# Yoshihisa Morimoto: Economic activity and prices in Japan and monetary policy

Speech by Mr Yoshihisa Morimoto, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Akita, 19 June 2014.

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## I. Recent economic and price developments

### *A. Japan's economy and prices*

#### *1. Current state of and outlook for the economy*

I will begin by explaining the current state of and outlook for Japan's economy. Since the start of fiscal 2014, a subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been observed, mainly in private consumption, such as of durable goods, but domestic demand including business fixed investment has remained firm as a trend. Therefore, a virtuous cycle of economic activity has been operating firmly, accompanied by steady improvements in supply and demand conditions in the labor market. In this situation, the economy has continued to recover moderately as a trend. Specifically, overseas economies – mainly advanced economies – are recovering, albeit with a lackluster performance still seen in part of emerging economies. Japan's exports had been picking up as a trend through early autumn 2013, but since then have been leveling off more or less, partly due to temporary downward pressure, such as firms' stance of placing priority on domestic shipments in response to the front-loaded increase in demand prior to the consumption tax hike and the unusually severe winter weather in the United States, in addition to the sluggishness in emerging economies. Looking at domestic demand, private consumption and housing investment have remained resilient as a trend with improvement in the employment and income situation, although a subsequent decline in demand following the front-loaded increase has recently been observed. Business fixed investment has increased moderately as corporate profits have improved; for example, on a GDP basis, it increased in the January-March quarter of 2014 for the fourth consecutive quarter, and thus is growing at an accelerated pace. Public investment continues to increase, due in part to the effects of various economic measures, and has more or less leveled off recently at a high level.

As for the outlook, Japan's economic growth rate for the April-June quarter is expected to temporarily decline due to the subsequent decline in demand following the front-loaded increase. However, the virtuous cycle among production, income, and spending is expected to be maintained, as private consumption is expected to remain resilient as a trend, reflecting improvement in the employment and income situation, and as exports and business fixed investment are expected to follow a moderate increasing trend. Therefore, although the economy will be affected by the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike, the recovery will not stall, and the economy is likely to continue growing at a pace above its potential as a trend. In the Bank of Japan's April 2014 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), the median of the Policy Board members' forecasts for the economic growth rate was 1.1 percent for fiscal 2014, 1.5 percent for fiscal 2015, and 1.3 percent for fiscal 2016.

#### *2. Prices*

Next, I will talk about price developments. The year-on-year rate of change in the consumer price index (CPI) for all items less fresh food turned positive in June 2013, rose to 1.3 percent in December, and has recently been around 1¼ percent. The rate of increase for April 2014 registered 3.2 percent, and on a basis excluding the direct effects of the consumption tax hike, it marked 1.5 percent, which is somewhat higher than the rate for

March. Given this, the tax increase appears to have been passed on to prices on the whole, on the back of resilient private consumption. As for the outlook, although the effects of the upward pressure from energy-related goods that are directly affected by foreign exchange rates are likely to subside through this summer, 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. This is due to strengthening of the underlying upward pressure on prices on the back of improvement in the aggregate supply and demand balance, or the output gap. Thereafter, in a situation where the virtuous cycle of economic activity continues to operate, the upward pressure on wages and prices is likely to become stronger with the output gap following an improving trend, and medium- to long-term inflation expectations are also likely to rise. Thus, the rate of increase in the CPI is likely to reach around 2 percent – the price stability target – around the middle of the projection period, which is from fiscal 2014 through fiscal 2016. Specifically, in the Bank's April 2014 Outlook Report, the median of the Policy Board members' forecasts for the year-on-year rate of increase in the CPI (all items less fresh food, excluding the direct effects of the consumption tax hikes) was 1.3 percent for fiscal 2014, 1.9 percent for fiscal 2015, and 2.1 percent for fiscal 2016.

### *B. Overseas economies*

I would now like to give an overview of overseas economies. These are expected to moderately increase their growth rates as advanced economies continue to see firm recovery and its positive effects gradually spread to emerging economies. According to the projections for global economic growth released by the International Monetary Fund (IMF) in April 2014 in its *World Economic Outlook*, global growth is projected to strengthen to 3.6 percent in 2014 and then to 3.9 percent in 2015, rising at a moderate pace to reach a rate exceeding its long-term average.

Looking at respective major countries and regions, in the United States, real GDP for the January-March quarter of 2014 decreased from the previous quarter, mainly due to the effects of the unusually severe winter weather, but has returned to a moderate recovery trend. As for the outlook, the pace of recovery is expected to gradually rise, led mainly by private demand – such as firm private consumption – as accommodative financial conditions are expected to be maintained and fiscal drag is likely to weaken. The euro area economy is recovering moderately, registering positive growth for four consecutive quarters. Although faced with structural problems such as excess debt, it is expected to continue recovering moderately, supported in part by improvement in household and business sentiment. Regarding risks to the economy, close attention needs to be paid to a possible prolonged disinflationary trend and the effects of the situation in Ukraine and Russia. The Chinese economy continues to see stable growth, although it has been growing at a somewhat reduced pace, mainly in real estate-related areas. The Chinese authorities have taken the stance of continuing to pay consideration to economic activity while progressing with structural reforms, and already have taken some policy measures to underpin economic activity. In addition, external demand is expected to continue improving moderately, mainly in advanced economies, and thus the Chinese economy is likely to continue to see stable growth, albeit at a slightly slower pace. Meanwhile, some of the other emerging and commodity-exporting economies remain weak in a situation where they are facing issues regarding, for example, current account balance and inflation rates. These economies will likely continue to lack growth momentum for the time being, but are expected to gradually increase their growth rates due to positive effects of the recovery in advanced economies, on the assumption that global financial markets remain generally stable.

### *C. Major issues surrounding the outlook for economic activity and prices*

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

### *1. Household spending and the employment and income situation*

I will first touch on household spending and its supporting pillar – the employment and income situation. Regarding household spending, it is important to examine the effects of the consumption tax hike in April 2014. Private consumption has remained resilient as a trend with improvement in the employment and income situation. The effects of the decline in consumption due to the front-loading of demand are likely to start waning from this summer. Since April, a clear decline following the tax hike has been observed, mainly in purchases of durable goods such as automobiles, demand for which increased substantially prior to the tax hike. So far, however, many firms have indicated that the degree 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. Furthermore, retailers, such as department stores and supermarkets, have indicated that the decline in consumption is gradually shrinking. Also, sales in the food service industry and outlays for travel remain steady. These views have been reflected in the *Economy Watchers Survey*. In the latest survey, the diffusion index (DI) for future economic conditions for two to three months ahead recovered to surpass 50, the borderline between improvement and deterioration. Of course, it is necessary to continue to carefully examine the upcoming results of this survey. As for the outlook, while the employment and income situation continues to improve, private consumption is likely to stay on an increasing trend, albeit at a moderate pace, partly due to active spending by the elderly – the baby-boomer generation in particular. Housing investment is expected to remain resilient as a trend, supported by improvement in the employment and income situation and accommodative financial conditions.

In this way, a sustained improvement in the employment and income situation is the key to keeping private consumption and housing investment resilient. Taking a look at supply and demand conditions in the labor market, the unemployment rate has fallen to 3.6 percent and the active job openings-to-applicants ratio has risen to 1.08. These figures are both at around the most favorable levels marked before the Lehman shock. Furthermore, in the March 2014 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the DI for employment conditions (the proportion of firms responding that employment conditions are “excessive” minus the proportion of those responding that they are “insufficient”) for nonmanufacturing showed the largest negative figure since December 1992, and that for manufacturing turned negative, indicating a further tightening of supply and demand conditions in the labor market. An increasing number of firms – mainly in the construction and retail industries, which are increasingly experiencing a shortage of labor – are reviewing working conditions to secure sufficient human resources, leading to more women and the elderly joining the workforce. Although this recent addition to the workforce has mainly represented employees with short working hours, such as part-time workers, this development will likely affect demand through, for example, increased income, and eventually lead to a rise in the medium- to long-term growth potential of Japan’s economy.

The tightening of supply and demand conditions in the labor market is starting to influence wages. Hourly cash earnings of overall employees have started to increase moderately, albeit with fluctuations. According to the currently available aggregate results of wage negotiations compiled by the Japanese Trade Union Confederation (Rengo), wage negotiations this spring are expected to result in a rise by firms, including small firms, of around 0.5 percent in base pay, and about 2.1 percent in overall wages. In addition, various surveys show that summer bonuses are likely to increase. As for the outlook, in a situation where Japan’s economy continues to grow at a pace above its potential, firms have shown more willingness to hire new recruits, including regular employees. Under such circumstances, it is likely that the labor supply and demand conditions will further tighten, and the unemployment rate is expected to continue declining to a level more or less close to the structural unemployment rate – a state in which excess labor force has disappeared. In this situation, it is increasingly likely that wages, as well as prices, will be put under upward pressure.

### 2. *Business fixed investment*

I will now move on to business fixed investment. In order to achieve sustainable growth of the economy, it is important that improvements in corporate profits and increases in demand lead to firms' active investment. Corporate profits for fiscal 2013 rose significantly. As for fiscal 2014, firms have relatively conservative fixed investment plans at present. However, supported by a moderate increase in exports and developments in the foreign exchange market, in addition to firm domestic demand, corporate profits are expected to continue their improving trend. Under these circumstances, business fixed investment is likely to follow a moderate increasing trend, given its noticeable growth on a GDP basis and the upward trend in machinery orders, which represent a leading indicator of machinery investment.

Three factors are supporting the strength in business fixed investment. First is the improvement in investment profitability. The extent of the monetary easing stimulus to encourage investment is likely to strengthen, owing to a rise in the rate of return on capital due to improvement in economic activity, combined with the decline in real interest rates that mainly reflects a rise in inflation expectations. Second is the large potential demand. Business fixed investment, which has increased for four consecutive quarters, has just entered a recovery phase after dipping due to the effects of the Lehman shock and the Great East Japan Earthquake. Therefore, increased economic activity will easily encourage latent demand to materialize, such as for the maintenance and replacement of equipment. The third factor is a likely rise in firms' medium- to long-term growth expectations, due partly to the positive initiatives to strengthen the competitiveness and growth potential of Japan's economy, such as the government's regulatory and institutional reforms and firms' restructuring efforts.

Looking at business fixed investment overseas, the last one to two years have coincided with the periods in which investment decisions that were made after the Lehman shock – when the yen appreciated – proceeded to the actual implementation phase. Thus, the ratio of overseas business fixed investment relative to domestic investment has increased rapidly. In view of recent movements in the foreign exchange market, however, the pace of increase is likely to decelerate somewhat.

### 3. *Exports*

I would now like to talk about developments in exports. Exports have leveled off more or less, due partly to temporary downside pressure, such as the sluggishness in emerging economies, particularly the ASEAN economies, which are closely linked to Japan's economy, and the effects of the unusually severe winter weather in the United States. Moreover, the recent weakness in exports is likely to be affected to some degree by structural factors such as an increasing shift by Japanese manufacturers to move production overseas. From a somewhat longer-term perspective, however, the correction in the appreciation of the yen to date is likely to ease downward pressure on exports by putting a brake on the shift to move production overseas. As for the outlook, exports are likely to start increasing, albeit moderately, as overseas economies – mainly advanced economies – recover moderately on the whole. It should be noted that exports might deviate either upward or downward, depending on future developments in overseas economies. Therefore, it is necessary to continue to closely monitor developments, such as in emerging economies, the European debt problem, and the U.S. economy.

### 4. *Prices and inflation expectations*

I will now move on to developments in prices and inflation expectations. Excluding the direct effects of the consumption tax hike, the year-on-year rate of increase in the CPI (all items less fresh food) for April 2014 climbed to 1.5 percent. This was because, while the positive contribution from prices of energy-related goods that are directly affected by foreign exchange rates has peaked, improvements have become widespread for a broad range of items other than energy-related goods, including those in the services industry, such as accommodation charges, mainly on the back of an improvement in the output gap. On a basis excluding the direct effects of the tax hike, the year-on-year rate of change in the CPI for April, excluding prices of food and energy-related goods such as petroleum products, climbed to 0.8 percent from minus 0.8 percent for March 2013. Improvement has become pronounced, as the number of items for which prices have increased has been exceeding 50 percent of the total. As for firms' price-setting behavior, interviews with firms and other relevant information have revealed that some firms have been successful in their efforts, such as to raise selling prices while increasing value-added and tapping new potential demand.

Against this background, there seems to be a gradual increase in the responsiveness of prices to the output gap and in inflation expectations, including short-term ones. Let me note that the Bank, in the March 2014 *Tankan,* surveyed the inflation outlook of firms for the first time. Although there were disparities between the views of large firms and small ones, results showed that the outlook for general prices of all firms in all industries for one year ahead registered 1.5 percent on average, while those for three years and five years ahead were both slightly above 1.5 percent, indicating firms' expectations of a further rise in inflation. Given the current tightening of labor supply and demand conditions, mainly in nonmanufacturing, inflation expectations of firms – as well as households – are susceptible to gaining upward momentum. It should be noted, however, that the actual rate of inflation does affect the medium- to long-term expected rates of inflation. If, through this summer, the upward momentum of the CPI weakens due to a fall-off of the effects of the weak yen and to a slack in supply and demand conditions resulting from the decline in demand following the consumption tax hike, due attention should continue to be paid to how this will affect inflation expectations, even during the process of the economy returning to a moderate recovery path from the summer.

As I have explained, the Bank expects the inflation rate to increase gradually in a situation where economic activity will improve in a balanced and sustainable manner, accompanied by improvement in corporate profits and subsequent increases in employment, wages, and business fixed investment. Recently, while domestic demand remains firm, the output gap in Japan appears to have reached the past long-term average of about zero, reflecting factors such as a low birth rate and aging population working in the direction of reducing potential labor supply. In other words, supply-side issues have surfaced. Therefore, reinforcing supply capacity has become an important challenge with respect to raising Japan's economic growth in the medium to long term and achieving sustainable growth. To this end, it is essential to steadily carry out measures to enhance productivity and thereby raise the growth potential of the economy, such as by providing job opportunities for women and the elderly to secure a sufficient labor force, encouraging firms' active investment, and also implementing regulatory and institutional reforms. At the same time, it also is essential to continue creating demand to match the increased supply capacity. The government is accelerating implementation of its Japan Revitalization Strategy, which is designed to boost the growth potential, and in view of the discussions made after the introduction of the strategy, it is formulating a new growth strategy. The Bank, for its part, is actively proceeding with measures such as provision of funds to support strengthening of the foundations for economic growth. These endeavors will continue to be made steadily in an effort to address the issues facing Japan's economy that I have explained, and medium- to long-term growth expectations of firms and households are likely to rise accordingly.

## II. Conduct of monetary policy

### *A. Quantitative and Qualitative Monetary Easing (QQE)*

*1. Framework of QQE*

Next, I would like to turn to the Bank's monetary policy.

In order for Japan's economy to overcome deflation as early as possible and achieve sustainable growth with price stability, the Bank introduced in January 2013 the price stability target of 2 percent in terms of the year-on-year rate of change in the CPI. Then, in April of the same year, the Bank introduced QQE to achieve the price stability target at the earliest possible time, with a time horizon of about two years. With its steady continuation so far, QQE has been exerting its intended effects. The Bank has announced that it is committed to continuing 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. It will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate.

The specific measures of QQE are as follows. First, with a view to pursuing quantitative monetary easing, the Bank decided to increase the monetary base – which is the total amount of currency it directly supplies to the economy (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, thus doubling it in two years. Second, to achieve this, the Bank has been purchasing Japanese government bonds (JGBs) so that their amount outstanding increases at an annual pace of about 50 trillion yen. In doing so, the Bank has been working on interest rates across the yield curve – including longer-term ones – setting the average remaining maturity of its JGB purchases at about seven years. And third, the Bank has been purchasing exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their amounts outstanding increase at an annual pace of about 1 trillion yen and about 30 billion yen, respectively.

In conducting QQE, the Bank keeps in mind two key transmission channels: (1) lowering real interest rates, which are obtained by subtracting expected rates of inflation from nominal long-term interest rates; and (2) the portfolio rebalancing effect, which encourages financial institutions and institutional investors to shift their asset portfolio toward lending and investment in risk assets such as stocks. In lowering real interest rates, the Bank first applies strong downward pressure on nominal long-term rates by tightening JGB market conditions through its massive purchases of JGBs. Then, through a clear explanation of its determination to achieve the price stability target at the earliest possible time and the continuation of massive purchases of assets underpinning this determination, it aims to raise inflation expectations by boosting people's expectations that the economy will become revitalized. Consequently, real interest rates could be lowered if the extent of a pick-up in nominal rates is contained within the extent of a rise in inflation expectations. In other words, a decline in real interest rates would lessen firms' and households' interest burden relative to the improved corporate profits and household income, thereby helping to increase firms' investment and households' consumption. In order to achieve the price stability target, it is important – with this mechanism functioning effectively – to maintain the virtuous cycle in which prices rise moderately along with a balanced and sustainable improvement in economic activity that is accompanied by increases in corporate profits, employment, and wages. 2. Recent financial environment and the conduct of monetary policy I would now like to turn to the financial environment in Japan. With the steady continuation of QQE, financial conditions are accommodative. The monetary base has been increasing at a pace consistent with the Bank's policy guideline of increasing it at an annual pace of about 60–70 trillion yen and has been at a high year-on-year growth rate of around 45 percent. Through the end of 2014, the Bank plans to increase the monetary base to a level as high as about 270 trillion yen, which is equivalent to about 60 percent of nominal GDP.

In this situation, firms' funding costs have been hovering at low levels. The average interest rates on new loans and discounts for both the short and long terms have been at historical low levels. In these circumstances, interest payments by firms have been at sufficiently low levels in relation to their profitability. Financial institutions' lending attitudes as perceived by large as well as small firms, in addition to the financial positions of both sets of firms, have been on an improving trend. The levels of various DIs have been above the average for the period since 2000. Domestic demand for working capital by firms has been rising. There has also been an increase in demand for funds in sectors where there are prospects for growth, such as the medical and nursing business, and demand for funds related to corporate takeover activities. Against this backdrop, the year-on-year rate of increase in the amount outstanding of bank lending has been at around 2.5 percent, and the year-on-year rate of growth in the money stock has been in the range of 3.0–3.5 percent.

Looking at financial markets in Japan, interest rates – both long- and short-term – have been at extremely low levels as the Bank continues with massive purchases of JGBs and other measures. Money market rates – including those on term instruments with longer maturities – have been below the 0.1 percent level. Long-term interest rates have been stable even in the face of temporary rises in such rates in the United States and Germany, and have been stable at around 0.6 percent on the whole. Japanese stock prices had risen through end-2013, reflecting the rise in U.S. and European stock prices and further depreciation of the yen. After the turn of the year, however, they declined and thereafter have been more or less unchanged, albeit with fluctuations. In the foreign exchange market, the yen depreciated against the U.S dollar through end-2013, and recently has been more or less level in the range of 101–103 yen.

In this financial and economic environment, the Bank assumes that, amid a rise in observed price and wage inflation, people's inflation expectations will rise further, and the effects of monetary easing brought about by a decline in real interest rates will continue to strengthen. In relation to developments in portfolio rebalancing, although growth in bank lending remains marginal relative to the substantial decrease in financial institutions' holdings of government securities, bank lending growth is expected to gradually increase with the strengthening of the monetary easing effects, as a rise in business fixed investment has recently become evident. At present, the virtuous cycle continues to operate as the effects of QQE on economic activity are gradually becoming pronounced. Nevertheless, it is important to carefully examine economic developments and the effects of monetary policy, including the pick-up in economic activity after the decline in demand following the front-loaded increase prior to the consumption tax hike.

Furthermore, as Japan faces serious fiscal imbalances, even by international standards, establishing a sustainable fiscal structure is a critical prerequisite for achieving sustainable growth of the economy. In this regard, the government has indicated that it aims to halve the primary deficit-to-GDP ratio by fiscal 2015 and achieve a surplus in the primary balance by fiscal 2020. Based on these targets, it is strongly expected that efforts toward fiscal consolidation will continue to proceed steadily.

### *B. Loan support program*

Next, I will discuss the Bank's Loan Support Program. To support full use of the accommodative financial conditions by firms and households, the Bank – in addition to implementing aggressive monetary easing measures – has established the Loan Support Program through which it provides long-term funds at a low interest rate to financial institutions. Specifically, the Bank has been providing funds through two measures that constitute the program: 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). At the Monetary Policy Meeting held in February 2014, the Bank decided to enhance the two facilities.

Let me elaborate on the framework of these facilities. First, the Stimulating Bank Lending Facility aims to prompt financial institutions to take a more active lending stance and stimulate firms' and households' demand for credit. With this facility, the Bank provides funds to financial institutions up to an amount that is twice as much as the net increase in their lending at a fixed rate of 0.1 percent per annum for four years. There is no upper limit to the total amount of funds provided by the Bank under this facility. The amount outstanding of fund-provisioning under this facility is expected to reach about 13 trillion yen as of end-June 2014. According to the estimate made in February 2014 when the facility was enhanced, the amount outstanding of fund-provisioning under the facility is projected to be around 30 trillion yen if the growth rate of bank lending and the utilization rate of the facility remains more or less unchanged.

I will now move on to the Growth-Supporting Funding Facility, which aims to support the flow of funds to growth sectors. With this facility, the Bank provides funds – at a fixed rate of 0.1 percent per annum for four years for yen-denominated funds – to financial institutions for their lending and investment to areas that are expected to contribute to strengthening Japan's growth potential, such as medical and nursing care; environment and energy; agriculture, forestry, and fisheries; and tourism. The maximum amount of its fund-provisioning to financial institutions under the main rules and special rules is set as follows: 7 trillion yen under the main rules for financial institutions' investments and loans amounting to 10 million yen or more; 500 billion yen under the special rules for financial institutions' equity investments and asset-based lending (ABL), the latter of which uses assets such as accounts receivable and inventories as eligible collateral; 500 billion yen under the special rules for financial institutions' small-lot investments and loans; and 12 billion U.S. dollars – equivalent to 1.2 trillion yen – under the special rules for a U.S. dollar lending arrangement using the U.S. dollar reserves already held by the Bank.

Recently, with the virtuous cycle of economic activity continuing to operate, there has been a growing impetus among firms to make active investment. I expect that firms will increasingly make use of the accommodative financial conditions and thereby boldly seize new business opportunities. The Bank, for its part, will continue to provide firm support that enables them to meet their challenges.