Yoshihisa Morimoto: Economic activity and prices in Japan and monetary policy

Speech by Mr Yoshihisa Morimoto, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Iwate, 29 August 2013.

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I. Recent financial and economic developments and price developments

A. Overseas developments

1. Overseas economies

First, I will talk about key developments in overseas economies that are likely to affect the outlook for Japan's economy. With the recovery in the U.S. economy starting to clearly gain hold, overseas economies as a whole are gradually heading toward a pick-up, although a lackluster performance is partly seen. As for the outlook, overseas economies are likely to start recovering, albeit at a moderate pace. However, amid sluggish growth in emerging economies, the pace of recovery is expected to remain moderate on the whole.

I will now consider each region in more detail.

2. U.S. economy

Despite downward pressure from the fiscal side, the U.S. economy has been on a moderate recovery trend against the backdrop of steady private demand. As for the employment situation, total nonfarm payroll employment has been increasing by almost 200,000 a month, and the unemployment rate has been on a downtrend. In the household sector, although the tax increase at the beginning of the year continues to have an effect, with the employment situation following an improving trend and asset prices rising, household spending, including private consumption and housing investment, has been firm. Taking a look at the corporate sector, business sentiment has been improving on the back of firm private demand, although the pick-up in production has been moderate partly reflecting a large cut in government expenditures. For the time being, close attention needs to be paid to fiscal issues – particularly the federal debt ceiling problem – and developments in financial markets as well as their effects on, for instance, housing investment. If household spending continues its uptrend, however, this could lead firms to gradually become more proactive, thus strengthening the recovery momentum of the economy as a whole. Furthermore, the benefits of the shale gas revolution could help boost economic activity, mainly by reducing the volume of crude oil imports, lowering energy prices, and increasing business fixed investment in related sectors.

3. Euro area economy

In the euro area, with the European debt problem dragging on, an adverse feedback loop among the fiscal situation, the financial system, and economic activity has taken hold – particularly in peripheral countries – and economic activity has receded slowly. Looking at unemployment rates, these range from as low as 6–7 percent in Germany to as high as 26 percent in Spain, indicating widening regional disparities in business sentiment. Recently, however, there have been gradually growing signs of a bottoming out. Business and consumer sentiment in the area – including peripheral countries – is improving in a situation where financial markets have stabilized somewhat and the European authorities have modified their stringent fiscal consolidation plans, temporarily easing the measures. Exports are also bottoming out, and GDP growth for the April-June quarter turned positive for the first time in seven quarters. With these developments continuing, the euro area economy is likely to bottom out and head toward a pick-up.

4. China’s economy

With regard to emerging economies, the Chinese economy continues to see stable growth against the background of firm domestic demand, as evidenced in particular by stable private consumption reflecting a favorable employment and income situation and by rising fixed asset investment, which is growing at a year-on-year rate of about 20 percent. Nevertheless, China’s economic growth rate has been at a relatively low level of around 7.5 percent. Underlying this are the structural reforms that the Chinese authorities are engaged in, which emphasize quality-based growth and lowering income disparities. Specifically, one area of focus is measures to curb the excess production capacity and the rapid expansion in credit accompanying the 4 trillion renminbi stimulus package implemented in the wake of the global financial crisis. The so-called shadow banking system is another focal point. The Chinese authorities are proceeding with policy responses to contain the risk of an overly rapid credit expansion through banks as well as non-banks. As a result, total social financing – a measure of aggregate credit supply to the economy mainly consisting of loans and corporate bonds – has been increasing at a slower pace. Although these structural reforms tend to restrain growth, the authorities have also made clear that they will remain vigilant regarding economic growth, stating that they will fine-tune policies in a timely manner to achieve a growth rate of about 7.5 percent for 2013. With the authorities aiming for well-balanced, sustainable growth, the Chinese economy is likely to continue growing steadily at the current pace.

5. Uncertainties regarding overseas economies

Uncertainties in overseas economies that require careful monitoring include (1) the effects of speculation about the direction of U.S. monetary policy on financial markets and on emerging and commodity-exporting economies, (2) developments in the Chinese economy, and (3) the prospects for the European debt problem.

In the United States, the Federal Reserve’s tapering of its asset purchases has become a matter of discussion. The background to this is the moderate but steady recovery in the U.S. economy, and this recovery itself is a positive development for the world economy. Furthermore, the Federal Open Market Committee (FOMC) has repeatedly conveyed the message that it will begin to adjust the pace of its asset purchases only when there continues to be substantial improvement in the outlook for the labor market. Although this stance of the Federal Reserve is gradually being understood in the market, market participants have in some cases withdrawn funds from markets in emerging and commodity-exporting economies in anticipation of an eventual tapering of the Federal Reserve’s asset purchases, and the risk of similar responses in the future remains. The world economy’s momentum for recovery is still weak, and there is high uncertainty regarding the possible effects on financial markets and economic activity in the event of a rapid outflow of funds.

As for the Chinese economy, a key point of focus is whether it will be able to maintain stable growth. Specifically, it is necessary to pay close attention to whether, in grappling with various challenges such as overcapacity in the manufacturing sector and income disparities to achieve stable growth, the authorities can restrain credit expansion, such as in the shadow banking system at a pace exceeding economic growth, while steadily proceeding with structural reforms and rebalancing the economy from investment to consumption.

Uncertainty regarding the European debt problem remains, even though the extreme tail risk of a potential disintegration of the euro, which some had feared at one time, has receded. However, market tensions could rise yet again if efforts to strengthen economic and financial union of the euro area and to push through fiscal reforms are seen to be in retreat. Political developments in euro member countries warrant vigilance, starting with the outcome of the German federal election scheduled in September. Geopolitical risks, particularly in the Middle East, also require close attention.

B. Japan’s economy and prices

1. Current state of and outlook for Japan’s economy

I will now explain the current state of, and outlook for, Japan’s economy given the overseas economic developments I have just outlined. Japan’s economy was relatively weak in the second half of 2012 as exports and production decreased mainly reflecting the deceleration in overseas economies, which in turn adversely affected domestic demand such as business fixed investment in the manufacturing sector. Economic conditions, however, have become favorable since the beginning of 2013. Recently, domestic demand, in particular public investment and private consumption, has been firm, exports have been picking up in a situation where overseas economies are gradually heading toward a pick-up, and industrial production is increasing moderately. Against this backdrop, the June 2013 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) showed a significant improvement in business sentiment not only in the manufacturing sector, which has greatly benefited from the correction of the yen’s appreciation, but also across a wide range of other sectors including nonmanufacturing, as well as upward revisions in firms’ business forecasts such as with regard to profits and fixed investment. Taking into account that the level of economic activity had been rising moderately and a virtuous cycle from income to spending had gradually started operating, the Bank of Japan, at the Monetary Policy Meeting held on July 10 and 11, 2013, raised its basic assessment of the domestic economy, from the assessment that the economy “has been picking up” to the assessment that it “is starting to recover moderately.”

As for the outlook, exports are expected to increase moderately, mainly reflecting the pick-up in overseas economies and the correction of the yen’s appreciation. As for domestic demand, public investment and housing investment are expected to continue trending upward, business fixed investment is projected to increase moderately reflecting the improvement in corporate profits and the employment situation, and private consumption is expected to remain resilient. In this situation, industrial production is also expected to increase moderately, judging from interviews with firms and other relevant information. Against the backdrop of these developments in demand both at home and abroad as well as in production, Japan’s economy is expected to recover moderately.

Let me elaborate on these developments for a moment. Due in part to the correction of the yen’s appreciation and the rise in stock prices since the end of 2012, business and consumer sentiment has improved, and this improvement is likely to help underpin private consumption for the time being and gradually entice firms to increase their spending. Increased private consumption is particularly evident among the middle-aged and the elderly, who hold more stocks than other age groups. Consumption activity of the baby-boom generation is expected to remain firm due to their higher propensity to consume than other generations and to firms’ efforts to capture new demand. Meanwhile, business fixed investment is projected to increase moderately, mainly due to the resumption of postponed investment for the maintenance and replacement of items such as machinery and to investment related to disaster prevention and energy. Upward pressure on the economy from the public demand side is expected to gather full momentum as seen in the fact that the value of public works contracted, a leading indicator of public investment, has already increased significantly.

The key to ensuring that this trend toward economic recovery continues and to achieving the price stability target of 2 percent in terms of the year-on-year rate of change in the consumer price index (CPI) is that improvements in business performance lead to increases in employee income. Looking at the recent employment and income situation, supply and demand conditions in the labor market have improved, as evident in the unemployment rate and the active job openings-to-applicants ratio, and the year-on-year rate of change in the number of employees has been positive. In this situation, despite the downward pressure resulting from the uptrend in the ratio of part-time employees, the year-on-year rate of change in nominal wages per employee has turned slightly positive, with special cash earnings for June – which include summer bonus payments – showing an increase for the first time in three years. While uncertainty regarding the outlook remains, the Bank would like to confirm whether these developments also lead to a rise in scheduled cash earnings.

Keeping these points in mind, I would like to summarize the outlook for Japan's economy for the next three fiscal years. While the economy will be affected by the front-loaded increase and subsequent decline in demand prior to and after the two scheduled consumption tax hikes, it is likely to continue growing at a pace above its potential, as a trend, as a virtuous cycle among production, income, and spending is maintained. In the Bank's interim assessment in July of the April 2013 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), the median of the Policy Board members' forecasts for the economic growth rate is a somewhat high 2.8 percent for fiscal 2013 due to the effects of various economic measures and the front-loaded increase in demand, 1.3 percent for fiscal 2014 partly due to the subsequent decline in demand, and 1.5 percent for fiscal 2015.

2. Prices

Next, I will talk about price developments. The year-on-year rate of change in the CPI (all items less fresh food) had been in negative territory through April 2013, but has recently turned positive for the first time in 14 months, partly reflecting the correction of the yen's appreciation. Energy prices including those for petroleum products and electricity have been rising, and increases in the costs of raw materials have started to be passed on to sales prices of, for example, foodstuffs. Sales prices of some imported consumer goods such as personal computers and handbags have also been raised. Recently, there have been more signs of a change in firms' price-setting behavior, including the introduction of higher-end products and services in some areas within the food service industry. Under these circumstances, firms' forecasts for supply and demand conditions and prices in the June 2013 *Tankan* have clearly improved. As for the outlook, the year-on-year rate of increase in the CPI is likely to rise, reflecting factors such as the improvement in the aggregate supply and demand balance due to the recovery of Japan's economy as well as the rise in medium- to long-term inflation expectations in response to fundamental changes in the public's expectations. The rate of increase in the CPI is likely to reach around 2 percent – the price stability target – toward the latter half of the projection period, spanning from fiscal 2014 through fiscal 2015, as the overall economy improves in a balanced and sustainable manner. Specifically, in the Bank's interim assessment in July of the April 2013 Outlook Report, the median of the Policy Board members' forecasts for the year-on-year rate of increase in the CPI (all items less fresh food; for fiscal 2014 and fiscal 2015, excluding the direct effects of the consumption tax hikes) is 0.6 percent for fiscal 2013, 1.3 percent for fiscal 2014, and 1.9 percent for fiscal 2015.

II. Conduct of monetary policy

A. Introduction of "Quantitative and Qualitative Monetary Easing" (QQE)

1. Framework of QQE

Next, I would like to turn to the Bank's conduct of monetary policy.

In order for Japan's economy to overcome deflation as early as possible and achieve sustainable growth with price stability, the Bank introduced in January 2013 the price stability target of 2 percent in terms of the year-on-year rate of change in the CPI. It concurrently released a joint statement with the government, in which the government and the Bank clearly acknowledged the role each had to play and stated that they would work together to overcome deflation and achieve sustainable economic growth. Then, in April, the Bank introduced QQE to achieve the price stability target at the earliest possible time, with a time horizon of about two years. This policy measure represents a considerable departure from the Bank's previous practice both in terms of quantity (the size of increase in the amount of currency provided by the Bank) and quality (the type of assets the Bank purchases to increase the amount of currency).

Specifically, the Bank decided upon the following. First, with a view to pursuing quantitative monetary easing, the Bank changed the main operating target for money market operations from the uncollateralized overnight call rate to the monetary base, which is the sum of banknotes in circulation, coins in circulation, and current account deposits held by financial institutions at the Bank. On this basis, the Bank will increase the monetary base at an annual pace of about 60–70 trillion yen, thus doubling it in two years. Second, the Bank will purchase Japanese government bonds (JGBs) so that their amount outstanding will increase at an annual pace of about 50 trillion yen. As a result, the amount outstanding of JGBs held by the Bank is likely to more than double in two years. Moreover, the Bank extended the average remaining maturity of its JGB purchases from slightly less than three years to about seven years. It should be noted that in practice the average remaining maturity is subject to fluctuations, depending on bids by financial institutions; thus, it is appropriate to allow for a range of about six to eight years. And third, the Bank will purchase exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their amounts outstanding will increase at an annual pace of about 1 trillion yen and about 30 billion yen, respectively. The Bank will continue with QQE – consisting of these measures – aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate. In order to achieve the price stability target, it is important to create a virtuous cycle in which prices rise moderately along with a balanced and sustainable improvement in economic activity that is accompanied by increases in corporate profits, employment, and wages.

Furthermore, in order to fully ensure the effectiveness of monetary easing, it is important for the government to ensure market credibility of fiscal consolidation. Japan is facing serious fiscal imbalances, and if the credibility of its fiscal management were to decline, long-term interest rates would likely rise in a manner inconsistent with economic and price developments. The government indicated in the joint statement released in January that it would steadily promote measures aimed at establishing a sustainable fiscal structure. Moreover, in the Medium-Term Fiscal Plan, approved on August 8, 2013, it stated its targets of halving the primary deficit-to-GDP ratio by fiscal 2015 and of achieving a surplus in the primary balance by fiscal 2020. Based on these targets, it is expected that the government will continue making efforts toward fiscal consolidation.

2. Transmission channels of QQE

The transmission channels of QQE are as follows. First, the purchases of financial assets will encourage declines in long-term interest rates and risk premiums on assets. This helps to increase firms' and households' investment and consumption by lowering their funding costs and through wealth effects. Second, both financial institutions and institutional investors are expected to change their investment behavior and rebalance their portfolios to loans and/or risk assets, such as stocks, in the pursuit of higher returns. This is referred to as the portfolio rebalancing effect. This effect may strengthen the growth potential of Japan's economy if risk money is increasingly allocated to a wider range of emerging firms, for example. And third, the clear commitment to achieving the price stability target at the earliest possible time and the continuation of massive purchases of assets are expected to drastically change the expectations of markets and economic entities. With these channels acting together, QQE will contribute to pushing up prices by raising inflation expectations and, by stimulating private demand, improving the aggregate supply and demand balance.

3. Financial market developments since the introduction of QQE

Looking at developments in economic activity and financial markets since the introduction of QQE, the monetary base has been increasing at an annual pace of about 60–70 trillion yen – in line with the Bank's guideline for money market operations – owing to progress in the

Bank's large-scale JGB purchases as it proceeds with QQE. Despite some instability observed in the JGB market at the onset, the intended effects of QQE seem to have begun to materialize on the whole, with favorable developments spreading to economic activity and financial markets.

Meanwhile, financial conditions remain accommodative. In terms of firms' funding costs, the average contracted interest rates on new loans and discounts have been low, reaching a historical low, and the year-on-year rate of increase in the amount outstanding of bank lending has increased somewhat to a range of around 2 percent. Issuing conditions for CP and corporate bonds have continued to be favorable on the whole, and there have been several major corporate bond issues. The year-on-year rate of growth in the money stock (M2) has increased to its highest level since 1999, reaching almost 4 percent.

Looking at financial markets, money market rates for all maturities have been stable, hovering at a level slightly below 0.1 percent. Long-term interest rates exhibited increased volatility and temporarily reached 1 percent, but have regained stability as the Bank conducted JGB purchases in a flexible manner while maintaining a close dialogue with market participants. Japan's long-term interest rates have generally been flat in spite of a rise in overseas long-term interest rates reflecting speculation about the direction of U.S. monetary policy, and have recently been contained at a level of 0.7–0.8 percent, below the historical average. Meanwhile, it can be said that inflation expectations have been on a rising trend on the whole, as evidenced (1) by the rise in the diffusion index for output prices in the June 2013 *Tankan* as well as the rise in the inflation expectations of firms, households, and economists, and (2) by the upturn in market-related indicators following a halt in their decline. Under these circumstances, real interest rates – calculated as nominal interest rates minus the expected inflation rate – have been on a declining trend. If inflation expectations were to rise, this would exert upward pressure on long-term interest rates. The key to strengthening monetary easing effects therefore lies in maintaining real interest rates at a relatively low level, by exerting downward pressure on nominal interest rates through a compression of risk premiums (including term premiums). As for the outlook, downward pressure on interest rates is likely to become increasingly pronounced as the Bank proceeds with its large-scale JGB purchases. In this situation, portfolio rebalancing – in which investors and financial institutions that used to invest their funds in JGBs shift their investment to lending and other assets – is likely to spread steadily.

Reflecting the wealth effects brought about by the rise in stock prices since the beginning of the year and the improvement in corporate profits due to the correction of the yen's appreciation, business and household sentiment has recently improved and fundraising by the private sector has increased moderately. Looking ahead, with the effects of QQE on economic activity becoming increasingly pronounced, a virtuous cycle – in which positive developments in economic activity and changes in expectations bring about further improvement in economic activity and further increases in inflation expectations – would enable the Bank to achieve the 2 percent price stability target.

B. Loan support program

In order to maintain this virtuous cycle, it is important that firms and households actually make use of the accommodative financial conditions for funding and increase investment and spending, which in turn will lead to an improvement in the aggregate supply and demand balance. However, although some positive developments can now be observed in the demand for credit, many firms still do not borrow to finance their business fixed investment and instead invest only as much as their cash flow will allow. To promote full use of the accommodative financial conditions by firms and households, the Bank – in addition to implementing aggressive monetary easing measures – has established the Loan Support Program. The program consists of two measures: the fund-provisioning measure to stimulate bank lending (hereafter the Stimulating Bank Lending Facility) and the fund-provisioning measure to support strengthening the foundations for economic growth (hereafter the Growth-Supporting Funding Facility).

1. The stimulating bank lending facility

The Stimulating Bank Lending Facility was introduced with the aim of prompting financial institutions to take a more active lending stance and stimulating greater proactive credit demand of firms and households. With this facility, the Bank provides long-term yen-denominated funds at a low interest rate to financial institutions that have increased their lending, at their request, up to an amount equivalent to the net increase in their lending for a period of five quarters – the January-March 2013 quarter until the end of the January-March 2014 quarter – from the base period of the October-December 2012 quarter. There shall be no upper limit to the total amount of funds provided by the Bank under this facility. The lending, based on which the net increase is calculated, can be either yen-denominated or foreign currency-denominated. Japanese firms' international operations as well as financial institutions' activities to provide funds for such operations play an important role in capturing global demand, so that the Bank's measure to support lending to firms located overseas or lending by domestic financial institutions' overseas offices – including foreign currency-denominated lending – contributes to strengthening Japan's growth potential. In the first loan disbursement under this facility in June 2013, loans amounted to as much as 3.1 trillion yen, underlining the strong demand for such funds.

2. The growth-supporting funding facility

The Growth-Supporting Funding Facility was introduced with the aim of supporting the flow of funds to areas with growth potential. The Bank introduced this facility because, in order to overcome deflation and achieve sustainable economic growth with price stability, the Bank deemed it important to (1) reverse the downward trend in Japan's growth rate in the face of the unparalleled decline in the birthrate and aging of the population, (2) increase medium- to long-term growth expectations for Japan's economy, and (3) put Japan's economy on a higher medium- to long-term growth path. With this facility, the Bank provides long-term funds – both yen-denominated and foreign currency-denominated – at a low interest rate to financial institutions for their lending and investment to areas that are expected to contribute to strengthening Japan's growth potential, such as medical and nursing care; environment and energy; agriculture, forestry, and fisheries; and tourism. The total amount of lending under these arrangements was set to about 5.5 trillion yen, and the current amount outstanding is nearly 4 trillion yen. The amount of lending and investment actually provided by private financial institutions using this facility greatly exceeds the amount of loans disbursed by the Bank, demonstrating its usefulness as a catalyst. These measures are expected to continue promoting lending activity by financial institutions and to lead to an increase in firms' proactive demand for credit, such as that for business fixed investment.

In order to sustain this cycle for strengthening the economy's growth potential, it is necessary to help private economic entities to realize their potential to the fullest. In addition to support from the financial side, it is therefore important to build an economic environment where innovations in a broad sense – including the development of new business models – can be achieved more easily. Recently, firms have been making active efforts in a wide range of areas to capitalize on social changes, including business focusing on the elderly, the environment and energy, and information and telecommunications. Such developments need to be supported on the policy side as well. Moreover, securing the labor force by increasing flexibility in the labor market is another significant issue. The labor force participation rate of women currently forms an M-shaped curve, declining to about 70 percent for women aged 25 to 45. If this rate were to rise gradually as a result of greater support for working mothers to both pursue a career and raise children, the decrease in the labor force overall would be moderated. Moreover, if an increasing number of those aged 60 and above were to participate in the labor force, it would be possible to maintain the labor force at the current level for the time being, even in the face of the decline in the birthrate and the aging of the population.

In the joint statement with the Bank released in January 2013, the government made clear its intention to formulate measures for strengthening competitiveness and growth potential of Japan's economy and promote them strongly, in order to revitalize the economy. In the government's Japan Revitalization Strategy formulated in June, three action plans – (1) the Plan for the Revitalization of Japanese Industry, (2) the Strategic Market Creation Plan, and (3) the Strategy of Global Outreach – have been laid out as concrete measures to be given top priority among other steps forming the growth strategy. If these measures are steadfastly implemented and firms' growth expectations rise further as a result, and given declining real interest rates, this would further enhance the stimulative effects of monetary easing. The Bank, on its part, will also continue to make its utmost contributions.

C. Efforts on the financial side in response to the Great East Japan Earthquake

I would now like to talk about the Bank's efforts on the financial side following the Great East Japan Earthquake. Since immediately after the earthquake, financial institutions in the disaster areas have made strenuous efforts to maintain the functioning of financial and settlement systems by restoring their offices and establishing temporary ones. They have also responded to the needs of people and firms in the disaster areas in various respects, such as permitting the withdrawal of deposits in cases where depositors had lost their passbook, allowing for the exchange of damaged banknotes and coins, and providing support for the funding of disaster-stricken firms. More recently, these institutions have been providing strong support for the restoration of local economies, mainly in business matching and support for corporate turnarounds.

From immediately after the earthquake, the Bank swiftly took a range of measures, such as the provision of ample liquidity and the further enhancement of monetary easing, focusing on three major aspects: maintaining the functioning of financial and settlement systems, ensuring the stability of financial markets, and supporting the economy. In this situation, in April 2011 the Bank decided to introduce a funds-supplying operation that provides financial institutions in the disaster areas with longer-term funds at low interest rates in order to lend support to their initial efforts to meet demand for funds for restoration and rebuilding. It also decided to broaden the range of eligible collateral for money market operations. As for the former operation, the deadline for new applications for loans was initially set at end-October 2011, six months after the introduction, but was successively extended thereafter up to the current deadline of end-April 2014.

Looking at the usage of loans under this funds-supplying operation to support financial institutions in the disaster areas, the amount outstanding of loans a year after the earthquake reached about 500 billion yen vis-à-vis the 1 trillion yen ceiling, and most recently has been about 400 billion yen. The reason that financial institutions in the disaster areas have made little use of loans under this operation relative to the ceiling is that their funding conditions have generally been favorable as they have been receiving funds for reconstruction from various sources. Nevertheless, the operation can be regarded as effective in that it has provided a safety valve for any unanticipated demand for funds, providing leeway for these institutions in their efforts to meet demand for funds for restoration and rebuilding. As the disaster areas are expected to see an increase in the demand for funds as reconstruction progresses, the Bank will continue to provide firm support to financial institutions engaged in reconstruction efforts so as to allow for active lending.