Takahide Kiuchi: The economic outlook and monetary policy

Speech by Mr Takahide Kiuchi, Member of the Policy Board of the Bank of Japan, at the Japan Securities and Economics Club, Tokyo, 26 November 2013.

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Thank you for giving me an opportunity to speak at the Japan Securities and Economics Club. Today, I would like to talk about the economic outlook at home and abroad and the conduct of monetary policy in Japan.

I. Economic outlook

The Bank of Japan released the latest *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) at the end of October 2013, and presented the following outlook. Comparing the current projection with that in the July 2013 interim assessment, overseas economies have been somewhat weaker than anticipated, but domestic demand is expected to be somewhat stronger, partly due to the effects of various economic measures by the government. As a result, the projected growth rates as well as the outlook for prices in Japan are expected to be more or less unchanged from the July assessment.

As for Japan's economy, while exports have been picking up at a somewhat slower pace, domestic demand, notably private consumption, has been firm and overseas economies are picking up moderately. Looking ahead, while domestic demand is likely to maintain firmness as external demand is expected to increase, albeit moderately, a virtuous cycle among production, income, and spending is likely to be maintained.

As for prices, the year-on-year rate of change in Japan's consumer price index (CPI, for all items less fresh food, and the same hereafter) 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. The year-on-year rate of increase in the CPI, excluding the direct effects of the consumption tax hikes, is likely to follow a rising trend, reflecting factors such as the improvement in the aggregate supply and demand balance, as well as the rise in medium- to long-term inflation expectations resulting from economic recovery. In the October 2013 Outlook Report, it is projected to reach 1.9 percent in fiscal 2015 in terms of the median of the Bank's Policy Board members' forecasts.

As the background to this outlook for Japan's economy and prices, overseas economies have been somewhat weak, but they are expected to pick up gradually, particularly the advanced economies. Looking at respective major countries and regions, the U.S. economy has been recovering moderately on the back of firm private demand and is expected to gradually accelerate its pace of recovery, as accommodative financial conditions will be maintained and the fiscal drag will gradually fade. The European economy, which had been receding slowly, has finally bottomed out and is expected to gradually pick up. The Chinese economy is likely to maintain stable growth at around the current pace. By contrast, growth in other emerging and commodity-exporting economies will likely continue to lack momentum for the time being.

II. Risk factors to the outlook

The Outlook Report points out upside and downside risks to the Bank's aforementioned baseline scenario regarding the economy and prices. I personally pay closer attention to downside risks. Moreover, I formulated a proposal both in April and October 2013 to change the description of the Outlook Report, such as in terms of the outlook for prices. Let me share some of my considerations regarding the outlook with you.

A. Overseas economies

I am paying particular attention to the uncertainty regarding developments in overseas economies.

Looking at the revisions made to the World Economic Outlook released recently by the International Monetary Fund (IMF), the forecast for global economic growth has continued to be revised downward. In the latest forecast in October 2013, which updated the July 2013 forecast, global economic growth was revised downward in just three months by 0.3 percentage point for 2013 and 0.2 percentage point for 2014, mainly due to the lower growth outlook for emerging and commodity-exporting economies including China.

This seems to reflect an adjustment of imbalances that have built up in emerging economies since the Lehman shock. Such a buildup of imbalances is clearly apparent in the form of significant accumulation of private-sector debt against the background of excessive fiscal and monetary policy measures since the Lehman shock, and of the increase in capital inflows to these economies based on excessive expectations for economic growth. If the adjustment process is actually occurring, growth in these economies will likely continue to lack momentum for a protracted period.

Meanwhile, uncertainty remains regarding the momentum toward recovery for the U.S. economy and other advanced economies. In this situation, I am paying particular attention to the slowdown in the labor productivity growth trend in these economies, especially in the United States. With this slowdown, expectations for income increases may not rise easily even in a situation where employment continues to increase stably, and private consumption – a key determinant of the outlook for the U.S. economy – may not regain momentum soon. Therefore, I am carefully monitoring these developments.

B. Domestic demand

Economic recovery this time has been led by the nonmanufacturing sector so far, mainly driven by private consumption. In order to have continued firm domestic demand, it is important to maintain a situation in which improvement in the employment and income situation supports consumption. Another important factor in considering the future of domestic demand is the increase in firms' business fixed investment.

Turning to indexes related to consumption, private consumption remains resilient, but there is a sign of slowing in its growth momentum. The household activity-related diffusion indexes (DIs) for current and future economic conditions in the *Economy Watchers Survey*, which seem to reflect consumer confidence, dropped for the fifth consecutive month since April 2013. This development is consistent with that of real consumption expenditure in the *Family Income and Expenditure Survey*. The sign of slowing in consumption is also reflected to the latest GDP statistics. The real GDP growth rate in the July–September quarter of 2013 registered 0.5 percent on a quarter-on-quarter basis. On an annualized quarter-on-quarter basis, it slowed to 1.9 percent from around 4.0 percent in the first half of the year. Private consumption also slowed compared to the first half of the year, to 0.1 percent on a quarter-on-quarter basis. Business fixed investment on the whole grew for the third consecutive quarter, reflecting an improvement in corporate profits, to 0.2 percent on a quarter-on-quarter basis, but the recovery in the manufacturing sector still shows a lackluster performance. Meanwhile, exports – which largely affect investment by manufacturing firms – lack resilience and decreased for the first time in three quarters, to minus 0.6 percent on a quarter-on-quarter basis. I think the key to the future of domestic demand lies particularly in the extent to which business fixed investment will grow under these circumstances, but that a full-fledged recovery of such investment will take time.

C. Outlook for prices

As for the outlook for prices, I formulated a proposal to make the following changes in the October 2013 Outlook Report, although it was defeated by a majority vote during the

Monetary Policy Meeting (MPM). First, with regard to the outlook for prices toward the latter half of the projection period, I proposed to change the current expression that the year-on-year rate of change in the CPI "is likely to reach around 2 percent – the price stability target" to a new expression that "the rate of increase in the CPI is expected to rise moderately". Second, with regard to inflation expectations, I proposed changing the current expression that inflation expectations "are likely to continue on a rising trend under quantitative and qualitative monetary easing (QQE), partly supported by a rise in the observed inflation rate, gradually converging to around 2 percent – the price stability target" to a new expression that they "are likely to continue on a moderate rising trend, partly supported by a rise in the observed inflation rate".

In achieving the price stability target, it is important to create a virtuous cycle in which the inflation rate gradually rises as the economy as a whole grows in a sustainable manner and as people's standards of living improve. From such a viewpoint, I personally consider that it is neither easy nor appropriate to aim at achieving a price stability target of 2 percent in a short time frame of about two years.

The recent rise in prices is partly attributed to some strength in demand, but so far it has largely been attributed to other factors such as increases in energy prices and the effects of changes in foreign exchange rates. In order to achieve sustainable price increases together with economic improvement, a rise in wages – especially employees' scheduled cash earnings – is considered to be the key.

It is most likely that some firms will raise wages including base salaries in the upcoming spring wage negotiations and that the average rate of wage increase will rise to some extent. However, in order for an increasing number of firms to significantly raise base salaries and for prices to be on an uptrend as a result, supply and demand conditions in the labor market must improve further through a heightening of growth expectations. Since developments in employment and wages tend to lag behind economic growth, my view is that a considerable time lag is to be expected until the inflation rate rises together with the wage increase. For example, under an assumption that the real wage growth rate equals the labor productivity growth rate, if the labor productivity growth rate is about 1 percent, the nominal wage growth rate – consistent with the price stability target of 2 percent – should reach about 3 percent, and by the same token, if the labor productivity growth rate is about 0.5 percent, the nominal wage growth rate should rise to about 2.5 percent. To attain such a level of growth in nominal wages will take considerable time. Having said that, what I think is important is to create and maintain a virtuous cycle in which the inflation rate rises, albeit gradually, along with an increase in nominal wages.

In this connection, I think that, even in a situation where wages and prices increase in a balanced manner over time, given that other advanced economies are currently on a disinflationary trend, Japan's inflation rate may still be susceptible to downward pressure.[1]

III. Monetary policy

The Bank introduced QQE in April 2013, with a view 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. In this policy, the main operating target for money market operations was changed from the uncollateralized overnight call rate to the monetary base, and it was decided that the Bank would aim to double the monetary base in two years. In doing so, it would purchase massive amounts of Japanese government bonds (JGBs),

[1] For historical developments in Japan's inflation rate and a comparison with other major economies, see "Recent Developments in Economic Activity and Prices, and Future Monetary Policy", a speech by Takahide Kiuchi at a meeting with business leaders in Kanagawa on February 28, 2013, available on the Bank's web site (http://www.boj.or.jp/en/announcements/press/koen_2013/ko130319a.htm/).

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 QQE as long as it is necessary for maintaining the target in a stable manner.

So far, QQE has exerted positive effects on Japan's economy through a positive influence on the expectations of financial markets and of firms and households. Since the introduction of the policy in April, however, while supporting the concrete measures of QQE, I have continued to propose changing the expression in the Statement on Monetary Policy regarding the time frame for achieving the 2 percent price stability target and for continuing with QQE, although my proposal has been repeatedly defeated by a majority vote during the MPMs. Let me explain the intention of my proposal as well as my personal views on some points of discussion regarding the conduct of monetary policy.

A. Flexibility of the commitment

My proposal is to replace the expression in the Statement on Monetary Policy with a new one stating that "the Bank will aim to achieve the price stability target of 2 percent in the medium to long term. On this basis, it will designate QQE as an intensive measure with a time frame of about two years, and thereafter will review the monetary easing measures in a flexible manner". This proposal aims to make the current policy commitment more flexible. First, it does not restrict the time frame for achieving the 2 percent price stability target to about two years. Second, it clearly states the idea that the time frame for continuing with QQE should be about two years, and that when this time frame comes to an end, the Bank will review the monetary easing measures in a flexible manner, as necessary.

As shown in the minutes of the MPM held on April 3 and 4, 2013, the reasons behind this proposal were that (1) achieving the price stability target of 2 percent with a time horizon of about two years entails high uncertainty; and (2) in such a situation there is concern that, if a rise in expectations – namely, that QQE would continue for a protracted period – were to occur, this could lead to a buildup of financial imbalances, for example, given that the Bank's purchases of financial assets would be unprecedented in scale. In the minutes, other potential risks were also pointed out: the possibility of a rise in speculation that the Bank is engaged in financing fiscal deficits, the possibility that the financial system would become more vulnerable to risks with financial institutions' profits being squeezed, and the possibility that market functioning would be impaired considerably.

While fully recognizing these potential risks, I have nonetheless supported the concrete measures of QQE because I have judged that its positive effects on the economy outweigh, albeit slightly, the associated potential risks or side effects.

However, if the current large-scale monetary easing were to be protracted or strengthened, there would be a possibility that the side effects would instead outweigh the positive effects. In this regard, one cannot rule out the possibility that, under the current policy commitment, if financial markets increasingly view achieving the price stability target in about two years as difficult, the Bank will be obliged to extend or strengthen its monetary easing driven by such external factors, even in a situation where it is judged that side effects outweigh positive effects on the economy. Taking this possibility into account, I have proposed not to restrict the time frame for achieving the price stability target, and proposed to designate QQE as an intensive measure with a time frame of about two years based on the recognition that it is appropriate to secure an opportunity for the Bank to thoroughly examine, after a certain period of time, whether the side effects of the large-scale monetary easing are not outweighing the positive effects and review the easing measures in a flexible manner depending on economic and financial conditions at the time.

B. Price stability target and medium- to long-term inflation expectations

In my proposal, the price stability target of 2 percent is set as a medium- to long-term goal because I think the 2 percent target may become consistent with Japan's economic fundamentals only in the medium to long term.

The Bank's commitment to achieving the price stability target of 2 percent does not mean that a temporary achievement of this rate is sufficient. It is important to maintain the 2 percent target in a stable manner. To this end, it is necessary for not only the observed inflation rate but also medium- to long-term inflation expectations to be about 2 percent. If the observed inflation rate hovers around 2 percent on average and firms and households act on the assumption that prices will increase by about 2 percent, this will lead to price stability in the medium to long term.

So far, the observed inflation rate has been rising, but many indicators suggest that the rise in medium- to long-term inflation expectations, such as for five to ten years ahead, will remain moderate. This implies that the Bank's decision of setting the 2 percent price stability target alone is not enough for achieving its aim to raise medium- to long-term inflation expectations to the targeted level.

I think that medium- to long-term inflation expectations are mainly determined by supply side factors such as the potential growth rate and the labor productivity growth rate, rather than by the supply and demand balances in the goods and labor markets. If QQE induces positive movements by private economic entities and the government's economic growth strategy makes progress in parallel, the growth potential of Japan's economy would gradually strengthen and, accordingly, medium- to long-term inflation expectations would likely rise as well. However, as shown in my proposal with regard to the outlook for prices in the Outlook Report, I take the view that such a process will take considerable time, and therefore think it appropriate not to set a specific time frame for achieving the price stability target. Moreover, I think there will be room for a future reconsideration of the level of the price stability target that is currently set at 2 percent, considering future changes in the growth potential and medium- to long-term inflation expectations.

C. QQE and fiscal consolidation

QQE itself is a powerful policy, but it will exert maximum effects when combined with the government's efforts to secure confidence in fiscal sustainability.

The Bank's measures, including JGB purchases, are solely conducted for the purpose of achieving the price stability target, but if this is perceived by the markets as financing fiscal deficits, the effects of QQE could be hampered as long-term interest rates rise due to an expansion in risk premiums. The joint statement by the government and the Bank released in January 2013 stated that the government will steadily promote measures aimed at establishing a sustainable fiscal structure with a view to ensuring the credibility of fiscal management. The government's recent decision to raise the consumption tax rate is part of such efforts toward fiscal consolidation.

Apart from the government's efforts toward fiscal consolidation, domestic private entities' perception also constitutes an important factor when examining the fiscal risk. One of the reasons why Japan's financial markets have been stable despite the increase in the amount outstanding of government debt lies in the fact that JGBs are mostly held by the domestic private sector, and market participants seem to believe that domestic private entities will ultimately behave rationally – for example, by accepting tax hikes and expenditure cuts – to avoid decreases in the value of their assets caused by realization of the fiscal risk. Market participants, however, may change their views if the public starts thinking that fiscal consolidation can be achieved without revenue and expenditure reforms, mainly reflecting the public's excessively optimistic expectations for future potential growth, thereby significantly impairing the effects of the Bank's monetary policy. In this respect, as much as it is important to achieve fiscal consolidation, it is also important that the public and the markets widely recognize that strengthening growth potential requires considerable time.

IV. Concluding remarks

While the Bank has been implementing QQE, other major central banks have also introduced unconventional monetary policy measures to deal with the economic and financial crisis that materialized in the aftermath of the bursting of the global credit bubble following the Lehman shock in the autumn of 2008. Such developments in other economies and related discussions will serve as a useful reference in considering the future conduct of monetary policy in Japan. In closing, I will touch on two points in particular.

First, as I mentioned earlier, a slowdown in the labor productivity growth trend is observed in advanced economies, and this suggests a decline in potential growth rates in these economies. While monetary policy may be able to buy time until necessary adjustments are made for such structural changes, it cannot substitute for structural reforms such as raising the labor productivity growth rate and solving labor market mismatch. Therefore, policymakers have to correctly recognize structural changes and respond to them appropriately, while taking into account what monetary policy can and cannot do. If they do not recognize structural changes and depend too much on monetary policy, excessive easing could result in the accumulation of economic and financial imbalances.

Second, I would like to refer to the division of roles between two policy tools; namely, conventional and unconventional monetary policy. Taking the Federal Reserve's practice of these two types of policy tools as an example, my understanding is that the Federal Reserve regards the asset purchase policy as a measure to generate upward momentum in economic activity and prices and affect the direction of such momentum under the non-negativity constraint on nominal interest rates, while regarding the interest rate policy as a measure to encourage economic activity and prices to reach desirable levels. Such division of roles between the two policy tools in the United States will likely serve as a reference in considering Japan's future monetary policy. In this regard, in calculating Japan's policy interest rate under the Taylor rule,[2] my estimate – which had been in negative territory – shifted upward, and it is around 0 percent at present. Although this estimate is subject to a considerable margin of error, as it could change depending on the specific assumption employed, this suggests that financial conditions are becoming increasingly accommodative on the back of the rise in prices and of the improvement in the output gap following the introduction of QQE, and that, therefore, maintaining the zero interest rate may lead to the accumulation of economic stimulus effects. Going forward, when an expansionary momentum of economic activity and prices becomes sufficiently strong as a result of the positive outcome of QQE, it will be important to find the most appropriate balance between the two types of policy tools by carefully weighing the associated positive effects and side effects that differ between them, while paying due attention to the increased effects on the economy of the zero interest rate policy.

Thank you for your attention.

[2] The Taylor rule is a monetary policy rule under which the level of a benchmark policy interest rate is calculated based on a particular formula using, for example, the deviation of the observed inflation rate from the targeted inflation rate, and the output gap.