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, Nagoya, 2 December 2013.

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Accompanying charts can be found at the end of the speech.

Introduction

It is my great pleasure to have this opportunity to address such a distinguished gathering of business leaders in the Chubu region today. I would like to express my sincere gratitude to you for your cooperation with our Nagoya branch.

The greatest challenge facing Japan's economy is overcoming deflation that has lasted for nearly 15 years. Amid protracted deflation, corporate profits and wages have been compressed, the spending of firms and households has declined accordingly, and Japan's economy has become oriented toward contraction. Under deflation, as the real value of cash rises with a decline in the prices of goods and services, saving cash at hand will be relatively advantageous, rather than making investment that pursues new opportunities. In such a situation, the incentive to take on challenging new business opportunities will decline and people's mindset as a whole will become pessimistic, thereby depriving Japan's economy of vitality.

In response, at the Monetary Policy Meeting held on April 3 and 4, the Bank of Japan made a clear commitment to achieving a 2 percent price stability target at the earliest possible time, with a time horizon of about two years, and introduced a new phase of "quantitative and qualitative monetary easing" (QQE) to underpin that commitment. So far, the QQE has been steadily exerting its intended effects, with an improvement in the real economy, financial markets, and people's expectations and mindsets, and Japan's economy has been following the path toward achieving the 2 percent price stability target, as expected.

Today, before exchanging views with you, I would like to explain the Bank's view on the current situation and outlook for economic activity and prices as well as effects of the QQE, in part by referring to the *Outlook for Economic Activity and Prices* (Outlook Report) released at the end of October.

I. Current situation and outlook for Japan's economy

Japan's economy has been recovering moderately as domestic demand has been firm and overseas economies as a whole have been picking up moderately. Compared with what was anticipated at the time of the April Outlook Report, the economy as a whole has been developing almost as expected, with external demand slightly weaker, as exports have been picking up at a somewhat slower pace, and domestic demand slightly stronger.

Looking ahead, as external demand is expected to increase, albeit moderately, while domestic demand is likely to maintain firmness, a virtuous cycle among production, income, and spending is likely to be maintained. While the economy will be affected by a swing in 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. In terms of the median of the real GDP projections by the nine Policy Board members in the Outlook Report released at the end of October, it is 2.7 percent for fiscal 2013, 1.5 percent for fiscal 2014, and 1.5 percent again for fiscal 2015 (Chart 1).

As for price developments against such a backdrop, the year-on-year rate of change in the consumer price index (CPI, all items excluding fresh food) turned positive in June 2013 and recently accelerated to 0.9 percent in October (Chart 2). 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, improvement has been spreading in a wide range of items as domestic demand, including private consumption, has been firm. This can be confirmed by the fact that the year-on-year rate of change in the CPI (all items excluding food and energy) has turned positive and that the number of items for which prices are increasing has surpassed that of items for which prices are decreasing (Chart 3).

Looking ahead, the year-on-year rate of change in the CPI is likely to follow an increasing trend, as an improvement in the aggregate supply and demand balance brought about by economic recovery will contribute to lifting prices, and as people's medium- to long-term inflation expectations are likely to rise, due partly to an increase in the observed inflation rate. In terms of the median of the CPI growth projections by Policy Board members, on the basis of excluding direct effects of the consumption tax hikes, it is 0.7 percent for fiscal 2013, 1.3 percent for fiscal 2014, and 1.9 percent for fiscal 2015 (Chart 1). Namely, it is likely to reach around the price stability target of 2 percent toward the latter half of the projection period up to fiscal 2015.

II. Outlook for Japan's economy and overcoming of deflation

Let me next talk about points that warrant attention with regard to achieving the aforementioned outlook after confirming the features of economic recovery this time around. Unlike the typical pattern of exports and large manufacturing firms leading economic recovery, this economic recovery features the nonmanufacturing sector recovering ahead of the manufacturing sector, led by private consumption and public investment. In fact, while the Indices of Tertiary Industry Activity, which show the level of activity in the nonmanufacturing sector, have recovered to a level close to that seen prior to the Lehman shock, production in the manufacturing sector has remained at about 80 percent of its peak 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 improving ahead of that for the manufacturing sector (Chart 4).

Given the pattern of economic recovery this time, in looking to the sustainability of economic recovery, the sustainability of firm domestic demand that has led the economy so far will be a key. Another key will be whether overseas economies recover and exports see a smooth increase while domestic demand underpins the economy. Let me touch on developments in overseas economies, followed by those in households' employment and income situation and in firms' business fixed investment in relation to the sustainability of domestic demand.

Overseas economies

Overseas economies as a whole are picking up moderately, although there are partly lackluster movements.

They are expected to continue to pick up, led mainly by advanced economies. In its *World Economic Outlook*, the International Monetary Fund (IMF) projects that the world economy will grow 2.9 percent in 2013 and moderately accelerate its pace of growth to 3.6 percent in 2014, and to 4.0 percent in 2015 (Chart 5). Looking at respective regions, the U.S. economy is expected to gradually see an acceleration in its pace of recovery, led mainly by domestic demand, as the fiscal drag will gradually fade. The European economy is expected to gradually pick up on the back of recovery in exports in tandem with a pick-up in domestic demand. In addition, the Chinese economy is likely to maintain stable growth, as the government, while progressing with reforms to address structural problems, is expected to pursue policy measures that take due account of economic activity. Meanwhile, there are partly weak movements in other emerging and commodity-exporting economies, and thus those economies will likely lack growth momentum for the time being, from a longer-term perspective; however, growth rates are expected to pick up again.

Of course, uncertainties remain high regarding the outlook for overseas economies, such as consequences of the government debt problem in the United States, the debt problem and efforts to restore financial soundness in Europe, outcomes of structural reforms to address problems such as excess production capacity in the manufacturing sector in China, and efforts to address structural problems in other emerging and commodity-exporting economies, all of which warrant attention. However, even bearing in mind such uncertainties, the baseline scenario is that overseas economies will continue to pick up and Japan's exports will accordingly increase moderately.

Developments in employment and income

From the perspective of a sustainable recovery in domestic demand, I would like to talk next about developments in employment and income. As mentioned earlier, Japan's economy is expected to recover moderately in a virtuous cycle among production, income, and spending, and will achieve the 2 percent price stability target. To this end, it is critical to have an improvement in income in order to underpin private consumption.

Looking at current employment and income developments, supply and demand conditions in the labor market continue to recover steadily, albeit moderately, due partly to resilient domestic demand, and the unemployment rate has declined to the level observed prior to the Lehman shock, of around 4 percent (Chart 6). This improvement in supply and demand conditions in the labor market has started to influence nominal wages. The year-on-year rate of change in nominal wages per regular employee has become slightly positive, partly reflecting growth in summer bonuses for the first time in three years and an increase in overtime pay. In addition, the year-on-year rate of growth in hourly nominal wages per part-time employee has been modestly accelerating (Chart 7).

Going forward, as the improvement in supply and demand conditions in the labor market continues, nominal wages are expected to be put under upward pressure gradually. While scheduled wages per employee have remained negative year-on-year, due partly to an increase in the proportion of part-time workers, if these stable wages start to increase, this will contribute to a sustainable increase in household spending. Amid increasing corporate profits, partly due to ongoing initiatives through cooperation among the government, workers, and employers, we anticipate an increase in scheduled wages, including an increase in base wages.

Developments in business fixed investment

Turning to the corporate sector, to achieve an economic recovery accompanied by a virtuous cycle among production, income, and spending, it is critical that an increase in corporate profits lead to an increase in business fixed investment. Corporate profits have been recovering, due partly to a correction of the past yen appreciation (Chart 8). Business fixed investment has been resilient in the nonmanufacturing sector, and there also are signs of improvement in the manufacturing sector, which has been lagging (Chart 9).

Going forward, business investment is likely to follow a moderate increasing trend, reflecting an improvement in corporate profits as well as effects of monetary easing. In the context of investment profitability, profitability from business fixed investment is likely to improve and monetary easing effects are likely to strengthen, reflecting a rise in the rate of return on capital due to economic recovery together with declining real interest rates under the QQE. In addition, reflecting past restraints on firms' investment, pent-up demand in business fixed investment is likely to surface (Chart 10). Furthermore, firms' medium- to long-term growth expectations are likely to rise moderately, due partly to the positive initiatives to strengthen competitiveness and growth potential, such as the government's regulatory and institutional reforms and various tax reduction measures, as well as firms' restructuring efforts. Given such an environment, business fixed investment is more likely to increase as the level of economic activity further elevates.

Looking back, amid nearly 15 years of deflation, firms have been accumulating cash in order to prepare for the worst by, for example, containing business fixed investment relative to cash flow (Chart 11). As a result, firms' cash at hand has reached 230 trillion yen, which is almost 50 percent of nominal GDP. Given the deflationary economy, it seems rational for a firm to increase its cash at hand as a relatively better investment; however, as a result of a firm not effectively using precious cash, Japan's economy as a whole has been deprived of vitality. In an economy that has overcome deflation, it will be better, unlike in the past, to effectively use cash in the form of business fixed investment, research and development, and staffing, rather than to save it. I expect firms to gauge such a change in environment as a business opportunity that will lead them to take positive economic actions.

III. Conduct of monetary policy

Lastly, I would like to talk about the conduct of monetary policy. In April this year, the Bank committed to achieving the 2 percent price stability target at the earliest possible time, with a time horizon of about two years, and introduced the QQE to underpin the commitment. Specifically, it would increase the monetary base at an annual pace of about 60–70 trillion yen and double the monetary base in two years. In order to do so, it would purchase Japanese government bonds (JGBs) so that the amount outstanding of JGB holdings would increase at an annual pace of about 50 trillion yen (Chart 12). While the chart shows the outstanding amounts of the monetary base and JGB holdings as of end-2013 and end-2014, these are projected amounts under the current policy and do not suggest in any way a time limit of the policy conduct. As I will mention later, the Bank will continue with the QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining the target in a stable manner.

The effects of the QQE are expected to carry through the economy via several different routes, and the most important of these is to lower real interest rates. To be specific, 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, it will put strong downward pressure on nominal long-term interest rates through massive purchases of JGBs. Consequently, real interest rates could be lowered if the extent of a pick-up in nominal rates can be contained within the extent of a rise in inflation expectations. And the decline in real interest rates is expected to have the effect of stimulating business fixed investment and household spending.

For the last eight months, our endeavor on this front has been successful. According to surveys on households and economists, inflation expectations seem to have been rising on the whole (Chart 13). By contrast, long-term rates have remained stable at a low level of around 0.6 percent in Japan despite the rise in long-term interest rates in other advanced economies (Chart 14). Therefore, real interest rates have been declining. Under such stimulative effects, Japan's economy has been recovering moderately and the year-on-year rate of change in 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. In such a manner, the QQE has been exerting its intended effects.

Concluding remarks

As I have explained to you today, 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 examine both upside and downside risks to economic activity and prices, and make adjustments as necessary to achieve the price stability target. I would like to conclude my speech by promising that the Bank will surely manage to overcome deflation, which is the largest challenge facing Japan's economy, through such conduct of monetary policy.

Thank you for your attention.

Japan's Economy and Monetary Policy

Speech at a Meeting with Business Leaders in Nagoya

December 2, 2013

Haruhiko Kuroda

Governor of the Bank of Japan

Chart 1

Forecasts of the Majority of Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2013	**+2.7** <+2.8>	**+0.7** <+0.6>	
Fiscal 2014	**+1.5** <+1.3>	+3.3 <+3.3>	**+1.3** <+1.3>
Fiscal 2015	**+1.5** <+1.5>	+2.6 <+2.6>	**+1.9** <+1.9>

Notes: 1. Figures indicate the median of the Policy Board members' forecasts (point estimates).
2. Figures in angle brackets are the median forecasts made in July 2013.
Source: Bank of Japan.

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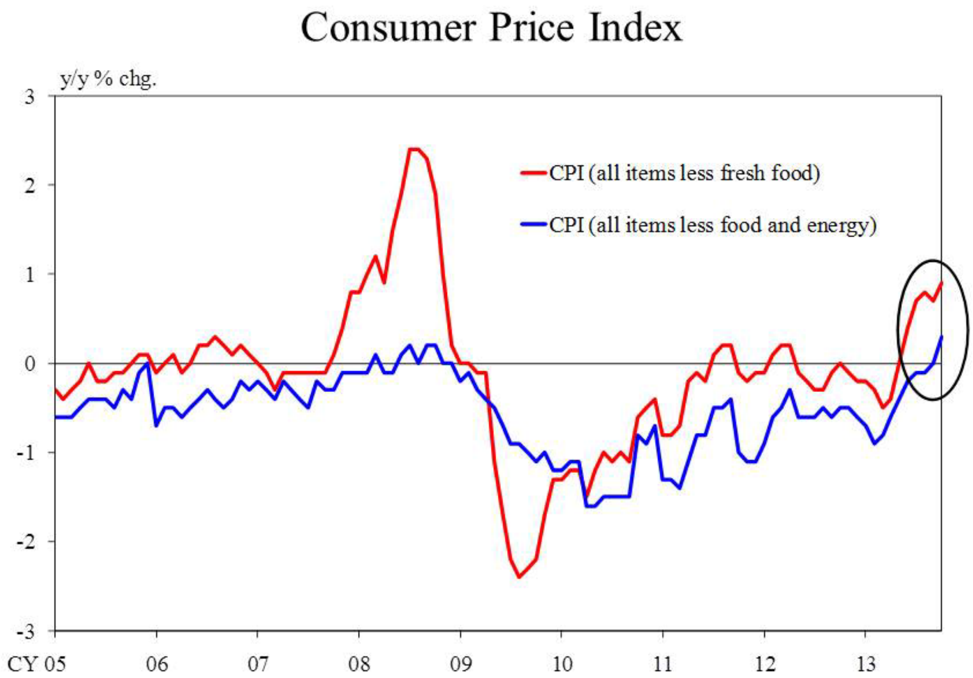
Chart 2



Source: Ministry of Internal Affairs and Communications.

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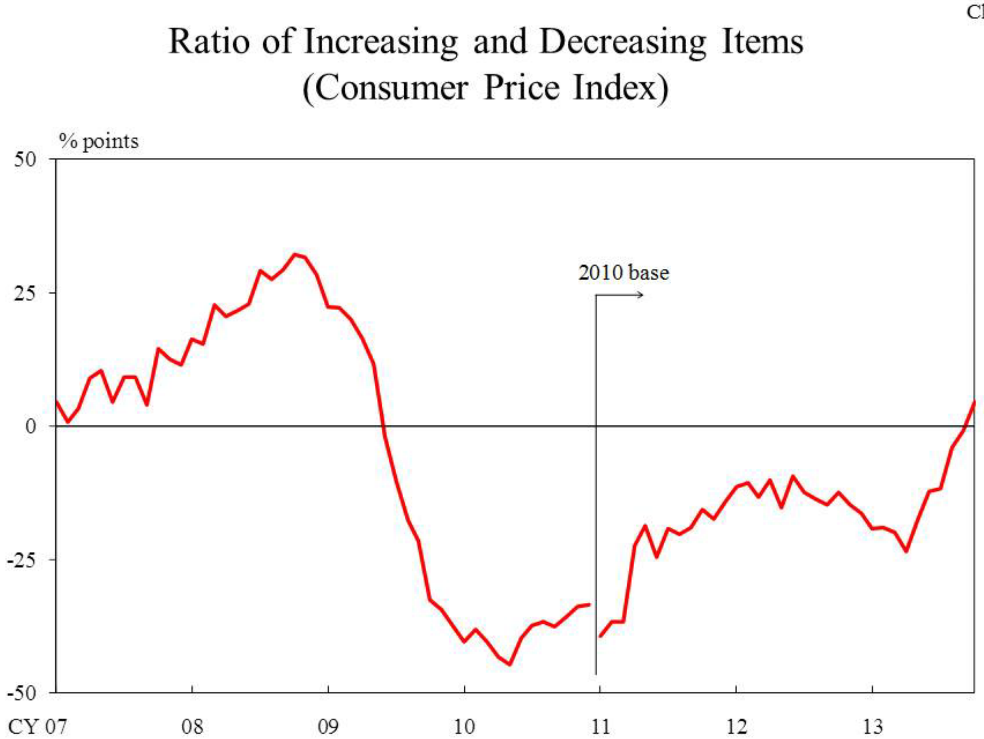
Chart 3



Note: Proportion of items whose year-on-year rates of price change increased/decreased. All items less fresh food.
Source: Ministry of Internal Affairs and Communications.

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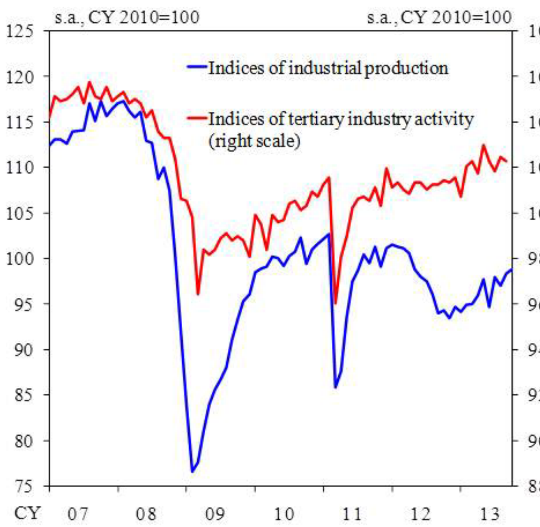
Chart 4

Features of the Current Economic Recovery

Industrial Production and Tertiary Industry Activity



Business Conditions
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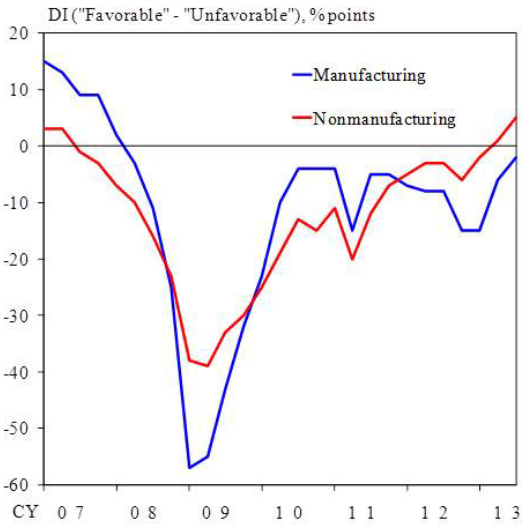

Sources: Ministry of Economy, Trade and Industry; Bank of Japan.

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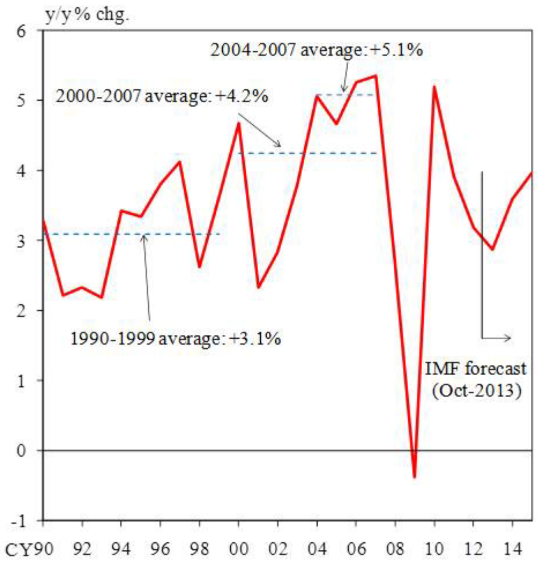
Chart 5

World Economy

Real GDP Growth Rate



Projections for Major Economies

y/y % chg.

	2011	2012	Projections 2013	Projections 2014	2015
World	3.9	3.2	2.9 (-0.3)	3.6 (-0.2)	4.0
Advanced Economies	1.7	1.5	1.2 (0.0)	2.0 (0.0)	2.5
United States	1.8	2.8	1.6 (-0.1)	2.6 (-0.2)	3.4
Euro Area	1.5	-0.6	-0.4 (0.1)	1.0 (0.0)	1.4
Japan	-0.6	2.0	2.0 (-0.1)	1.2 (0.1)	1.1
Emerging Market and Developing Economies	6.2	4.9	4.5 (-0.5)	5.1 (-0.4)	5.3
Developing Asia	7.8	6.4	6.3 (-0.6)	6.5 (-0.5)	6.6
China	9.3	7.7	7.6 (-0.2)	7.3 (-0.4)	7.0
Brazil	2.7	0.9	2.5 (0.0)	2.5 (-0.7)	3.2

Note: Figures in parentheses are the difference from the July 2013 WEO.
Source: IMF, "World Economic Outlook, October 2013."

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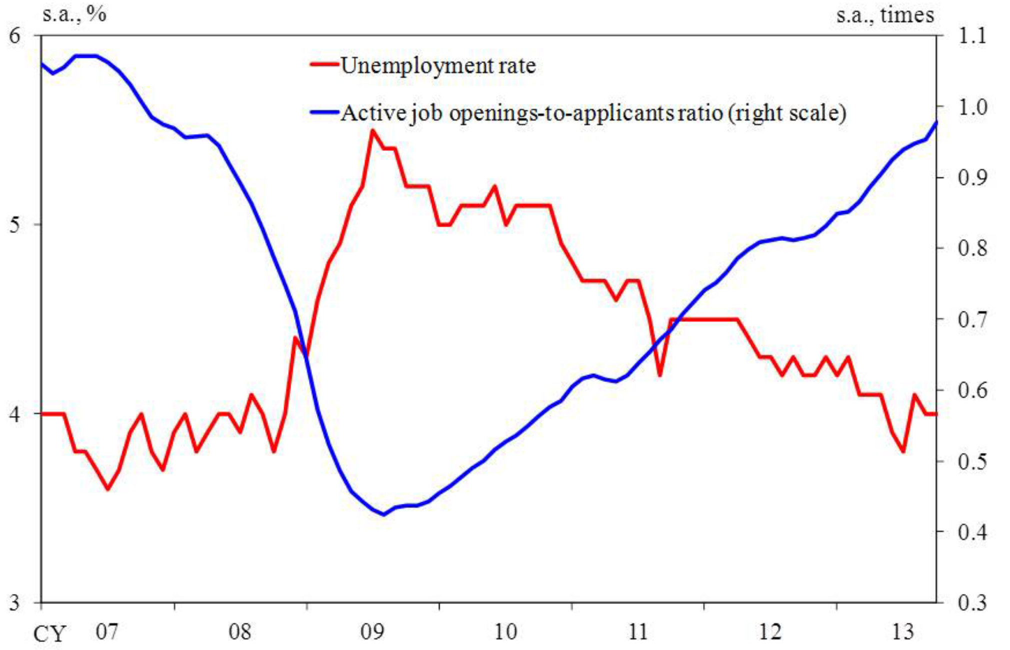
Chart 6

Employment Situation



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

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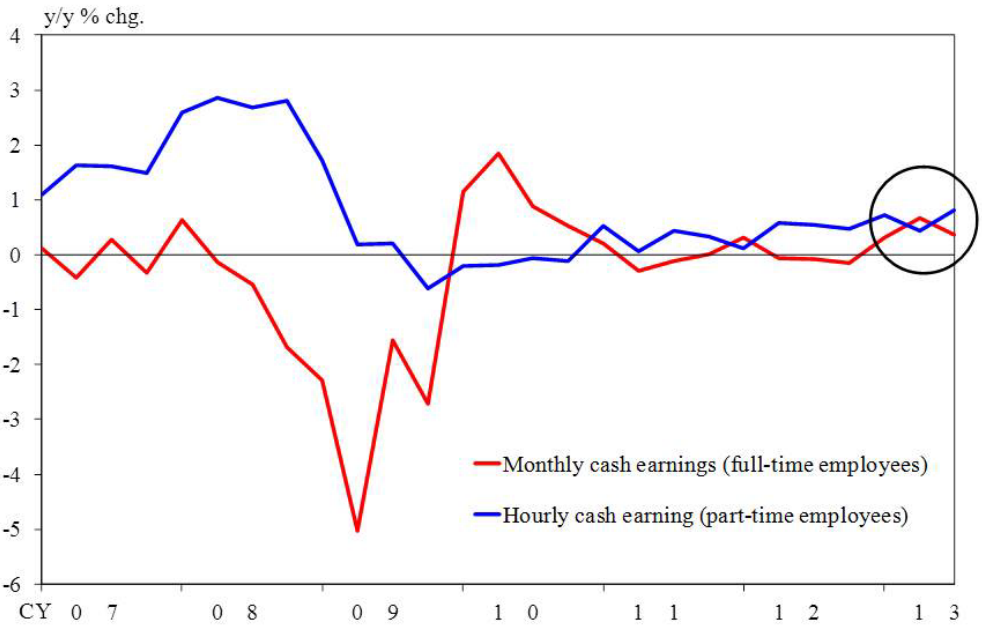
Chart 7

Cash Earnings



Note: Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. Figures for 2013/Q3 are those of September.
Source: Ministry of Health, Labor and Welfare.

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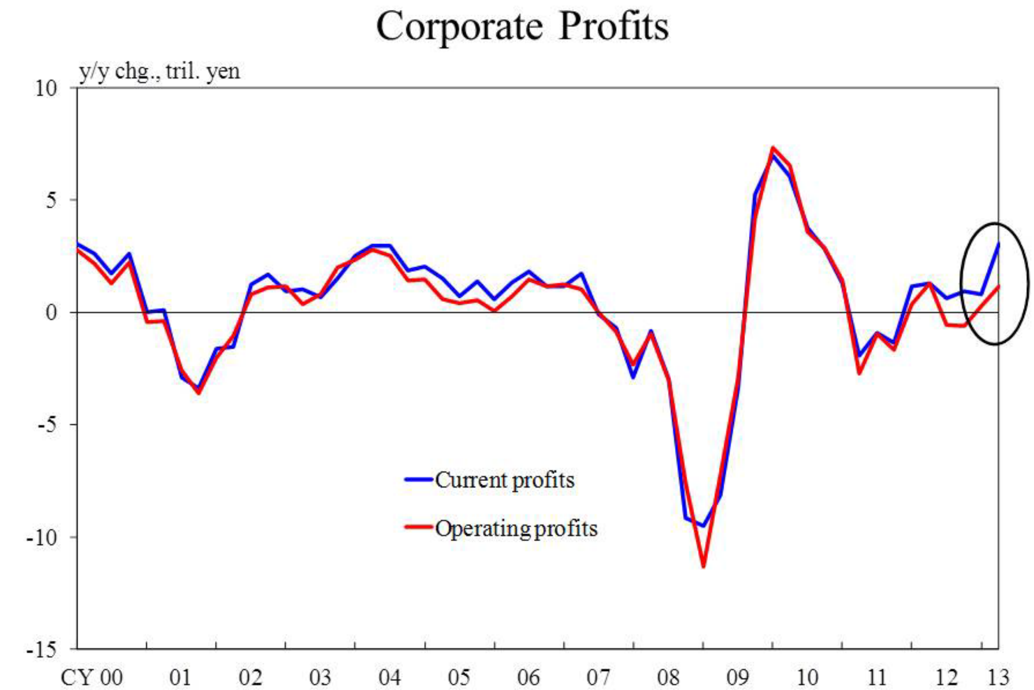
Chart 8



Note: Taken from the "Financial Statements Statistics of Corporations by Industry, Quarterly." Figures are based on all enterprises except finance and insurance.
Source: Ministry of Finance.

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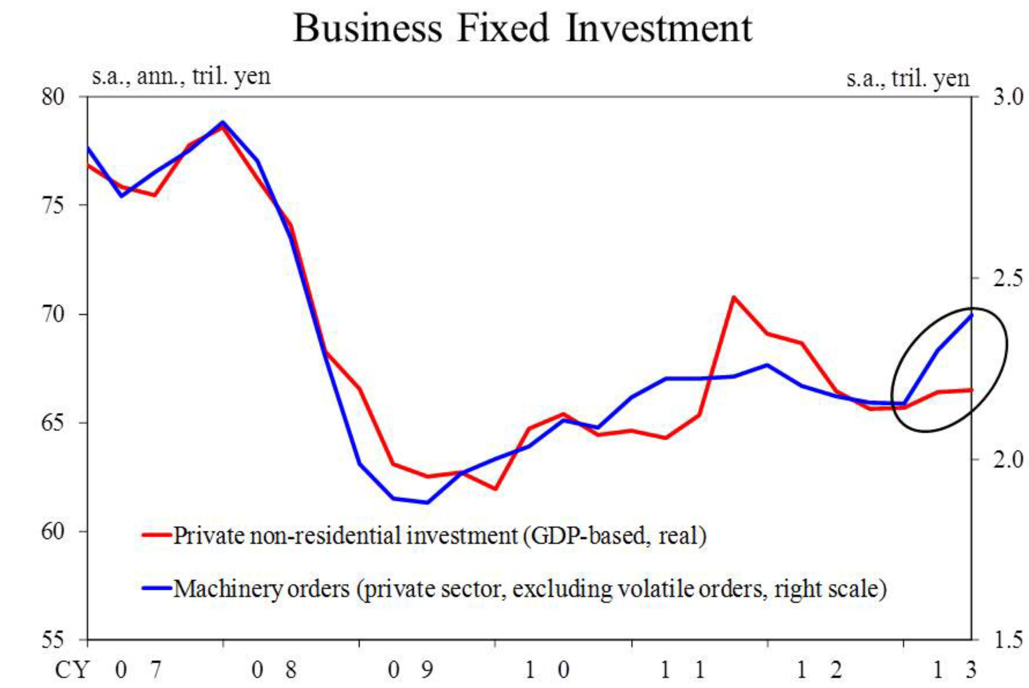
Chart 9



Note: Volatile orders: Orders for ships and those from electric power companies.
Source: Cabinet Office.

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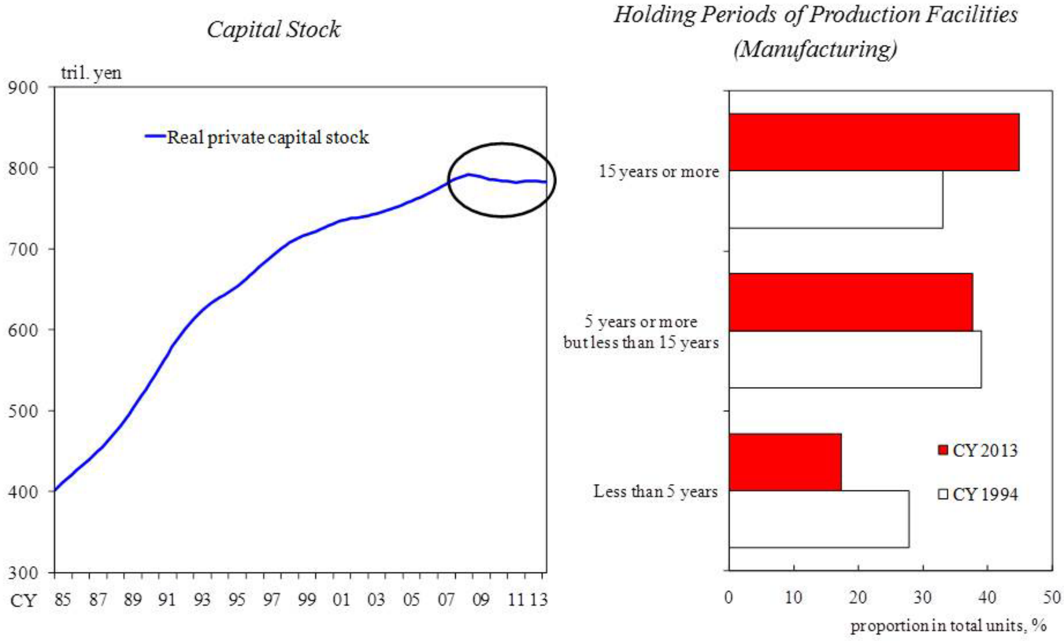
Chart 10

Factors Supporting Business Fixed Investment



Sources: Ministry of Economy, Trade and Industry; RIETI, etc.

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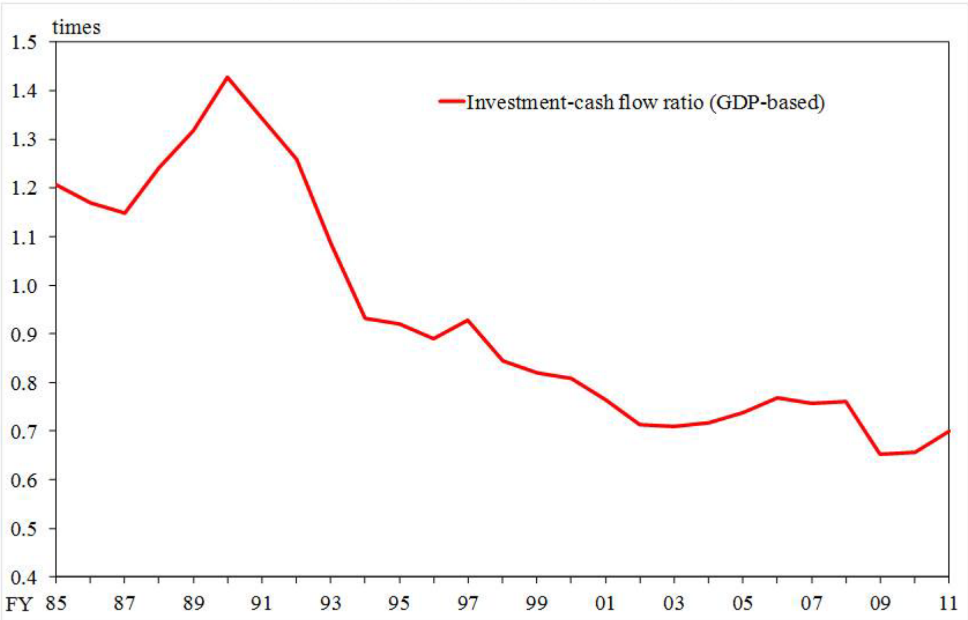
Chart 11

Investment-Cash Flow Ratio



Note: Cash flow = consumption of fixed capital + (operating surplus + net property income) / 2
Source: Cabinet Office.

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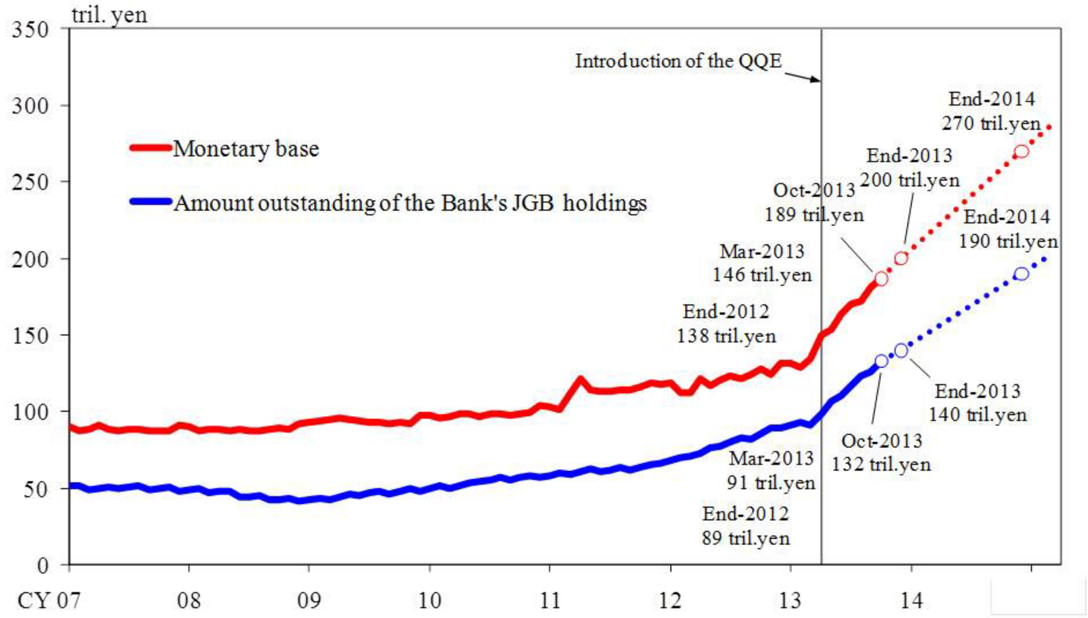
Chart 12

Expansion in the Monetary Base and JGB Holdings



Source: Bank of Japan.

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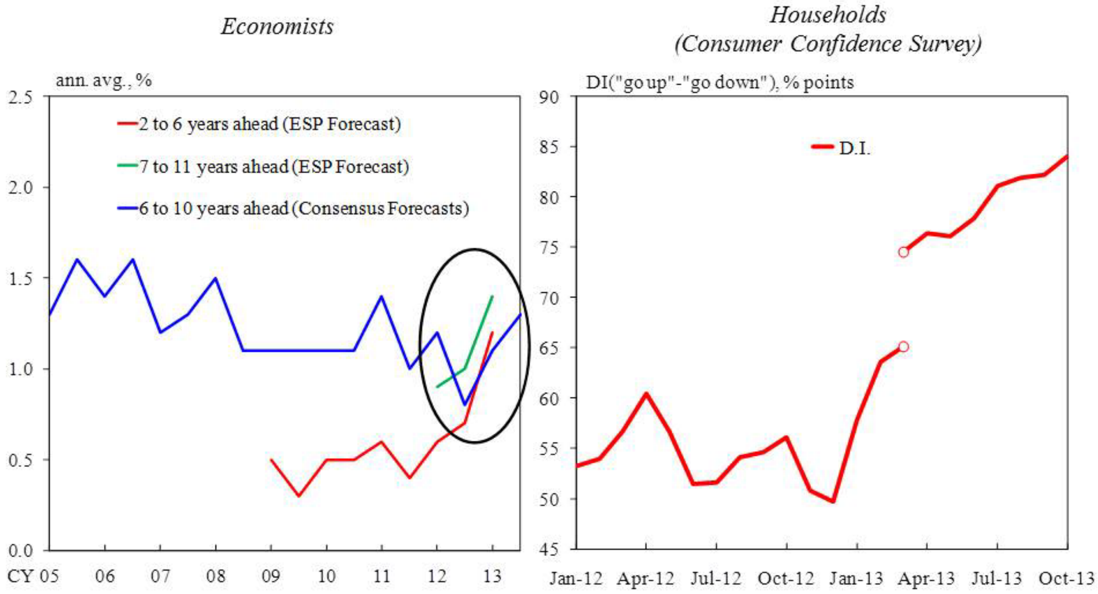
Chart 13

Inflation Expectations



Notes: 1. Figures for the ESP Forecast exclude the effects of the scheduled consumption tax hikes.
2. In the Consumer Confidence Survey, there is a discontinuity between figures up to March 2013 and those thereafter due to the change in the survey method in April 2013. Figures for March 2013 via the new survey method are reference values obtained from the examination survey.
Sources: Consensus Economics Inc.; JCER; Cabinet Office.

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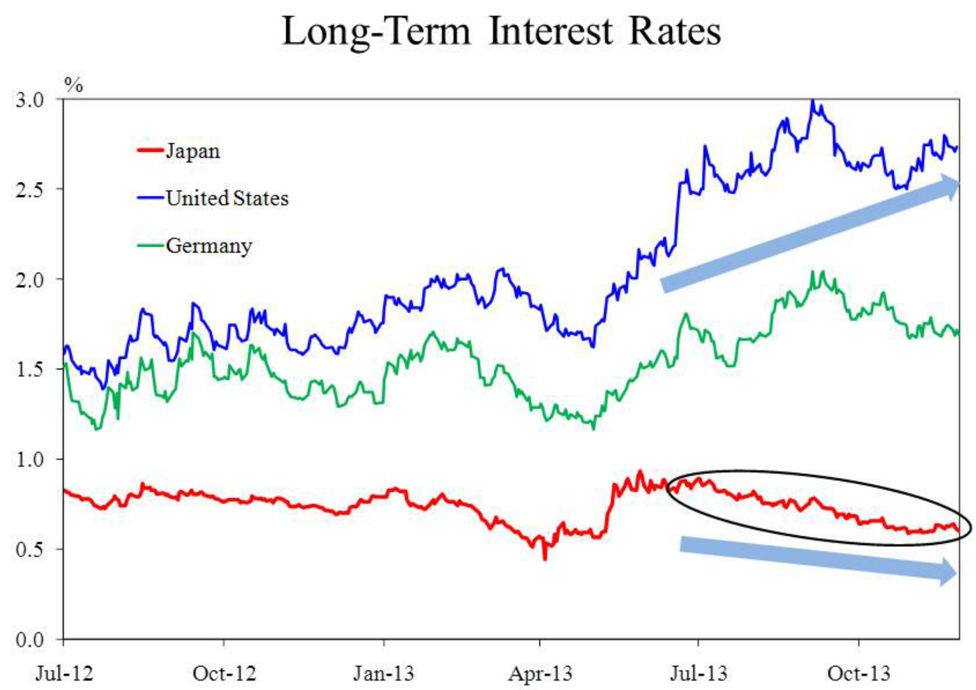
Chart 14



Source: Bloomberg.

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