Kikuo Iwata: Japan's economy and monetary policy

Speech by Mr Kikuo Iwata, Deputy Governor of the Bank of Japan, at a meeting with business leaders in Miyazaki, 6 February 2014.

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Introduction

It is my great pleasure to speak before the people of Miyazaki Prefecture. I would like to express my sincere gratitude to you for your cooperation with the activities of the Bank of Japan, especially of our Kagoshima Branch and Miyazaki Office.

Let me start with a personal note. When I was a high school student, a long time ago, I came to Miyazaki in early spring during a trip around Kyushu. Today, it is my great pleasure to be back here after a long while. I recall fond memories of my youth, such as the brightness of the Nichinan coast and the beautiful fields of mustard flowers.

Over the years, I have consistently emphasized from an academic viewpoint that the biggest challenge for Japan's economy is to overcome deflation at the earliest possible time and that the role of monetary policy is crucial.

It is for this reason that I accepted the post of deputy governor last March. I have a strong desire and willingness to meet this challenge of overcoming deflation that has entrenched Japan's economy for decades, and want to make my best effort to eliminate it once and for all.

This desire is embodied in a new policy framework called quantitative and qualitative monetary easing (QQE), which was introduced on April 4 last year.

Under the QQE, the Bank aims to achieve the price stability target of 2 percent in terms of the year-on-year rate of change in the consumer price index (CPI) and continue with the QQE as long as it is necessary for maintaining that target in a stable manner. Based on this, it has been steadily increasing the monetary base, mainly through the purchase of long-term Japanese government securities.

Looking at recent economic and financial developments, Japan's economy has steadily been pursuing its course toward overcoming deflation. In my view, however, the impact of monetary easing will be full scale from now on, and it is particularly important for the Bank to facilitate a deeper understanding of monetary policy within the public by explaining our aim and commitment under the QQE in order to ensure that its expected effects will be realized.

Today, before exchanging views with you, I will first explain the Bank's assessment of the current and future developments in economic activity in Japan and overseas. Next, I will explain the background and underlying thinking behind the QQE.

I. Current and future developments in economic activity in Japan and abroad

A. Current and future developments in Japan's economy

First are the current and future developments in economic activity in Japan. Japan's economy has continued to recover moderately, underpinned by a virtuous cycle among production, income, and spending. This cycle is currently at work both in the corporate sector and the household sector. On the price front, the year-on-year rate of increase in the CPI excluding fresh food has been widening across an increasing number of items, having registered 1.3 percent in December 2013. The CPI excluding food and energy has also been improving, with its rate of increase having registered 0.7 percent in December 2013.

Looking ahead, while domestic demand is likely to maintain firmness, external demand is expected to increase, albeit moderately, and the virtuous cycle among production, income, and spending is likely to be maintained. Against this backdrop, while the economy will be affected by the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike, it is expected to continue growing at a pace above its potential, as a trend. At the monetary policy meeting held last month, the Bank reviewed its outlook for economic activity and prices through fiscal 2015. The medians of the Policy Board members' forecasts for the real GDP growth rates are 2.7 percent in fiscal 2013, 1.4 percent in fiscal 2014, and 1.5 percent in fiscal 2015, respectively.

As for prices, the Bank expects moderate inflation – accompanying a rise in wages – to continue in light of improvement in the aggregate supply and demand balance on the back of this economic development, and of rising inflation expectations. Looking at the outlook for prices in more detail, the inflation rate – on the basis of figures excluding the direct effects of the consumption tax hikes – is likely to be around 1¼ percent until this summer as the positive contribution stemming from the rise in energy prices such as petroleum prices will gradually decline while the underlying upward pressure on prices is likely to strengthen. Subsequently, however, against the background of further improvement in the aggregate supply and demand balance and the rise in the medium- to long-term inflation expectations, the inflation rate is expected to pick up and is likely to reach the price stability target of 2 percent toward the latter half of the projection period. Again, citing the medians of the Policy Board members' forecasts, the inflation rate is expected to register 0.7 percent in fiscal 2013, 1.3 percent in fiscal 2014, and 1.9 percent in fiscal 2015.

B. Looking to the future

Let me now elaborate on several points that deserve particular attention in terms of realizing the outlook for economic activity and prices that I just mentioned. I will first touch on issues related to domestic demand, followed by those concerning external demand.

Effects of consumption tax hike

As far as domestic demand is concerned, the first is the effects of the consumption tax hike. From this April, the consumption tax will be raised from the current 5 percent to 8 percent. The tax hike will affect the economy through two channels. First, it will generate the front-loaded increase and subsequent decline in demand prior to and after the hike. Second, it will lead to a decline in disposable income.

As for the first channel, while the front-loaded increase in spending has already been observed in the areas of housing investment and spending on durable goods such as automobiles, the growth rates of the October–December quarter in 2013 and the January–March quarter in 2014 are expected to be quite high on the back of the front-loaded increase in consumer spending. By contrast, the growth rate for the April–June quarter in 2014 is likely to decline due to the subsequent drop in spending. That said, after entering the July–September quarter in 2014, the economy will likely return to a growth path above its potential without losing momentum toward economic recovery as the effects of the subsequent decline in spending will gradually ebb away, public investment will remain at a high level, and exports and business fixed investment are expected to increase moderately.

Having said all this, some people may be more cautious about the outlook for the economy because the tax hike will impose a negative impact on households' disposable incomes. In my view, such a negative effect will be mitigated due to the following reasons. First, various economic measures are being taken by the government. Second, the tax hikes seem to have already been factored in substantially among households. And third, the rate hikes are expected to have the effect of alleviating households' future concerns over the fiscal condition and the social security system.

In sum, the consumption tax hike will temporarily generate a swing in the economy's growth rates and negatively affect disposable income. Despite such developments, the virtuous cycle that has already been working in Japan's economy will continue and the economy is likely to continue growing at a pace above its potential, as a trend.

Employment and income situation

The second issue related to domestic demand concerns the employment and income situation. The current economic recovery is characterized as being driven by domestic demand such as private consumption and public investment. Going forward, in order to maintain the firmness in domestic demand, it is important that the improvement in the employment and income situation continue to sustain private consumption. In particular, in the context of rising prices, wages have to rise in a balanced manner to ensure sustainable growth in the economy.

Looking at the current developments in employment and income, the supply and demand balance in the labor market continues to improve moderately. The unemployment rate is in the range of 3.5–4.0 percent and the active job openings-to-applicants ratio stands at just over 1.0. That is, they have reached the levels seen prior to the Lehman crisis. Likewise, according to the December 2013 *Tankan* survey (Short-Term Economic Survey of Enterprises in Japan), the employment conditions DI shows that insufficiency in employment was aggravated, particularly within the nonmanufacturing sector. In these situations, the year-on-year rate of change in total cash earnings of full-time employees per employee has registered an increase, albeit marginally, against the backdrop of increases in non-scheduled cash earnings (i.e., overtime payment) and special cash earnings (i.e., bonuses). Moreover, hourly cash earnings of part-time employees have continued to increase moderately year-on-year.

Looking ahead, from somewhat of a longer-term perspective, an uptrend in total cash earnings is expected to gradually become evident, accompanied by a pick-up in scheduled cash earnings, including base pay, on the back of the improvement in corporate profits and the rise in inflation expectations, in addition to tighter labor supply and demand conditions brought about by economic recovery. Cooperation among the government, workers, and employers in order to realize the virtuous cycle is also expected to contribute to a pick-up in wages. Against the background of continued improvement in the employment and income situation, private consumption will likely remain resilient as a trend despite downward pressure on disposable income stemming from the tax hike.

Business fixed investment

The last issue related to domestic demand concerns the outlook for business fixed investment. Corporate profits have improved, and business fixed investment has been picking up against this backdrop. As machinery orders – a leading indicator of machinery investment – clearly show signs of picking up, the improving trend in investment in the manufacturing sector, which was somewhat lagging, has become more evident. Going forward, on the back of continued improvement in corporate profits, as the effects of monetary easing – particularly through the decline in expected real rates – will materialize at full scale, business fixed investment is likely to follow an increasing trend. Investment in the manufacturing sector is also likely to gain momentum as exports are expected to increase moderately during the course of the recovery in overseas economies. This is an issue that I will now talk about.

Overseas economies and exports

Next, I would like to explain external demand. While Japan's exports have been picking up as a trend, they still lack momentum. Looking ahead, whether an increase in exports will become evident is critical for Japan's economy.

While some emerging economies still face lackluster performance, overseas economies – particularly advanced economies such as the U.S. and European economies – are starting to recover. As for the outlook, overseas economies are expected to continue recovering moderately, mainly driven by advanced economies. According to the global outlook report released by the International Monetary Fund last month, the growth rate of the global economy is expected to rise gradually at a projected pace of 3.0 percent in 2013, 3.7 percent in 2014, and 3.9 percent in 2015.

On a regional basis, the downside risk of the U.S. economy has declined, reflecting progress in the fiscal situation. The economy is likely to grow at a faster pace as downside pressure from the fiscal side will ebb away. As for the European economy, while further developments regarding the European debt problem still require attention, financial markets have shown stable performance, as exemplified by the decline in interest rates of sovereign bonds issued by peripheral countries. The economy as a whole has become increasingly resilient.

In China, the authorities have positioned themselves to address structural problems while paying due regard to economic growth, and the Chinese economy is expected to grow at a pace similar to where it is now. By contrast, some emerging economies – including the ASEAN economies – continue to show lackluster performance. They are expected to lack momentum in terms of growth for some time while they are faced with structural problems such as fiscal deficits and current account deficits. In the medium- to long-term, however, as the economic recovery in the United States, Europe, and China starts to spread, they will gradually gain growth momentum.

In light of these developments, exports from Japan are picking up but are lacking momentum somewhat. There are several reasons behind this. While a structural factor such as a shifting of production sites to overseas by the manufacturing companies may have a role to play, there is a more fundamental issue of the effects stemming from moderate growth in the ASEAN economies that are closely tied with Japan, possibly having a large impact on the exports' performance. Indeed, analyzing exports to different regions, while exports – mainly of automobiles – to the United States have been on an increasing trend and those to Europe and China are picking up as a trend, those to the ASEAN economies continue to show somewhat weak performance.

Down the road, exports to the United States, Europe, and China will continue to pick up and those to the emerging economies including the ASEAN economies, where somewhat weak performance has been observed, are expected to start picking up as growth in these economies gathers momentum. Thus, exports on the whole will likely increase moderately as overseas economies recover.

II. Conduct of monetary policy

A. Details of the QQE and its transmission mechanism

Next, I would like to explain the thinking behind the QQE.

The QQE consists of two pillars. The first pillar is the commitment under which the Bank will achieve the price stability target of 2 percent as soon as possible. In its statement, the Bank said that it "will achieve the price stability target of 2 percent" at the earliest possible time, "with a time horizon of about two years." This is a strong and clear commitment by the Bank.

The second pillar is to engage in actions that embody the commitment specified in the first pillar. As exemplified by the words comprising the name "quantitative and qualitative monetary easing," these actions are to increase the "quantity" of the Bank's balance sheet and change the "quality" of its asset purchases.

An increase in quantity requires massively increasing the monetary base – that is, the amount of money the Bank supplies to the financial system – by purchasing different assets, mainly Japanese government bonds (JGBs).

A change in quality requires purchasing assets with a higher risk profile. Among JGBs, the Bank started purchasing those with longer remaining maturities. In addition, it increased the amounts of purchases in exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) in order to reduce risk premiums.

While the QQE consists of these two pillars, as far as its transmission channels are concerned, the most important factor of all in terms of affecting the economy is lowering expected real interest rates.

The effect the QQE has of reducing nominal interest rates, coupled with the effect of lifting inflation expectations, will exert powerful downward pressure on expected real interest rates, which are derived from subtracting expected rates of inflation from nominal rates in financial markets.

While nominal rates are visible, expected real rates are based on the public's expectations, taking account of changes in prices. These expectations are akin to asking "how much would my effective purchasing power go up if I buy JGBs?"

They also can be viewed as equivalent to borrowers' expectations regarding their real costs of borrowing, taking into account price changes, when they borrow money at a certain nominal interest rate. Consequently, the lower the expected real rates, the more subdued their real cost of borrowing.

The decline in expected real rates will stimulate demand in economic activity in a number of ways. For example, by encouraging the decline in those rates, investment in cash, deposits, and fixed-income securities becomes less attractive; thus, people will shift their portfolios from those financial assets to equities and tangible assets such as land and houses, or to foreign-denominated assets with higher returns. The rise in equity prices and the appreciation of foreign currencies will stimulate private consumption through the wealth effect.

In addition to the decline in expected real rates, other factors – including an increase in consumption and the depreciation of the yen – will encourage firms to be more aggressive in their business fixed investment. Furthermore, exports will be expected to increase on the back of the yen's depreciation.

Through an increase in a range of demand components such as private consumption, business fixed investment, exports, and public investment, the output gap of the economy will improve by closing its negative gap, and Japan will then find its way out of deflation.

The economy is also expected to maintain the virtuous cycle in which the household sector will further increase its spending on the back of a better labor supply and demand condition and higher employee income, and the corporate sector will increase its business fixed investment, supported by higher corporate profits, as an increase in demand will trigger more production.

B. Working on expectations: What does it mean?

As I explained earlier, one of the Bank's challenges under the QQE is to change the way the public forms its view on inflation for the future. To work on the public's expectations sounds somewhat ambiguous and may leave an impression with you that monetary policy is not entirely reliable.

In fact, it is not only monetary policy but also other economic policies that influence the way people form their expectations. This is because human beings decide their current behavior by forming expectations for the future. As a result, it is very important to conduct policy by taking account of their expectations.

Likewise, concerning expectations about economic phenomena, it is important to understand that expectations can be self-fulfilling. A simple example is as follows. If many investors buy stocks of a company based on a belief that these stocks will go up, the actual price will rise. Self-fulfilling expectations have a big impact on the actual economy.

Up until recently, many people shared the view that deflation or declining prices would continue, and based on such expectations they refrained from spending and investment. This may have aggravated the deflationary environment. Put differently, deflationary expectations have generated actual deflation; hence, the situation of persistent self-fulfilling deflation.

In order to overcome deflation and achieve price stability in a stable manner, it is vital to change the public's mindset from having "deflationary expectations" to adopting "inflationary expectations." This is why the Bank has been aggressively pursuing the QQE in order to shift their expectations.

Changing the public's expectations as a main challenge on monetary policy is surely unprecedented in the history of central banking. It is for this reason that the Bank is pursuing this policy with a strong determination to cultivate the frontier of monetary policy making.

C. The QQE and increase in lending

So far, I have explained that the main challenge of the QQE is to generate aggregate demand by reducing the expected real interest rates, which will lead to the overcoming of deflation.

Related to this, we sometimes hear people say that lending by financial institutions has not increased no matter how much money the Bank provides by expanding the monetary base. They further point out that this may be a sign that monetary easing is not working. Let me offer my thoughts on these views.

Faced with prolonged deflation, many firms including SMEs have hoarded cash and deposits; as a result, the corporate sector has registered a financial surplus. Indeed, during the deflation that lasted for some 15 years, firms restrained their business fixed investment and accumulated cash and deposits. Consequently, the total amount outstanding of cash and deposits held by the corporate sector reached as high as about 230 trillion yen. This is nearly half of Japan's GDP. At the initial phase of getting out of deflation, firms finance their credit demand for working capital and business fixed investment with their cash at hand. Moreover, increasing cash flow will be used to repay debts; thus, none of these lead to a situation where lending by financial institutions simply increases. A pick-up in lending will only start once firms are no longer able to finance their credit demand for inventory investment or business fixed investment with their cash at hand.

Moreover, during the process of overcoming deflation, stock prices will rise significantly and the markets' expectations regarding future interest rates will also go up. Under such circumstances, more firms will decide to raise long-term funds from the capital market by issuing new stocks and bonds rather than borrowing short-term funds from banks. This is another reason for the lackluster performance in lending that exists for some time during the initial stages of overcoming deflation.

More recently, a typical situation was seen during the recovery phase at the beginning of the 2000s. At that time, bank lending decreased rather than increased for some time after the economic recovery gradually gathered steam, although one needs to take note that the disposal of non-performing loans was well under way and this led to a decline in bank lending.

Recent developments since end-2013 show that lending by commercial banks has increased year-on-year and the pace of increase has picked up. Compared with the economic recovery phase of the early 2000s, the pick-up in lending during the current economic recovery phase is actually stronger than originally anticipated.

D. Time horizon of the QQE and further easing

Next, I will explain the time horizon of the QQE and then touch on the issue of the possibility of further easing. This is a question that has received considerable attention quite recently.

After exchanging views with a range of people, I was left with an impression that there is a misunderstanding that the Bank will start tightening monetary policy soon after it achieves the price stability target of 2 percent. This might be due to the fact that the message to "achieve 2 percent in two years" was forceful.

On this point, the Bank has made it clear since last April, when it introduced the QQE, that it aims to achieve the price stability target of 2 percent and continue with the QQE as long as it is necessary for maintaining that target in a stable manner. Based on this commitment, the Bank promised to achieve the price stability target at the earliest possible time, with a time horizon of about two years.

This commitment might not have been so clear to the public. The point I would like to emphasize is the part of commitment that reads "as long as it is necessary for maintaining that target in a stable manner." In other words, even if the CPI reached 2 percent year-on-year, unless the Bank projects that inflation is likely to remain at around 2 percent in a stable manner, it will not simply end monetary easing. This is the commitment the Bank has made under the QQE.

If the Bank judges that achieving the 2 percent target will become difficult due to some unforeseeable risk factors, then it will make adjustments in the conduct of monetary policy as appropriate. Referring to the policy statement, this has been written as follows: the Bank "will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate."

According to the Bank's outlook, Japan's economy is on track to achieve the price stability target of 2 percent and the year-on-year rate of increase in the CPI is likely to reach around 2 percent toward the latter half of the projection period through fiscal 2015.

Taking the above outlook into account, what is most important at this juncture is that the Bank steadily make progress under the current policy framework of the QQE.

E. Pace of JGB purchases

In the last part of my explanation about monetary policy, let me elaborate on somewhat of a technical issue.

Under the QQE, the Bank has been purchasing JGBs so that their amount outstanding will increase at an annual pace of about 50 trillion yen.

This 50 trillion yen is equivalent to a net purchase – i.e., subtracting the amount of redemption from that of new purchases. As JGBs that had already been purchased by the Bank in the past come to maturity, it is necessary to offset such reduction in the amount outstanding held by the Bank, through additional purchases of (i.e., reinvestment in) JGBs. Therefore, on a gross basis, the amount of purchases should far exceeded 50 trillion yen, and naturally the amount of purchases on a gross basis will change depending on the amount of redemption (i.e., the amount of reinvestment).

Nevertheless, there is a view in the market that an increase or decrease in the amount of purchases on a gross basis reflects changes in the Bank's monetary easing stance. Let me emphasize that the amount of purchases on a gross basis may increase or decrease depending on the amount of redemption; thus, it is by no means a tapering of the pace of JGB purchases nor a reduction of quantitative easing as long as the annual pace of purchases on a net basis remains about 50 trillion yen.

Furthermore, the JGB purchases are carried out in a flexible manner from the perspective of putting downward pressure on interest rates across the yield curve while taking account of financial market conditions. Owing to these reasons, monthly purchases can change depending on developments in the financial markets. Indeed, when we look back at the track record since last April, monthly purchases have fluctuated in the range of about 6–8 trillion yen from one month to the next.

Concluding remarks

Let me finish my remarks by touching on the economy of Miyazaki Prefecture.

Miyazaki's economy was hit harshly by a number of natural disasters from 2010 to 2011 – namely, foot-and-mouth disease, avian flu, and the eruption of the Shinmoedake volcano. After that, the economy started to pick up gradually, as seen in the improvement in the tourism sector. I would like to extend my great respect for the efforts made by those who have confronted and overcome such difficulties during those years.

From somewhat of a medium- to long-term perspective, Miyazaki produces a variety of foods and there are many items – such as livestock and vegetables – for which production is at the top in Japan. Some of them are so renowned that they are named after Miyazaki, such as "Miyazaki mango" and "Miyazaki beef." There are many picturesque places that are deeply rooted in Japan's historical record of ancient matters, such as *Kojiki* and *Chronicles of Japan*, as well as attractive touristic places set in the exotic locale of a southern land. Furthermore, Miyazaki is famous as a spring training base for professional baseball teams and has hosted major golf tournaments.

By taking full advantage of its abundant resources and environment and capturing the potential demand of consumers, Miyazaki can further reinvigorate its economy. There are a number of achievements that have highlighted your dedicated efforts over the years. One is that Miyazaki beef was awarded the gold medal in 2012 at a contest, held once every five years, to select the best Wagyu beef in Japan. This was the first time the same brand of beef had received this award on a consecutive basis. Another is that production of Miyazaki caviar started at end-2013 after almost 30 years of R&D activity.

Going forward, construction of the East Kyushu Highway will be accelerated, extending from Miyazaki City to Kita-Kyushu City in fiscal 2014. In addition, the number of scheduled flights connecting Miyazaki and Taipei will go up next month. All these factors show that the social infrastructure in transportation will be built at an accelerated pace and this will further extend the chance for Miyazaki's economy to take a major step forward.

I sincerely hope that all the endeavors people in Miyazaki are making will bear fruit and contribute to the further growth and prosperity of your esteemed prefecture.

Thank you.