Koji Ishida: Economic activity and prices in Japan and monetary policy

Speech by Mr Koji Ishida, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Saitama, 26 February 2014.

*   *   *

I. Monetary policy

A. Introduction of the price stability target and the joint statement by the government and the Bank of Japan

First, I would like to describe the status of the Bank of Japan's monetary policy conduct in January 2013. At the Monetary Policy Meeting (MPM) held on January 21 and 22, 2013, the Bank decided to introduce the price stability target of 2 percent in terms of the year-on-year rate of change in the consumer price index (CPI). At the same time, it released a joint statement with the government, which clearly stated that the government and the Bank would strengthen their policy coordination and work together to overcome deflation early and achieve sustainable economic growth with price stability. In the statement, the Bank announced that, under the price stability target, it would pursue monetary easing and aim to achieve this target at the earliest possible time. Concurrently, the government announced that it would not only flexibly manage macroeconomic policy but also formulate measures for strengthening the competitiveness and growth potential of Japan's economy, and promote them strongly. The government also announced that it would steadily promote measures aimed at establishing a sustainable fiscal structure with a view to ensuring the credibility of fiscal management.

B. Quantitative and Qualitative Monetary Easing (QQE)

Now I would like to talk about the Bank's current monetary policy measures.

At the MPM held on April 3 and 4, 2013, the Bank introduced QQE to achieve 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. The features of this new monetary policy measure are as follows. First, with a view to pursuing quantitative monetary easing, the Bank changed the main operating target for money market operations from the uncollateralized overnight call rate to the monetary base, which is the total amount of money the Bank directly supplies to the economy. On this basis, the Bank is increasing the monetary base – defined as the sum of banknotes in circulation, coins in circulation, and current account deposits held by financial institutions at the Bank – at an annual pace of about 60–70 trillion yen. Second, the Bank is purchasing Japanese government bonds (JGBs) as the primary means of increasing the monetary base, so that their amount outstanding will increase at an annual pace of about 50 trillion yen. Moreover, the average remaining maturity of the Bank's JGB purchases has been extended from slightly less than three years to about seven years – equivalent to the average maturity of the amount outstanding of JGBs issued. Third, in addition to JGBs, with a view to lowering risk premiums of asset prices, the Bank is purchasing exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their amounts outstanding will increase at an annual pace of about 1 trillion yen and 30 billion yen, respectively. And fourth, the Bank will continue with QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary to maintain the target in a stable manner. It will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate.

So far, I have explained the basic framework of QQE. Almost a year has passed since QQE was introduced in April 2013. The amount outstanding of the monetary base has increased from 138 trillion yen at the end of 2012 to 202 trillion yen at the end of 2013, and has been accumulating smoothly toward 270 trillion yen, the amount projected at end-2014. The amount outstanding of JGBs has also been accumulating smoothly toward 190 trillion yen, the amount projected at end-2014, increasing from 89 trillion yen at the end of 2012 to 142 trillion yen at the end of 2013.

C. Loan support program

In addition to implementing QQE, the Bank has been employing the Loan Support Program to promote financial institutions' use of the large scale monetary base – supplied by the Bank through its aggressive monetary easing – for their efforts to increase the amount of bank lending and strengthen the growth potential of Japan's economy. At the MPM held on February 17 and 18, 2014, the Bank decided to double the scale of the Loan Support Program and to extend its application period by one year. The Loan Support Program consists of two measures: the fund-provisioning measure to stimulate bank lending (hereafter the Stimulating Bank Lending Facility) and the fund-provisioning measure to support strengthening the foundations for economic growth (hereafter the Growth-Supporting Funding Facility). Specifically, under the former, the Bank decided to enable financial institutions to borrow funds from the Bank up to an amount that is twice as much as the net increase in their lending. As for the latter, the Bank decided to double the maximum amount of its fund-provisioning under the main rules from 3.5 trillion yen to 7 trillion yen. Under these facilities, financial institutions will be able to borrow funds at a fixed rate of 0.1 percent per annum for four years.

Thus far, the Loan Support Program has supported financial institutions' efforts to increase the total amount of their lending and has produced positive effects as a catalyst in regard to firms' and financial institutions' efforts to strengthen the foundations for Japan's economic growth. The Bank expects that the enhancements made at the February MPM will further promote financial institutions' actions as well as stimulate firms' and households' demand for credit, with a view to encouraging banks' lending and strengthening the foundations for economic growth.

D. Developments in financial conditions and financial markets

Reflecting such policy measures, financial conditions in Japan are accommodative. Firms' funding costs have been hovering at low levels, with long-term average contract interest rates on new loans and discounts recording a historic low. Issuing conditions for CP and corporate bonds have also been favorable. In addition, in a situation where the year-on-year rate of change in bank lending continues to increase, loans provided by *shinkin* banks have also been recording year-on-year positive growth since summer 2013. Firms have continued to see financial institutions' lending attitudes as improving. Firms' financial positions have also improved regardless of firm size. This was evidenced by the diffusion index for financial positions of small firms: the proportion of firms responding that their financial positions were "easy" exceeded the proportion of those responding that they were "tight" for the first time since the bubble period of the early 1990s.

Turning to developments in financial markets, yields on 10-year JGBs – the benchmark long-term interest rate – have been stable at a low level of around 0.6 percent as the Bank proceeds with its JGB purchases. Given that the year-on-year rate of increase in the CPI is currently around 1¼ percent, long-term real interest rates are presumed to be in negative territory. As for foreign exchange rates, the yen has been depreciating, albeit with some fluctuations. Stock prices have been trending upward.

Meanwhile, according to the money stock statistics, the growth rates of investment trusts and pecuniary trusts have been at high levels, indicating that money holders such as households have been increasing their risk assets.

As I have described, accommodative financial conditions seem to have recently been effectively stimulating private demand, and such conditions appear to be forming the basis for Japan's economy to overcome the negative effects of the consumption tax hikes and for a virtuous cycle among production, income, and spending to operate firmly.

II. Developments in economic activity and prices

A. Overseas economies

Next, I will talk about developments in economic activity and prices.

Overseas economies – mainly advanced economies – are starting to recover, although the performance remains lackluster in some parts. The growth rate of the global economy in 2014, released in January by the International Monetary Fund (IMF), is projected to accelerate to 3.7 percent from 3.0 percent for 2013. Naturally, the growth rates in emerging and commodity-exporting economies are higher than those in advanced economies. However, advanced economies are projected to show stronger growth momentum than emerging and commodity-exporting economies in 2014, compared to a year earlier.

Among advanced economies, the growth rate of the U.S. economy is projected to accelerate in 2014 compared to the previous year. Inevitably the growth rate of the U.S. economy in the January–March quarter of 2014 will be adversely affected by the record winter snowstorm since December 2013. However, in a situation where balance-sheet adjustments in the household sector seem to have mostly been completed and the fiscal drag has faded, production and private demand are expected to remain firm and the economic recovery is expected to become widespread from the spring. With regard to the employment situation, although some current data showed weakness reflecting the effects of the winter snowstorm, the improving trend remained, as evidenced by a declining trend in the unemployment rate. As for the euro area, in 2014 the economy is projected to emerge from negative growth. Concerns persist over further disinflation, but business and household sentiment continues to improve in a situation where financial markets have stabilized, and production has been picking up, albeit moderately.

Whereas improvements are observed in advanced economies as I described, the situation varies among emerging and commodity-exporting economies. First, the Chinese economy has continued to see stable growth, albeit at a slower pace than before, maintaining a year-on-year growth rate of 7.5–8.0 percent in the October–December quarter of 2013. The Purchasing Managers' Index (PMI) for manufacturing activity has recently shown some weakness, but the Chinese economy is expected to basically maintain stable growth at around the current pace under state control. Among other emerging and commodity-exporting economies, economic developments in the NIEs are picking up, particularly in exports, as the effects of the economic recovery in advanced economies spread to them. In contrast, growth momentum in the ASEAN countries has remained weak because of their relatively limited ability to profit from the recovery in advanced economies. In particular, there are concerns about the impact of unstable political situations in some of these countries on trade with Japan, for example.

Among emerging and commodity-exporting economies, some of them – which have structural vulnerabilities such as current account deficits – saw nervousness in their markets at one point as the Federal Reserve proceeded to reduce the pace of its asset purchases, but the situation recently regained stability.

B. Japan's economic activity and prices

1. Current situation

a. Economic activity

Now, I will discuss Japan's economic activity.

The Bank's current assessment is that Japan's economy has continued to recover moderately. Moreover, a front-loaded increase in demand prior to the consumption tax hike has recently been observed.

Real GDP for the October–December quarter of 2013, released on February 17, 2014, showed quarter-on-quarter growth of 0.3 percent, representing the fourth consecutive quarter of positive growth. By component, private demand for the quarter, including private consumption and business fixed investment, recorded a higher growth rate than in the July–September quarter. As for private consumption, consumption of goods such as durable goods increased partly reflecting the front-loaded increase in demand prior to the consumption tax hike amid the improvement in the employment and income situation evidenced by the increase in winter bonus payments. Business fixed investment, which had previously been lacking momentum compared to firms' annual fixed investment plans and the improving trend of their profits, rose noticeably at last in the October–December quarter. In contrast, exports have lacked momentum to date despite the recovery trend in overseas economies, mainly advanced economies, and movements in the foreign exchange market. As imports grew substantially, net exports continued to significantly push down the GDP growth rate, as they had in the July–September quarter.

Although only a handful of economic indicators have been released for the period starting in January 2014, the seasonally adjusted number of new passenger-car registrations – a consumption-related indicator – increased rather substantially by 6.9 percent for January on a month-on-month basis, suggesting the possibility that the front-loaded increase in demand prior to the consumption tax hike is becoming pronounced. Meanwhile, real exports for January declined by 2.3 percent overall, presumably due to a drop in exports to China. Indices of industrial production for January, which reflected these developments in domestic and external demand, are scheduled for release on February 28. According to the Survey of Production Forecast in Manufacturing released in January, production for January was expected to show relatively stronger growth led by production to meet domestic demand.

b. Prices

Regarding developments in prices, the year-on-year rate of increase in the CPI (all items less fresh food) for December 2013 climbed from the previous month to 1.3 percent. Through the latter half of 2013, rises in prices of energy-related items such as petroleum products – reflecting movements in crude oil prices and foreign exchange rates – contributed to the rise in prices. However, price increases have gradually been observed in other items recently, while private consumption has remained resilient, indicating that such increases are steadily becoming widespread. In fact, the year-on-year rate of increase in the CPI (all items less food and energy) rose to 0.7 percent for December 2013, representing the strongest growth since August 1998.

2. Outlook for economic activity

In terms of economic activity, while domestic demand, particularly private consumption, 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, whereas the upward contribution from price movements in energy-related items is likely to diminish gradually, the boosting effect of an improvement in the aggregate supply and demand balance accompanied by an economic recovery is expected to spread. Consequently, the year-on-year rate of increase in the CPI (all items less fresh food), excluding the direct effects of the consumption tax hike, is likely to be around 1¼ percent for some time.

As I mentioned, Japan's economy is likely to continue a moderate recovery as a trend, while it will be affected by the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike. For the time being, I will pay attention to the following points.

a. The effects of the consumption tax hike

The first point for attention is the effects of the consumption tax hike. The front-loaded increase in demand prior to the consumption tax hike has already been observed to a considerable extent in durable consumer goods, mainly houses, passenger cars, and white goods. If the scale of the front-loaded increase in demand is greater than expected toward the end of fiscal 2013, the subsequent decline in April and beyond will be all the more substantial.

It is inevitable that the consumption tax hike will have adverse effects on households' real income. Nevertheless, while the economy as a whole will be underpinned by the government's economic measures, an increase is likely in exports and business fixed investment – which have lacked momentum to date. Therefore, even if the economy temporarily posts negative growth for the April–June quarter of 2014, the recovery trend itself is unlikely to dissipate.

Meanwhile, I consider it necessary to carefully assess the underlying trend of various indicators scheduled for release over the period through the first half of fiscal 2014, given that they are likely to show large fluctuations, both upward and downward, due to the consumption tax hike.

b. Risks for overseas economies and developments in exports

The second point for attention is risks for overseas economies and developments in exports. Overseas economies – mainly advanced economies – are starting to recover, but a high degree of uncertainty is likely to remain over the outlook for some emerging and commodity-exporting economies with structural vulnerabilities such as fiscal and current account deficits. Although the markets are currently calming down, it is necessary to monitor whether such risks in these economies will materialize and affect the global economy.

Exports are expected to offset a temporary fallback in demand that is likely to be observed from April 2014 following the consumption tax hike, and are expected to play their traditional role as the trigger of a virtuous economic cycle. However, they lack some momentum at the moment. As background to this lack of momentum, a number of issues have been raised for discussion concerning both cyclical and structural problems, such as the pace of the recovery in overseas economies and the shift of manufacturing firms' production sites to overseas. I am also monitoring whether exports, which have significant spillover effects on business fixed investment, will act as a driving force of Japan's economy as expected from fiscal 2014 onward.

c. The employment and income situation

The third point for attention is developments in the employment and income situation of households. With regard to the recent situation, supply and demand conditions in the labor market have continued to improve steadily, as shown by the fact that the active job openings-to-applicants ratio rose to 1.03 in December 2013. Employee income has also picked up moderately because, while total cash earnings per employee have generally bottomed out, the year-on-year rate of increase in the number of regular employees has expanded.

For domestic demand, particularly private consumption, to maintain its firmness concurrently with a rise in prices, it is essential that the virtuous cycle of improvement continue in the employment and income situation supporting consumption. I intend to monitor the results of this spring's wage negotiations and the extent to which employee income as a whole improves, including the degree to which the number of employees increases.

III. Achieving the price stability target

A. Forecasts for prices through fiscal 2015

Thus far, I have outlined the Bank's assessment of Japan's recent economic activity and prices. Based on this assessment, the Bank compiled and released the Policy Board members' forecasts for economic activity and prices through fiscal 2015. In terms of the medians of the members' forecasts for prices, the year-on-year rate of change in the CPI (all items less fresh food) is expected to register 0.7 percent for fiscal 2013. Excluding the effects of the consumption tax hikes, it is projected to reach 1.3 percent and 1.9 percent for fiscal 2014 and 2015, respectively. It is likely to reach around 2 percent – the price stability target – toward the latter half of the projection period, that is, through fiscal 2015.

B. The price stability target and price indices

The Bank judges that the basic indicator used to express the price stability target must be a price index that comprehensively covers goods and services consumed by households and that the general public at large is accustomed to. To this end, the Bank views the CPI for all items as important. However, since the CPI for all items can be affected by temporary fluctuations of some of its components, the Bank uses the CPI (all items less fresh food) to identify the underlying trend of inflation; fresh food is excluded from the index because it is a highly volatile component.

To grasp the underlying trend in the CPI, the Bank also examines reference indices such as the CPI (all items less food and energy), the Laspeyres chain index (all items less fresh food), and the 10 percent trimmed mean. As for other price indices, the CPI (all items less imputed rent) is used as a deflator to convert nominal figures into real ones in statistics relating to household consumption expenditures. This price index was adopted because it was considered to be the one most suitable for measuring actual household consumption expenditures, given that imputed rent on owner-occupied homes is not actually paid.

In the long run, each of these price indices shows the same movements as the overall index, but at each point in time they could move somewhat differently, reflecting temporary factors. For example, the year-on-year rates of growth for December 2013 in the CPI (all items less fresh food) and the CPI (all items less food and energy) were 1.3 percent and 0.7 percent, respectively – as I mentioned earlier – while that in the CPI for all items was 1.6 percent, the Laspeyres chain index (all items less fresh food) was 1.2 percent, the 10 percent trimmed mean was 0.8 percent, and the CPI (all items less imputed rent) was 2.0 percent.

The Bank judges it necessary to assess price developments comprehensively by monitoring a wide range of price indices such as those just mentioned. It seeks to achieve the price stability target at the earliest possible time and maintain it in a stable manner. In this way, it seeks to fulfill its mission of "achieving price stability, thereby contributing to the sound development of the national economy", as stipulated in the Bank of Japan Act.