Hiroshi Nakaso: Japan's economy and monetary policy

Speech by Mr Hiroshi Nakaso, Deputy Governor of the Bank of Japan, at a Meeting with Business Leaders, Shimane, 9 October 2013.

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Introduction

It is my great pleasure to be given an opportunity today to exchange views with administrative, financial, and business leaders in Shimane Prefecture. I would like to take this opportunity to express my sincerest gratitude for your cooperation with the activities of the Bank of Japan's Matsue Branch.

On a personal note, my relationship with the San-in region goes back long years. My father was born in Yonago, Tottori, and I have visited his birthplace several times. The reason why I feel nostalgic, despite this being my first time in Matsue, is that my roots are in this region.

Japan's economy has long been in a state of deflation, since the financial crisis of the 1990s. For Japan's economy to escape this situation and restore its vitality, it is most important to first overcome deflation and change the mind-sets of economic entities such as firms and households so that they become more proactive. In this sense, the biggest immediate challenge facing Japan's economy is the overcoming of deflation at the earliest possible time, and I realize that the role the Bank of Japan has to play is crucial. Based on this recognition, the Bank introduced a new policy in April, called "quantitative and qualitative monetary easing" (QQE).

Today, before exchanging views with you, I would like to talk about economic developments at home and abroad. I will also elaborate on the thinking behind the QQE. Lastly, I will talk about economic development in this region.

I. Recent developments and outlook for economic activity at home and abroad

Recent developments and outlook for Japan's economy

First, I will focus on Japan's economy. A virtuous circle from income to spending has gradually been taking hold both in the household and business sectors. In the household sector, private consumption has been resilient. Sales at department stores have remained firm and consumption of services such as outlays for travel and sales in the food service industry have held steady. With underlying active consumption by senior citizens, notably baby boomers, such resilience in private consumption seems to have been sustained mainly by wealth effects stemming from a rise in stock prices and an improvement in sentiment since the turn of the year. It has gradually been supported by the improvement in the employment and income situation. The employment condition continues to improve moderately, as the unemployment rate and active job openings-to-applicants ratio recovered almost to levels seen prior to the Lehman crisis. Against this background, special cash earnings – such as bonuses – registered a clear increase year on year, and total cash earnings per employee have begun to bottom out. Reflecting this improvement in the employment condition, as well as in wages, employees' total cash earnings in Japan as a whole have been increasing year on year.

In the business sector, corporate profits continue to improve and business fixed investment has been picking up, mainly in the non-manufacturing sector, as evidenced by real business fixed investment in the GDP statistics registering a quarter-on-quarter increase for the first time in six quarters. This is an encouraging development, as we thought that a key to the sustainability of economic recovery would be business fixed investment. While the relatively lagging business fixed investment in the manufacturing sector is a matter of concern, potential demand for such investment seems to be growing as existing capital stock has become obsolete due to the restraint on business investment up to now, and firms have subdued their R&D investment. Under such circumstances, if overseas economies start to pick up gradually and exports increase moderately, an improvement in business fixed investment in the manufacturing sector – mainly in investment for maintenance and replacement of existing capital stock, R&D investment, and IT-related investment – is likely to become evident. In fact, in the recently released September *Tankan* survey, the business fixed investment plan in the manufacturing sector for fiscal 2013 was for an increase of 7.0 percent year-on-year, marking a steady increase.

Owing to those developments, the Bank said in its statement released after the Monetary Policy Meeting in September that "Japan's economy is recovering moderately," using the words "is recovering" for the first time since the Lehman crisis. Going forward, the Bank expects that Japan's economy is likely to continue recovering moderately on the back of a virtuous circle among production, income, and spending. While the economy will experience a front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike, it is likely to continue growing, as a trend, at a pace higher than its potential growth rate.

Main features of present economic recovery

Let me touch on the main features of the current economic recovery. A typical pattern of Japan's economic recovery in the past was that it started with an increase in exports and production, thereby centering on the manufacturing sector. However, unlike the pattern of past recoveries, the major feature of the recovery this time is that it is led by the non-manufacturing sector against the backdrop of firmness in domestic demand such as private consumption and public investment. That might be because, while consumption by senior citizens and reconstruction-related spending have been underpinning domestic demand, there also have been effects of various stimulus policy measures under "Abenomics" and improvement in household sentiment on the back of high expectations for the current economic policy management, as well as favorable developments in financial markets. Indeed, while exports and production remain short of the pre-Lehman crisis levels, tertiary industry activity index – an indicator of the state of economic activity in the non-manufacturing sector – has come close to the pre-Lehman crisis level. A pick-up in business fixed investment also has taken place mainly in the non-manufacturing sector, as I mentioned earlier.

The non-manufacturing sector requires more human resources than the manufacturing sector. At present, improvement in employment and income, mainly in the non-manufacturing sector, is supporting private consumption in a virtuous cycle. The virtuous circle from income to spending has been gradually taking hold, and this has supported resilience in domestic demand. Such development is expected to continue.

Recent developments and outlook for overseas economies

In this recovery, the resilience in domestic demand has been pronounced. Exports are picking up, although they remain lackluster so far. In considering the future of Japan's economy, it is important that overseas economies pick up while domestic demand is resilient, and that the economy move to a phase led by domestic demand and external demand as a pair of wheels. Let me now turn to the recent developments in overseas economies.

Overseas economies as a whole are gradually heading toward a pick-up. Looking at respective regions, the U.S. economy is on a moderate recovery trend owing to firm private demand in the face of the fiscal drag. As for the fiscal situation, government debt increased significantly, mainly due to large-scale fiscal spending after the Lehman crisis. In response, there have been moves toward fiscal consolidation, and austerity measures – including an expiration of various tax reductions and a start to budget sequestration – have been taken since the turn of the year. In the face of this fiscal drag, U.S. private demand is resilient due to continuing accommodative financial conditions under low interest rates. For example, housing investment is picking up as a trend due to low mortgage rates. As a prerequisite for scaling back the pace of asset purchases, the Fed pointed out that employment conditions should continue to improve, supported by a moderate recovery in economic growth. Therefore, on the assumption that the Fed will continue with its proper conduct of monetary policy, it is unlikely that private demand will decline substantially. In this situation, as the fiscal drag will gradually fade, the pace of recovery is expected to gradually accelerate.

The greatest uncertainty for the U.S. economy is the consequence of fiscal consultation, an issue on which the Democrats and the Republicans continue to oppose each other sharply. As a preliminary budget has not been agreed on, some government institutions have already been forced to close. The debt ceiling will be reached in the middle of this month, and the redemption and interest payment of government securities will be stopped if it is not raised. If that happens, this might have significant adverse effects on the global economy through a downgrading of U.S. government bonds and an associated rise in premiums transmitting to markets in other countries, inducing a rise in long-term interest rates, a plunge in stock prices, and fluctuations in foreign exchange rates. By contrast, if this problem is resolved successfully, this would eliminate the current uncertainty surrounding the U.S. economy, and thus might provide a boost toward economic recovery. At any rate, a prompt resolution of the fiscal consultation issue is critical for the global economy, including Japan.

Turning to the European economy, while it continued to remain sluggish, real GDP growth registered a quarter-on-quarter increase in the April-June quarter of this year for the first time in seven quarters, suggesting that the economy is finally leveling off. As for crisis resolution, policy measures pertaining to the European debt problem have surely seen a material progression since the summer of 2012, including the introduction of the government bonds purchase program by the European Central Bank (ECB) and the establishment of the European Stability Mechanism, through which financial assistance will be provided in the event that the euro member countries encounter a fiscal crisis. In this situation, there is now improvement in both business and household sentiment. Some adjustment in the fiscal austerity program has also mitigated the downward pressure on the economy from the fiscal side. Moreover, exports are bottoming out, particularly in Germany. It is likely that the European economy will start picking up gradually as these developments continue.

However, I must say that a fundamental resolution of the European debt problem has only reached the halfway point. The current stability in European financial markets seems to have been brought about because the ECB has been buying time through its large-scale monetary easing. In the meantime, it is necessary to steadily take steps through various structural reforms and toward forming banking, fiscal, economic, and political unions as presented in a roadmap for unification of Europe. The time the ECB can buy is limited and might be gradually becoming costly.

The Chinese economy continues to grow steadily, although the pace of growth has become somewhat lower than that in the past. From the time of inauguration, the new government clearly showed its stance of pursuing structural reforms, by announcing frugality laws and measures to contain real estate prices. Against such a backdrop, there has been concern since around the turn of the year that the economy might slow down. However, the government in July showed its stance of focusing on achieving this year’s target of economic growth of around 7.5 percent and it decided various measures that paid due consideration to economic growth; thus, looking to the future, it is expected that stable growth at around the current pace will continue, supported by resilient domestic demand. In terms of further policy responses, the fiscal situation in China remains relatively sound and there is additional room for fiscal stimulus. Owing to these developments, the chance of the Chinese economy decelerating significantly, at least in the short run, is viewed as not great.

In the meantime, what is somewhat worrisome are emerging economies. Looking back, after escaping from acute symptoms of the Lehman crisis, the global economy recovered, led by high growth in emerging economies. Behind this, there were mainly two reasons. First, the trend of domestic demand in those economies was robust due to the consumption spree associated with a rise in the living standard and to the need to expand social infrastructure. Second, after the financial crisis, aggressive monetary easing in advanced economies led to capital inflow to emerging economies, providing additional impetus for emerging economies to grow. However, recently, the U.S. and European economies have been improving, while growth momentum in emerging economies is somewhat weak. The first thing that comes to mind as a reason for this is that, immediately after the financial crisis, emerging economies also adopted expansionary policy measures, and some "excesses" in business fixed investment and lending may have emerged during that process. Second, while economic activity in the United States and Europe has been recovering, concern has been raised that capital inflow into emerging economies may reverse its course.

Under such circumstances, triggered by speculation that the Fed is likely to scale down the pace of its asset purchases, financial markets in the emerging economies have recently become instable, with some, mainly current-account deficit countries, experiencing depreciation in their currencies. Such instability in financial markets might have adverse effects on the real economy through tightening financial conditions and deteriorating business and household sentiment, and this requires attention. Having said that, in my view, the likelihood that the current situation will become one similar to the Asian currency crisis in 1997–98 seems marginal. The Asian crisis became widespread due mainly to vulnerability of the banking systems in Asian countries. By contrast, the current situation is limited to market risk, as exemplified by the heightening of market volatility. Moreover, from the perspective of safety nets, those economies have accumulated substantial foreign reserves and backstops were put in place, such as the Chiang Mai Initiative – a swap agreement network to make short-term foreign currencies available among participating countries. Owing to these developments, emerging economies have become more resilient against possible capital outflows. In addition, as seen at the G20 meeting and meetings at the Bank for International Settlement, frameworks are now in place that enable advanced economies and emerging economies to have direct discussions.

To sum up, while each country or region has its own risk factors, it is expected that overseas economies – most notably the U.S. economy – will generally start picking up gradually. Under such circumstances, exports and production in Japan are expected to increase.

II. Basic thinking behind QQE

I would now like to explain the thinking behind the QQE that the Bank is currently pursuing. In April, the Bank, with a view to achieving the price stability target of 2 percent in terms of the year-on-year rate of change in the consumer price index at the earliest possible time, with a time horizon of about two years, introduced a new policy of "quantitative and qualitative monetary policy" (QQE). In this policy, the main operating target for money market operations was changed from the short-term interest rate to the monetary base, which is the sum of banknotes and currency in circulation as well as commercial banks' current account balance held with the Bank, and the Bank will double the monetary base in two years. In doing so, it will purchase massive amounts of Japanese government bonds (JGBs), with all maturities made eligible for purchases. In addition, in aiming to achieve the price stability target of 2 percent, the Bank made a commitment that it would continue with such drastic monetary easing as long as it is necessary for maintaining the target in a stable manner.

The Bank conducts monetary policy based on the principle of "achieving price stability, thereby contributing to the sound development of the national economy." Therefore, in achieving the price stability target, it is important to create a virtuous cycle of prices that gradually increase as the economy as a whole grows in a sustainable fashion and as people's standards of living improve.

Routes to raise inflation expectations

The QQE is expected to raise prices via the following two different routes. The first is improving the supply and demand balance of the economy as a whole by stimulating economic activity. Namely, through elevating the level of economic activity in Japan as a whole, the supply and demand balances in goods, services, and labor will tighten, leading to a pickup in prices and wages. The supply and demand balance of the economy as a whole is gauged as the output gap – namely, the difference between potential GDP, which can be produced in an average situation for the labor force and for facilities, and actual GDP. There seems to be a negative output gap – where actual GDP is below potential GDP and there is an excess in the labor force and in facilities – remaining in Japan's economy. We need to move this into positive territory. Japan's GDP has been growing at an annualized rate of about 4 percent for two consecutive quarters. This growth rate substantially exceeds the potential growth rate, which is estimated to be around 0.5 percent. In this situation, the output gap has been steadily narrowing and is expected to turn positive.

The second route is raising people's inflation expectations. While some may be unfamiliar with this terminology, these are inflation rates that the public foresees. As deflation has continued for nearly 15 years in Japan, the view that prices are unlikely to rise has become embedded. In a state of deflation, holding cash and deposits, as well as related assets, becomes a relatively better investment. In this situation, businesses and households have been refraining from consumption and making investment, and the economy's vitality has been lost. In order to escape from such a situation, it became necessary to dispel such deflationary expectations entrenched among the public; namely, to raise their inflation expectations. To this end, the Bank, upon making a strong and clear commitment that it would achieve the price stability target of 2 percent with a time horizon of about two years, decided on drastic monetary easing both in terms of quantity and quality to underpin the commitment. By doing so, the QQE aims to drastically change the deflationary expectations of economic entities such as businesses and households. Specifically, how do these two routes work on the real economy? I will explain this next.

Impact on interest rates: logic behind real interest rates

While the QQE has a number of transmission channels, what is important above all is to influence real interest rates. Real interest rates are calculated by subtracting expected rates of inflation from nominal interest rates. In other words, if businesses and households consider that prices will rise and sales as well as wages will likewise rise in the future, the interest burden in real terms will be smaller than what nominal rates may suggest. As the spending behavior of businesses and households will be greatly influenced by real interest rates, if real rates can be lowered, both private consumption and business investment will be stimulated and the level of economic activity will heighten. As a result, supply and demand balances will tighten in goods and services markets, as well as the labor market, and prices will rise accordingly.

It is considered that nominal interest rates, notably long-term interest rates, will be determined according to the outlook for economic activity and prices. Therefore, intrinsically, if the real economy and prices improve and inflation expectations increase, nominal interest rates will rise. Were nominal interest rates to rise in parallel with a rise in inflation expectations, real interest rates would not change. That is, to lower real interest rates, it is necessary to raise inflation expectations while containing a rise in nominal rates. It is for this reason that the QQE, while lifting the public's inflation expectations by changing their expectations, undertakes market operations to contain a rise in nominal rates as much as possible through the massive purchase of the JGBs. This is a highly difficult policy to conduct, and it requires subtle balancing.

Interest rate developments after introduction of QQE

So far, this policy conduct has been successful. Inflation expectations appear to be rising on the whole. While it is difficult to directly observe inflation expectations, taking break-even inflation rates measured by inflation-linked government bonds and various surveys on households, economists, and market participants as a whole, people's inflation expectations seem to have been rising.

By contrast, Japan's long-term interest rates have been hovering in a stable fashion. Given that market operations to contain an increase in nominal interest rates as much as possible are what the Bank is trying to achieve by purchasing massive amounts of JGBs in the JGB market, it is essential to have market participants' cooperation. Therefore, from the very day the Bank introduced the QQE in April, it started a dialogue with market participants. Subsequently, there were phases in which the volatility in the JGB market heightened as market participants digested the QQE's contents, and long-term interest rates rose in reflection of the cautious attitude of market participants toward JGB investment. In response, based on its dialogue with market participants, the Bank has been improving its methods of purchasing JGBs.

As a result of these efforts, the JGB market regained stability, and now long-term interest rates in Japan remain stable at low levels of less than 0.7 percent. Amid the upticks in long-term interest rates overseas in response to a rise in the U.S. long-term interest rates, on the back of speculation over the Fed's scaling down of its pace of asset purchases, the stability in Japan's long-term interest rates has been conspicuous. With JGB yields, which form the basis for bank lending rates, having been stable at low levels, contractual lending rates, which show developments in lending rates to firms and households as a whole, have remained at historic low levels.

As people's inflation expectations appear to be rising on the whole while long-term interest rates remain stable, real interest rates are expected to be on a declining trend. Under such circumstances, prices in Japan – when assessed by the year-on-year rate of change in the consumer price index excluding fresh food – turned positive in the middle of this year and accelerated to 0.8 percent in August. Looking ahead, as the aggregate supply and demand balance in the economy is expected to improve and inflation expectations to rise further, the year-on-year rate of change in the CPI is likely to reach close to the price stability target of 2 percent from the latter half of fiscal 2014 through fiscal 2015. While we recognize that lifting inflation expectations through monetary policy is an extremely ambitious approach in unchartered waters, we would like to meet the longstanding challenge of overcoming deflation on all counts by steadily gaining the fruits of pursuing the QQE.

Concluding remarks

In conclusion, I will touch on the economies of Shimane Prefecture and the San-in region. Shimane Prefecture seized the historical watersheds of "1300 years of the Kojiki – Japan's oldest chronicle" in 2012 and "Izumo Taisha's *Sengu* – a period of massive repair work – of the Heisei Period" in 2013 as golden opportunities, and has been making efforts all over the prefecture to establish a sightseeing brand. Its aggressive PR activities are also seen in the metropolitan area. Together with the recent boom in visitors to spiritual places and the opening of the Matsue Expressway, tourism demand has been increasing to a substantial degree. According to the Bank's Matsue branch, the economic effect of an increase in tourism demand in 2013 stemming mainly from Izumo Taisha's *Sengu* was estimated to be slightly less than 30 billion yen. Given that Shimane's gross prefectural production is slightly more than two trillion yen, the increase in tourism demand will be a substantial boost for the regional economy, for which the average growth rate over the past 10 years has been about zero percent.

In addition to firm tourism, business conditions in the non-manufacturing sector, including the construction industry, which has been underpinned by an increase in public and private construction, have been generally improving. Business conditions have also been improving in the manufacturing sector due mainly to strong production in electronic parts for smartphones and tablet computers as well as automobile-related goods, and increased production in food & beverages and construction-related materials, reflecting an increase in domestic demand such as tourism and public investment. As a result, the economy of Shimane Prefecture has been moderately recovering. According to the recently released September *Tankan* survey, business conditions in the San-in region reached the highest level since 1991, confirming that economic recovery has been spreading. The business conditions have been at almost the same level compared with those nationwide.

During Japan's longest post-war economic recovery, between 2002 and 2007, an improvement in business conditions in the San-in region was markedly sluggish compared with that of the national average. There were several reasons behind this. As the economic recovery at that time was led by external demand reflecting an expansion in the global economy, the region was not able to benefit much from the recovery. In addition, the effects of a cut in public investment during the period weighed heavily on the regional economy, in which the contribution of construction industry to the regional economy as a proportion was high. By contrast, the reason why business conditions in the San-in region have been improving in tandem with those nationwide during this recovery phase seems to be that the feature of this recovery – namely, that firm domestic demand has been inducing an improvement in economic activity in the non-manufacturing sector – has similarly occurred in the San-in region. In addition, the structure of the regional manufacturing sector – namely, a relatively high contribution to the regional economy as a proportion, compared with nationwide, of the food & beverages industry and lumber & wood products industry, which are highly domestic demand-dependent – has partly bolstered production in the manufacturing sector. Against such a backdrop, due mainly to a moderate increase in production, a virtuous circle from income to spending has also started to operate in this region, mainly in the business sector.

The Bank will steadily pursue the QQE to ensure that this fledgling virtuous circle seen nationwide, inclusive of this region, will keep operating firmly in the future. In doing so, we believe it is critical to carefully examine economic activity and prices while firmly gauging developments in regional economies through the Bank's nationwide branch network, including the Matsue branch. From this perspective, we would like to continue to seek your cooperation with respect to research and other activities of the Matsue branch.

This region has plenty of "resources" – namely, the ample resources of tourism and of agriculture, forestry, and fisheries, as well as a concentration in the manufacturing sector with advanced technologies. For Shimane's economy not to make the current recovery a transient one, it is critical to effectively utilize these resources to improve growth potential. In this regard, it is expected that, with the tourism industry and other regional industries working together, there will be further promotion of initiatives related to "local production for local consumption" in a broad sense – namely, to "effectively make use of regional resources to spur production and expand regional consumption." With heartfelt hope for further development through these initiatives in the economy of the region of my roots, I would like to conclude my speech.

Thank you.