Haruhiko Kuroda: Challenges to achieving the price stability target of 2 percent

Speech by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at a meeting, held by the Naigai Josei Chosa Kai (Research Institute of Japan), Tokyo, 6 November 2015.

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Introduction

It is my great honor to have the opportunity to address you today at the Naigai Josei Chosa Kai.

At the Monetary Policy Meeting held on October 30, the Bank of Japan produced the *Outlook for Economic Activity and Prices* (Outlook Report) and published its projections for Japan's economic activity and prices through fiscal 2017.

Looking at the recent economic developments, Japan's exports and production have been sluggish, reflecting the slowdown in emerging economies, particularly China. On the price front, the year-on-year rate of change in the consumer price index (CPI, all items less fresh food) has declined and reverted to about 0 percent, due mainly to the effects of the substantial decline in crude oil prices.

However, as I will explain, the fundamentals of Japan's economy are sound and the environment surrounding firms and households has significantly improved compared to some years ago. Moreover, the underlying trend in inflation has been improving steadily. Quantitative and qualitative monetary easing (QQE), which the Bank introduced in April 2013, has been exerting its intended effects toward overcoming deflation.

The Bank will continue to steadily pursue QQE and solidly maintain accommodative financial conditions. In this circumstance, firms and households are expected to be more proactive in economic activity, Japan's economy is likely to continue growing at a pace above its potential, and the price stability target of 2 percent certainly would be achieved. Today, I would like to explain the Bank's view on the outlook for economic activity and prices, as well as on its monetary policy while touching on the Outlook Report. I would first like to elaborate on the Bank's baseline scenario regarding the outlook for economic activity and prices, which is considered most probable, and then touch on risks to the baseline scenario.

I. Current situation of Japan's economic activity and its outlook

Corporate profits at high levels and firms' positive investment stance

Let me start by discussing the current situation of Japan's economic activity and its outlook. As many of you must be aware, the slowdown in emerging economies, particularly China, has become marked recently, and this has affected Japan's exports and production. In the April-June quarter of 2015, private consumption was somewhat weak, reflecting in part bad weather. Against this backdrop, the projected real economic growth rate for fiscal 2015 was revised downward to 1.2 percent in the Outlook Report compared with the projection of 1.7 percent in the July 2015 interim assessment (Chart 1).

Nevertheless, corporate profits have been seeing record highs, and improvements in the employment and income situation have continued. A virtuous cycle from income to spending has been operating steadily in both the corporate and household sectors, and it is judged that Japan's economy has continued to recover moderately.

A situation in which corporate profits continue increasing despite the flattening of exports and industrial production was not commonly observed in Japan's past economic recoveries. Let me point out two reasons why this time is different. The first is firmness in domestic demand.

In the past economic recoveries, the general course of events was an increase in exports leading to rises in corporate profits and business fixed investment in the manufacturing sector; this time, the nonmanufacturing sector has shown a strong recovery on the back of resilience in domestic demand. This can be observed in a clear improvement in the diffusion index for business conditions and corporate profits of the nonmanufacturing sector compared to the manufacturing sector, as shown in the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) (Chart 2). As the current economic recovery has been driven by domestic demand, even though Japan's exports have become more or less flat due to the slowdown in overseas economies, the tolerance of Japan's economy for this slowdown seems to be relatively high compared to the recoveries in the past. Second, the decline in commodity prices, mainly crude oil prices, affected in part by the slowdown in emerging economies, has pushed up profits through an improvement in the terms of trade. Put differently, a sort of automatic adjustment has been working in which the negative impact from a decline in quantity has been offset by positive effects in terms of prices. In addition, the rise in repatriated income from overseas business through dividends and interest, which has accelerated partly as a result of the depreciation of the yen, has contributed to the recent improvement in corporate profits.

Under this favorable situation in corporate profits, firms' fixed investment stance has become positive. According to business plans for fiscal 2015 released in the September *Tankan*, the year-on-year rate of growth of fixed investment plans for all enterprises and industries was revised upward from the June *Tankan*, from 3.4 percent to 6.4 percent.

Turning to overseas economies, as shown in the October 2015 World Economic Outlook (WEO) published by the IMF, global growth for this year is projected to decline compared to 2014, but to accelerate toward 2016 (Chart 3). Advanced economies have continued to see a firm recovery trend, mainly in the United States. Emerging economies are likely to continue their slowdown for the time being. Since the Chinese authorities, having relatively large room for monetary and fiscal policy, have proactively been carrying out economic stimulus measures, the Chinese economy is expected to follow a generally stable growth path, albeit at a somewhat reduced pace. Emerging economies other than China are also likely to move out of their deceleration phase on the back of the robust growth in advanced economies. Based on these projections of overseas economies, the favorable developments seen in Japan's corporate sector are likely to continue.

Improvement in the employment and income situation, and resilient private consumption

I would next like to explain developments in the household sector. Needless to say, the employment and income situation is a key factor in deciding household spending. On this point, the tightening trend in labor market conditions has continued. Namely, the active job openings-to-applicants ratio is currently 1.24 times, a high level last seen in 1992, and the unemployment rate has declined to 3.4 percent, a low level last seen in 1997 (Chart 4). What is worth noting is that the labor market has continued to tighten despite the flattening of exports and production. In fact, as seen in the diffusion index for employment conditions released in the September *Tankan*, a perception of labor shortage has heightened further among firms, and the labor market can be regarded as being in a situation of "full employment."

As corporate profits have increased to their highest level historically and tightening in labor market conditions has continued, there has been upward pressure on wages. Based on the *Monthly Labour Survey*, scheduled cash earnings have increased, reflecting in part a rise in base pay, which was seen for two consecutive years (Chart 5). According to various survey results, summer bonuses this year were raised in many sectors and firms. As a result, the employment and income situation has been improving steadily, and consumer sentiment, which deteriorated after the consumption tax hike in 2014, has been on an improving trend on the whole (Chart 6). Private consumption for the April-June quarter was somewhat weak due to lackluster sales of small cars and the effects of bad weather, but results of various sales statistics suggest that private consumption has turned to an increase since around July in many categories, and can be judged as being resilient on the whole.

With a virtuous cycle from income to spending in both the corporate and household sectors, Japan's economy through fiscal 2016 is likely to continue growing at a pace above its potential, which is currently estimated to be around 0.5 percent or lower. 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.

II. Price developments and the path toward achieving the price stability target of 2 percent

Current state of and outlook for prices

Let me turn to price developments. The year-on-year rate of change in the CPI for all items less fresh food, which was minus 0.5 percent just before the introduction of QQE, increased to as high as 1.5 percent in April 2014, excluding the effects of the consumption tax hike. However, as somewhat weak developments in private consumption continued after the consumption tax hike and crude oil prices declined substantially from the summer of 2014, annual CPI inflation declined and has been about 0 percent in recent months (Chart 7).

Nevertheless, the underlying trend in inflation has steadily improved, excluding the effects of the decline in energy prices. For example, the year-on-year rate of change in the CPI for all items less fresh food and energy has been positive for 24 consecutive months since October 2013, increasing to 1.2 percent this September. This was the first time since the late 1990s, when Japan's economy fell into deflation, that a continued price increase was seen. Meanwhile, the rate of increase in the daily or weekly price indices, such as for food and daily necessities, has followed an accelerating trend since this April. Firms' price-hiking has become widespread and sustained, as seen in the fact that the share of items in the CPI for which prices have risen has been outweighing that for which prices have declined by an increasing margin (Chart 8).

Monthly data for the CPI are susceptible to various factors, such as developments in import prices that reflect changes in energy prices and fluctuations in foreign exchange rates. On the other hand, the underlying trend in inflation is determined mainly by the output gap and medium- to long-term inflation expectations. From this perspective, significant changes that have not been seen in recent years are taking place. I will elaborate on these two aspects as follows.

Developments in the output gap

The output gap indicates the supply and demand balance of Japan's economy as a whole; that is, the extent to which capital and labor are utilized. Although capacity utilization has continued its increasing trend as the economy continues to recover moderately, the effects of the flattening of exports, reflecting the slowdown in emerging economies, have been observed recently (Chart 9). Meanwhile, labor market conditions have continued to tighten. This is partly because, reflecting firmness in domestic demand, the current economic recovery has been largely attributable to the nonmanufacturing sector, which is more labor-intensive than the manufacturing sector. Therefore, the output gap has steadily followed its improving trend, mainly on the labor side (Chart 10). Looking ahead, with the economy expected to continue growing at a pace above its potential, capital and labor utilization is likely to rise further and thereby the output gap is expected to continue improving further. Thus, upward pressure on prices stemming from the output gap is likely to increase steadily.

Developments in medium- to long-term inflation expectations

Let me move on to inflation expectations. Medium- to long-term inflation expectations appear to have been rising on the whole from a somewhat long-term perspective. Inflation expectations can be assessed from various market indicators and survey results. Although there are some indicators or results showing that inflation expectations have been somewhat weak, they have been flat on the whole recently, despite the significant decline in crude oil prices (Chart 11). In addition, it is important to analyze firms' and households' views on prices upon which they engage in economic activities. Since the turn of the fiscal year, firms' price-hiking behavior has been increasingly conspicuous. At the same time, households have come to accept price increases as well, against the backdrop of actual and prospective increases in their income. The increases reflect rises in wages, including base pay, which took place at many firms. This makes a striking contrast with the episode that occurred last April, when many firms attempted to raise their sales prices, only to back off rather quickly as demands faltered, perhaps because this move coincided with the consumption tax hike. As firms' and households' views on prices have changed clearly, especially since the turn of the fiscal year, a positive feedback between the increase in wages and the moderate rise in inflation is now firmly in place on the back of record profits.

Relationship between wage increases and inflation

I would like to elaborate on the relationship between wage increases and inflation of goods and services. Our experience shows that wage increases have been moving almost in parallel with inflation of goods and services (Chart 12). It often is said that, if wages do not match up with inflation, real income will decrease, thereby exerting negative effects on consumption. However, such developments, if they occur at all, will not last for long, at least in the economy as a whole. This is because, if they were to occur, consumption will decrease, making it difficult for firms to keep raising prices. In turn, if wages increase, firms will be urged to raise their sales prices in order to secure their profit margins, leading to higher inflation. Thus, there are only two scenarios in reality: either both wages and prices increase or neither wages nor prices increase. Wage increases and price rises are two sides of the coin, so to speak. QQE, which the Bank has been pursuing, is not intended to engineer increases merely in prices by any means. But rather, it is designed, in accordance with the mechanism of the economy, to realize a moderate inflation being accompanied with wage increases.

Looking ahead, as the Bank pursues QQE and the observed inflation rate rises, medium- to long-term inflation expectations are also likely to follow an increasing trend and gradually converge to around 2 percent – the price stability target. Accordingly, firms' wage- and price-setting behavior is expected to be more proactive, and inflation rates are likely to gradually rise accompanied by wage increases.

The year-on-year rate of change in the CPI for all items less fresh food is likely to be about 0 percent for the time being, due to the effects of the decline in energy prices and, as the underlying trend in inflation steadily rises and the effects of the decline in crude oil prices dissipate, the rate of increase is expected to accelerate toward 2 percent – the price stability target. Although the timing of reaching around 2 percent depends on developments in crude oil prices, it is projected to be around the second half of fiscal 2016, assuming that crude oil prices will rise moderately from the recent level. As shown in the October 2015 Outlook Report, the projected rates of increase in the CPI for fiscal 2015, 2016, and 2017 are 0.1 percent, 1.4 percent, and, excluding the direct effects of the scheduled consumption tax hike, 1.8 percent, respectively (Chart 1). Compared to the projections in the July 2015 interim assessment, the projected rates of increase in the CPI for fiscal 2015 and 2016 are lower due mainly to the effects of the decline in crude oil prices, but the projection for fiscal 2017 is more or less unchanged.

III. Risk factors regarding the outlook for economic activity and prices

I have so far explained the baseline scenario regarding the outlook for economic activity and prices. However, there are various uncertainties surrounding the economy, and I would like to touch on the risk factors that can affect the outlook for economic activity and prices.

The most important risk factor with regard to the outlook for economic activity is the slowdown in emerging economies, particularly in China. The Chinese economy is currently in the transition process from investment-driven high growth to consumption-driven stable growth. The industrial structure is also shifting from one centered on manufacturing to one on nonmanufacturing. It is in this context that economic activity in manufacturing has been sluggish recently, whereas that in nonmanufacturing maintains its robustness (Chart 13). With regard to short-term developments, the pace of increase in spending by local governments, whose deceleration was one of the sources of sluggishness in the Chinese economy in the first half of this year, has accelerated recently, due partly to instructions by the central government and the measures taken to facilitate the financing of local governments (Chart 14). It therefore is expected that the growth rate in China will accelerate toward next year.

That said, we have to bear in mind the risk that the structural problems, such as excess capacity in steel, automobiles, and other industries, will be protracted in the transition process toward stable economic growth. There is also an uncertainty about the impact of fiscal stimulus, depending on its composition, on boosting the economy. Even if the growth rate in China picks up, its impact on other economies in East Asia should be carefully assessed (Chart 15). In China, the relative weight of nonmanufacturing has been on the rise, and even within the manufacturing sector, domestic production of manufactured parts and products with high value-added, which were mostly imported previously, has been increasing. Against this background, the effects of the economic growth in China stimulating exports of other countries in East Asia via a trade channel have been getting smaller. Taking this into account, there remains uncertainty about the impact of the positive spillover from the recovery of the Chinese economy on other economies in East Asia.

As I described earlier, the slowdown in emerging economies already has been exerting downward pressure on Japan's exports and production, which already is incorporated in the baseline scenario. If the slowdown in emerging economies is within the range of our assumption, notwithstanding its negative impact, Japan's economy is expected to continue to grow, reflecting the steady increase in domestic demand and the positive impact of the decline in energy prices on real income. However, if the slowdown in emerging economies becomes much deeper than expected or prolonged, the negative impact on Japan's economy accordingly will be larger. What matters most is the impact on the business confidence of Japanese firms. If firms start to downsize their fixed investment plans or wage increases against the backdrop of increasing concerns over the developments in emerging economies, this will have a negative impact on the steady increase in domestic demand. Although this is currently one of the risk factors rather than a probable scenario, we are mindful of it.

When it comes to the impact on prices, the focal point is the developments in wage increases toward next fiscal year. As I described earlier, the rates of increase in wages and in prices move almost in parallel in the long run, and the underlying trend in inflation already has shown a clear improving trend. In order to maintain the real wages and income of households, it is important for the underlying trend in inflation to be reflected in wage increases, notwithstanding the recent seeming decline in the rate of change in inflation. In the baseline scenario, wage increases that are consistent with the trend inflation are expected. We are mindful of a downside risk, however, of firms becoming more cautious with regard to wage increases against the backdrop of uncertainties regarding developments in overseas economies, particularly emerging economies. There is also a downside risk that, in the case of insufficient wage increases, consumers will become more resistant to price increases on goods and services, pushing down the pace of inflation.

IV. Challenges toward overcoming deflation

Japan's economy has been improving steadily toward achieving the price stability target of 2 percent, but it is only halfway through and due attention needs to be paid to risk factors including developments in emerging economies. In my concluding remarks, I would like to touch on the challenges toward overcoming deflation and achieving the price stability target of 2 percent, particularly those of firms' behavior and monetary policy.

As I described earlier, firms are now enjoying record profits and the labor market can be considered to be in a situation of full employment. In light of the mechanism of the economy, under such favorable circumstances, firms are expected to increase business fixed investment for their future growth, and to raise wages to secure the labor force needed for the further expansion of business and production. Indeed, they continue to show a positive stance toward fixed investment, and wages have been rising moderately, including base pay increases. At the same time, however, the data to date give us an impression that the pace of increase in fixed investment and wages is not at a high enough level in light of record profits. The fact that firms are still restrained from spending amid a high level of profits is also evidenced from the ample cash they hoard, which has accumulated to an even higher level (Chart 16).

One of the reasons behind such restrained behavior of firms – exemplified by record profits mostly being used just to build up already ample cash rather than being used for fixed investment and wages – is that the deflationary mindset of firms still has not necessarily been removed. From a different perspective, firms tend to see the current high level of profits as windfall profits, being only transitorily helped by the current benign circumstances, and thus they restrain from taking advantage of them.

Given that Japan's economy has been mired in deflation for a long period of time, it is never easy to get out of such a situation and dramatically change firms' persistent mindset. But the direction is clear. Firms should be strongly encouraged to devise a new strategy that fits with the post-deflation era based on the prospect of Japan's economy overcoming deflation. In light of this prospect, firms' forward-looking actions, which were not sufficiently rewarded in the deflationary period, look quite promising. Firms should recognize that, without such actions, it will be difficult to generate profits in the future and to increase firms' value. Not all firms need to change at the same time. The more firms start to act in view of such a prospect, the more vibrant the economy will become. Some forward-looking firms have started to act already, and they will be rewarded in the end if such actions become widespread.

The Bank of Japan will definitely and decisively play its role to make this happen. For these past two and half years, the Bank has strongly committed to achieving the price stability target of 2 percent and has been pursuing QQE. Japan's economy has been improving steadily toward achieving the target. The Bank will continue the unprecedented large-scale monetary easing to achieve the target. As I explained, the Bank currently is of the view that the price stability target of 2 percent can be achieved through continuation of the current policy. At the same time, the Bank will continue to carefully assess economic activity and prices, recognizing downside risks to them, including the effects of the slowdown in emerging economies. The Bank will make the most appropriate policy decisions by scrutinizing the current situation of economic activity and prices and their outlook, various risk factors, and developments in financial and capital markets at every Monetary Policy Meeting. Let me reiterate that the Bank will make adjustments without hesitation if judged as necessary to achieve the price stability target of 2 percent at the earliest possible time.

Thank you.

Chart 1

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

y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2015	+1.2	+0.1	
Forecasts made in July 2015	+1.7	+0.7	
Fiscal 2016	+1.4	+1.4	
Forecasts made in July 2015	+1.5	+1.9	
Fiscal 2017	+0.3	+3.1	+1.8
Forecasts made in July 2015	+0.2	+3.1	+1.8

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

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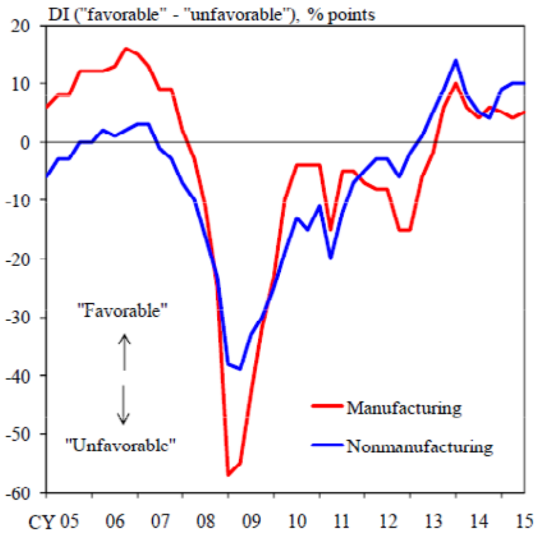
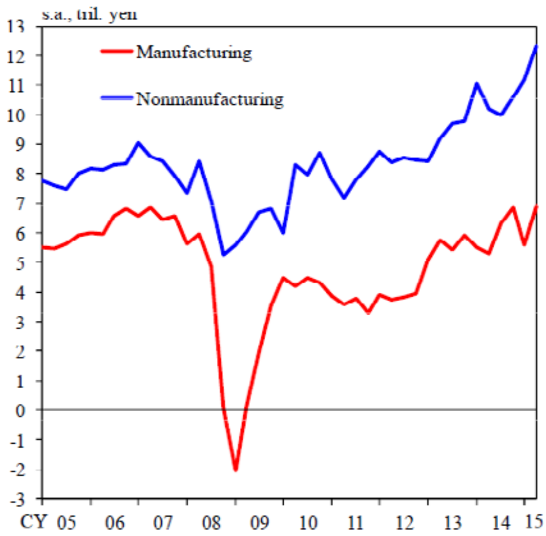
Chart 2

Business Sentiment and Corporate Profits

Tankan: Business Conditions DI



Current Profits



Note: Figures for current profits exclude those for the finance and insurance industry.
Sources: Bank of Japan; Ministry of Finance.

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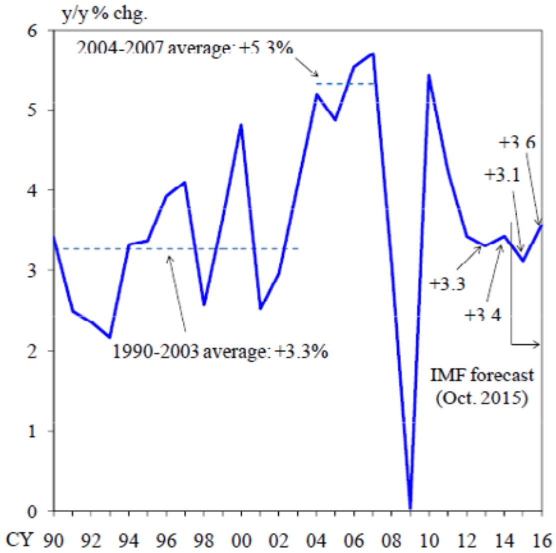
Chart 3

World Economic Outlook Released by the IMF

Real GDP Growth Rate



Projections for Major Economies

y/y % chg.

	2013	2014	Projections 2015	Projections 2016
World	3.3	3.4	3.1	3.6
Advanced Economies	1.1	1.8	2.0	2.2
United States	1.5	2.4	2.6	2.8
Euro Area	-0.3	0.9	1.5	1.6
Japan	1.6	-0.1	0.6	1.0
Emerging Market and Developing Economies	5.0	4.6	4.0	4.5
China	7.7	7.3	6.8	6.3
ASEAN5	5.1	4.6	4.6	4.9

Note: ASEAN5 are Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam.
Source: IMF.

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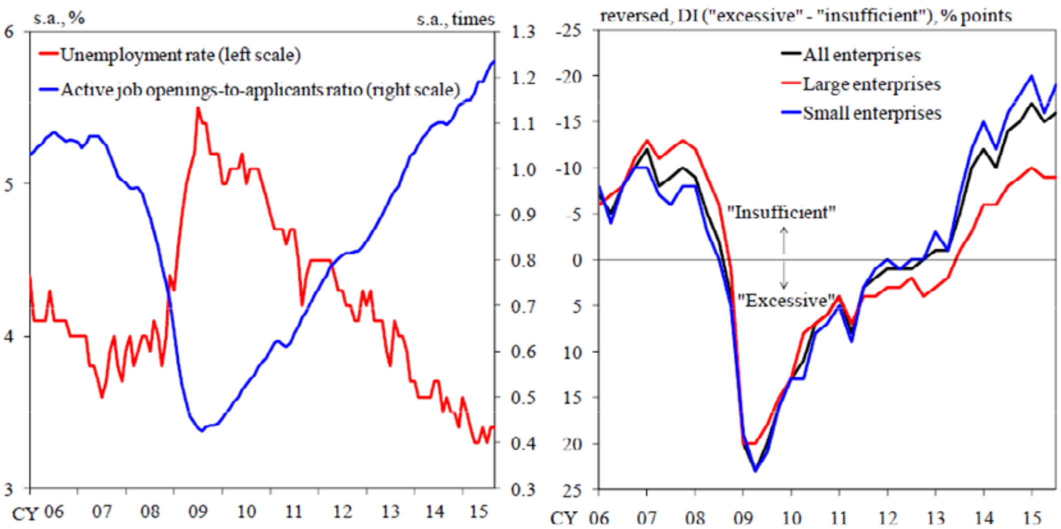
Chart 4

Labor Market Conditions

Unemployment Rate and Job Openings-to-Applicants Ratio

Tankan: Employment Conditions DI



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

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Chart 5

Wages

Scheduled Cash Earnings

Summer Bonuses

y/y % chg.

Survey conductor	FY2015 summer
Japan Business Federation (Keidanren)	2.8
Nikkei Inc.	2.1
The Institute of Labour Administration	3.0
Ministry of Health, Labour and Welfare	4.0

Note: The figure for scheduled cash earnings for 2015/Q3 is the July-August average.
Sources: Ministry of Health, Labour and Welfare; Japan Business Federation (Keidanren); Nikkei Inc.; The Institute of Labour Administration.

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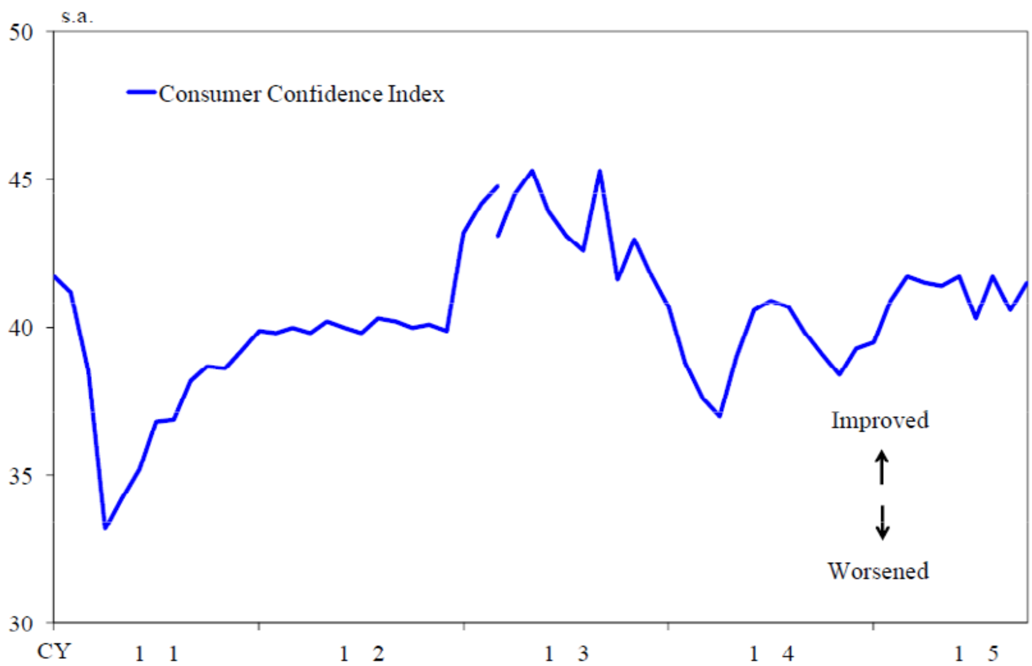
Chart 6

Consumer Confidence



Source: Cabinet Office.

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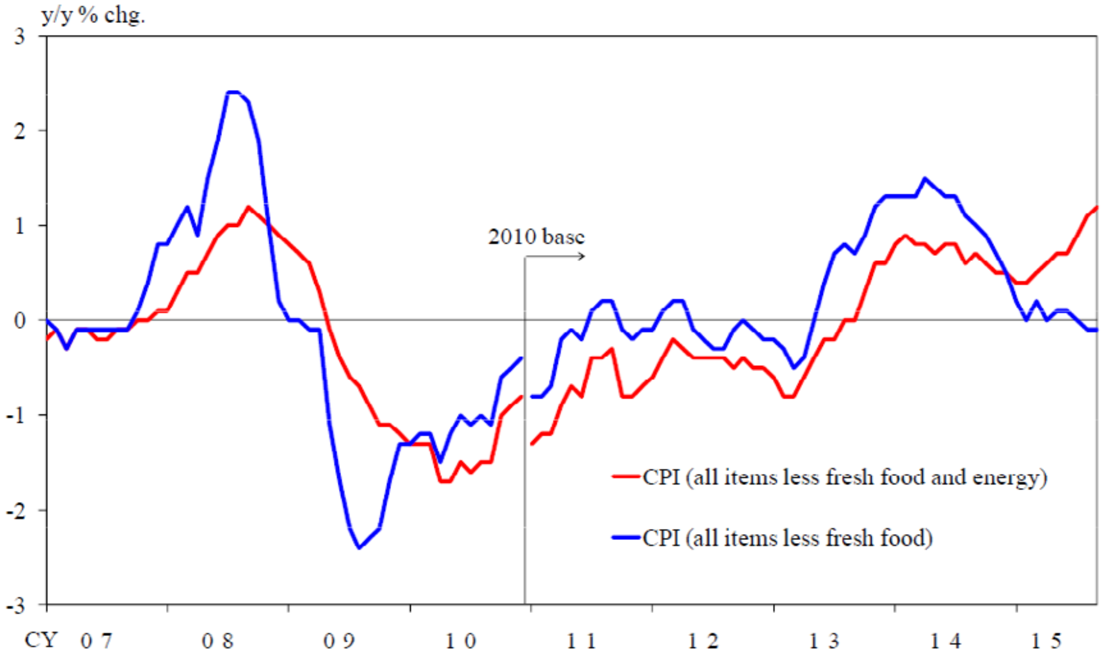
Chart 7

Consumer Prices



Note: Figures are estimated by adjusting the direct effects of the consumption tax hike in April 2014.
Figures for the CPI (all items less fresh food and energy) are calculated by the Research and Statistics Department, Bank of Japan.
Source: Ministry of Internal Affairs and Communications.

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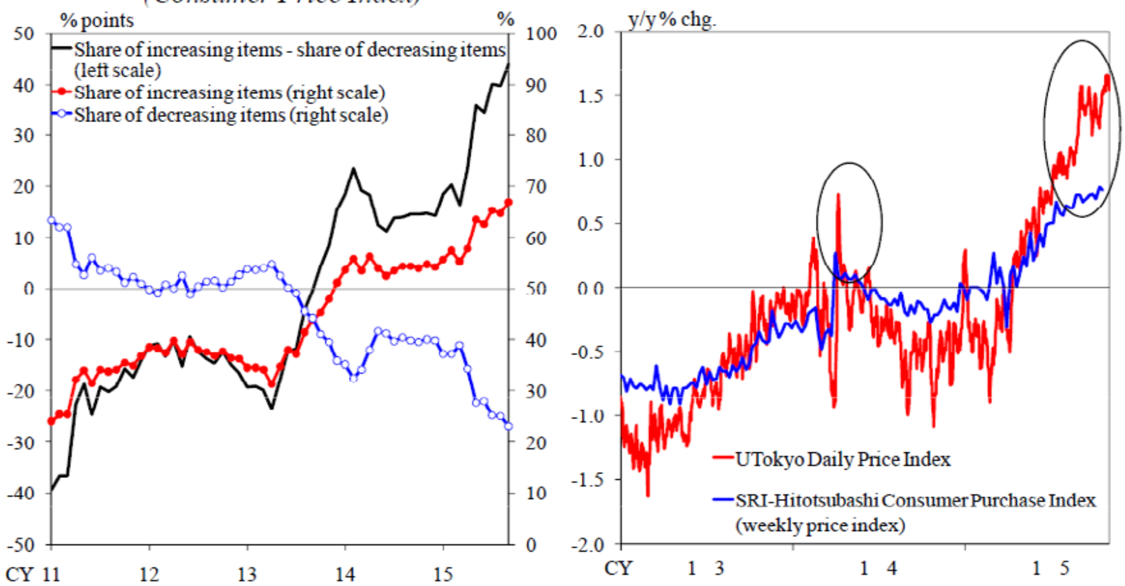
Chart 8

Price Developments

Share of Increasing and Decreasing Items (Consumer Price Index)

UTokyo Daily Price Index and SRI-Hitotsubashi Consumer Purchase Index



Notes: 1. The share of increasing/decreasing items is the share of items in the consumer price index (all items less fresh food) whose price indices increased/decreased from a year earlier. The price indices are estimated by adjusting the direct effects of the consumption tax hike in April 2014.
2. The UTokyo Daily Price Index is a 7-day backward moving average.
Sources: Ministry of Internal Affairs and Communications; UTokyo Daily Price Index Project; Research Center for Economic and Social Risks, Institute of Economic Research, Hitotsubashi University.

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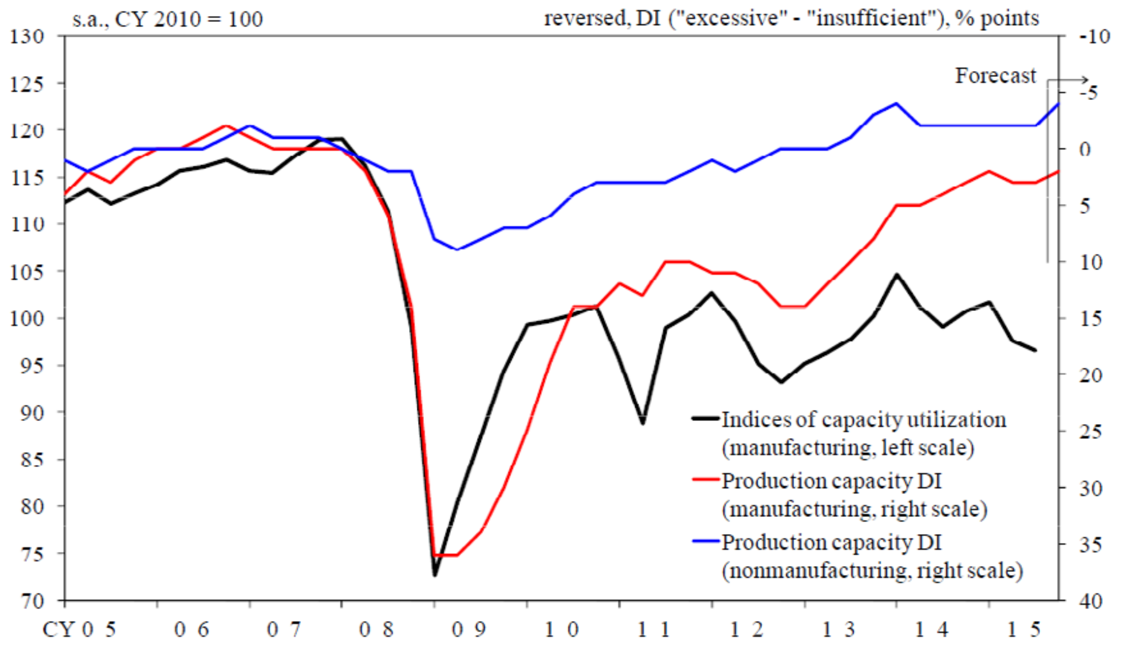
Chart 9

Indices of Capacity Utilization



Note: The figure for 2015/Q3 for the indices of capacity utilization is the July-August average.
Sources: Ministry of Economy, Trade and Industry; Bank of Japan.

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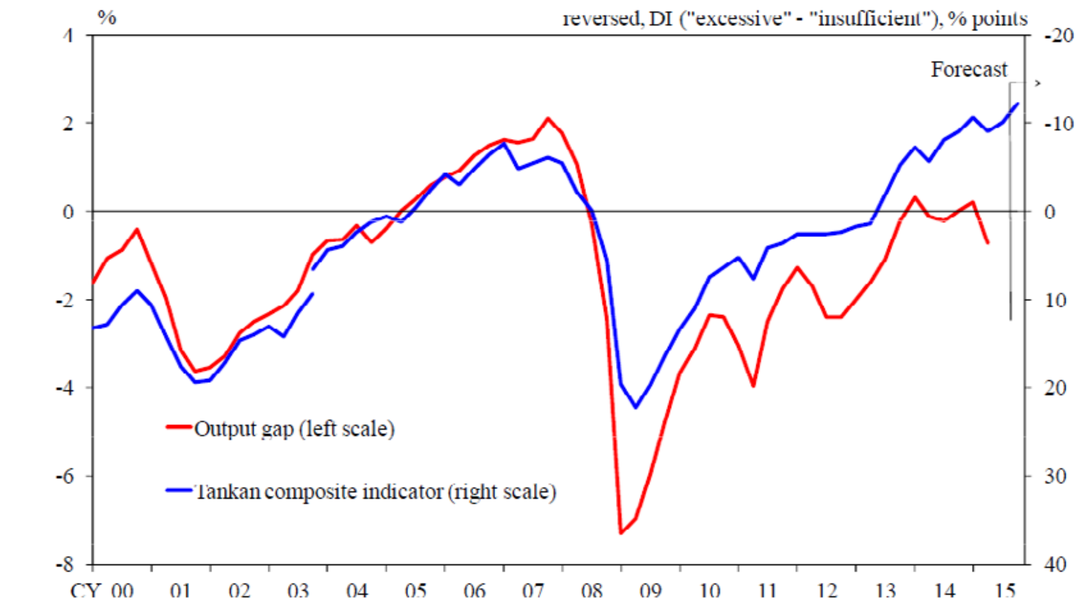
Chart 10

Output Gap



Notes: 1. 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.
2. The Tankan composite indicator is calculated as the weighted average of the production capacity DI and employment conditions DI for all enterprises. The fiscal 1990-2013 averages of capital and labor shares in the "National Accounts" are used as weights. There is a discontinuity in the data for the December 2003 survey due to a change in the survey framework.
Sources: Cabinet Office; Bank of Japan, etc.

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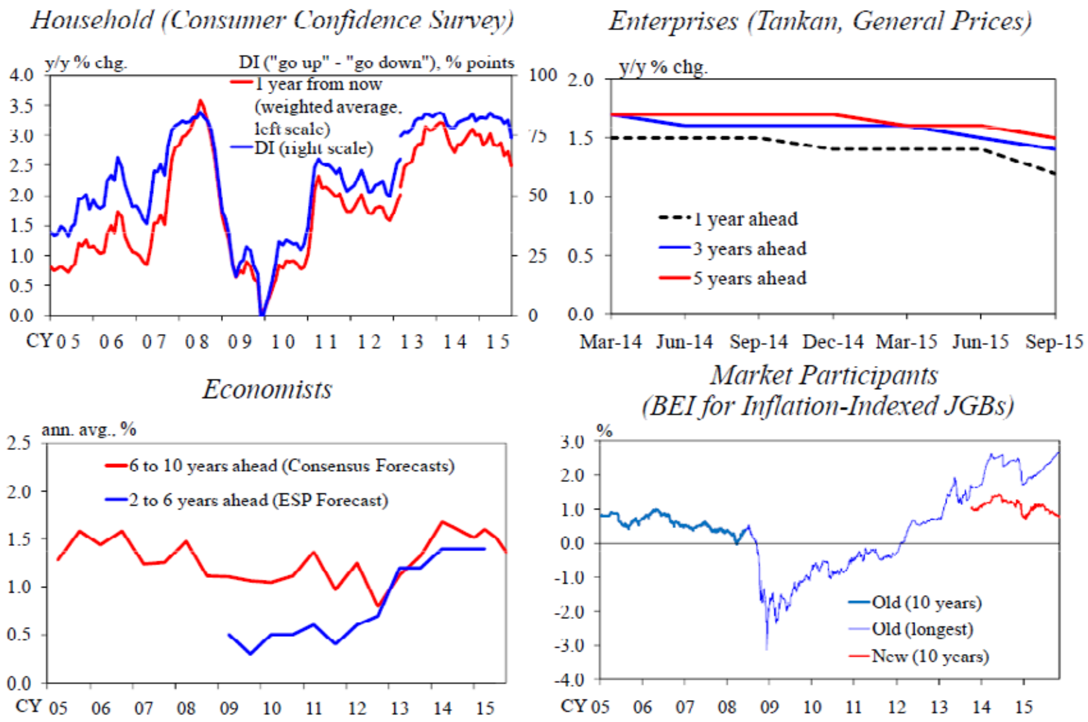
Chart 11

Inflation Expectations



Sources: Cabinet Office; Bank of Japan; Consensus Economics; JCER; Bloomberg.

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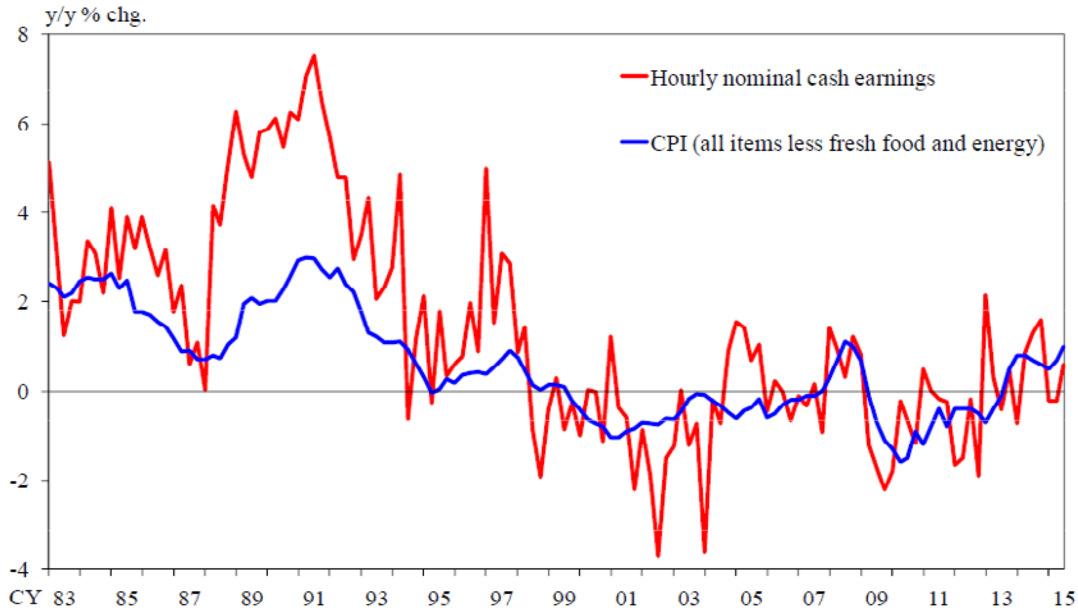
Chart 12

Wages and Prices



Notes: 1. Figures for hourly nominal cash earnings up through 1990/Q4 are for establishments with 30 or more employees.
2. Figures for the CPI (all items less fresh food and energy) are calculated by the Research and Statistics Department, Bank of Japan. Those are adjusted to exclude the estimated effect of changes in the consumption tax rate.
3. Figures for 2015/Q3 are July-August averages.

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

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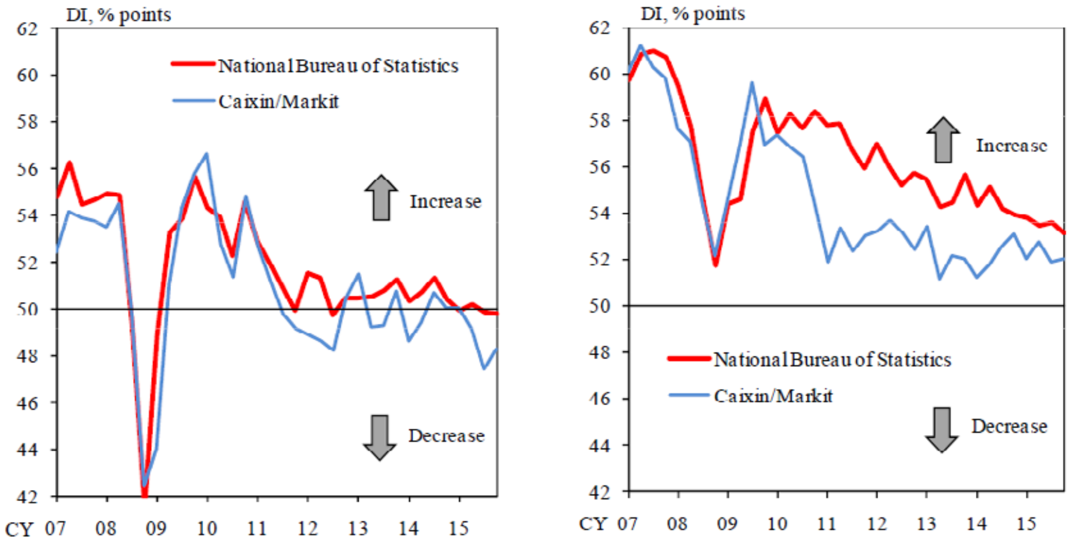
Chart 13

China's PMI

Manufacturing *Nonmanufacturing*



Sources: CEIC; Markit (© and database right Markit Economics Ltd 2015. All rights reserved.)

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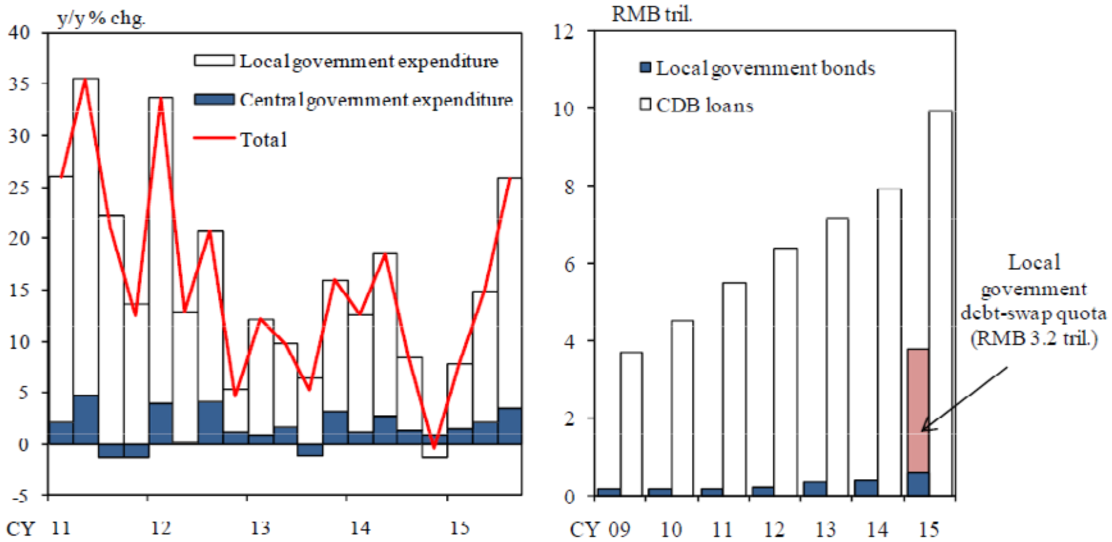
Chart 14

China's Fiscal Position

Government Expenditure *Local Government Bond Issuance and China Development Bank Loans*



Note: The amount of local government bonds for 2015 is based on the budget draft, and the amount outstanding of CDB loans is based on the prospect by the authority.
Sources: CEIC, Ministry of Finance of the People's Republic of China, China Development Bank.

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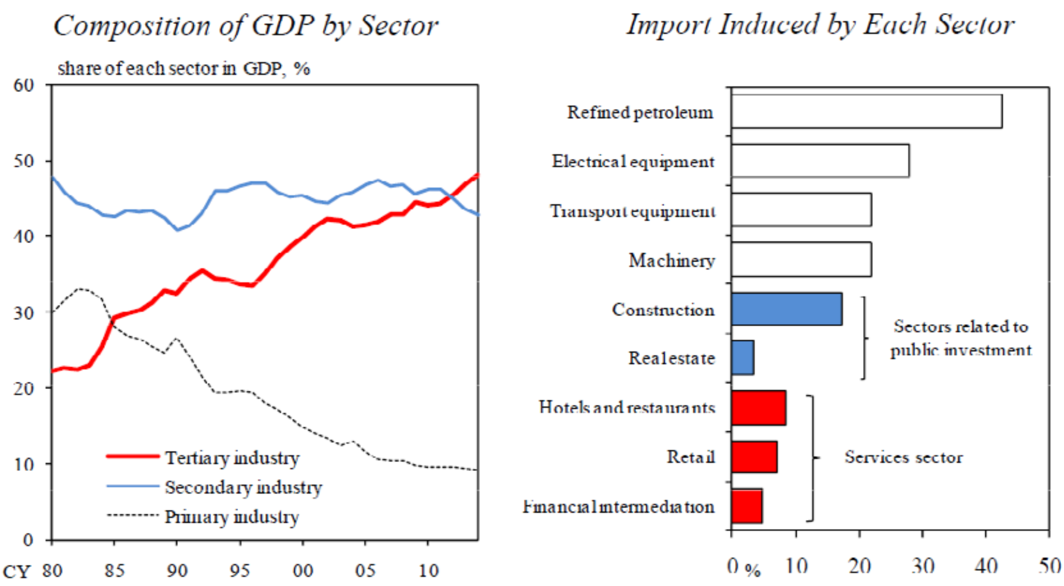
Chart 15

Structural Changes in Chinese Economy



Note: Import induced by each sector refers to the reaction of value-added in a foreign country in response to one unit increase of the final demand in each sector.
Sources: CEIC; WIOD.

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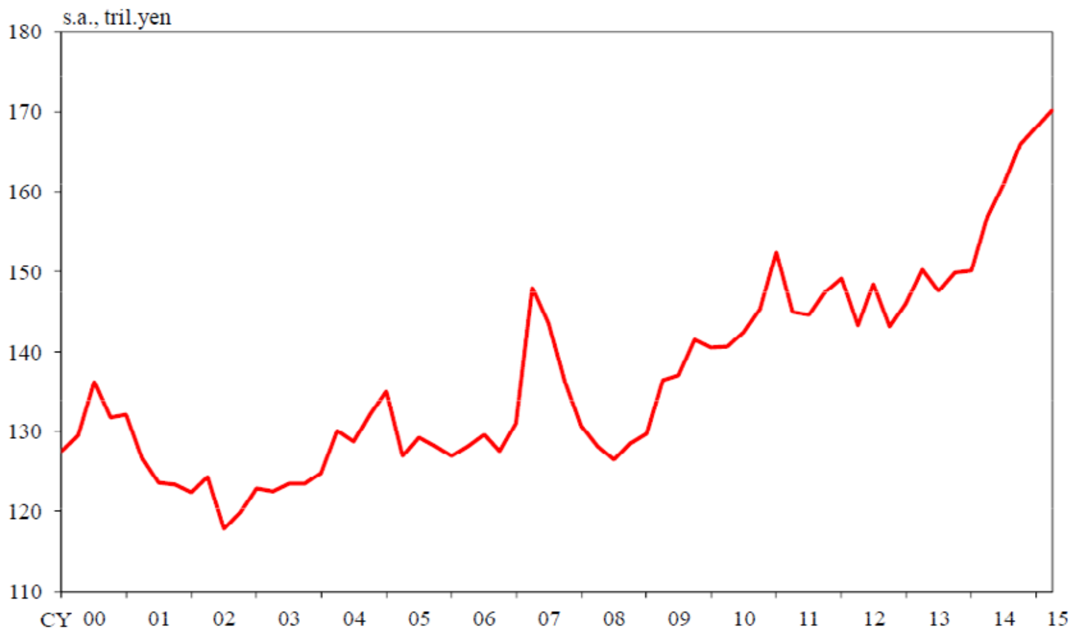
Chart 16

Cash Hoarding by the Corporate Sector



Note: Figures exclude those for the finance and insurance industry.
Source: Ministry of Finance.

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