Haruhiko Kuroda: Japan's economy and monetary policy

Speech by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at a meeting with business leaders, Osaka, 5 November 2013.

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Introduction

It is a great honor to have this opportunity to address such a distinguished gathering of business leaders in Osaka today. I would like to start by expressing my deep gratitude to you for your cooperation with our branches in Osaka, Kobe, and Kyoto.

What I recognized most strongly when I assumed the role of the Governor of the Bank of Japan in March this year was that we must bring Japan's economy out of deflation that has lasted for almost 15 years. Amid protracted deflation, Japan's economy has been deprived of vitality. The greatest challenge facing Japan's economy in the immediate future is a prompt overcoming of deflation, and the role the Bank has to play to that end is critical. Based on such recognition, a new policy of quantitative and qualitative monetary easing (QQE) was introduced in April. While pursuing this policy, the real economy, financial markets, and people's sentiment and expectations have been improving, and thus the QQE has been steadily exerting its intended effects. As for the outlook, as shown in the *Outlook for Economic Activity and Prices* (Outlook Report) released last week, Japan's economy is expected to grow above its potential, as a trend, amid a continued virtuous cycle among production, income, and spending, and is likely to steadily follow a path toward achieving a 2 percent price stability target.

Today, before exchanging views with you, I would like to explain the Bank's view on economic activity and prices, followed by thoughts on the QQE.

I. Developments in domestic and overseas economies

Outlook for Japan's economy

Let me start with the outlook for Japan's economy.

The economy has been recovering moderately as domestic demand has been firm and overseas economies have gradually been picking up. Since the turn of the year, real GDP has registered high growth of about 4 percent on an annualized basis for two consecutive quarters. Comparing external demand with domestic demand, while exports have generally been picking up at a somewhat slower pace, domestic demand, notably private consumption and public investment, has been firm. Compared with what was anticipated at the time of the Outlook Report six months ago, external demand has been somewhat weaker and domestic demand has been somewhat stronger.

Looking ahead, while domestic demand is likely to maintain firmness as external demand is expected to increase, albeit moderately, the virtuous cycle among production, income, and spending is likely to be maintained. In terms of the real GDP projections in the Outlook Report released last week, that for fiscal 2013 is somewhat high, at 2.7 percent, partly reflecting a front-loaded increase in demand prior to the consumption tax hike. Thereafter, real GDP is expected to decline in fiscal 2014 to 1.5 percent, partly reflecting a drop following the tax hike, and should be 1.5 percent in fiscal 2015 (Chart 1). Therefore, while the economy will be affected by a swing of 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, which is estimated to be around 0.5 percent, as a trend.

Two points that deserve particular attention in looking to the future of Japan's economy are the sustainability of firm domestic demand and the outlook for overseas economies.

Sustainability of firmness in domestic demand

First is the sustainability of domestic demand.

The major feature of the recovery this time is that, starting with domestic demand such as private consumption and public investment, the nonmanufacturing sector has been leading the recovery. This differs from typical patterns of postwar recovery in Japan, in which the recovery started with an increase in exports and production and was led mainly by the manufacturing sector. In fact, while production in the manufacturing sector has remained at about 80 percent of its peak prior to the Lehman shock, the indices of Teritiary Industry Activity, which show developments in the nonmanufacturing sector, have recovered to a level close to that seen prior to the Lehman shock. Looking at the diffusion index (DI) for business conditions in the *Tankan* survey, the DI for the nonmanufacturing sector has been better than that for the manufacturing sector in this recovery phase (Chart 2).

Of this firm domestic demand, private consumption had been supported by an improvement in consumer confidence and wealth effects from the rise in stock prices since the turn of the year, while buoyant consumption by the elderly, notably baby boomers, had been serving as an underlying factor (Chart 3). Recently, it also has begun to be backed by improvement in the employment and income situation.

Namely, the employment situation continues to improve moderately but steadily, with both the unemployment rate and the ratio of job offers to applicants having almost recovered to the level observed prior to the Lehman shock. There has also been an increasing sense of a labor shortage on the firms' side (Chart 4). This improvement in the employment situation has started to influence wages. The year-on-year rate of change in nominal wages per employee has gradually stopped declining on the whole, partly due to growth in summer bonuses for the first time in three years. Meanwhile, scheduled wages per employee as a whole have remained negative year-on-year, and this is partly attributable to a shortening in hours worked due to the increased labor participation of women and the elderly in the form of part-time workers. Nevertheless, as the number of employees has been increasing, employee income – the number of employees times wages per employee – has turned positive year-on-year (Chart 5). Thus, the income situation as a whole has been gradually improving.

Going forward, an improving trend in the employment situation is likely to continue as the economy recovers moderately, and nominal wages per employee are expected to be put under upward pressure gradually. From a somewhat longer-term perspective, wages will likely show a clear uptrend as the effects of tightening supply and demand conditions in the labor market emerge and inflation expectations rise. While we are intrinsically aware of the severe competitive environment surrounding firms, we expect that wages will increase, supported by improving corporate profits, and also by initiatives pursued through cooperation among the government, workers, and employers.

Another important point in considering the future of domestic demand is the developments in business fixed investment in the corporate sector. Reflecting the major feature of the economic recovery this time, business fixed investment has been resilient in the nonmanufacturing sector, and recently there also are signs of improvement in the manufacturing sector, which has been lagging, and thus business fixed investment has been picking up on the whole (Chart 6).

Regarding the outlook for the situation surrounding business fixed environment, accommodative financial conditions under the QQE are expected to underpin business fixed investment. In the context of investment profitability, the extent of the monetary easing stimulus to encourage investment is likely to strengthen, reflecting a rise in the rate of return on capital due to economic recovery, together with declining real interest rates, partly in reflection of a rise in inflation expectations. In addition, the effects of various anticipated tax reduction measures for businesses are likely to support business fixed investment through a decline in capital costs and stronger-than-expected cash flows. Furthermore, reflecting past restraints on firms' investment attitude, existing equipment has aged and thus potential demand for maintenance and replacement is likely to be strengthened. If the level of economic activity further elevates and the improvement in corporate profits continues, such potential demand becomes more likely to surface cyclically.

Overseas economies

Next, I will turn to the outlook for overseas economies.

As mentioned earlier, with regard to the outlook for Japan's economy, while domestic demand is likely to maintain firmness, external demand is expected to increase, albeit moderately. This is based on the assumption that overseas economies are expected to pick up gradually as financial markets remain generally stable. In its world economic outlook released last month, the International Monetary Fund (IMF) projects that the world economy will gradually see an acceleration in its pace of growth from 2.9 percent in 2013 to 3.6 percent in 2014, and to 4.0 percent in 2015 (Chart 7).

Looking at respective regions, the U.S. economy has been recovering moderately on the back of firm private demand under accommodative financial conditions, despite the fiscal drag. The economy is expected to gradually see an acceleration in its pace of recovery, as accommodative financial conditions will be maintained and the fiscal drag will gradually fade. Nevertheless, as uncertainty regarding the fiscal problem remains, such as the federal debt ceiling issue, future developments warrant attention.

The European economy, which had been receding slowly, has finally bottomed out, and there has recently been movement toward a pick-up. Households' and firms' sentiment are improving as financial markets have remained stable. In addition, changes in the stance of fiscal austerity have been made to some extent and the fiscal drag has weakened somewhat. Exports, especially in Germany, are bottoming out. Although it is necessary to pay attention to the consequence of the European debt problem, as it has not yet been fundamentally resolved, the European economy is expected to gradually pick up on the back of the aforementioned developments.

The Chinese economy is likely to maintain stable growth at around the current pace, as the government, while progressing with reforms in structural problems such as excess production capacity and excess debt in the manufacturing sector, is expected to carry out various policy measures to underpin economic activity in the event it weakens during the process. Meanwhile, growth in other emerging and commodity-exporting economies has been lacking momentum compared with a while ago, partly due to such problems as excess debt. In addition, financial conditions have been on a tightening trend – particularly in economies with current account deficits – such that progress in currency depreciation and declines in stock prices were partly observed, reflecting speculation about the direction of U.S. monetary policy, and in some economies, policy interest rates were raised in response to the currency depreciation. Therefore, these economies will likely lack growth momentum for the time being. From a longer-term perspective, however, growth rates are expected to pick up again as the U.S. and other advanced economies improve.

As mentioned, each country and region has its own respective risks, but the baseline scenario is that overseas economies, particularly the advanced economies, are expected to pick up gradually. In this situation, with regard to Japan's economy, external demand is expected to increase moderately.

Effects of the consumption tax hikes

At the beginning of October 2013, the government decided to raise the consumption tax rate to 8 percent in April 2014 as initially scheduled. The rate hike is a part of the government's efforts to secure stable financial resources for social security functions and to establish a sustainable fiscal structure in the medium to long term, and the Bank considers the government's decision as extremely meaningful.

In the October 2013 Outlook Report, on the assumption that the consumption tax rate will be raised twice, the Bank considered that, while there will be a swing due to the front-loaded increase and subsequent decline in demand, Japan's economy is likely to continue growing at a pace above its potential, as a trend. It is true that the consumption tax hikes will have adverse effects on households' real disposable incomes. However, the adverse effects are expected to be mitigated to some extent, partly because (1) various economic measures are scheduled to be taken by the government, (2) the tax hikes seem to have already been factored in substantially among households, and (3) the rate hikes are expected to have the effect of alleviating households' future concerns over the fiscal condition and the social security system.

II. Price developments in Japan

Let me now turn to the price developments in Japan.

The year-on-year rate of change in the consumer price index (CPI, all items excluding fresh food) turned positive in June 2013 for the first time in 14 months and has recently been accelerating to the range of 0.5–1.0 percent. While it is true that a rise in the prices of energy-related goods such as petroleum products and electricity has contributed to lifting the index, there has been an improvement in a wide range of items as the economy continues to recover moderately, as seen in resilient private consumption. In fact, the year-on-year rate of change in the CPI (all items excluding food and energy) saw a steady reduction in the extent of its decline and became 0 percent in September (Chart 8). In addition, taking into account market indicators and various surveys, inflation expectations appear to be rising on the whole. The expected rate of inflation measured by using an inflation-indexed government bond for which principal and interest changes according to future inflation rates – the so-called break-even inflation rate – has been maintaining an uptrend viewed from a somewhat longer-term perspective. Also, in surveys on economists, medium- to long-term inflation expectations have been rising (Chart 9).

At present, in Japan's economy, it seems that there is still a negative output gap – namely, a situation in which labor force and production capacity are in excess (Chart 10). However, as the economy continues to grow above its potential growth rate, labor and capacity utilization will further rise and thus the output gap is likely to turn positive in the future. In such a situation, a tightening of supply and demand conditions of goods and services as well as labor will become evident, and prices and wages are likely to rise. Furthermore, a rise in medium- to long-term inflation expectations will also contribute to a rise in prices and wages. Under the QQE, medium- to long-term inflation expectations will follow an uptrend, supported by an actual rise in observed inflation, and will gradually converge on the price stability target of about 2 percent.

Taking these points into consideration, the year-on-year rate of change in the CPI, on the basis of excluding direct effects of the consumption tax hikes, is likely to follow an increasing trend and reach the price stability target of about 2 percent through the second half of the projection period up to fiscal 2015. To cite the figures in the October Outlook Report, it is projected to be 0.7 percent in fiscal 2013, 1.3 percent in fiscal 2014, and 1.9 percent in fiscal 2015 (Chart 11).

III. Conduct of monetary policy

Lastly, I would like to talk about the conduct of monetary policy.

The biggest challenge facing Japan's economy is to overcome deflation. Over the nearly 15 years of deflation, inflation expectations of firms and households have declined and the deflationary mindset has been firmly embedded in their minds. Under deflation, holding of cash and deposits has become a relatively better investment. In fact, the total amount of currency and deposits held by Japanese firms has reached 230 trillion yen, equivalent to nearly 50 percent of the nominal GDP. The protracted deflation has created an environment in which maintaining the status quo is better than embarking on new challenges through investment, and this has deprived Japan of economic vigor. In order to exit such an environment, it is vital to dispel the deflationary expectations embedded in the people.

To address the challenge of overcoming deflation, the Bank introduced the QQE in April. The QQE has two pillars: first, it commits to achieving the price stability target of 2 percent in terms of the year-on-year rate of change in the CPI at the earliest possible time, with a time horizon of about two years; second, it represents pursuit of a new phase of bold monetary easing in order to underpin such commitment. Specifically, the Bank declared that it would double the monetary base, the amount of money it directly provides, in two years. In order to do so, it decided to make massive purchases of Japanese government bonds (JGBs) including those with long remaining maturities. For the last six months since it introduced the QQE, the Bank has been progressing with the provision of the monetary base and the purchase of JGBs as scheduled (Chart 12).

The effects of the QQE are expected to carry through the economy via several different routes. The most important of these is to lower real interest rates. Here, I would like to spend some time to explain the mechanism behind this. First of all, by committing to achievement of the 2 percent price stability target at the earliest possible time and announcing the continuation of a new phase of monetary easing into the future to underpin that commitment, the Bank aims to drastically change people's expectations and raise inflation expectations. Second, the Bank will put strong downward pressure on nominal long-term rates through the massive purchases of JGBs. Consequently, real interest rates could be lowered if the extent of a pickup in nominal rates could be contained within the extent of a rise in inflation expectations.

As the spending behavior of firms and households is influenced by real interest rates, the decline in real interest rates will stimulate business fixed investment, housing investment, and household consumption, thereby providing a strong backing to the economy. If the supply and demand balances in goods and services as well as labor supply and demand conditions tighten as the economy recovers, there will be upward pressure on prices. If actual prices rise, this will further lead to raising the people's inflation expectations. In sum, triggered by a rise in inflation expectations through a new phase of monetary easing, we will generate a virtuous cycle of a decline in real interest rates, an improvement in economic activity, a rise in actual prices, and a rise in inflation expectations.

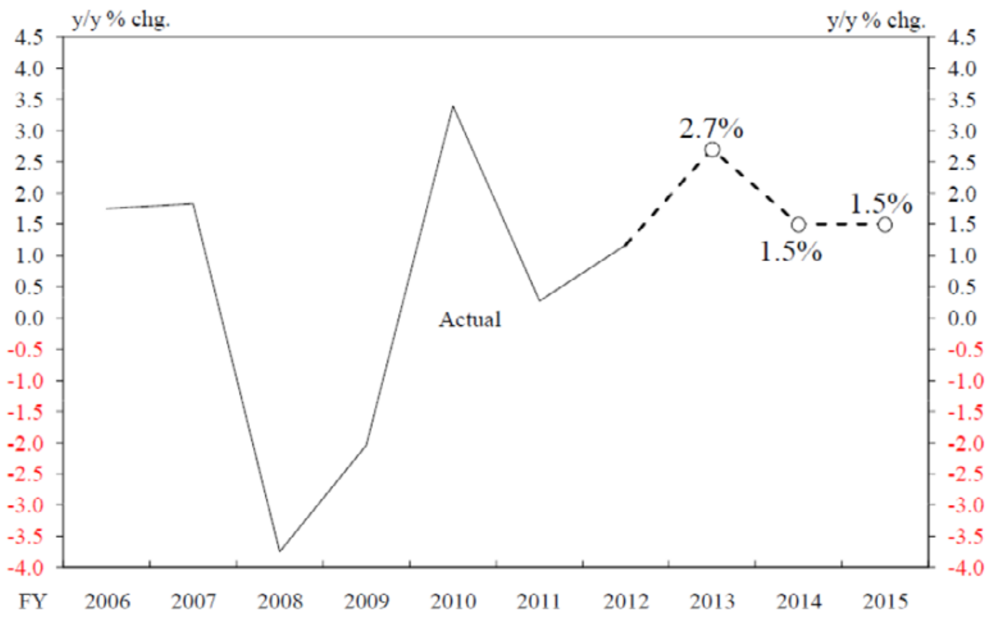
For the last six months, our endeavor on this front has been successful. As I said before, inflation expectations appear to be rising on the whole. By contrast, long-term rates remain stable at a low level of around 0.6 percent in Japan despite the rise in long-term interest rates in other economies (Chart 13). Bank lending rates have declined to a historic low level. In such situation, real interest rates should be declining. With such stimulative effects coming from monetary easing, Japan's economy has entered a recovery phase and the CPI has turned positive. What contributes to a rise in people's inflation expectations is not just the Bank saying that it will achieve the 2 percent inflation, but also the fact that actual prices have been rising.

As I have explained to you today, the QQE has been exerting its intended effects. Under the QQE, Japan's economy has been following the path toward achieving the 2 percent price stability target as expected. The Bank will continue with the QQE, aiming to achieve that target, as long as it is necessary for maintaining it in a stable manner. It will thoroughly examine both upside and downside risks to economic activity and prices, and make adjustments as necessary to achieve the price stability target. With such conduct of monetary policy, the Bank will surely manage to overcome deflation, which has been the challenge for nearly 15 years.

Thank you.

Chart 1

Forecast of Real GDP



Note: The circles in the chart indicate the median of the Policy Board members' forecast (point estimate).
Source: Bank of Japan.

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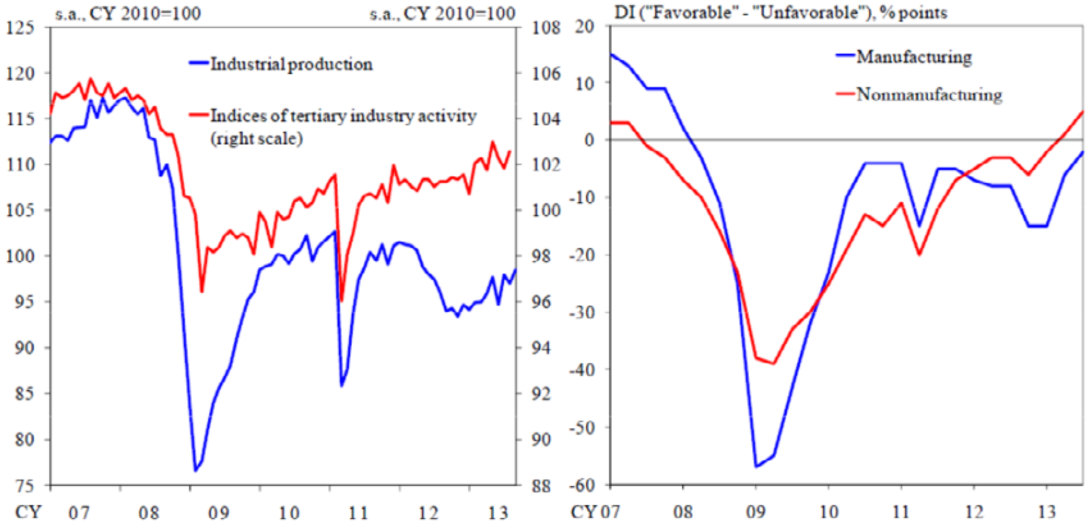
Chart 2

Features of the Current Economic Recovery

Industrial Production and Tertiary Industry Activity | *Business Conditions*



Sources: Ministry of Economy, Trade and Industry; Bank of Japan.

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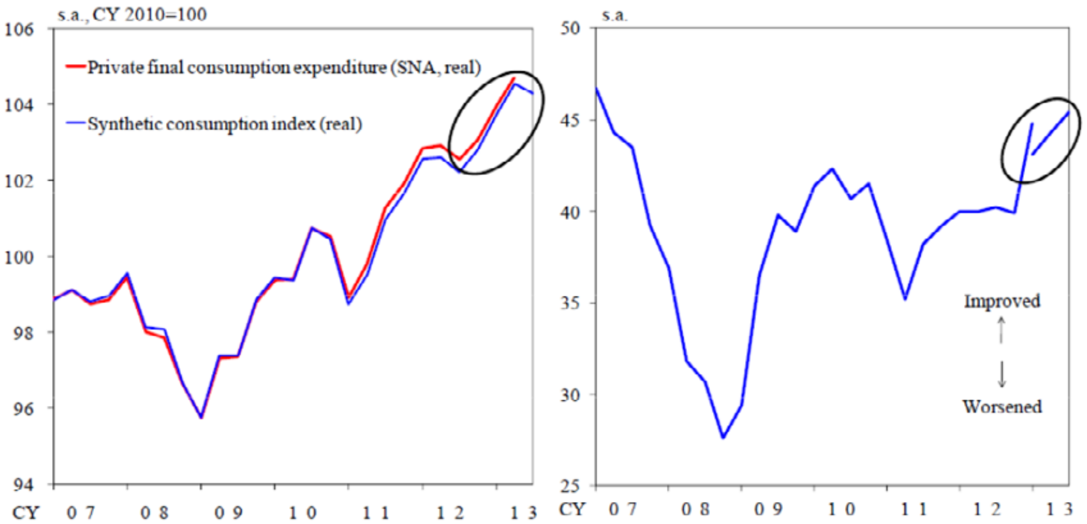
Chart 3

Private Consumption

Private Final Consumption Expenditure and Synthetic Consumption Index | *Consumer Confidence Index*



Note: The figure for the synthetic consumption index for 2013/Q3 is the July-August average.
Source: Cabinet Office.

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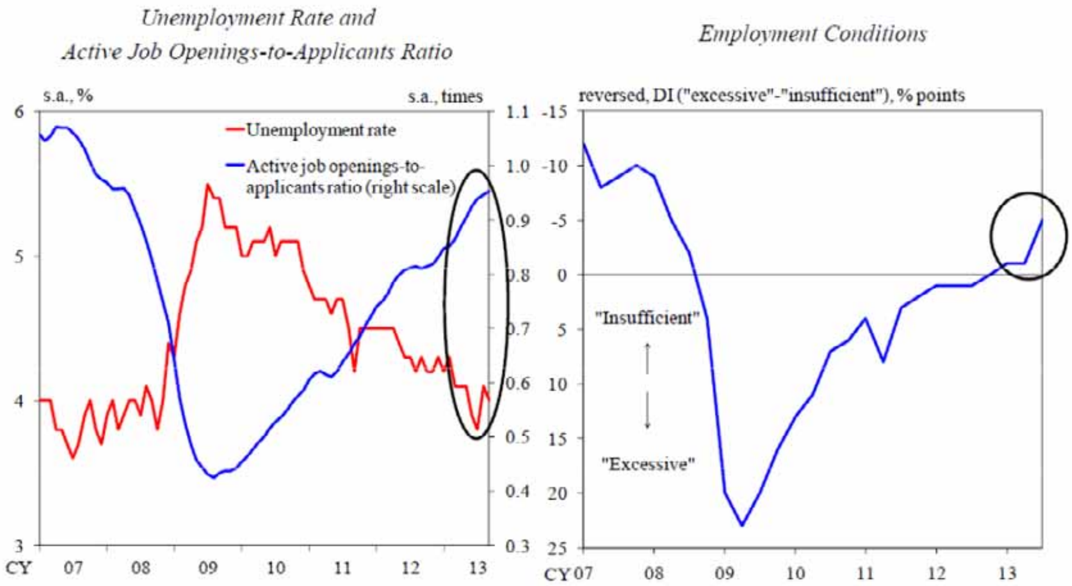
Chart 4

Employment Situation



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

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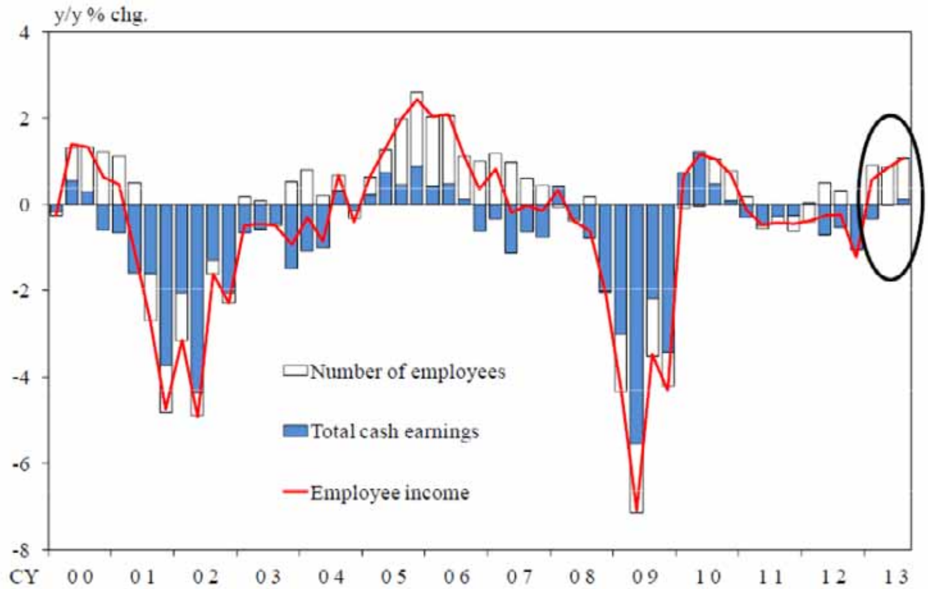
Chart 5

Breakdown of Employee Income



Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. Figures for 2013/3Q are those of September.
2. Employee income = number of employees (Labor Force Survey) × total cash earnings

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

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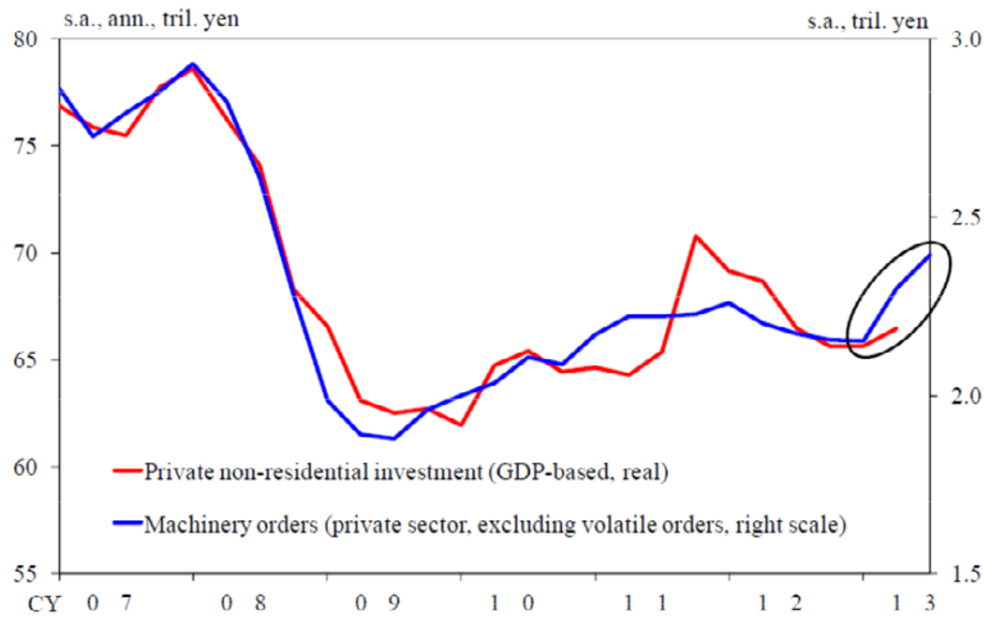
Chart 6

Business Fixed Investment



Note: The figure for 2013/Q3 is the July-August average.
Source: Cabinet Office.

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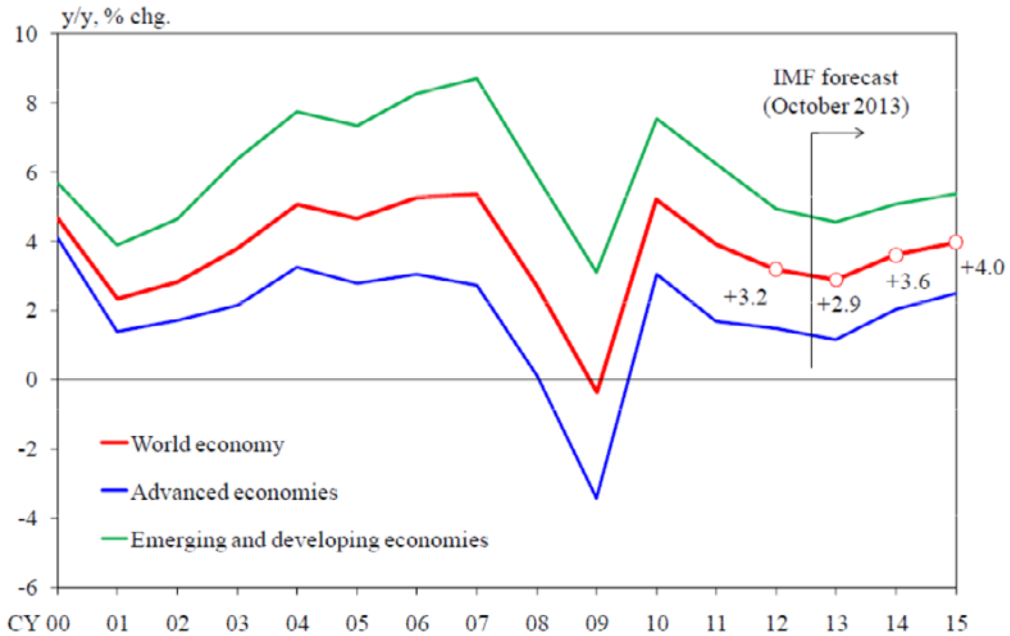
Chart 7

Overseas Economies Forecast



Source: IMF, "World Economic Outlook, October 2013."

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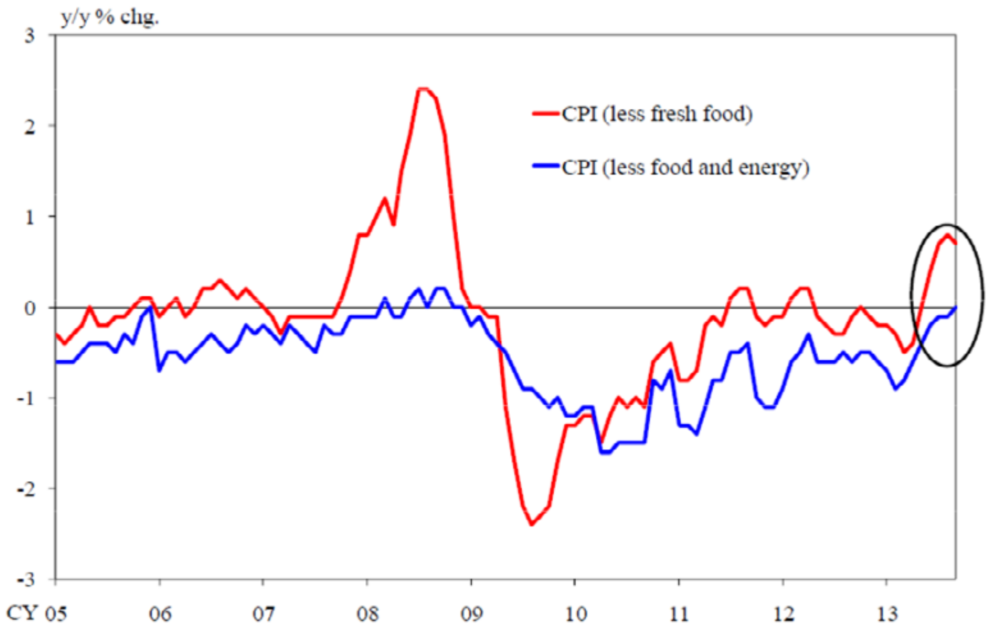
Chart 8

Consumer Price Index



Source: Ministry of Internal Affairs and Communications.

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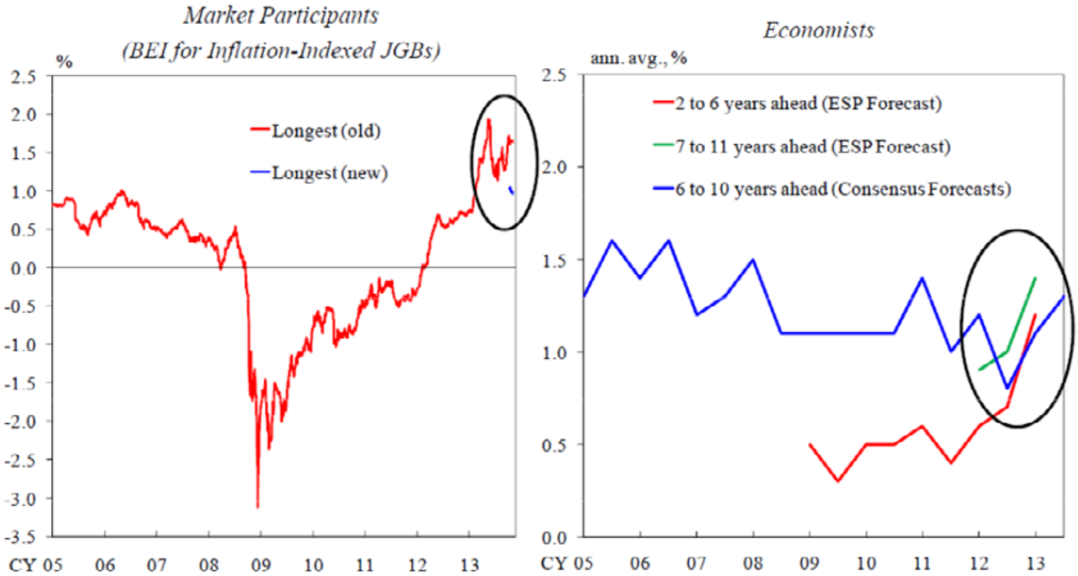
Chart 9

Inflation Expectations



Notes: 1. BEI (break-even inflation) rates are yield spreads between fixed-rate coupon-bearing JGBs and inflation-indexed JGBs. Inflation-indexed JGBs issued since October 2013 are designated as "new," while the rest of them are designated as "old." Figures for "longest" are calculated using yield data for the inflation-indexed JGBs that have the longest maturity at each period, which currently correspond to those maturing in June 2018 for "old" and September 2023 for "new."

2. Figures for the ESP Forecast exclude the effects of the scheduled consumption tax hikes.

Sources: Bloomberg; Consensus Economics Inc.; JCER.

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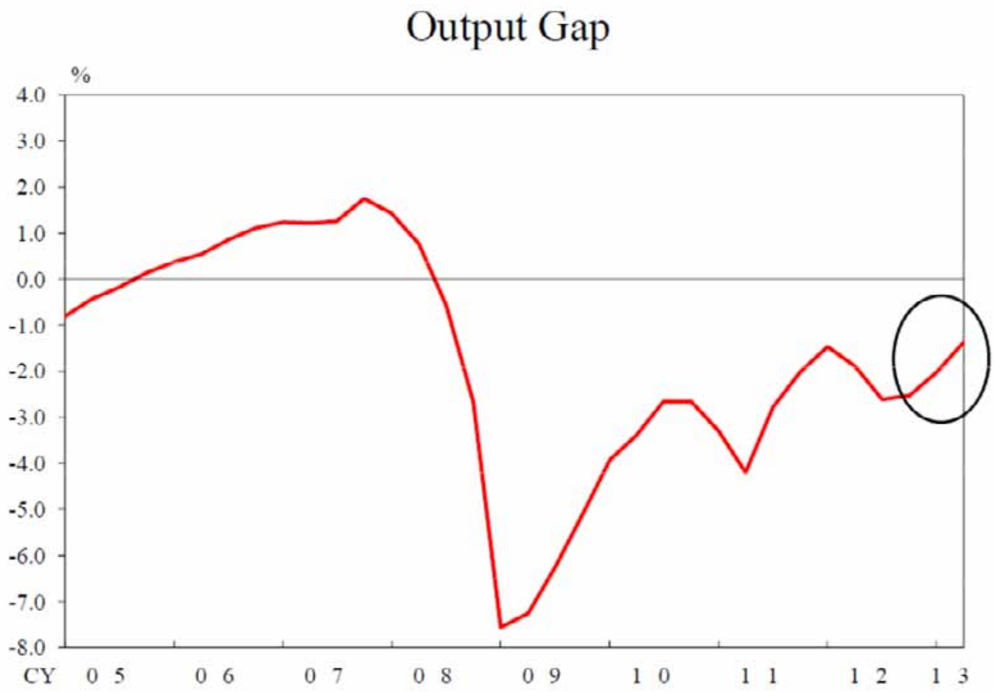
Chart 10



Note: The figures are estimated by the Research and Statistics Department, Bank of Japan.
Sources: Cabinet Office, etc.

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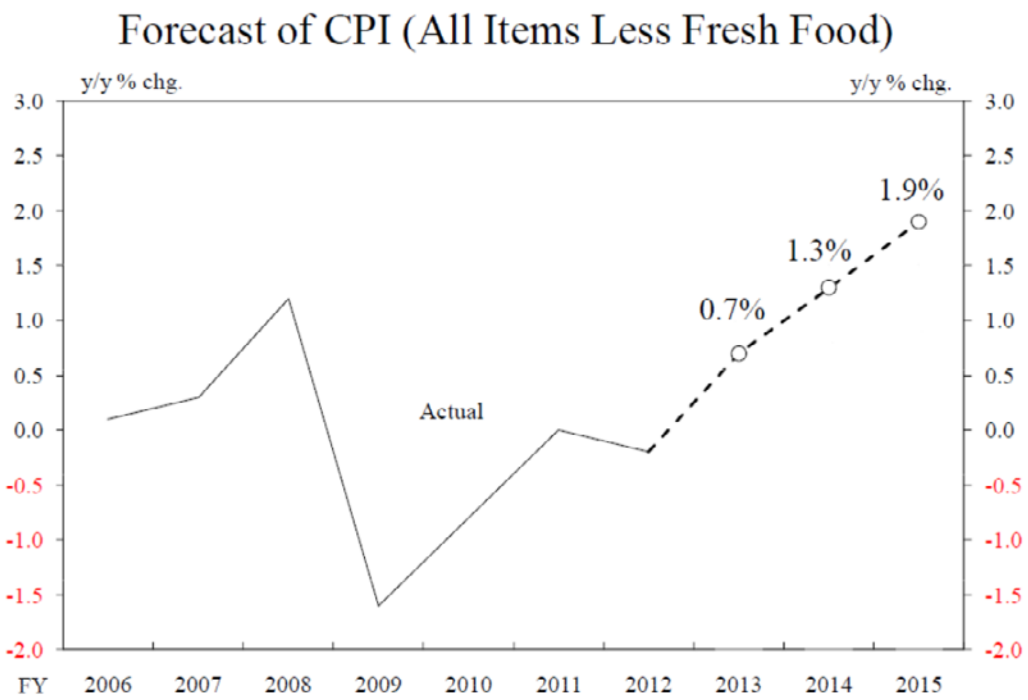
Chart 11



Notes: 1. The circles in the chart indicate the median of the Policy Board members' forecast (point estimate).
2. Excluding the direct effects of the scheduled consumption tax hikes.
Source: Bank of Japan.

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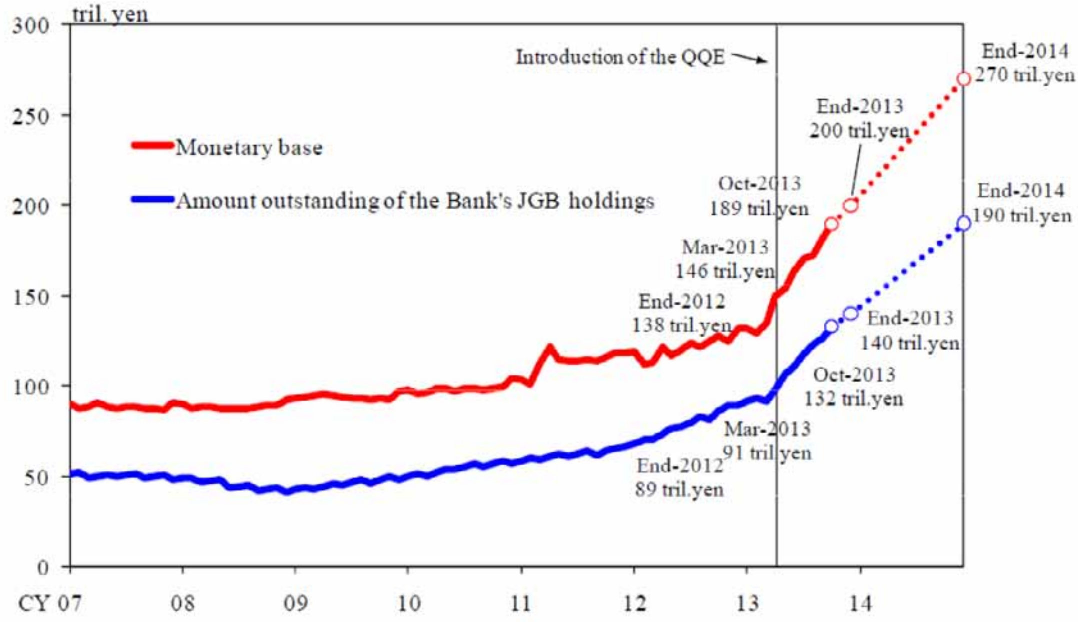
Chart 12

Expansion in the Monetary Base and JGB Holdings



Source: Bank of Japan.

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Chart 13

Long-Term Interest Rates

Source: Bloomberg.

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