Haruhiko Kuroda: Toward the early achievement of the 2 percent price stability target and sustainable growth of Japan's economy

Speech by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at the Keizai Doyukai (Japan Association of Corporate Executives) Members' Meeting, Tokyo, 23 June 2014.

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

Introduction

It is my great honor to be invited to the Keizai Doyukai (Japan Association of Corporate Executives) Members' Meeting and have the opportunity to address distinguished business leaders in Japan.

In April last year, the Bank of Japan introduced quantitative and qualitative monetary easing (QQE) to achieve the price stability target of 2 percent at the earliest possible time, with a time horizon of about two years. More than one year has passed since then and QQE has so far been having its intended effects, with Japan's economy on a path suggesting that the 2 percent price stability target will be achieved as expected. However, we are only half way there. The Bank will therefore continue with QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner.

The topic I would like to talk about today is the Bank's view concerning the current state of and outlook for economic activity and prices. Based on that, I will then talk somewhat in depth about the mechanisms based on which inflation is expected to increase toward 2 percent. In concluding, I will offer my views on the challenge of strengthening Japan's medium- to long-term growth potential.

I. Current situation of and outlook for economic activity and prices

Economic activity

Let me start with the economic situation. Domestic demand, including business fixed investment, remains resilient as a trend, although a decline in demand following the consumption tax hike in April this year – mainly in private consumption such as durable goods – can be observed. In this situation, along with the clear improvement in the employment and income situation, the virtuous cycle of economic activity has continued to operate steadily, and Japan's economy has continued to recover moderately as a trend.

Looking ahead, as domestic demand is likely to remain firm and exports are expected to increase moderately, the virtuous cycle among production, income, and spending is likely to be maintained. Therefore, for the next three years or so, Japan's economy as a trend is likely to continue growing at a pace above its potential, although growth will be affected by fluctuations in demand associated with the two rounds of consumption tax hikes (Chart 1).

For the above scenario to materialize, two factors are of key importance. The first is that exports, fuelled by a recovery in overseas economies, start increasing again. The second is that domestic demand, which has been driving Japan's recovery so far, remains firm. Let me discuss these two factors in more detail.

Exports and overseas economies

The first key factor is developments in exports. Exports have recently remained more or less flat and have been lacking momentum despite the correction of the excessive appreciation of the yen (Chart 2). These trends in exports are essentially due to cyclical factors, including, for example, the sluggishness in emerging economies such as the ASEAN countries. At the same time, however, structural factors such as the increasing relocation of production overseas by Japanese manufacturers have also played a certain role. In addition, temporary factors have likely put downward pressure on exports. Examples include the fact that firms placed priority on domestic shipments in response to the front-loading of demand prior to the consumption tax hike and the effects of the unusually severe winter weather in the United States. Therefore, looking ahead, exports are likely to start increasing again, albeit moderately, once the effects of these temporary factors diminish and growth in overseas economies, including emerging economies, gradually picks up.

Looking at the current situation of and outlook for overseas economies in more detail, overseas economies – in particular advanced economies such as the U.S. and European economies – are recovering, although economic performance remains lackluster in some emerging economies. As for the outlook, overseas economies are likely to continue to recover moderately. The International Monetary Fund (IMF) expects global economic growth, which fell to 3.0 percent in 2013, to accelerate gradually to 3.6 percent in 2014 and 3.9 percent in 2015 (Chart 3). Looking at individual countries or regions, the U.S. economy registered negative GDP growth in the January–March quarter due mainly to the unusually severe winter weather. However, since March, a number of economic indicators have rebounded as the severe winter weather waned, and the U.S. economy has returned to a moderate recovery trend, led mainly by private demand. Given the accommodative financial conditions, the pace of recovery is likely to accelerate gradually as improvements in the employment and income situation become more pronounced. In Europe, the year-on-year rate of change in consumer prices in the euro area, which has been struggling with structural problems such as excessive debt, has been less than 1 percent for more than six months, giving rise to concern over deflation. That being said, with business and household sentiment improving, forces to cyclically elevate economic activity have recently been at work and the economy has been recovering moderately, with GDP in the euro area registering positive growth for four consecutive quarters. The euro area economy is likely to continue recovering, reflecting not only the recovery in domestic demand, but also expected moderate improvements in external demand. As for the Chinese economy, the deceleration in growth observed since the beginning of the year appears to have come to a halt, and the economy is expected to continue growing stably at around the current pace due partly to the economic stimulus measures implemented by the government. Finally, other emerging economies and commodity-exporting economies will likely continue to lack growth momentum for the time being, but from a somewhat longer-term perspective growth is expected to gradually pick up against the background of the recovery in advanced economies. Nevertheless, looking at the outlook for advanced economies, which are expected to be the main driving force in the global economy for the time being, attention should be paid to the pace of recovery in the U.S. economy and the prospects for the European debt problem. In addition, it is necessary to keep an eye on issues such as excess production capacity and excess debt in China, developments in emerging and commodity-exporting countries that face structural problems such as a current account deficit or high inflation, and geopolitical risks emanating from some countries. Thus, there remain various uncertainties regarding the outlook for overseas economies, which all warrant vigilance.

Sustainability of domestic demand

Let me next talk about the sustainability of domestic demand, especially the current situation of and outlook for business fixed investment and private consumption (Chart 4).

As for business fixed investment, while some argue that increases in investment cannot be expected due partly to the increased relocation of production overseas, recent figures show that investment has grown moderately. In the GDP statistics, for example, investment has registered quarter-on-quarter increases for four consecutive quarters. Quarter-on-quarter growth in the January–March quarter of this year, at 7.6 percent, was particularly high reflecting temporary upward momentum due to, for example, renewal demand stemming from the ending of support for some software programs and to the front-loading of demand prior to the strengthening of gas emission regulations. Looking ahead, since corporate profits are likely to continue improving, business fixed investment is projected to follow a moderate upward trend as firms seek to expand capacity on the back of increased capacity utilization and as monetary easing continues to underpin demand for investment.

With regard to private consumption, the outlook crucially depends on the effects of the consumption tax hike. To consider these effects, they need be divided into two aspects. The first aspect is the short-term effects of the decline in demand following the front-loading of consumption prior to the tax hike, while the second aspect is the longer-term effects of the decline in real incomes as a result of the tax hike, which will materialize only gradually. Economic indicators released so far indicate a clear decline following the tax hike in purchases of durable goods such as automobiles, demand for which increased substantially prior to the tax hike. However, many firms indicate that the magnitude of the decline in consumption following the tax hike has been broadly in line with expectations and that private consumption continues to remain resilient as a trend. At this stage, it therefore appears that the effect of the decline in consumption due to the front-loading of demand is likely to start waning in the coming few months. As for the adverse effects through the decline in real incomes, the key will be to what extent improvements in the employment and income situation can alleviate these effects. With labor market conditions continuing to improve steadily, employee income is expected to continue rising moderately, and private consumption is likely to remain resilient. How the tax hike affects consumption is something we will continue to examine in the coming months.

Prices

Let me turn to price developments. The year-on-year rate of change in the consumer price index (CPI, excluding fresh food) was plus 1.3 percent for four consecutive months from December last year to March this year, and, after excluding the direct effects of the consumption tax hike, accelerated somewhat to plus 1.5 percent in April (Chart 5). Breaking down the year-on-year rate of increase shows that price increases have been seen in a wide range of items reflecting that Japan's economy has continued to recover moderately, while energy-related goods have stopped pushing up the year-on-year rate of increase.

With regard to the outlook, the year-on-year rate of change in the CPI after excluding the direct effects of the consumption tax hike is likely to be around 1¼ percent for some time, as upward pressure from import prices – in particular energy prices – will likely wane, while trend inflationary pressure – due mainly to the improvement in the output gap – will increase. Specifically, through the summer, the year-on-year rate of increase in the CPI is expected to slow to around 1 percent. Subsequently, as trend inflationary pressure continues to strengthen, the year-on-year rate of increase in the CPI is expected to follow an upward trend again from the second half of this fiscal year and reach around 2 percent – the price stability target – around the middle of the current projection period from fiscal 2014 through fiscal 2016, that is, in or around fiscal 2015. Thereafter, the rate of increase is likely to edge up, since medium- to long-term inflation expectations will converge to around 2 percent and the output gap is expected to continue expanding in positive territory (Chart 1).

Hence, Japan's economy is likely to achieve an inflation rate of around 2 percent and thereafter shift to a growth path that sustains such inflation in a stable manner.

II. Path toward the price stability target of 2 percent

The Bank's outlook for prices I just outlined is fairly bullish compared to the average view of market participants and economists. Therefore, in the following, I would like to explain the mechanisms that, in the Bank's view, underlie the increase in inflation toward 2 percent in a little more depth. To sum up in advance, we are of the view that upward pressure on prices will further increase in the future for the following two reasons. First, the output gap is likely to improve steadily and, second, medium- to long-term inflation expectations are likely to rise, which in turn will influence actual wage and price setting.

Upward pressure on prices from the output gap

Let me start with the output gap. A key characteristic of the current economic recovery is that it has been led by domestic demand such as public investment and private consumption. As a result, the nonmanufacturing sector has been playing a central role in the recovery. Since the nonmanufacturing sector is more labor-intensive than the manufacturing sector, this, on the whole, has led to a further tightening in labor market conditions. Those who are here today may be aware of this in your daily business. In terms of economic data, the unemployment rate has been approaching the structural unemployment rate, which is considered to be around 3.5 percent, and the active job openings-to-applicants ratio has risen to 1.08, which is the same level as the peak reached before the global financial crisis (Chart 6). This tightening of labor market conditions has started to influence wages, and, in the regular annual wage negotiation this spring, the number of firms that raised not only bonuses but also base pay has increased substantially. In addition to this increase in the utilization of labor, a growing number of firms, particularly in the nonmanufacturing sector, are experiencing capacity shortages, and the output gap has been narrowing moderately. While the level of the output gap is subject to a considerable margin of error, the gap seems to have narrowed to close to 0 percent, that is, the long-term average (Chart 7). As for the outlook, inflationary pressure from the output gap is likely to strengthen further, given that the economy is expected to continue growing at a pace above its potential.

Upward pressure on prices from inflation expectations

Let me next outline developments in medium- to long-term inflation expectations. According to various surveys and market indicators, inflation expectations appear to be rising on the whole (Chart 8). Looking at the mechanism behind this rise, it appears that, in the first instance, the Bank's strong and clear commitment to overcome deflation through QQE, together with bold monetary easing to underpin this commitment, has affected expectations of economic entities, and inflation expectations started to rise. Subsequently, the actual increase in the inflation rate due to the narrowing of the output gap has then led to a further rise in inflation expectations. As mentioned earlier, the year-on-year rate of change in the CPI (excluding fresh food) has been above plus 1 percent. Except for the period of the surge in global commodity prices around 2008, this is the first time in the two decades since 1993 that the CPI has risen by more than 1 percent year-on-year for several months in a row. With firms and households experiencing these price increases, their inflation expectations have changed and have started to influence wage and price setting. As seen in the wage negotiations this spring, the increase in inflation has been taken into account in the wage negotiations between management and labor. In addition, a shift in firms' price-setting strategies from strategies focusing on low prices to strategies seeking to raise sales prices while increasing value added can be observed. Given that the Bank continues to steadily pursue QQE and that inflation continues to be above 1 percent, medium- to long-term inflation expectations will likely follow an increasing trend, which will further reinforce inflationary pressure.

Upward drift of the Phillips curve

Although somewhat technical, let me summarize this price rise mechanism by using the concept of the Phillips curve (Chart 9). The Phillips curve depicts the relationship between the output gap and inflation, and illustrates the following mechanism: if economic conditions are favorable and the labor market and the market for goods and services are tight, inflation will rise. In the chart, the vertical axis depicts the inflation rate, while the horizontal axis depicts the output gap. The Phillips curve is assumed to be upward-sloping; that is, if economic conditions improve and we move to the right along the Phillips curve, the inflation rate will increase. Note that the inflation rate here depicts the year-on-year rate of change in the CPI excluding food and energy, both of which are likely to be affected by changes in the exchange rate of the yen.

Let us first look back at the situation before the introduction of QQE. The green curve is based on data up to the first half of the 1990s, while the blue curve is based on data since the second half of the 1990s. Comparing these two, you can see that the Phillips curve shifted downward during the prolonged period of deflation. As a result, the relationship between economic activity and prices had become such that even when the output gap is zero – when the economy is in a normal state – inflation is about 0 percent. Under these circumstances, the view that prices will decline or not rise had become firmly entrenched among firms and households.

QQE aims at drastically changing this deflationary mindset of firms and households and at raising inflation expectations toward 2 percent. In terms of the Phillips curve, this means that the Bank aims at shifting the Phillips curve upward, slightly above the green curve, so that the relationship between economic activity and prices is such that inflation will be 2 percent when the output gap is zero, that is, when the economy is in a normal state.

Developments in the past year

In light of this aim, how much progress have we made? Let us next look at changes since the introduction of QQE. The red circles in the chart illustrate developments over the past year and indicate the following.

First, with the economy growing at a pace above its potential under QQE, the output gap has improved and we have moved to the right. Along with this, there has been upward pressure on prices.

Second, the red circles are located above the blue Phillips curve for the deflation period. This suggests that inflation has been higher than can be explained solely by the improvement in the output gap. There are likely several reasons behind this. One is that the depreciation of the yen may have affected items in the CPI other than food and energy, which, as I mentioned earlier, are already excluded. Another reason is that factors that exerted strong downward pressure on wages and prices during the deflation period, especially in the mid-2000s, such as the increase in non-regular workers and inflows of low-priced imports from emerging economies, are unlikely to put further downward pressure on wages and prices. Yet another reason is that, under QQE, inflation expectations seem to have risen and the Phillips curve has started to drift upward. This is confirmed, as mentioned earlier, by developments in inflation expectations gauged through various surveys and market indicators as well as recent patterns in wage and price setting.

It is difficult to clearly disentangle the contributions of these different factors. However, the fact is that we have seen inflation rates that are notably higher than anticipated by many people at the time of the introduction of QQE in April last year. Moreover, the very least we can say is that the relationship between economic activity and prices over the past year has been different from that seen previously. At the Bank, we believe that this is because QQE has been having its intended effects. Prices so far have been developing almost in line with the outlook for prices published by the Bank in April last year, so that in our eyes there has been no unexpected inflation. So far, CPI inflation has increased and reached around 1¼ percent according to the mechanisms we envisaged at the time of the introduction of QQE.

With these mechanisms continuing to work, inflation is likely to approach the target of 2 percent. However, the aim of QQE is not to temporarily achieve 2 percent inflation but to maintain it at that level in a stable manner. To that end, it will be necessary for inflation expectations to converge toward 2 percent and to ensure that they stay there, that is, to anchor them. Put simply, we need to achieve a world in which people engage in economic activities based on the assumption that 2 percent inflation is a given. To reach this world, it is necessary to further raise both actual inflation rates and inflation expectations. This is the reason why I said earlier that we are only half way there.

The Bank will therefore continue with QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. If the outlook changes due to the manifestation of some risk factors, the Bank will make adjustments without hesitation if this is judged necessary for achieving the price stability target.

III. Toward strengthening Japan's medium- to long-term growth potential

As I explained, Japan's economy has been recovering moderately and is on a path suggesting that the 2 percent price stability target will be achieved as expected. Against this backdrop, discussions on labor shortages and supply capacity constraints have increasingly come to the forefront. Although the decline in the potential growth rate was clearly recognized as one of the key challenges facing Japan, this was overshadowed by concerns over excess labor and excess capacity, which were considered to be the most immediate problems, since demand was weak. However, the situation has changed in the past year or so. With the increase in demand thanks to large-scale monetary easing, fiscal spending, and the rejuvenation of private-sector activity, the supply capacity constraints that were lurking below the surface have now become apparent. In this situation, it seems to have become widely recognized that it is important to enhance supply capacity from a medium- to long-term perspective. In my view, with the supply capacity constraints having surfaced, this is a golden opportunity to push ahead with initiatives to address the challenges Japan is facing. Therefore, I would like to offer my view on the issue of Japan's medium- to long-term growth potential.

An economy's medium- to long-term growth potential, in other words, the potential growth rate, depends on the growth in production factors, that is, capital and labor, as well as improvements in productivity through innovation and the like. Japan's potential growth rate has been declining as a trend since the 1990s (Chart 10).

Looking in more detail at the reasons for the decline in Japan's potential growth rate, the deceleration in capital accumulation and in productivity growth in the 1990s played a major role. During this period, Japanese firms were weighed down by the need to resolve the so-called three excesses – excess labor, capital stock, and debt – that had piled up during the preceding bubble period and could not sufficiently respond to changes such as increasing globalization and the revolution in information and communication technology. In addition, the adjustment of excesses itself did not progress smoothly and inefficient parts of the economy were preserved. This to some extent led to a slowdown in the metabolism of the economy as a whole and a decline in productivity. In addition, the decline in labor input as a result of demographic trends and the decrease in working hours as the economy matured and shorter working hours became more common have put downward pressure on the potential growth rate. Protracted deflation and the additional shock of the global financial crisis led firms to defer fixed investment, so that growth in the capital stock has been subdued. As a result of these various factors that have successively exerted downward pressure on the economy, Japan's potential growth rate has been declining since the 1990s and recently seems to have been hovering around 0.5 percent.

What should be done to raise medium- to long-term growth potential? In short, it is critical to promote initiatives that address the aforementioned factors affecting the potential growth rate. Namely, it is essential to (1) encourage forward-looking investment by firms and increase the capital stock, (2) enhance labor supply capacity by raising the labor participation of women and the elderly as well as utilizing high-skilled foreigners, and (3) raise productivity through regulatory and institutional reforms. In this regard, the government has formulated a growth strategy, the Japan Revitalization Strategy, to stimulate private investment and has been implementing measures included in the Strategy. Taking into account subsequent discussions, the government is now in the process of revising the Japan Revitalization Strategy. The Bank strongly hopes that the government will push ahead with the steady implementation of its growth strategy.

Concluding remarks

In concluding, let me briefly touch on the relationship between strengthening the growth potential and monetary policy management. While initiatives to strengthen the growth potential are critical, these are medium- to long-term challenges. Some time is required for such initiatives to bear fruit and growth potential to actually rise. It is of course desirable that the potential growth rate increases steadily. However, even if the potential growth rate does not rise, this would not make it any more difficult for monetary policy to achieve the price stability target. I believe that by steadily pursuing QQE, the Bank can achieve the target of 2 percent based on the aforementioned mechanisms, that is, through improvements in the output gap and a rise in inflation expectations. The Bank's mission to ensure price stability remains unchanged irrespective of the level of the potential growth rate. The Bank will pursue monetary policy management on its own accord to achieve the price stability target of 2 percent at the earliest possible time.

While strengthening the growth potential is mainly the responsibility of the government and its growth strategy as well as private entities and their actions in response to the growth strategy, there may be ways in which the Bank can help. That is, in a deflationary environment, proactive initiatives such as conducting business fixed investment provided little reward in terms of the risks and returns for individual firms, and it was rational for firms to hoard cash and maintain the status quo. Changing the environment from one of deflation to one of 2 percent inflation will change firms' incentives and can be expected to lead to a more proactive investment stance and greater efforts to raise productivity. Against this background, let me assure you again that the Bank will steadily pursue QQE and achieve the price stability target of 2 percent at the earliest possible time. I would like to conclude my speech by expressing the hope that the Bank's policy conduct provides an environment that helps your firms to take proactive actions.

Thank you.

Chart 1

Outlook for Economic Activity and Prices (as of April 2014)

y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2013 (Actual)	+2.3	+0.8	
Forecasts made in January 2014	+2.7	+0.7	
Fiscal 2014	+1.1	+3.3	+1.3
Forecasts made in January 2014	+1.4	+3.3	+1.3
Fiscal 2015	+1.5	+2.6	+1.9
Forecasts made in January 2014	+1.5	+2.6	+1.9
Fiscal 2016	+1.3	+2.8	+2.1

Note: Figures indicate the median of the Policy Board members' forecasts (point estimates).
Source: Bank of Japan.

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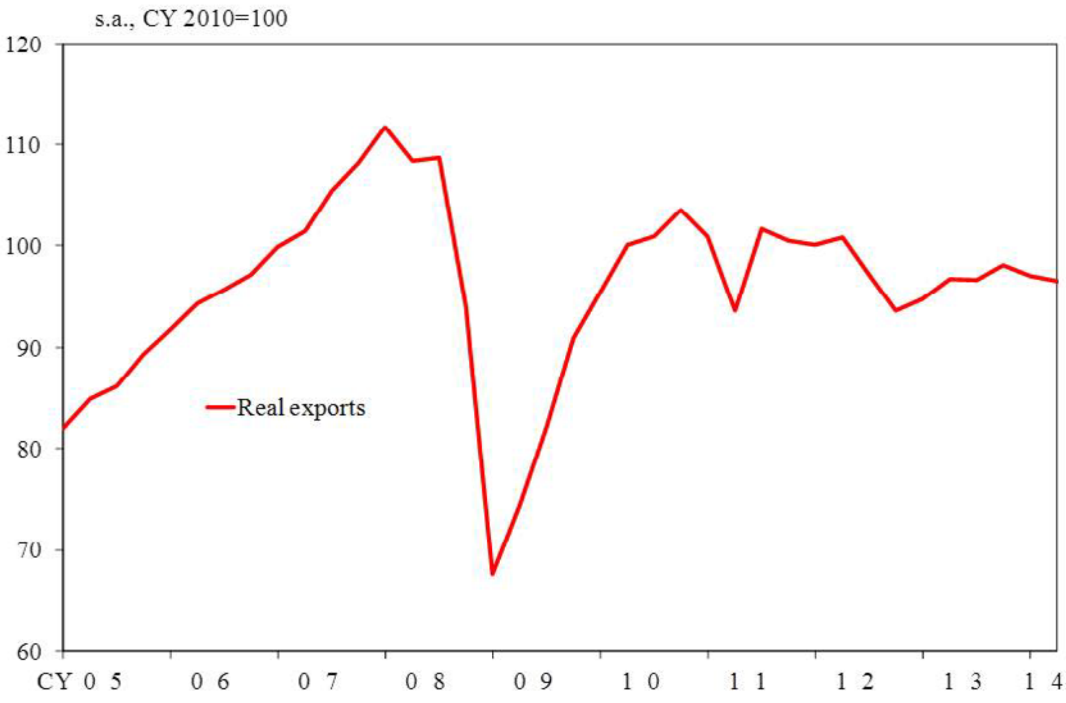
Chart 2

Exports



Note: The figure for 2014/Q2 is the April-May average.
Sources: Ministry of Finance; Bank of Japan.

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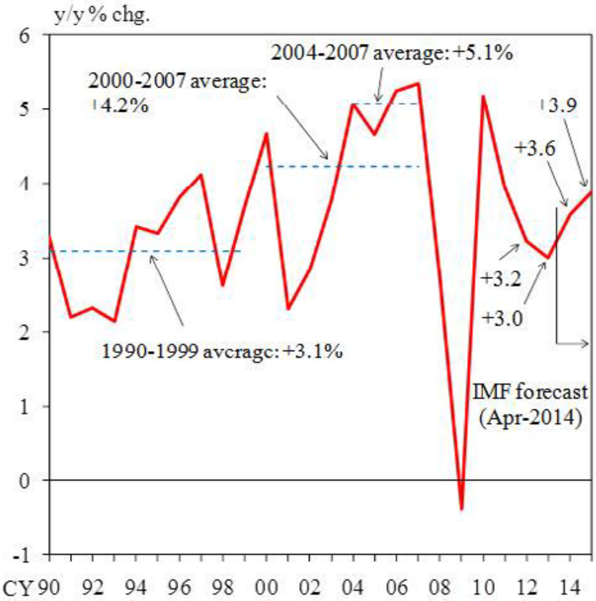
Chart 3

World Economy

Real GDP Growth Rate



Projections for Major Economies

y/y % chg.

	2012	2013	Projections 2014	Projections 2015
World	3.2	3.0	3.6 (-0.1)	3.9 (-0.1)
Advanced Economies	1.4	1.3	2.2 (0.0)	2.3 (0.0)
United States	2.8	1.9	2.8 (0.0)	3.0 (0.0)
Euro Area	-0.7	-0.5	1.2 (0.1)	1.5 (0.1)
Japan	1.4	1.5	1.4 (-0.3)	1.0 (0.0)
Emerging Market and Developing Economies	5.0	4.7	4.9 (-0.2)	5.3 (-0.1)
Developing Asia	6.7	6.5	6.7 (0.0)	6.8 (0.0)
China	7.7	7.7	7.5 (0.0)	7.3 (0.0)
ASEAN	6.2	5.2	4.9 (-0.2)	5.4 (-0.2)
Latin America and the Caribbean	3.1	2.7	2.5 (-0.4)	3.0 (-0.3)

Note: Figures in parentheses are the difference from the January 2014 WEO.
Source: IMF, "World Economic Outlook, April 2014."

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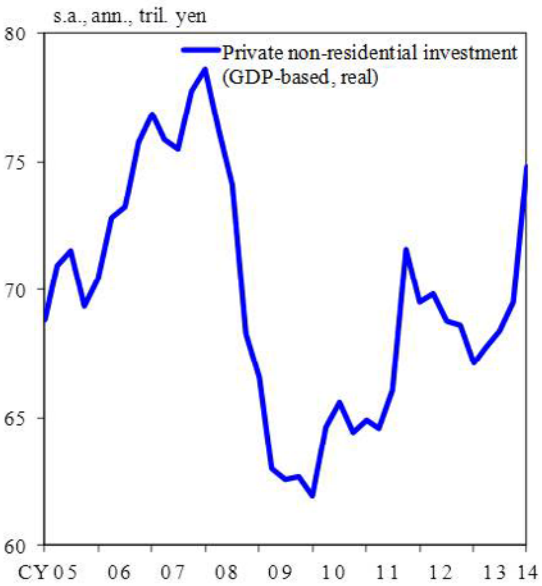
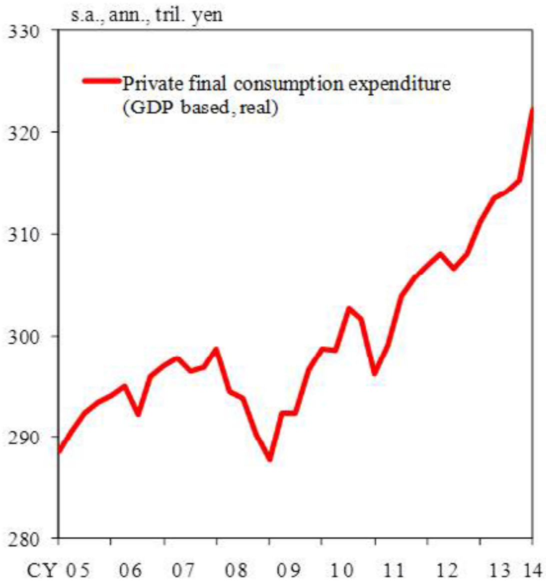
Chart 4

Domestic Demand

Business Fixed Investment



Private Consumption



Source: Cabinet Office.

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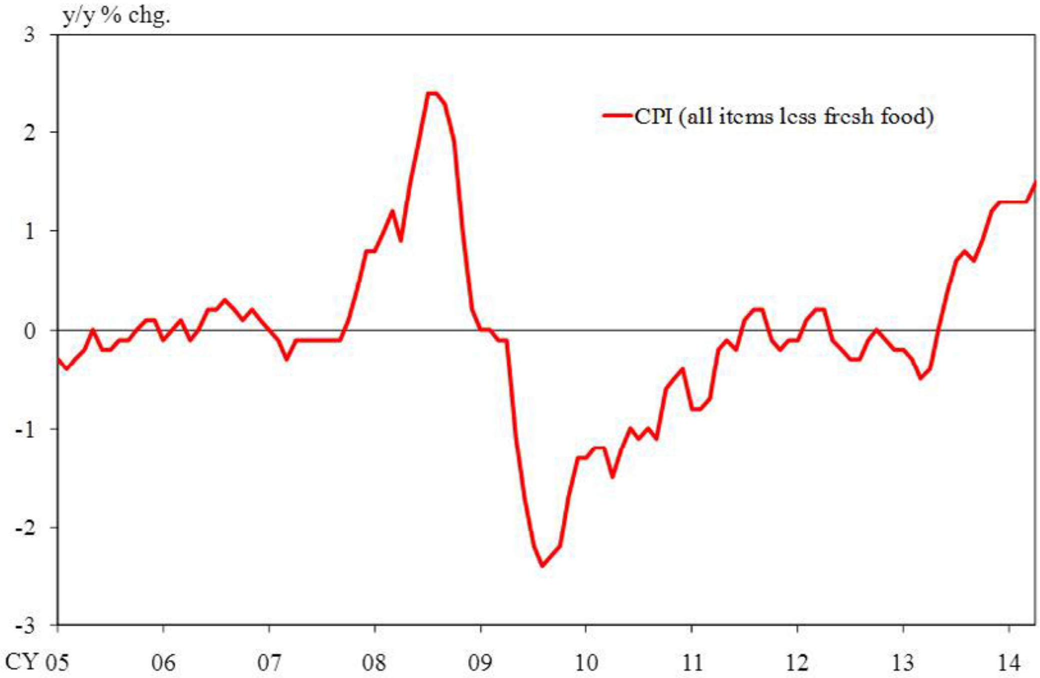
Chart 5

Consumer Prices



Note: The effects of the consumption tax hike (from 5 percent to 8 percent) are calculated as having pushed up the year-on-year rate of change in the CPI for April 2014 by 1.7 percentage points for all items less fresh food.
Source: Ministry of Internal Affairs and Communications.

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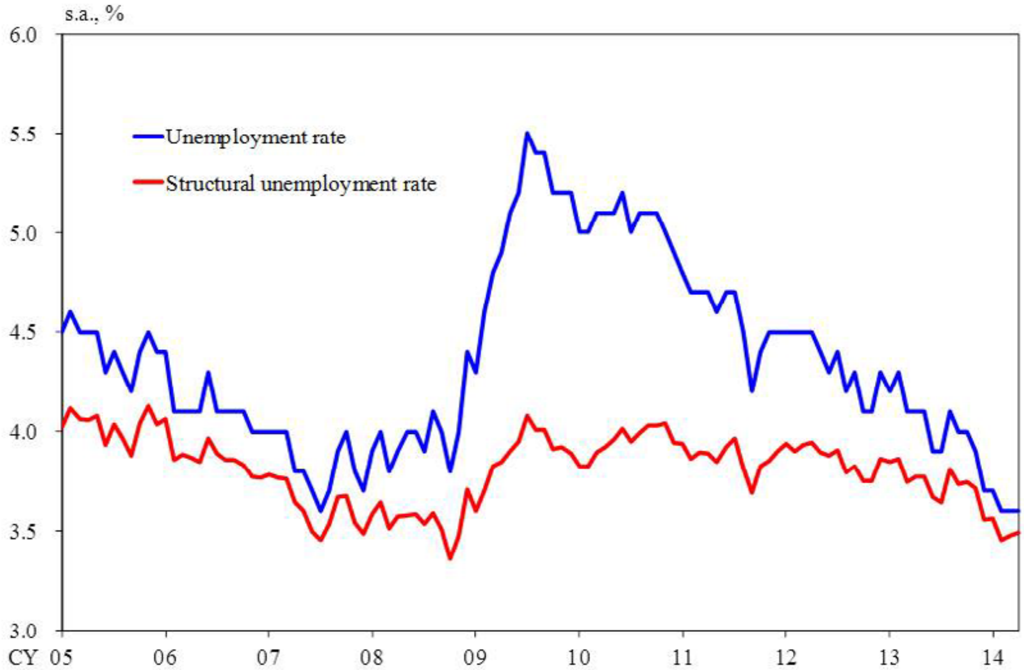
Chart 6

Labor Supply and Demand



Note: The structural unemployment rate is defined as the level of the unemployment rate where the number of vacancies equals that of the unemployed, given the empirical relationship between job vacancies and unemployment (estimation by the Research and Statistics Department, Bank of Japan). It captures frictional unemployment and unemployment caused by the mismatch between supply and demand in the labor market.
Source: Ministry of Internal Affairs and Communications.

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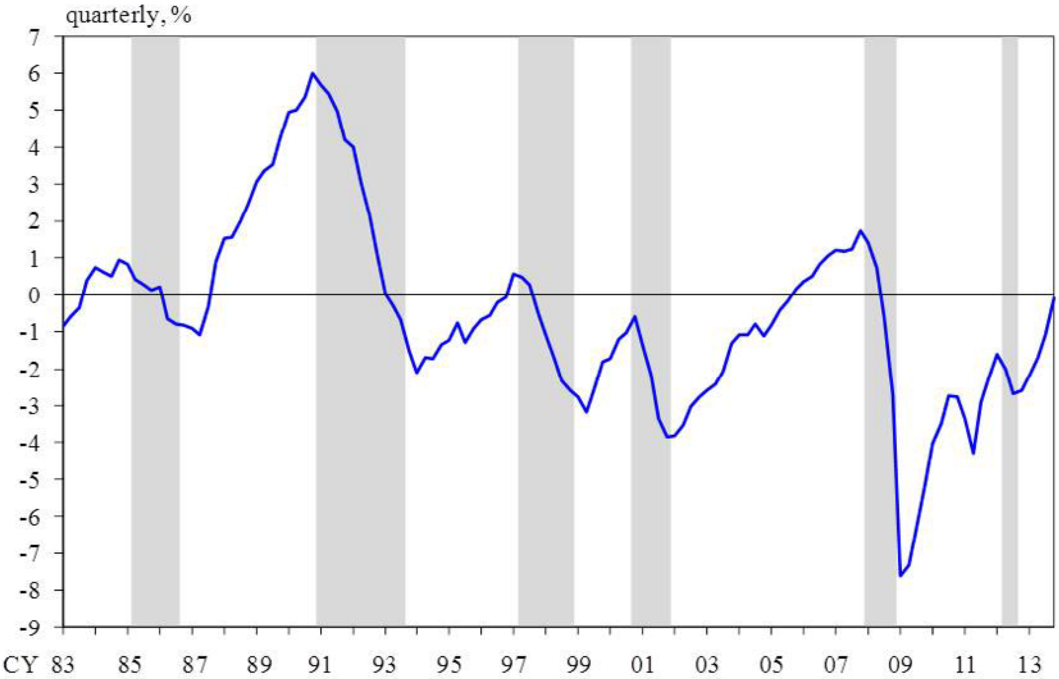
Chart 7

Output Gap



Notes: 1. The output gap is estimated by the Research and Statistics Department, Bank of Japan. For the estimation procedures, see "The New Estimates of Output Gap and Potential Growth Rate," Bank of Japan Review Series, 2006-E-3.

2. Shaded areas indicate recession periods.

Sources: Bank of Japan, etc.

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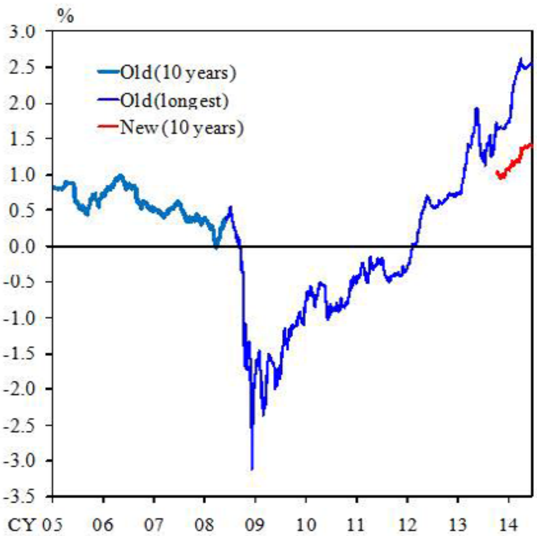
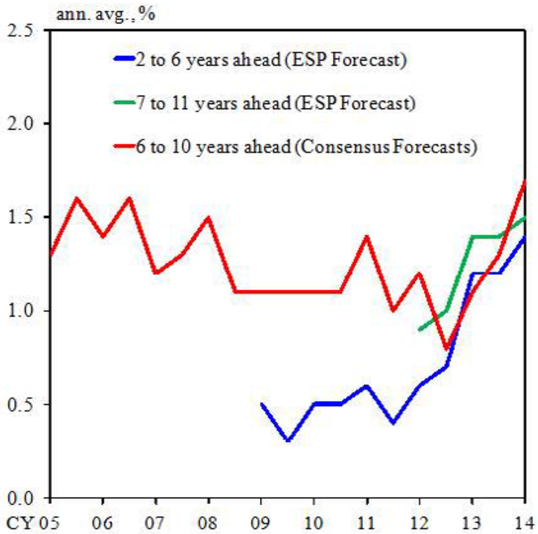
Chart 8

Inflation Expectations

Market Participants (BEI for Inflation-Indexed JGBs)



Economists



Notes: 1. BEI (break-even inflation) rates are yield spreads between fixed-rate coupon-bearing JGBs and inflation indexed JGBs. Inflation-indexed JGBs issued since October 2013 are designated as "new," while the rest are designated as "old." Figures for "old (longest)" are calculated using yield data for issue No.16 of the inflation-indexed JGBs, which matures in June 2018.

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

Sources: Bloomberg; Consensus Economics Inc.; JCER.

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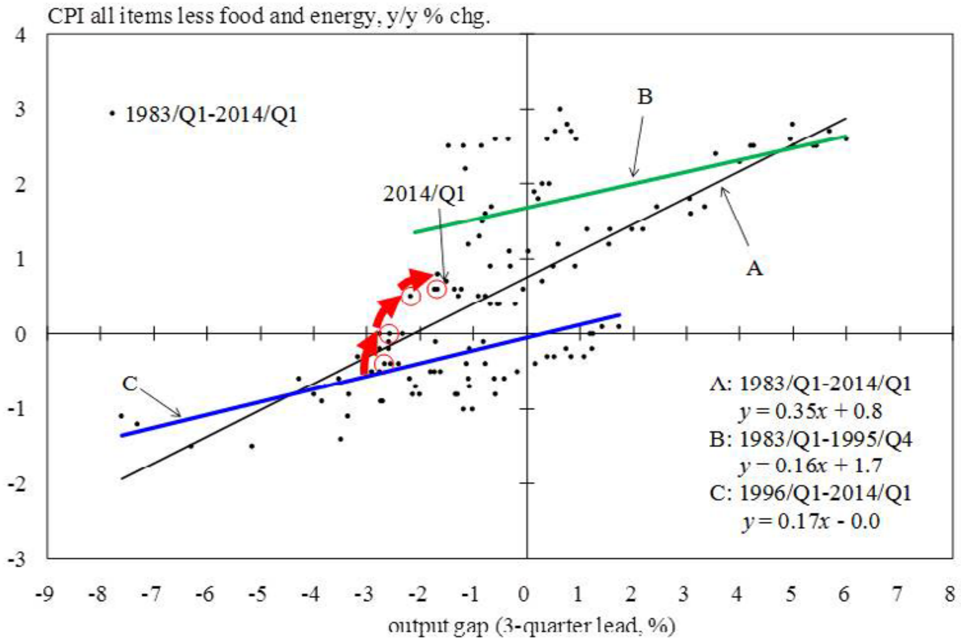
Chart 9

Phillips Curve



Notes: 1. The red circled marks are the latest four positions.
2. Figures for the CPI are adjusted to exclude the effect of changes in the consumption tax rate.
3. The output gap is estimated by the Research and Statistics Department, Bank of Japan. For the estimation procedures, see "The New Estimates of Output Gap and Potential Growth Rate," Bank of Japan Review Series, 2006-E-3.
4. The number of lags is chosen so that the cross-correlation between the output gap and the CPI is maximized.

Sources: Ministry of Internal Affairs and Communications; Cabinet Office; Bank of Japan, etc.

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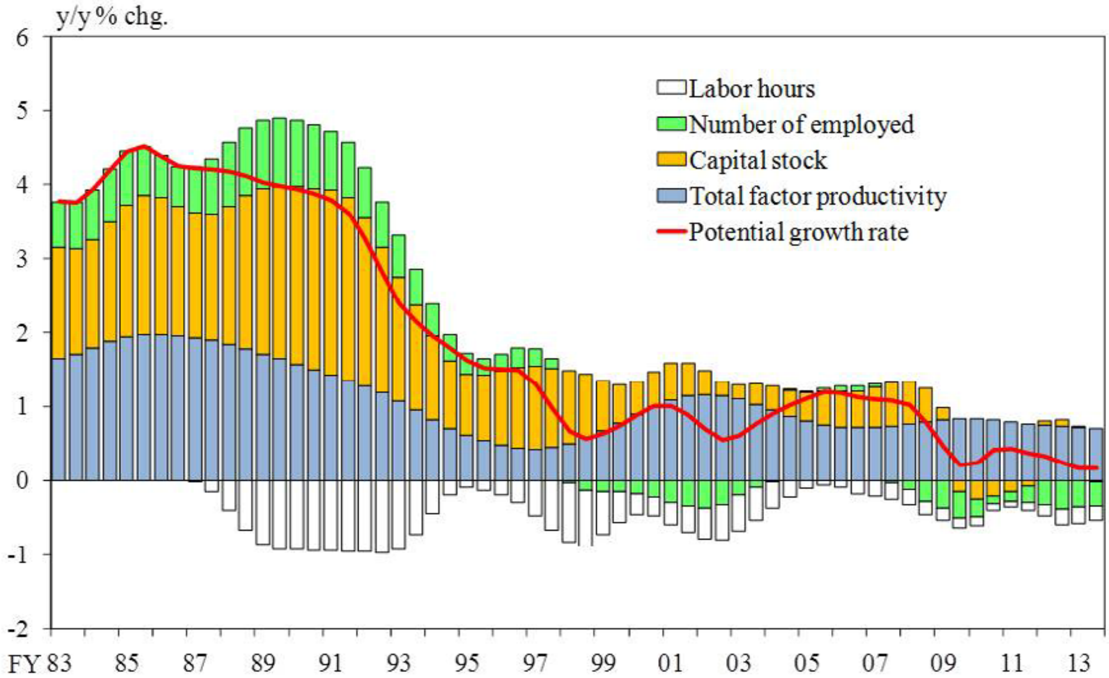
Chart 10

Potential Growth Rate



Note: The potential growth rate is estimated by the Research and Statistics Department, Bank of Japan. Figures for the second half of fiscal 2013 are those of 2013/Q4.

Sources: Cabinet Office; Bank of Japan; Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Ministry of Economy, Trade and Industry, etc.

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