starting from firm household spending. In addition, the European economy, in which the momentum for recovery had been weak, has recently been seeing a clear increase in private consumption, reflecting the effects of the decline in crude oil prices and of a rise in stock prices. It also has been seeing a pick-up in business sentiment and production activity resulting from an improvement in exports and corporate results due to the depreciation of the euro. Going forward, the European economy is expected to continue to see moderate recovery with the permeation of the effects of depreciation of the euro and those of the monetary easing measures by the European Central Bank (ECB). Meanwhile, turning to emerging economies, the growth momentum of the Chinese economy has been sluggish against the backdrop of the deceleration in fixed asset investment and continued inventory adjustments. Nevertheless, it is likely to follow a generally stable growth path as there are likely to be effects of the authorities' policy measures to support economic activity, although the pace of growth is expected to be somewhat reduced. Other emerging economies and commodity-exporting economies have continued to lack momentum on the whole, but are expected to gradually increase their growth rates, mainly as the recovery in advanced economies spreads to them.

In sum, the global economy – mainly advanced economies – is expected to continue recovering moderately, and against this backdrop, Japan's exports are expected to increase moderately. Of course, various uncertainties – including the pace of growth in the U.S. economy, the prospects regarding the European debt problem, including developments in Greece, developments in the emerging and commodity-exporting economies, and geopolitical risks – continue to call for close attention.

In a situation where exports have been picking up and, as I will explain later, private consumption has been resilient, production has been picking up. Corporate profits have increased to historical highs and business sentiment has generally stayed at a favorable level (Chart 3). Under these circumstances, with regard to firms' business plans for fiscal 2015, shown in the March *Tankan* (Short-Term Economic Survey of Enterprises in Japan), corporate profits as a whole are projected to continue improving and a positive stance on business fixed investment has been maintained for this time of year. In this way, a virtuous cycle in the corporate sector – in which business fixed investment will continue its moderate increasing trend amid a continued improvement in corporate profits – is expected to operate going forward.

B. Household sector

Next, turning to the household sector, positive developments in the corporate sector have led to a tightening in labor market conditions and to an improvement in the employment and income situation in accordance with that tightening. The unemployment rate has declined to around 3.5 percent, and judging from firms' view on employment, the labor shortage is growing further (Chart 4). Reflecting this tightening in labor market conditions, nominal wages have increased moderately, albeit with fluctuations. In this way, since nominal wages have been rising and the number of employees has been increasing, employee income has been increasing moderately.

An improving trend in private consumption is becoming evident gradually amid steady improvement in the employment and income situation, although some areas had been sluggish. Such firmness in private consumption was also confirmed by the GDP statistics released last week, which showed that private consumption has increased for three consecutive quarters. In addition, a pick-up in consumer sentiment is becoming evident. As for the outlook, the employment and income situation is likely to continue to see steady improvement as many firms will increase wages, including base pay, which will be raised to a larger extent than last year in the annual labor-management wage negotiations in spring 2015; in this situation, private consumption is expected to remain resilient.

As I have explained, a virtuous cycle from income to spending is likely to continue operating in both the corporate and household sectors, since domestic demand is likely to be resilient and exports are expected to increase moderately. Against this backdrop, Japan's economy is likely to continue growing at a pace above its potential from fiscal 2015 through fiscal 2016. Thereafter, through fiscal 2017, the economy is projected to maintain its positive growth, although with a slowing in its pace to around a level somewhat below the potential growth rate. The slowdown is due mainly to (1) the effects of a front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike planned in April 2017 and (2) cyclical deceleration. In the Bank's April 2015 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), the Policy Board members' forecasts of the real GDP growth rate were around 2 percent for fiscal 2015, around 1.5 percent for fiscal 2016, and in the range of 0.0–0.5 percent for fiscal 2017 (Chart 5).

II. Conduct of monetary policy and price developments in Japan

Next, I would like to touch on the conduct of monetary policy and price developments in Japan.

A. Change in policy regime

The Bank is pursuing policy measures that aim at converting people's deflationary mindset, which has been formed firmly amid the prolonged period of deflation, to one that expects moderate inflation. That is, preparing a platform on which people can act on the assumption that prices continue to rise moderately.

To begin with, in January 2013, the Bank set the price stability target of 2 percent in terms of the year-on-year rate of change in the CPI; in other words, the introduction of "inflation targeting."

With a view to achieving this price stability target, the Bank has been implementing an aggressive monetary easing measure called quantitative and qualitative monetary easing (QQE) since April 2013, and expanded the measure in October 2014 (Chart 6).

By implementing such bold policy measures, the Bank has intended to clearly indicate to the public that the basic thinking behind its monetary policy – that is, the policy regime – has changed, and also to encourage them to change their behavior in view of such change. In other words, this is the Bank's declaration that "the rules of the game have been changed."

B. Commitment to achieving the price stability target at the earliest possible time

Before the introduction of QQE, the Bank had pursued various monetary easing measures that were considered unconventional, such as the introduction of the zero interest rate policy and quantitative easing, and this made the Bank a forerunner in monetary policy history. Although each of the measures on their own could have been a quite powerful policy tool, it turned out that they were not effective enough to overcome deflation.

While a variety of analyses attempted to explain why the Bank was not successful in overcoming deflation, a major reason, in my view, was that the Bank's faith that "deflation can be overcome through monetary policy" was not strong enough, and that its commitment to achieving this aim was insufficient; in other words, the policy regime was not changed considerably. Thus, the mindset of private economic entities such as households, firms, and financial institutions was not converted.

Based on this bitter experience, when QQE was introduced in April 2013, the Bank entered a new phase of monetary easing by adopting a large-scale measure and made clear the time frame for achieving the target – namely, that it will achieve the price stability target of 2 percent at the earliest possible time, with a time horizon of about two years. The Bank showed its commitment to achieving the price stability target at the earliest possible time in a stronger manner than ever, by stating that it was putting forth a specific time horizon of about two years, rather than simply adopting a stance of achieving it at the earliest possible time.

As I will discuss later, the Bank currently expects that the CPI inflation rate is likely to reach around 2 percent around the first half of fiscal 2016. This timing is somewhat delayed from the previous projection. However, the underlying trend in inflation itself has been rising steadily with the mechanism of QQE working as envisaged, and at this moment the Bank has no intention of changing its commitment to achieving the price stability target at the earliest possible time.

C. Why has the CPI inflation not reached 2 percent yet?

Looking at developments in the year-on-year rate of change in the CPI (all items less fresh food), or the core inflation rate in Japan, it had hit a bottom of minus 0.5 percent immediately before the introduction of QQE, and thereafter, excluding the direct effects of the consumption tax hike, followed a steady rising trend until it reached 1.5 percent in April 2014. This means that QQE had pushed up the core inflation rate by 2.0 percentage points in about one year. During this period, the effects of QQE were clearly confirmed on the price front.

Nevertheless, the price stability target of 2 percent has not been achieved yet. The core inflation rate peaked in April 2014, and then followed a gradual declining trend. It has recently been about 0 percent (Chart 7). In my view, there are two major factors behind the decline in the inflation rate.

1. Consumption tax hike

The first factor is negative effects on demand of the consumption tax hike in April 2014.

Although the decline in demand following the front-loaded increase prior to the consumption tax hike had been expected, the degree of the decline had not been projected to be as large as the decline associated with the April 1997 hike, when the consumption tax rate rose from 3 percent to 5 percent.

However, the actual negative effects exceeded most of the projections, and were protracted. There are various reasons for this, but here I would like to point out an increase in low-income households due to the protracted sluggish employment situation as well as an increase in the number of pensioners reflecting the aging of the population as part of the background.

That being said, as I have explained, with the steady improvement in the employment and income situation and in corporate profits continuing, a virtuous cycle from income to spending has been operating firmly in both corporate and household sectors. Against this backdrop, the downward pressure on demand exerted by the consumption tax hike has been dissipating.

2. Decline in crude oil prices

The other factor behind the recent decline in inflation rates is a rapid and substantial fall in crude oil prices that has occurred since last summer.

It should be noted that the effects of falling crude oil prices may be assessed differently depending on the time horizon that you have in mind. To be more specific, the decline in crude oil prices will result in lower costs for various economic activities, and thereby exert wide-ranging positive effects on the real economy. From a longer-term perspective, it will push up prices as the aggregate demand increases. However, from a short-term perspective, until effects of an increase in the aggregate demand are manifested on the price front, the direct effects of falling energy prices exceed those of an increase in demand. Thus, there is temporary downward pressure on prices.

The short-term effects of the decline in crude oil prices are expected to dissipate gradually from the second half of fiscal 2015, assuming that crude oil prices will rise moderately from around the recent level, though the timing of this depends on developments in crude oil prices.

D. Underlying trend in inflation

The year-on-year rate of increase in the CPI is projected to be about 0 percent for the time being, with negative contributions of energy-related items offsetting positive contributions of other items.

However, as I have explained, the underlying trend in inflation is likely to rise steadily, and the inflation rate is projected to accelerate toward the target level of 2 percent as the effects of the decline in crude oil prices dissipate.

In assessing the underlying trend in inflation, it is necessary to take into account factors such as the following: (1) the output gap that is the difference between the aggregate demand and the supply capacity of the economy as a whole; (2) medium- to long-term inflation expectations; and (3) the extent to which a future increase in prices will be taken into account in wage and price settings.

To begin with, let me discuss the first factor, the output gap. Private consumption is expected to remain resilient with the improvement in the income situation against the background of tightening in labor market conditions, together with manifestation of positive effects of the decline in energy prices on real income. Business fixed investment is projected to continue a moderate increasing trend as corporate profits improve. Exports, which have been picking up recently, are expected to increase moderately against the background of the recovery in overseas economies and of underpinning effects of the depreciation of the yen. As such, the improving trend in the output gap will continue with the aggregate demand in the economy as a whole expanding, and upward pressure on prices is expected to increase gradually.

Let me turn to the second factor, inflation expectations. Judging from indicators that are observable in the market and analyses of various survey results, medium- to long-term inflation expectations appear to be rising on the whole, despite the recent decline in the inflation rate. Going forward, the observed inflation rate is likely to accelerate. That will bring about a rise in inflation expectations, and such expectations are expected to remain firm.

Moreover, as I have mentioned earlier, as a result of the annual labor-management wage negotiations in spring 2015, many firms will increase wages, including base pay, which will be raised to a larger extent than last year. The business model of firms seems to be in a process of transformation from one of the deflationary type – that is, one in which firms adopt a lower price-setting strategy through cutting expenses mainly in labor costs – to one of the innovative type – that is, one in which firms do not resort to lower prices but devote their efforts to developing new products and services that can enhance customer satisfaction. In this situation, some firms have been shifting their price-setting strategy to one of raising sales prices while increasing value-added.

In this way, the mechanism of inflation accelerating moderately accompanied by wage increases has continued to operate, and the underlying trend in inflation has steadily improved. In the April 2015 Outlook Report, the Policy Board members' forecasts of the year-on-year rate of increase in the CPI (all items less fresh food) were 0.8 percent for fiscal 2015, 2.0 percent for fiscal 2016, and 1.9 percent for fiscal 2017 (Chart 5). Although the timing of reaching around 2 percent depends on developments in crude oil prices, it is projected to be around the first half of fiscal 2016, assuming that crude oil prices will rise moderately from the recent level. Thereafter, the year-on-year rate of increase in the CPI is likely to be around 2 percent on average.

Concluding remarks

In conclusion, let me touch on the economy of Hokkaido Prefecture.

The economy has been recovering moderately, although some weakness has been observed in some aspects, such as the public construction sector, which largely affects small firms. Turning to final demand, there are somewhat weak developments in terms of the decline in public investment, but a marked increase in the number of foreign visitors to Japan has been underpinning demand. Moreover, over the period of more than a year since the consumption tax hike, even durable consumer goods and housing investment have started to level off. Meanwhile, as seen in the steady improvement in the employment and income situation, a virtuous cycle from income to spending has been operating in the region in the same way as in Japan as a whole.

In Hokkaido Prefecture, there are plenty of topics associated with encouraging tourism. For example, Yoichi city became the setting for *Massan*, a morning drama serial by Japan Broadcasting Corporation (*Nippon Hoso Kyokai*, NHK). In addition, the Hokkaido shinkansen will commence its operation by March 2016, and it is scheduled to be extended to Sapporo city. These topics show that Hokkaido Prefecture will receive further attention going forward. Moreover, Sapporo city has announced its intention to bid for the 2026 Winter Olympics, and this will increase the opportunity for Hokkaido Prefecture to display to the world its appeal.

Other than tourism, Hokkaido Prefecture has strength in the food industry on the back of its abundant agricultural and fishery resources. I have heard that Hokkaido Prefecture now faces problems such as lower production of raw milk resulting from increasing abandonment of farming as well as slack in unloading in the fishing industry, but I expect that production of higher value-added goods will be promoted through efforts such as Healthy-Do, which is the certification system of functional food that the Hokkaido government is making efforts to popularize.

Other initiatives include promoting Hokkaido Prefecture as a back-up base for the metropolitan area and Honshu – the main island of Japan – since Hokkaido Prefecture faces less natural disasters. This initiative has actually led to attracting firms to Hokkaido Prefecture, and I have heard that even some export-related manufacturers, such as those in transportation equipment, in which Hokkaido Prefecture had been facing a disadvantage, have been lured. I believe this will largely contribute to reinforcing Hokkaido Prefecture's industrial infrastructure.

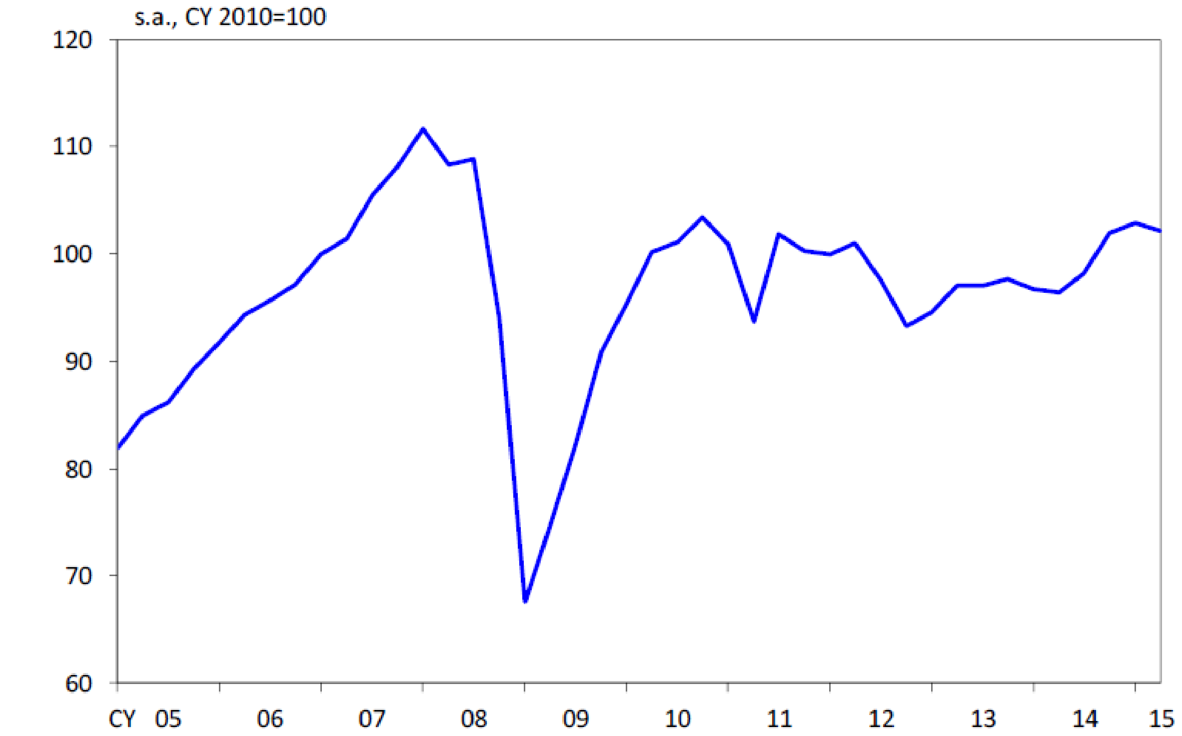
As common issues across the country, the population decline as well as declining birth rate and an aging population have been pointed out, and in this region these issues have progressed faster than in Japan as a whole. Therefore, I expect that, with cooperation among industry, academia, the government, and finance, the region will overcome this problem by promoting vitalization of the local economy ahead of other regions in Japan and developing business models that would apply for Japan as a whole. The Bank's Sapporo Branch will conduct analyses of the regional economy so as to contribute to such efforts as much as possible.

In closing, I wish all the best for the further development of the regional economy.

Thank you.

Chart 1

Real Exports

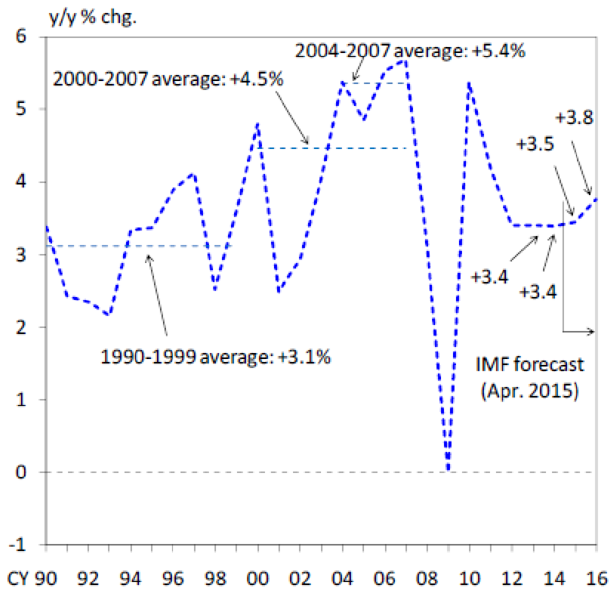


Note: The figure for 2015/Q2 is that of April.
Sources: Ministry of Finance, "Trade Statistics"; Bank of Japan, "Corporate Goods Price Index."

Chart 2

World Economy

Real GDP Growth Rate



Projections for Major Economies

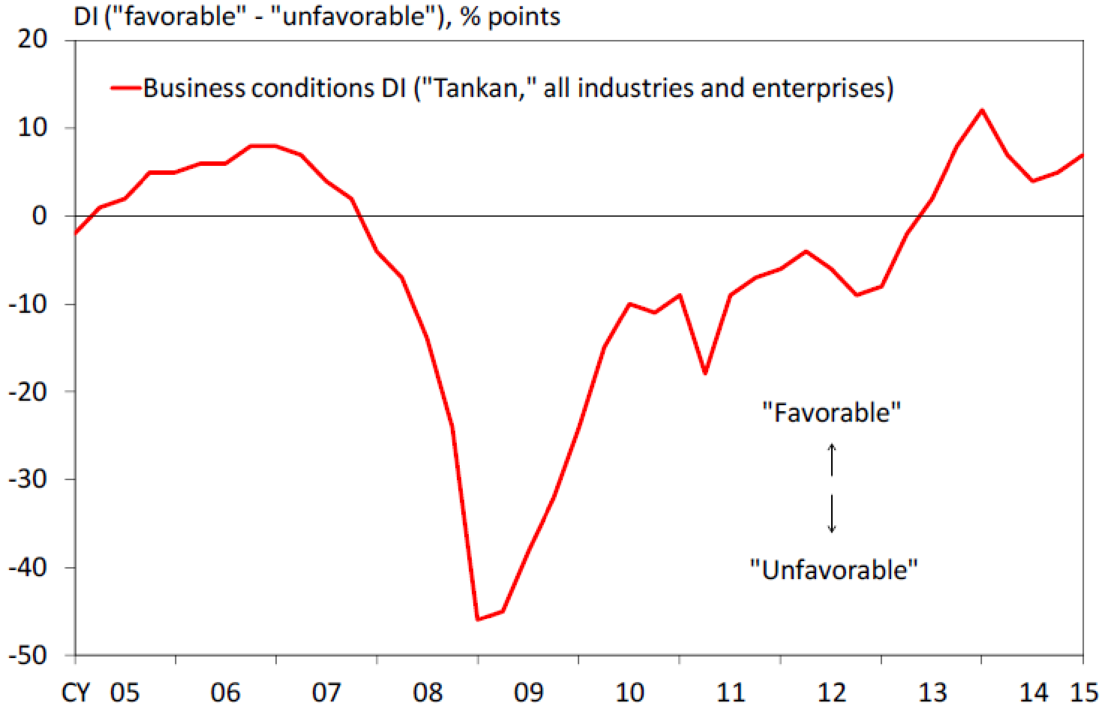
y/y % chg.

	2013	2014	Projections 2015	Projections 2016
World	3.4	3.4	3.5 (0.0)	3.8 (0.1)
Advanced Economies	1.4	1.8	2.4 (0.0)	2.4 (0.0)
United States	2.2	2.4	3.1 (-0.5)	3.1 (-0.2)
Euro Area	-0.5	0.9	1.5 (0.3)	1.6 (0.2)
Japan	1.6	-0.1	1.0 (0.4)	1.2 (0.4)
Emerging Market and Developing Economies	5.0	4.6	4.3 (0.0)	4.7 (0.0)
China	7.8	7.4	6.8 (0.0)	6.3 (0.0)

Note: Figures in parentheses are the difference from the January 2015 WEO projections.
Source: IMF, "World Economic Outlook."

Chart 3

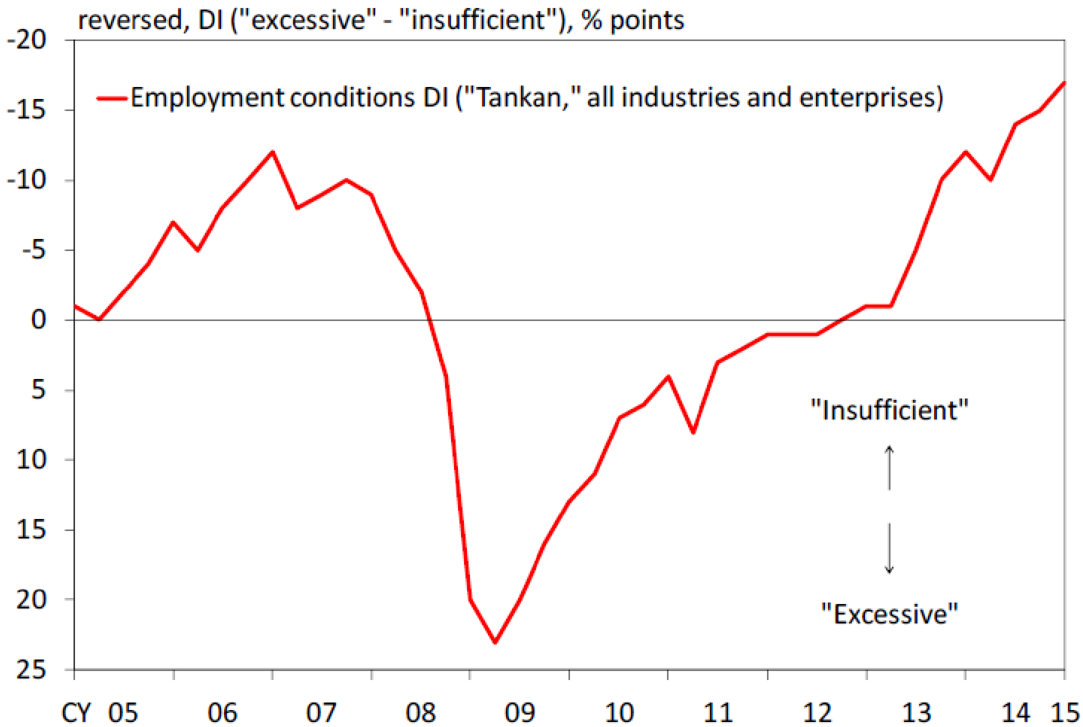
Business Sentiment



Source: Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan."

Chart 4

Firms' View on Employment



Source: Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan."

Chart 5

Outlook for Economic Activity and Prices (as of April 2015)

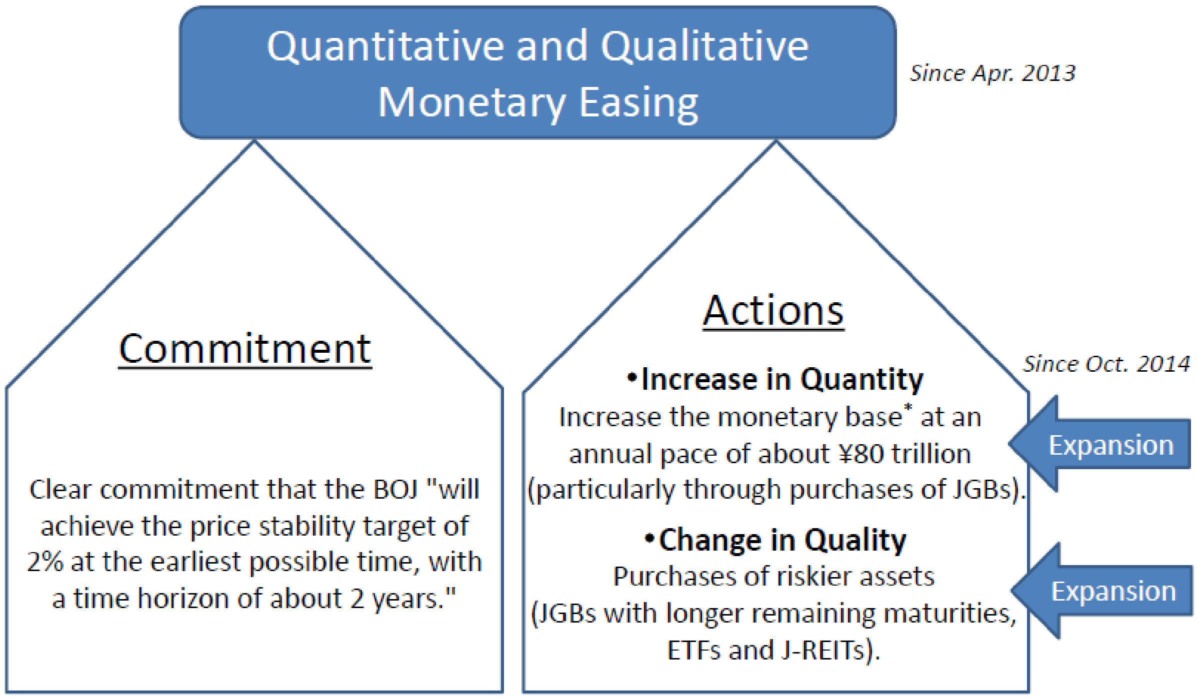
y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2015	+2.0	+0.8	
Forecasts made in January 2015	+2.1	+1.0	
Fiscal 2016	+1.5	+2.0	
Forecasts made in January 2015	+1.6	+2.2	
Fiscal 2017	+0.2	+3.2	+1.9

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

Chart 6

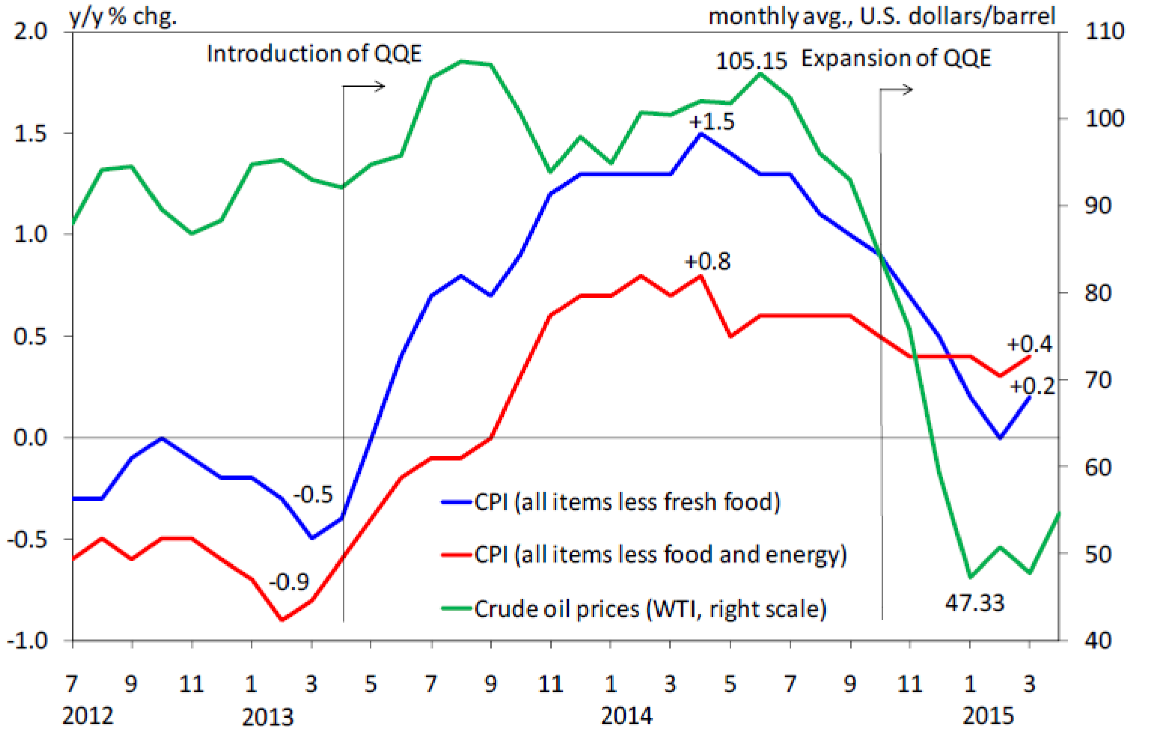
Tangibility of "Policy Regime Change"



* Money supplied directly from the central bank to the financial system.

Chart 7

Consumer Prices and Crude Oil Prices



Note: Figures for the CPI from April 2014 onward are calculated to adjust the direct effects of the consumption tax hike.
Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index"; Bloomberg.