Takahide Kiuchi: Recent developments in economic activity, prices and monetary policy

Speech by Mr Takahide Kiuchi, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Yamanashi, 23 February 2017.

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I. Economic Activity and Prices in Japan

A. Current Situation of Economic Activity and Prices and the Baseline Scenario of the Outlook

The Bank of Japan explains the current situation of Japan's economic activity and prices and the baseline scenario of the outlook in the Statement on Monetary Policy, which is released after each Monetary Policy Meeting (MPM), and in the *Outlook for Economic Activity and Prices* (the Outlook Report), which is published quarterly. Next, I will provide an overview of the current developments in and outlook for economic activity and prices based on the latest Outlook Report released in January 2017.

Japan's economy has continued its moderate recovery trend. As for the outlook, it is likely to continue growing at a pace above the potential growth rate through the projection period — that is, through fiscal 2018 — on the back of highly accommodative financial conditions and the effects of the government's large-scale stimulus measures, with the growth rates in overseas economies increasing moderately. Comparing the current projections with the previous ones, the projected growth rates are somewhat higher, mainly reflecting improvement in overseas economies and the yen's depreciation, in addition to an upward revision to the GDP due to the comprehensive revision to GDP statistics.

The year-on-year rate of change in the consumer price index (CPI) for all items less fresh food has been about 0 percent. Regarding the outlook, it is likely to increase from about 0 percent and become slightly positive, reflecting developments in energy prices. Thereafter, it is expected to increase toward 2 percent as the aggregate supply and demand balance (the output gap) improves and medium- to long-term inflation expectations rise. Comparing the current projections with the previous ones, the projected rates of increase in the CPI (all items less fresh food) are more or less unchanged. The timing of the year-on-year rate of change in the CPI (all items less fresh food) reaching around 2 percent will likely be at the end of the projection period — that is, around fiscal 2018.

B. My Outlook

I believe that Japan's current growth rate and inflation rate are generally stable, in light of the economy's growth potential, and that there is a high probability of this stable situation continuing during the projection period in the January 2017 Outlook Report. However, it can be said that my view continues to be fairly cautious compared with the medians of the Policy Board members' forecasts.

Let me explain the reasons behind my view. First, there is not a driving force — including in terms of the effects of monetary easing — that will bring about economic growth that is sustainable at a level clearly higher than the potential growth rate, as the phase of economic recovery has been prolonged and the output gap has already almost closed. The economy is therefore likely to continue growing generally at about the same level as the potential growth rate, which is estimated to be around 0.5 percent. Second, as a result of these factors, the output gap is expected to remain more or less at a neutral level. Therefore, in my view, price conditions will remain consistent with the economy's growth potential, as it is difficult to expect that there will be a marked rise in the underlying trend in inflation, which excludes factors causing temporary fluctuations, such as in fresh food prices and energy prices, as well as in import prices that are affected by changes in foreign exchange rates.

1. Considerations regarding the economic outlook

I consider that Japan's economy is likely to continue growing generally at about the same level as the potential growth rate throughout the projection period that covers through fiscal 2018. In my view, however, risks are skewed to the downside, especially at the end of the projection period. I will now explain risks to the economic outlook to which I pay particular attention.

a. Overseas economies and exports

Points to be considered regarding overseas economies include (1) the U.S. fiscal policy and its global impact, (2) the possibility of protectionist policies spreading around the world, (3) China's lagged response to structural problems such as excess debt and excess production capacity, and (4) the vulnerability of the banking sector in Europe.

Among these, I am particularly paying attention to the U.S. fiscal policy and its global impact. Since fall 2016, the possible implementation of large-scale fiscal policy in the United States has been factored into financial markets, which has in some way contributed to the improvement in the economic sentiment worldwide. However, the detail and scale of such fiscal policy are still unclear, and it may take considerable time for them to be revealed. Moreover, reflecting the decline of the U.S. economy's presence, due mainly to growth in emerging economies, the effects of the U.S. fiscal policy on the global economy may actually be less than what financial markets expect. On the other hand, it is also possible to say that, due to the worldwide rise in long-term interest rates, which was triggered by a rise in U.S. long-term interest rates, the "crowding out" effect of the U.S. fiscal policy has been produced on a global scale. Ultimately, if negative effects — such as (1) the downward pressure exerted by the worldwide rise in long-term interest rates on each economy and (2) the destabilization of financial markets caused by an outflow of funds from emerging markets in response to the appreciation of the U.S. dollar — outweigh the positive effects of the U.S. fiscal policy on each economy, this could cause a negative impact on the global economy as a whole.

In addition to such developments in overseas economies, it should be noted that Japan's economy has been increasing its momentum on the back of the pick-up in exports since the latter half of 2016. I therefore consider that the export environment poses the most serious downside risks to Japan's economy. In relation to this, my understanding is that there is a possibility that the potential volatility of yen exchange rates has risen toward both appreciation and depreciation in the foreign exchange market after the introduction of Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control in September 2016, and I am paying attention to the possible effects of these developments on the export environment.

b. Business fixed investment

The first point to be considered regarding business fixed investment is developments in foreign exchange rates. Specifically, if the yen appreciates in the foreign exchange market as a result of investors' risk aversion having increased globally, due in part to developments in overseas economies, this could in turn deteriorate corporate profits, thereby having the effect of constraining business fixed investment.

The second point is that medium- to long-term growth expectations for Japan's economy might not be raised as much as expected, depending on, for example, the progress made with respect to promotion of labor force participation of women and the elderly as well as the government's growth strategy and the private sector's initiatives in strengthening the economy's growth potential.

c. Private consumption

The first point to be taken into account regarding private consumption is price developments. Namely, given that nominal wages continue to grow only moderately, there is a possibility that, if there are increases in prices — such as a surge in fresh food prices, a rise in energy prices, and an increase in import prices due to the yen's depreciation — households' outlook for real wages will deteriorate, thereby exerting downward pressure on private consumption.

Second, if corporate profits decrease due to the yen's appreciation, or if the economy's potential growth rate and firms' growth expectations for the domestic market wind up being lower than expected, firms might become more cautious about wage raises, which could in turn restrain private consumption.

2. Thinking behind the outlook for prices

Let me turn to the year-on-year rate of change in the CPI (all items less fresh food). The Bank's baseline scenario is that the timing of the rate of change reaching around 2 percent will likely be at the end of the projection period — that is, around fiscal 2018. On the other hand, my view is much more cautious than the baseline scenario: the year-on-year rate of change in the CPI (all items less fresh food) will likely remain well below 2 percent throughout the projection period through fiscal 2018. I therefore have been casting a dissenting vote on the description on the price outlook in the Statement on Monetary Policy and the Outlook Report and submitting a proposal to change the description at MPMs.

I will explain what lies behind the difference between the Bank's baseline scenario and my view. The first is the difference in the outlook for the output gap. The baseline scenario assumes that the output gap will improve as a trend and upward pressure on prices stemming from demand-supply conditions is likely to be exerted noticeably. As I mentioned, however, economic growth that is clearly above the potential growth rate is not easily sustainable, and therefore I consider that the notable improvement in the output gap is unlikely.

The second is the difference in the outlook for medium- to long-term inflation expectations. The baseline scenario is that medium- to long-term inflation expectations are likely to follow an increasing trend and gradually converge to around 2 percent. However, the inflation rate is still at a low level, and this most probably will restrain the rate of increase in wages resulting from the wage negotiations between workers and management this coming spring. I therefore take the view that medium- to long-term inflation expectations will be more or less unchanged from the current level for the time being.

The third is the difference in the outlook for services prices. Administered prices and some services prices seem to be not particularly responsive to the changes in demand-supply conditions, and these prices continue to show dull responses even amid the tightening of labor market conditions. In particular, housing rent has declined at a moderately accelerated pace recently, and it is my view that this might possibly constrain the inflation rate.

The fourth is the difference in the outlook for the effects of the yen's depreciation. According to the baseline scenario, the observed inflation rate is expected to rise, due in part to the recent yen depreciation. In this regard, I consider that, in light of the experience since 2013, although foreign exchange rates seem to have an increasing impact on inflation through import prices — reflecting structural changes such as the rise in import share of electrical parts that are used for the domestic production of electrical appliances — such rates will affect inflation for only a relatively short time and have a limited impact on the underlying trend in inflation.

The fifth is the difference in the outlook for wages. In my view, it is unreasonable to expect a noticeable rise in the rate of increase in wages from the wage negotiations between workers and management this coming spring. I also consider that, if the yen's depreciation and other factors cause a temporary rise in prices of items with high price volatility — such as energy-related products, food products, and electrical appliances — this more likely could result in a repeat of the situation in which a deterioration in consumer sentiment will result in weaker-than-expected private consumption, thereby restraining the inflation rate.

II. Conduct of Monetary Policy

In September 2016, the Bank conducted a comprehensive assessment of the developments in economic activity and prices as well as the policy effects since the introduction of QQE. Based on its findings, the Bank decided to introduce QQE with Yield Curve Control, which is a new monetary policy framework.

In my view, the introduction of yield curve control largely aimed at addressing some concerns that had arisen since the introduction of QQE with a Negative Interest Rate. These include the possibilities that the flattening of the yield curve at a low level might excessively squeeze banks' profits and that a substantial decline in interest rates at the long and super-long end will lower the rates of return on insurance and pension products and thereby might have a negative impact on economic activity through a deterioration in people's sentiment.

I consider that there is a positive aspect to yield curve control. For example, the Bank now has some latitude in terms of the pace of its purchases of Japanese government bonds (JGBs) because it changed the target for money market operations to short- and long-term interest rates upon the introduction of yield curve control. This leads to the possibility that the pace of JGB purchases will be reduced, thereby increasing the sustainability of such purchases.

However, as I will elaborate on shortly, my view is that there also are many negative aspects to yield curve control. Based on my examination and comparison of positive and negative aspects, I have been casting a dissenting vote on yield curve control since its introduction in September 2016 through the most recent MPM held in January 2017.

A. Assessment of Yield Curve Control

1. Issues regarding long-term interest rate control

I view the following as issues with regard to long-term interest rate control. First, under yield curve control, it is uncertain whether the pace of the Bank's JGB purchases will slow to an extent that would be sufficient to enhance the sustainability of such purchases; instead, there is a risk that the Bank might need to further increase the pace of its purchases. Since "quantity" and "interest rate" are generally determined simultaneously, my understanding is that it is difficult to conduct smooth money market operations while setting explicit targets for both dimensions. When the interest rate dimension is to be controlled, control over the quantity dimension could be lost. Therefore, the Bank's new policy framework can be explained as having taken this point into consideration, and non-rigid targets have been set on both the quantity and interest rate dimensions — indicating that an annual pace of increase in the amount outstanding of the Bank's JGB holdings should be "about" 80 trillion yen, and the target level of 10-year JGB yields is set at "around" zero percent. However, I regard this as entailing a high possibility that neither target will be achieved. Such a possibility is likely to materialize when there are external shocks to the JGB market. I therefore consider that the current upward pressure on Japanese long-term interest rates, which has been stemming from the rise in such rates in the United States since November 2016, is posing the first challenge for the Bank in controlling long-term interest rates.

Second, of the elements that constitute nominal long-term interest rates, only term premiums are considered to be directly affected by the adjustments in the pace of JGB purchases. However, since term premiums have been reduced to a considerable degree due to the Bank's JGB purchases to date, room for a further reduction is likely to be limited. On this basis, in order for the Bank to smoothly control nominal long-term interest rates while avoiding large fluctuations in the pace of its JGB purchases, one option is to make use of forward guidance regarding the future path of short-term interest rates. However, I believe that the longer the term of interest rates, the more likely the credibility of such forward guidance is lessened, thereby making it more difficult to control interest rates.

Third, controlling long-term interest rates at a certain level could undermine the automatic stabilizer function of the economy, which operates through fluctuations in interest rates. Compared with when long-term interest rates are not controlled, controlling these rates could increase the volatility in the economy and destabilize it. For example, in a case where a negative shock hits the economy and inflation expectations decline, if the Bank conducts an operation so that nominal long-term interest rates do not decline, such rates in real terms would rise in turn, thereby causing restraints on economic activity. In contrast, in a case where there is a positive shock to the economy and inflation expectations rise, if the Bank conducts an operation to constrain a rise in nominal long-term interest rates, such rates in real terms would decline in turn, thereby possibly producing an excessive stimulus to economic activity. In this regard, the Bank's monetary policy framework allows the Bank to make policy adjustments as appropriate, taking into account developments in economic activity and prices as well as financial conditions. However, I consider that, in reality, changing the target level of 10-year JGB yields is not easy. That is, if the target level is reviewed frequently, there is a risk that the credibility of the target might decline, leading to possible market volatility. Let me also note that, considering that the Bank is controlling not only short-term interest rates but also long-term ones in order to achieve the price stability target of 2 percent in a stable manner, it would be unreasonable to raise the target level of 10-year JGB yields in the near future when the inflation rate remains at a low level.

Fourth, if the Bank continues with its current pace of JGB purchases, I consider that there is a risk of falling into a spiral in which the liquidity in the JGB market will decline substantially and a resultant increase in the liquidity premium would lead to a rise in long-term interest rates, thereby causing the need for the Bank to further increase the pace of its JGB purchases.

Fifth, in my understanding, although the fixed-rate JGB purchase operations and fixed-rate funds-supplying operations with a long-term maturity could contribute to raising the Bank's ability to control interest rates, they could destabilize the JGB market through significant impairment of market functioning, as well as distort the pricing mechanism in overall financial markets. That is why I dissented from introducing these tools of market operations.

2. Adverse effects of the negative short-term policy interest rate

With regard to the adverse effects of guiding the short-term policy interest rate in negative territory, there is a risk that the financial intermediation function would be impaired through a deterioration in financial institutions' profits. I am concerned about such a risk, although it has not yet materialized, as this should be kept in mind if the negative short-term interest rate policy is to be prolonged.

Specifically, banks may take excessive risks at a time of profit deterioration in an attempt to increase their profits, but they may become excessively risk averse in the future, mainly because losses will be incurred by a possible worsening of economic and financial developments. This could negatively affect economic activity and financial markets by exacerbating firms' and households' borrowing constraints and through banks' fire sales of assets.

Furthermore, from a longer-term perspective, the impairment of banks' financial soundness might also have negative effects on the efficiency and productivity of the economy. To give an example, amid a continued decline in banks' profitability, banks with declining loss-absorbing capacity might postpone appropriate treatment of borrowers with weak performance. This may cause a situation in which capital and labor are being allocated to inefficient firms, and thus, in terms of the overall economy, result in pushing down the rate of increase in total factor productivity over the long run.

In consideration of these points, let me mention the following. Monetary policy is generally thought to affect the demand side of the economy. However, if the policy impairs financial system stability, the supply side of the economy — for example, the productivity growth rate and the potential growth rate — may also be adversely affected, causing significant losses in social welfare.

B. My Proposal Aimed at Enhancing the Stability and Sustainability of the Bank's JGB Purchases

I have been submitting a proposal, which includes the following: the Bank should set the amounts of its asset purchases as the target for money market operations, and with regard to the guidelines for asset purchases, it should purchase JGBs so that their amount outstanding will increase at an annual pace of about 45 trillion yen. Next, I will explain the idea behind the proposal.

The Bank has been purchasing large amounts of JGBs under QQE, and the share of its JGB holdings already has reached about 40 percent of the total outstanding amount of JGBs issued. On the other hand, financial institutions in Japan need to hold JGBs for a variety of reasons. For example, banks need to hold a certain amount of JGBs for such purposes as collateral for transactions and compliance with financial regulations. Pension funds are required to hold a certain portion of their investment assets as safe assets, like JGBs, with a view to structuring an appropriate portfolio. It is necessary for life insurance companies to hold a fair amount of JGBs, particularly super-long-term ones, for the purpose of asset-liability management (ALM) and of meeting accounting requirements, as they have very-long-term liabilities because of their life insurance products.

Therefore, it is not the case that the Bank is able to hold all of the JGBs issued. In my understanding, if the Bank continues with the current pace of JGB purchases, it inevitably will have difficulty in continuing to make such purchases. Moreover, there is a concern that the more difficult the JGB purchases become, the more easily interest rates will be volatile, as uncertainty over the future monetary policy increases and the liquidity in the JGB market declines excessively. This could have a serious impact on financial markets and economic activity. In order to prevent such incidents from occurring, I have been proposing since the MPM held in April 2015 to reduce the annual pace of increase in the amount outstanding of the Bank's JGB holdings from the current pace of about 80 trillion yen to about 45 trillion yen.

My understanding is that, since the introduction of yield curve control in September 2016, given that the Bank has temporarily reduced the pace of purchases of super-long-term JGBs, for example, market participants widely share the view that the Bank might proceed with the reduction in the pace of its JGB purchases as long as circumstances permit. It should be noted that one of the reasons why financial markets have stayed relatively calm despite such a view is that market participants are to some degree accepting the stock view — that is, the idea that the reduction in long-term interest rates and resultant monetary easing effects depend on a central bank's holdings of government bonds (stock) rather than the pace of bond purchases (flow).

Under these circumstances, I believe that the Bank should set the amounts of its asset purchases as the target for money market operations, and for the time being incrementally reduce the pace of its JGB purchases to the level at which the amount outstanding will be unchanged, instead of conducting yield curve control under which the controllability of the amount of its JGB purchases seems uncertain. This alternative measure will contribute to making the Bank's asset purchases more sustainable and enhancing market stability. By doing so, the Bank can keep long-term real interest rates stably at low levels and thereby secure the accumulated monetary easing effects seen so far, which I believe is most important for the Bank's monetary policy.

C. My View regarding the Price Stability Target and the Role of Monetary Policy

1. Need for the flexibility of the 2 percent price stability target

In addition to the proposal to change the guidelines for money market operations, I have been submitting a proposal to reset the time frame for achieving the price stability target of 2 percent to the medium to long term. I consider it appropriate to implement these two proposals together. Next, I will explain my view regarding the price stability target that lies behind my proposals.

First of all, I believe that the optimal inflation rate is at a level where households and firms can engage in economic activity in a stable manner without worrying about price developments. This rate is mostly consistent with medium- to long-term inflation expectations of households and firms. However, I should note that a wide range of indicators suggest that medium- to long-term inflation expectations have been clearly below 2 percent for a long time. I therefore consider it inappropriate at this point to aim at achieving the 2 percent price stability target in a short period of time — whereby the inflation rate will be maintained at around 2 percent in a stable manner — not only because this is unfeasible, but also because this will have a negative impact on the economic activity of households and firms.

2. Economic structure and the underlying trend in inflation

I would note that the underlying trend in inflation is considered to be determined by various factors, including the supply and demand balances in goods and services, developments in the labor market, the observed inflation rate, and the level of a central bank's inflation target. From a somewhat long-term perspective, it seems to be largely influenced by structural factors of the economy, such as the productivity growth rate and the potential growth rate.

For example, in a situation where the economy's potential growth rate and firms' growth expectations for the domestic market are at low levels, it is natural for firms to take a cautious stance toward raising base pay as such a raise could squeeze their profits in the future, and workers seem to acknowledge such a stance. In this situation, medium- to long-term inflation expectations of households and firms seem likely to be formed at low levels, thereby restraining the observed inflation rate at a low level as well. If, under these circumstances, the inflation rate were to rise temporarily due in part to the effects of monetary policy, consumers might restrain spending given concerns over the possible slower rate of increase in real wages, and as a result the observed inflation rate could decline in a short period of time.

In fact, it is difficult for monetary policy to directly bring about a positive change to the economic structure. To achieve such a change, it is necessary for firms to make efforts to enhance innovation and for the government to create initiatives for structural reforms, including deregulation that will encourage firms to make utmost efforts in that regard and measures to respond to the population decline. In order for the public to be able to enhance the quality of life in a sustainable manner, it is absolutely necessary that Japan's growth potential be strengthened through an improvement in the productivity growth rate and the potential growth rate.

3. Future role of monetary policy

If Japan's economy is able to achieve strong growth with further positive changes in economic structure going forward, households' and firms' medium- to long-term inflation expectations will rise to around 2 percent, and this will support the observed inflation rate continuing to be stable at around 2 percent. In this situation, it can be expected that it will become appropriate to set the price stability target at 2 percent. However, as it is difficult to project the time frame in which such a positive change in the economy will occur, I believe that the price stability target of 2 percent should be set as the target to be achieved in the medium to long term and be regarded as a kind of symbol in the Bank's aim, along with the government and firms, to realize a strong economy that is consistent with the 2 percent price stability target.

That being said, it seems difficult for the government and firms to make efforts to promote a positive change in economic structure under unstable financial and economic conditions. In this sense, my understanding is that the Bank's role is to ensure financial and economic stability, thereby consistently providing indirect support for efforts by the government and firms so that the economy's growth potential — which is represented mainly by the potential growth rate and the productivity growth rate — will increase to the level consistent with the 2 percent inflation rate. To this end, rather than aiming to strengthen monetary easing at any cost, it is more important to maintain the stable financial and economic environment by keeping long-term real interest rates at low levels in a stable manner and securing the monetary easing effects seen so far. My proposal to change the guidelines for money market operations, which I have been submitting at MPMs, is based on such a viewpoint. I believe that this proposal is in fact a quicker way of achieving the 2 percent price stability target.

4. Importance of flexible monetary policy conduct

It is important that the Bank, with the stance of aiming at achieving the price stability target of 2 percent in the medium to long term, conduct monetary policy in a flexible manner while paying close attention to risks such as an emergence of financial imbalances, in view of ensuring economic and price stability in the medium to long term.

In fact, the Bank conducts monetary policy, based on the framework of assessing economic activity and prices from two perspectives, in the context of the price stability target. Specifically, the first perspective is examining, as regards economic activity and prices over the next two years or so, whether the outlook deemed most likely by the Bank follows a path of sustainable growth under price stability. The second perspective is examining, in the longer term, various risks that are most relevant to the conduct of monetary policy aimed at achieving sustainable growth under price stability. In particular, financial imbalances will be examined as a risk that could significantly impact economic activity and prices when they materialize, although the probability of their emergence is not necessarily high.

It is fair to say that this framework was formulated in light of the lessons learned regarding the monetary policy conduct during the bubble period of the latter half of the 1980s. That was when policy action to address the accumulation of financial imbalances had been delayed in a situation where attention was focused on stable general prices at the time, and policy measures to achieve economic stability in the medium to long term were not implemented. I consider it necessary to recall the background and idea behind why the framework of assessing economic activity and prices from the two perspectives was established.

5. Responsibility of the Bank

Lastly, I will touch on the Bank's responsibility. I believe that the Bank has an important responsibility to make every effort to maintain financial and economic stability under the flexible price stability target and policy conduct. To this end, the Bank needs to normalize, at an appropriate timing, the unprecedented monetary policy that has been implemented since the introduction of QQE. The Bank also should carefully address various possible adverse effects of monetary easing — such as (1) turmoil in the JGB market stemming from a decline in liquidity, (2) a malfunctioning of financial intermediation under the low interest rate environment, and (3) a deterioration in the Bank's financial soundness in the case of a rise in the short-term interest rate while having a massive balance sheet — so as to prevent such adverse effects from materializing and having significant negative effects on Japan's economy and people's lives.