Haruhiko Kuroda: Outlook for Japan's economy and 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, 13 May 2016.

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Introduction

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

I would like to express my sincere condolences to the victims of the Kumamoto Earthquake and offer my heartfelt sympathies to those who are suffering. The Bank of Japan continues to provide its central banking services seamlessly following the earthquake – including the supply of cash and business operations at teller windows in its Kumamoto Branch as well as the operation of the Bank of Japan Financial Network System (BOJ-NET) used for funds settlement among banks – and is making efforts to maintain the financial infrastructure. With the support and cooperation of relevant parties, most of the branches of the financial institutions in the disaster area have been able to resume their operations, and the financial and settlement systems there are functioning in an organized manner. At the Monetary Policy Meeting (MPM) held in April 2016, the Bank decided to introduce a funds-supplying operation for financial institutions in disaster areas affected by the Kumamoto Earthquake at a total loan amount set at 300 billion yen, with a view to supporting them in their efforts toward meeting demand for funds for restoration and rebuilding. This operation will surely contribute to backing the restoration and rebuilding.

The Bank introduced "Quantitative and Qualitative Monetary Easing (QQE) with a Negative Interest Rate" at the January 2016 MPM. Since the turn of the year, global financial markets have been volatile against the backdrop of the further decline in crude oil prices and uncertainty such as over future developments in emerging and commodity-exporting economies, particularly the Chinese economy. Meanwhile, there was an increasing risk that an improvement in the business confidence of Japanese firms and conversion of the deflationary mindset might be delayed and that the underlying trend in inflation might be negatively affected. In order to preempt the manifestation of this risk and to maintain momentum toward achieving the price stability target of 2 percent, the Bank judged it necessary to implement an extremely powerful policy scheme. In fact, following the introduction of "QQE with a Negative Interest Rate," the policy effects on interest rates already have been seen; namely, a substantial decline in the Japanese government bond (JGB) yields and resulting declines in benchmark rates for business lending and in interest rates on housing loans. Going forward, these effects are likely to steadily spread to both the real economy and the price front. However, uncertainty over emerging economies has been strong and volatile developments in financial markets, including the stock market and yen exchange rates, have continued to be seen. Today, I would like to first explain the Bank's view on Japan's economic activity and prices under this situation and then elaborate on how it is going to implement the new policy framework of "QQE with a Negative Interest Rate."

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

Developments in the corporate sector

Let me start by discussing the current situation of Japan's economic activity and its outlook. At the MPM held in April, the Bank released the *Outlook for Economic Activity and Prices* (Outlook Report) and published its projections for Japan's economic activity and prices through fiscal 2018. I would like to give you the overview of this Outlook Report.

Developments in the corporate sector to date show that the pick-up in exports has paused recently due to the slowdown in overseas economies. As for business sentiment, manufacturers have become cautious mainly in the sectors that are closely linked to emerging economies, and the pace of improvement in corporate profits of manufacturers seems to have decelerated. On the other hand, nonmanufacturers' profits have followed a clear rising trend, partly because the decline in crude oil prices has led to an improvement in the terms of trade; thus, current profits in the corporate sector as a whole have remained at high levels. Firms maintain their positive stance toward fixed investment on the back of the high corporate profits. According to business fixed investment plans shown in the March 2016 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), investment made both by large and small firms in fiscal 2015 is likely to have increased on a year-on-year basis by about 10 percent and about 4 percent, respectively. Moreover, the plans for fiscal 2016 are relatively favorable (Chart 1).

With regard to the outlook for overseas economies, advanced economies are likely to continue to see a firm recovery trend, mainly in the United States. Meanwhile, emerging economies are expected to remain in a state of deceleration for the time being, but move out of their deceleration phase with positive effects of firm growth in advanced economies spreading. The Chinese economy is likely to broadly follow a stable growth path, albeit at a somewhat reduced pace, as authorities – having relatively large room for monetary and fiscal policy – have proactively been carrying out economic stimulus measures. Against this background, Japan's exports are projected to head toward a moderate increase, although sluggishness is likely to remain for the time being. In the meantime, business fixed investment is projected to continue to see a moderate uptrend, mainly due to continued high levels of corporate profits along with the further decline in real interest rates under "QQE with a Negative Interest Rate," an increase in growth expectations, and a rise in demand related to the 2020 Tokyo Olympic and Paralympic Games.

Improvement in the employment and income situation, and wide-spread wage increases

I would next like to explain developments in the household sector. Favorable corporate profits have steadily exerted positive effects on the employment and income situation. The tightening trend of labor market conditions is becoming clearer: the active job openings-to-applicants ratio has been 1.30 times recently, marking the highest level seen since 1991, and the unemployment rate has declined to 3.2 percent, which is the lowest level seen since 1997 (Chart 2). A perception of labor shortage suggested by the employment conditions DI in the March *Tankan* has heightened further, which can be regarded as full employment. The major feature of recent economic activity is that labor market conditions continue to tighten despite the sluggishness observed in exports and production.

In this situation, upward pressure has continued to be exerted on wages (Chart 3). In this spring's labor-management wage negotiations, or so-called *shunto*, it is almost certain that base pay will be raised for a third consecutive year. Although the rise in large firms is likely to be somewhat less than that of last year, wage increases seem to be spreading to small firms and non-regular employees, including part-time employees. This can be explained by the fact that, at small firms, mobility of employment is relatively high and wages are susceptible to the effects of labor market conditions. In addition, firms continue to be willing to return their profits to their employees in the form of bonuses. Thus, the high corporate profits have continued to positively affect employee income.

Against the background of steady improvement in the employment and income situation, private consumption has been resilient, although relatively weak developments have been seen in some indicators, due in part to a deterioration in consumer sentiment, reflecting volatile developments in financial markets. Private consumption is likely to increase moderately as the employment and income situation continues improving.

Outlook for economic activity presented in the April Outlook Report

Turning to the outlook for Japan's economic activity based on the developments explained so far, although sluggishness is expected to remain in exports and production for the time being, domestic demand is likely to follow an uptrend, and exports are expected to increase moderately on the back of emerging economies moving out of their deceleration phase. Thus, Japan's economy is likely to be on a moderate expanding trend. Taking into account the fluctuations due to a front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike planned in April 2017, the expected growth rates during the projection period are in the range of 1.0–1.5 percent for fiscal 2016, slightly positive for fiscal 2017, and about 1 percent for fiscal 2018 (Chart 4). Comparing the current projections through fiscal 2017 with those in the January 2016 Outlook Report, GDP growth is somewhat lower, influenced mainly by weaker exports that reflect the slowdown in overseas economies.

II. Current situation of prices and their outlook

Next, I will touch on price developments.

The year-on-year rate of change in the consumer price index (CPI, all items less fresh food), which had been 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 private consumption continued to be relatively weak after the consumption tax hike and as a result of a substantial fall in crude oil prices since summer 2014, the year-on-year rate of change has declined and currently is around 0 percent (Chart 5). Nevertheless, excluding the effect of the decline in energy prices, the underlying trend in inflation has improved steadily. For example, the year-on-year rate of change in the CPI for all items excluding fresh food and energy has remained positive for 30 consecutive months since October 2013, and was 1.1 percent in March 2016. This is the first time since the late 1990s, when Japan's economy fell into deflation, that sustained price increases have been seen.

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. Therefore, an assessment that takes account of the underlying trend in inflation and economic developments behind such trend is necessary in the Bank's monetary policy management. To this end, the output gap, which is one of the factors that determine the underlying trend in inflation, is more or less unchanged, as the tightening of labor market conditions has continued while an improvement in manufacturers' capacity utilization rates has been delayed against the background of the sluggishness in exports and production. Going forward, the output gap is expected to move into positive territory and gradually increase further from the second half of fiscal 2016, albeit with fluctuations due to the front-loaded increase in demand prior to the consumption tax hike, with an increase in capacity utilization rates as exports and production are likely to pick up. Thus, upward pressure on wages and prices due to the tightening of supply-demand conditions is likely to steadily increase.

Medium- to long-term inflation expectations, which represent another determinant of the underlying trend in inflation, have weakened recently, although they appear to be rising on the whole from a somewhat longer-term perspective. Market indicators – such as break-even inflation (BEI) rates calculated using yields of inflation-indexed JGBs – as well as results of various surveys conducted of households, firms, market participants, and economists imply that inflation expectations have been declining since end-2015. In Japan, where, unlike the United States and Europe, inflation expectations are not anchored firmly at 2 percent, these indicators tend to be largely affected by the observed inflation rate, financial market sentiment, and developments in crude oil prices. When assessing developments in inflation expectations, it is necessary to grasp firms' actual wage- and price-setting behavior as well.

On this point, firms have maintained their willingness to increase prices since last year in spite of low all-item CPI inflation due to the decline in energy prices. Consumers seem to be accepting the price increases, benefitting from an improvement in the employment and income situation. Taking anecdotal evidence into account, firms seem to be maintaining their willingness to increase prices in a situation where a base-pay rise for a third consecutive year is likely to be confirmed. The mechanism in which inflation rises moderately accompanied by wage increases has been operating steadily.

Looking ahead, as the Bank pursues "QQE with a Negative Interest Rate" 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. Against this backdrop, firms' wage- and price-setting stance is likely to shift further toward raising wages and prices, and with an acceleration in wage increases, inflation rates are expected to rise gradually.

Specifically, the year-on-year rate of change in the CPI (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, accelerate toward 2 percent. Meanwhile, assuming that crude oil prices will rise moderately from the recent level, it is likely that the contribution of energy items to the year-on-year rate of change in the CPI will decrease gradually from the current level of slightly more than minus 1 percentage point, but remain negative until the beginning of fiscal 2017. Based on this assumption, the timing of the year-on-year rate of change in the CPI reaching around 2 percent – the price stability target – is projected to be during fiscal 2017. Thereafter, the year-on-year rate of change in the CPI is likely to be around 2 percent on average. As shown in the April 2016 Outlook Report, the projected rate of increase in the CPI for fiscal 2016 is 0.5 percent, and excluding the direct effects of the scheduled consumption tax hike, those for fiscal 2017 and 2018 are 1.7 percent and 1.9 percent, respectively (Chart 4). Comparing these projections with those in the January 2016 Outlook Report, the projected rate of increase in the CPI for fiscal 2016 is lower, mainly reflecting downward revisions in projections for real GDP growth and wage developments, but that for fiscal 2017 is more or less unchanged.

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

Risks to economic activity: uncertainties surrounding overseas economies

Thus far, I have explained the baseline scenario of the outlook for economic activity and prices that the Bank considers most probable. From now on, I will explain risk factors that could affect the baseline scenario.

The most important risk factor regarding the outlook for economic activity would be developments in overseas economies. The outlook for emerging economies, particularly China, and commodity-exporting economies, including countries in the Middle East, Brazil, and Russia, remains uncertain. The Chinese economy is likely to follow a generally stable growth path, underpinned by proactive economic stimulus measures by the authorities, but if adjustments in excess production capacity are prolonged, that may delay the recovery of the emerging economies, particularly those in Asia, mainly through the trade channel (Chart 6). Meanwhile, although anxiety over crude oil prices marking a bottom has waned recently, uncertainty over both the demand and supply sides remains heightened (Chart 7). In addition, attention continues to be warranted on developments in the U.S. economy and the impact on global financial markets of expectations over the pace of future rate hikes by the Federal Reserve in reflection of the developments in the economy. Europe faces uncertainty regarding such factors as the outcome of the debt problem in Greece and other countries as well as the possibility of the United Kingdom leaving the European Union – so-called Brexit.

If these risks were to materialize, there is a possibility that firms' positive stance toward investing in physical and human capital might be restrained through the effects of business confidence, and this point continues to warrant attention.

Risks to prices

One of the risk factors specific to prices is developments in medium- to long-term inflation expectations. The baseline scenario of the April 2016 Outlook Report assumes that, amid rises in observed inflation accompanied by wage increases, people's inflation expectations will rise further and gradually converge to around 2 percent – the price stability target. However, the pace of any future increase in wages and inflation expectations is uncertain during a prolonged period of low energy prices and no visible rises in annual all-item CPI inflation. In this regard, the following factors indicate that progress is being made in terms of dispelling the deflationary mindset – that is, the entrenched view that wages will not rise: (1) the certainty that a base pay increase will be achieved for a third consecutive year in this year's *shunto* and (2) the spread of wage increases to small firms. This progress is an encouraging change toward overcoming deflation. At the same time, this year's base pay increase is viewed as being somewhat less than last year's rise, mainly at large firms; therefore, the pace of wage increases is not felt at present as accelerating. Factors such as the slowdown in overseas economies and volatile developments in global financial markets since the turn of this year seem to have made firms hesitate to take one step forward.

Based on the fact that corporate profits remain at historical high levels and that labor shortages have been heightened under a "full-employment" condition, while the labor share remains below the long-term trend, wage increases may well be projected to accelerate. It is strongly expected that firms will proactively invest in human capital based on the prospects of a post-deflationary economy.

As I explained earlier, the Bank is of the view that the mechanism in which inflation rises moderately accompanied by wage increases has been operating steadily. As wage increases have been spreading to small firms, firms as a whole seem to have maintained their willingness to increase prices even after the turn of this fiscal year. Depending on consumers' attitude toward price increases, firms' price-setting stance could be positively or negatively affected. The Bank will carefully assess the developments in CPI after April without preconception.

IV. The Bank's monetary policy management

Lastly, I will explain the Bank's monetary policy.

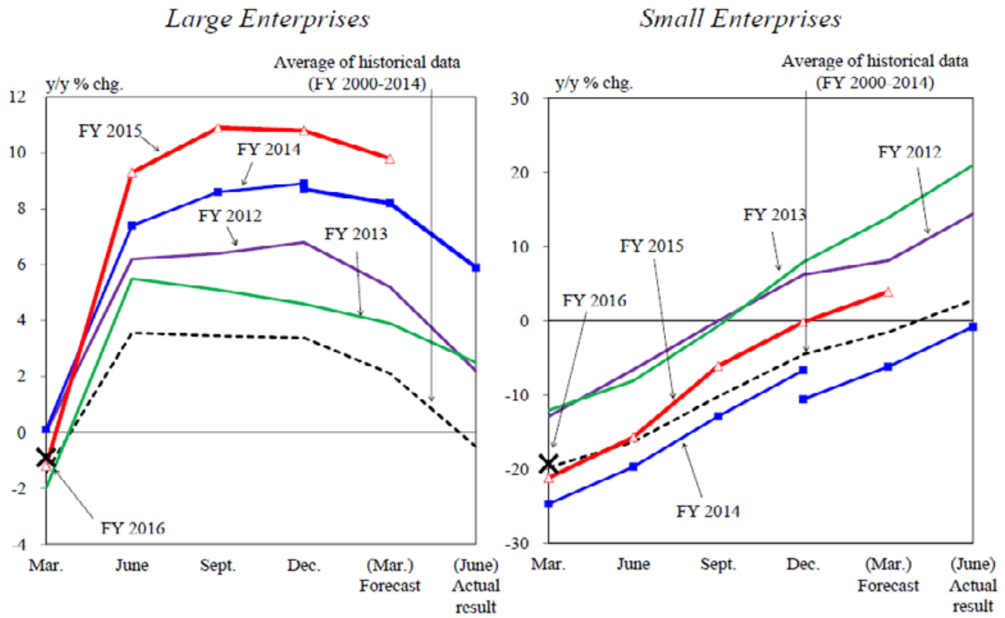
The Bank introduced "QQE with a Negative Interest Rate" at the end of January. Since then, yields on JGBs declined significantly, with rates up to a maturity of over 10 years having turned negative. Benchmark rates for business lending and interest rates on housing loans also declined clearly. Specifically, lending rates on 10-year fixed-rate housing loans have fallen to a level below 1 percent. In the March *Tankan*, financial institutions' lending attitudes as perceived by firms have improved further following the introduction of the negative interest rate policy, and firms' perception of borrowing costs is that these have declined notably to a degree that has not been seen for years (Chart 8). Issuance rates on CP and corporate bonds also have declined. A number of CPs have been issued with around zero interest rates, or even with negative rates in some cases, while long-term corporate bonds – with a maturity of ten years or longer in particular – are being issued with ultra-low rates recently (Chart 9). As such, the policy effects already have materialized in the form of declines in interest rates. These effects are expected to steadily spread to the real economy and inflation. Firms find themselves in an environment in which interest rates have never been lower. The financial conditions suggest that they face a once-in-a-lifetime chance for investment. Bearing this fact in mind, I acknowledge that firms' investment decisions critically should depend on the prospects for profitability of each project, which could be formed based on the outlook for medium- to long-term macroeconomic developments – in other words, growth expectations. In this context, unarguably, expanding the business frontier through, for example, regulatory reform is being called for to enhance said expectations. That said, it is by far the least convincing argument that the potential growth rate and growth prospects are too low for the economy to be stimulated by the current real interest rates, which are substantially negative. Looking at some specific data, *Financial Statements Statistics of Corporations by Industry, Quarterly* points to firms' profitability in terms of return on assets (ROA) at somewhere around 4 percent while average interest payments amount to only about 1 percent (Chart 10). Firms' ROA exceeds their funding cost by a larger margin than ever before. Among other points of evidence, we can reaffirm our progress made in the past three years. That is, negative real interest rates in fact have spurred the economy and raised prices significantly. As a result, we have come to a situation where the economy is no longer deflationary.

Even in normal cases, it takes some time to see the penetration of monetary policy effects. In circumstances such as those in evidence today, where global financial markets remain volatile, partly due to uncertainties regarding the outlook for emerging and commodity-exporting economies, it could be even more difficult for positive changes to emerge. Against this backdrop, at the April MPM, the Bank judged that it would be appropriate at present to examine the extent of the penetration of policy effects. To be clear, I am not saying that the Bank will stand pat until the policy effects can be confirmed. Rather, I would like to offer reassurance regarding the strength of monetary policy. Namely, we will take monetary policy measures in a timely, forward-looking manner. Risks to the outlook are tilted to the downside owing to (1) uncertainty over the global economy, particularly emerging economies, (2) volatile developments in financial markets, and (3) the repercussions on business sentiment. The Bank will continue to carefully examine these risks to economic activity and prices at each MPM, and take additional easing measures without hesitation in terms of three dimensions – quantity, quality, and the interest rate – if it is judged necessary for achieving the price stability target. "QQE with a Negative Interest Rate" is an extremely powerful policy scheme and there is no doubt that ample space for additional easing in each of these three dimensions is available to the Bank. It will carefully consider how to make the best use of the policy scheme in order to achieve the price stability target of 2 percent, and will act decisively as we move on.

Thank you.

Chart 1

Tankan: Business Fixed Investment Plans

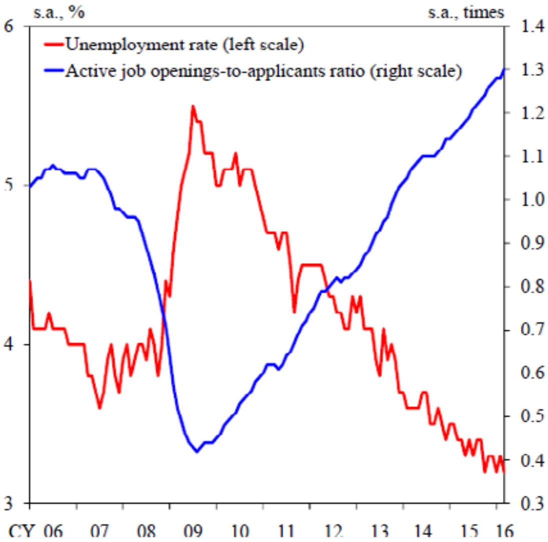


Note: Figures include land purchasing expenses and exclude software investment.
Source: Bank of Japan.

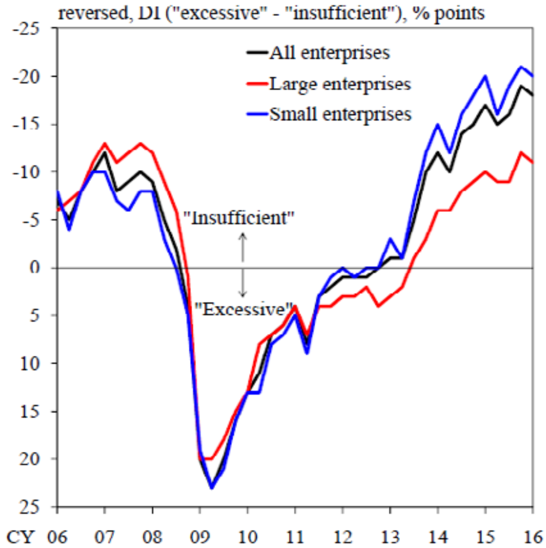
1

Labor Market Conditions

Unemployment Rate and Job Openings-to-Applicants Ratio



Tankan: Employment Conditions DI

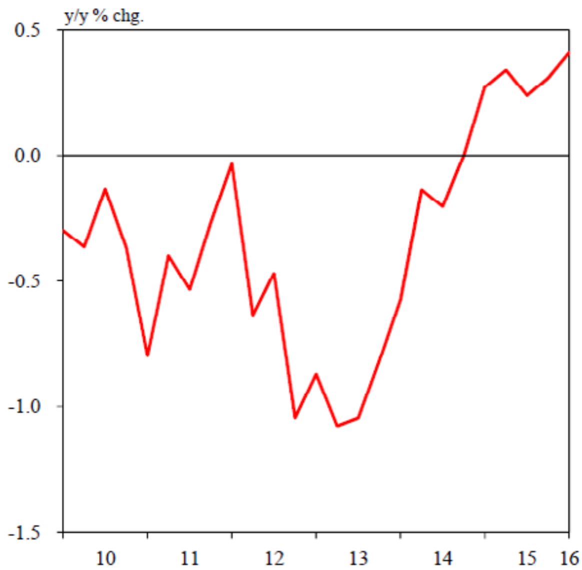


Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Bank of Japan.

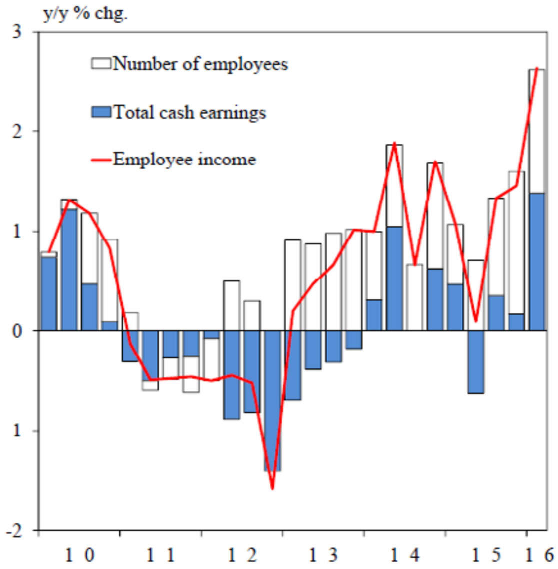
2

Wages

Scheduled Cash Earnings



Employee Income



Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. Figures for 2016/Q1 are those of March.
2. Figures for "employee income" are calculated as the "number of employees" (Labour Force Survey) times "total cash earnings" (Monthly Labour Survey).

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

3

Outlook for Economic Activity and Prices (as of April 2016)

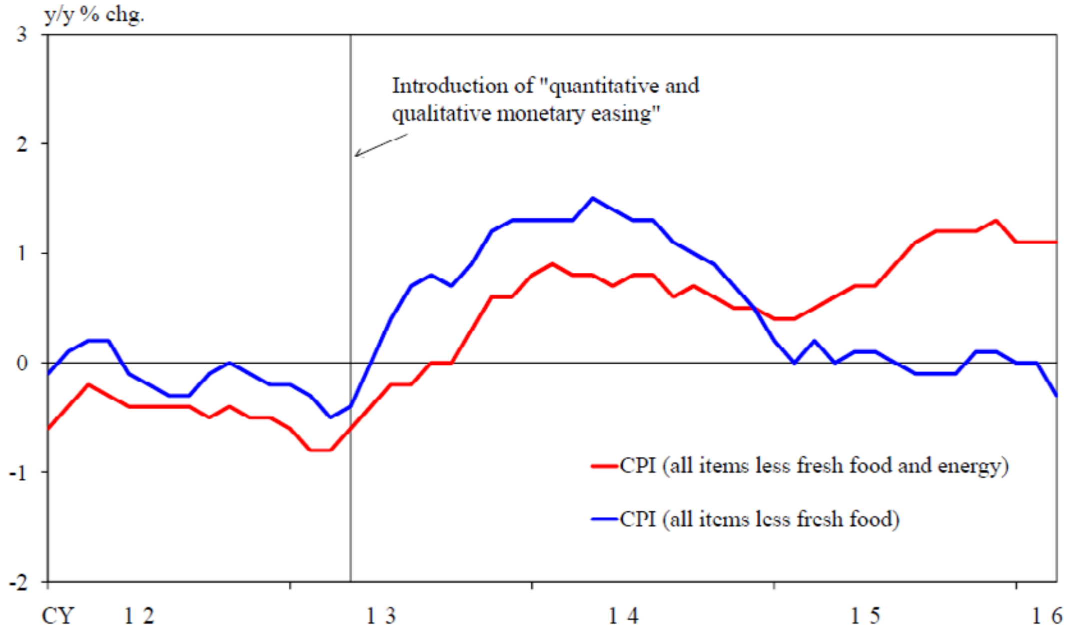
y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2015	+0.7	0.0	
Forecasts made in January 2016	+1.1	+0.1	
Fiscal 2016	+1.2	+0.5	
Forecasts made in January 2016	+1.5	+0.8	
Fiscal 2017	+0.1	+2.7	+1.7
Forecasts made in January 2016	+0.3	+2.8	+1.8
Fiscal 2018	+1.0	+1.9	

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

4

Consumer Prices



Note: Figures are adjusted to exclude the estimated effects of changes in the consumption tax rate.
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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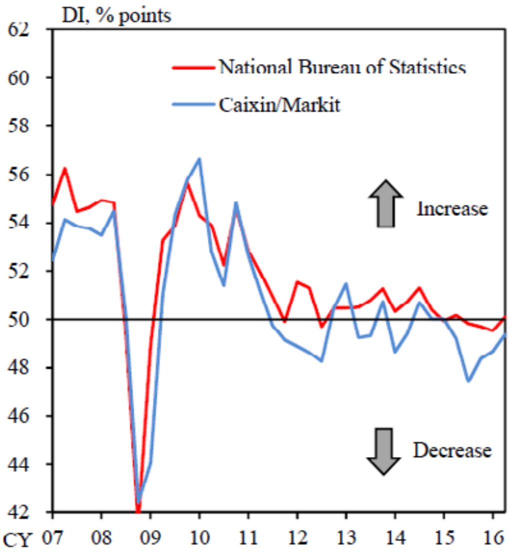
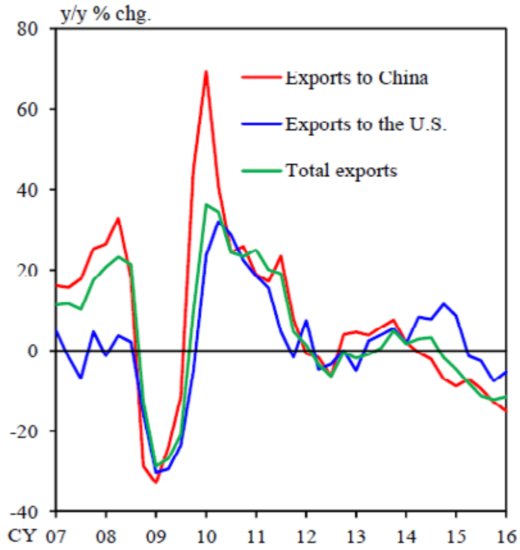
China's PMI and Exports from NIEs and ASEAN

China's PMI (Manufacturing)



Exports from NIEs and ASEAN



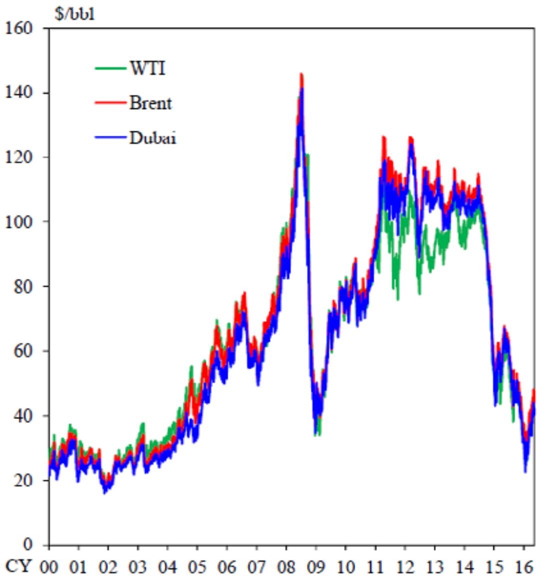
Notes: 1. Figures for China's PMI for 2016/Q2 are those of April.
2. Figures for exports from NIEs and ASEAN are based on nominal dollars.
Sources: CEIC, Markit (© and database right Markit Economics Ltd 2016. All rights reserved.)

6

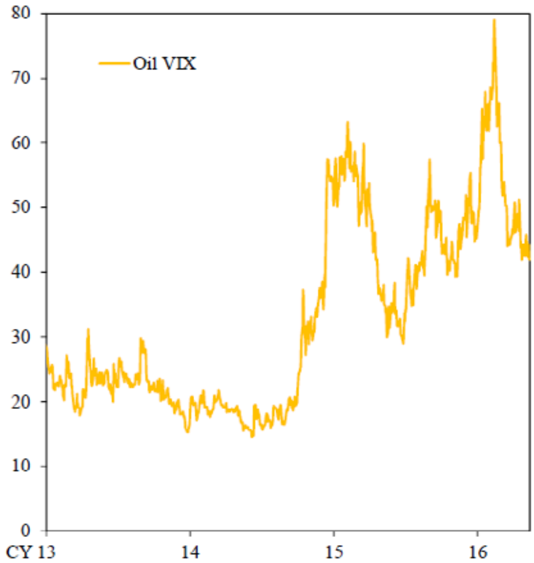
Chart 7

Crude Oil Markets

Crude Oil Prices



Volatility Index



Source: Bloomberg.

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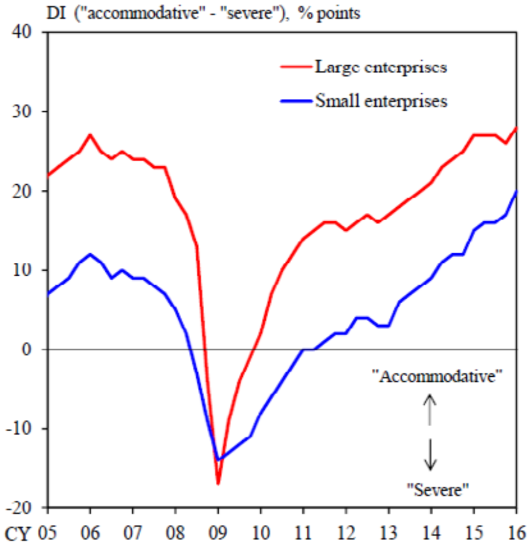
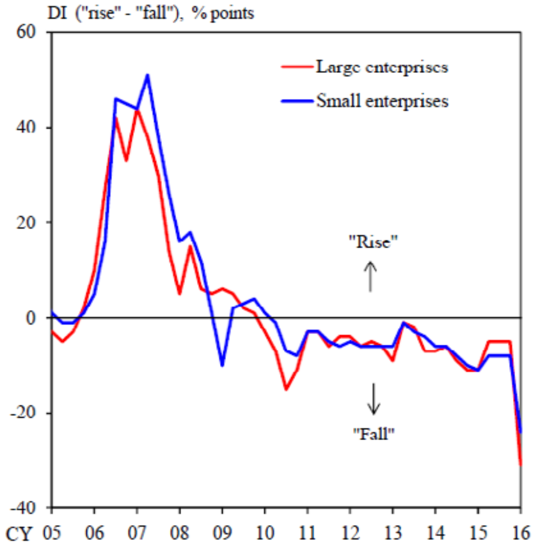
Chart 8

Funding Conditions (1)

Tankan: Lending Attitude of Financial Institutions



Tankan: Change in Interest Rate on Loans



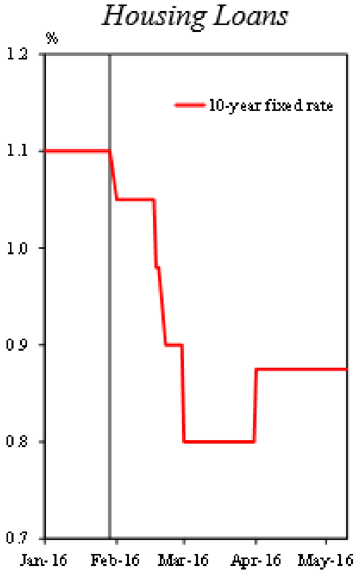
Source: Bank of Japan.

8

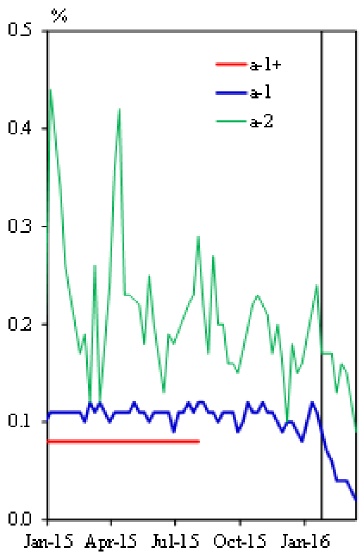
Chart 9

Funding Conditions (2)

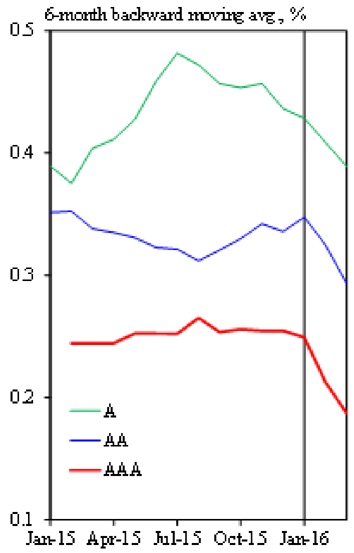
Lending Rates on Housing Loans



Issuance Rates on CP



Issuance Rates on Corporate Bonds



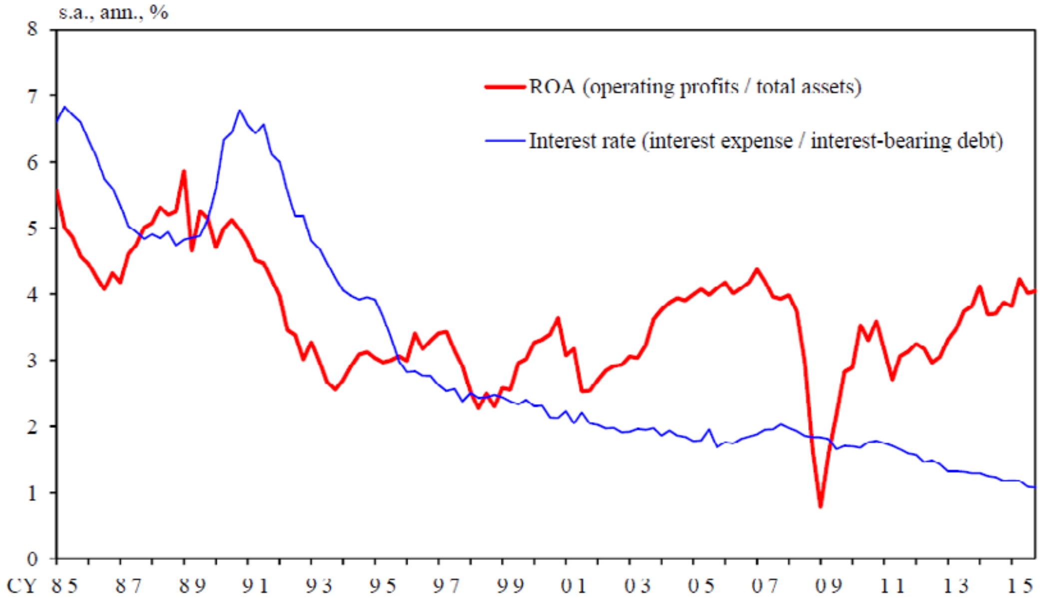
Notes: 1. The vertical lines in the charts indicate the announcement of the introduction of "QQE with a Negative Interest Rate."
2. Figures for lending rates on housing loans are the medians of lending rates of 6 large banks. The 6 large banks are Mizuho Bank, The Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui Banking Corporation, Resona Bank, Sumitomo Mitsui Trust Bank, and Shinsei Bank.
3. Figures for issuance rates on CP are weekly weighted averages. Rating information is obtained basically from R&I. CP issued by financial institutions and ABCP are excluded.
4. Figures for issuance rates on corporate bonds are the averages for domestically issued bonds launched on a particular date. Bonds issued by banks and securities companies, etc., are excluded. Bonds are classified based on the highest rating among the ratings from Moody's, S&P, R&I, and JCR. Breaks in a line indicate periods when bonds were not issued for six or more months.

Sources: Related private banks' web sites; Japan Securities Depository Center; Capital Eye; I-N Information Systems.

9

Chart 10

ROA and Interest Rate



Note: Figures are taken from the "Financial Statements Statistics of Corporations by Industry, Quarterly," and are the total for enterprises of all sizes and in all industries. The finance and insurance industries are excluded. Interest-bearing debt is the sum of long- and short-term borrowings, corporate bonds, and bills receivable discounted outstanding.

Source: Ministry of Finance.

10