# Hiroshi Nakaso: Japan's economy and monetary policy

Speech by Mr Hiroshi Nakaso, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Shizuoka, 23 July 2014.

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## Introduction

It is my pleasure to have the opportunity today to exchange views with administrative, financial, and business leaders in Shizuoka Prefecture. I would like to take this opportunity to express my sincerest gratitude for your cooperation with the activities of the Bank of Japan's Shizuoka Branch.

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 the Bank introduced QQE. Japan's economy has been on a path suggesting that the 2 percent price stability target will be achieved as expected, although we are only halfway there. Today, before exchanging views with you, I would like to explain economic developments at home and abroad and give you my views on the outlook. I will then talk about the recent situation of and challenges for the financial system. Lastly, I will talk about the economy in this region.

## I. Current situation of and outlook for economic activity at home and abroad

### *Current situation of and outlook for overseas economies*

Many of you might be interested in developments in overseas economies, since many manufacturing and exporting firms are clustered in Shizuoka Prefecture. Therefore, let me start by talking about developments in overseas economies. Overseas economies, particularly advanced economies such as the U.S. and European economies, have been recovering, although the economic performance of some emerging economies remains lackluster. As for the outlook, overseas economies are likely to continue their moderate recovery trend. The International Monetary Fund (IMF) expects global economic growth to accelerate moderately to 3.6 percent in 2014 and 3.9 percent in 2015 (Chart 1). Looking at individual countries or regions, the U.S. economy registered negative GDP growth in the January-March quarter due partly to the unusually severe winter weather. However, since spring, a number of economic indicators have rebounded, and the recovery trend in the U.S. economy, led mainly by private demand, has become more pronounced. Looking ahead, given that downward pressure on the economy through fiscal austerity will diminish and accommodative financial conditions will be maintained, the pace of recovery is likely to accelerate gradually. Recently, some have expressed the view that U.S. potential growth seems to have declined somewhat, that is, that the United States is suffering *secular stagnation*. However, at this stage there is no firm evidence to confirm this view and neither the Federal Reserve (Fed) nor private sector economists have notably revised down their forecasts for medium- to long-term growth rates (Chart 2).

Turning to the European economies, the European debt problem has yet to be fully resolved, and the year-on-year rate of change in consumer prices in the euro area has been less than 1 percent for more than six months, giving rise to some concern over deflation. Moreover, a potential risk factor is the situation in Ukraine and Russia, which warrants due attention. That being said, as for the recent economic situation, household and business sentiment has improved due in part to additional monetary easing by the European Central Bank (ECB), with financial markets being stable. In fact, GDP in the euro area has registered positive growth for four consecutive quarters. While the euro area economy is likely to continue recovering moderately, the effects of structural problems such as the excessive debt I just mentioned warrant due attention. The robustness of the financial system in the European

Union has been examined through the asset quality review (AQR) and stress tests, and the results are scheduled to be released in October this year. The outcome of these examinations holds the key to the outlook for the European economies.

The Chinese economy continues to grow steadily, although the pace of growth has become somewhat slower than in the past. Looking at recent developments, real estate investment has continued to decelerate, and the economy has faced downward pressure as authorities have continued to pursue structural adjustments. That being said, the deceleration in growth appears to have come to a halt due partly not only to the economic stimulus measures implemented by the authorities since spring this year, but also to a pick-up in external demand.

Meanwhile, what I am somewhat concerned about is the emerging economies, particularly those in Asia. While one should be careful not to lump emerging economies together, since their economic performance differs substantially across countries and regions, it seems that the NIEs and the ASEAN economies will continue to lack growth momentum for the time being (Chart 3). Because the NIEs and the ASEAN economies account for a large share of Japanese exports and Japanese firms have a large number of production sites in these economies, attention should be paid to the outlook for the Asian emerging economies together with developments in global financial markets.

To summarize, it is expected that the Chinese economy will continue growing stably, albeit at a slightly slower pace, and that – from a somewhat longer-term perspective – the recovery in the advanced economies will gradually spread to emerging economies.

### *Current situation of and outlook for Japan's economy*

Let me move on to developments in Japan's economy. While the economy has been affected by the front-loading of and subsequent decline in demand due to the consumption tax hike, it has continued growing at a pace above its potential as a trend. In the household sector, a decline in private consumption following the front-loading of demand prior to the consumption tax hike can be observed. However, the magnitude of the decline has been broadly in line with expectations prior to the consumption tax hike and private consumption has remained resilient, reflecting improvements in the employment and income situation. In this context, the *Regional Economic Report* released by the Bank on July 7 reported the effects of the consumption tax hike on private consumption across Japan, and all regions, including Shizuoka Prefecture, have maintained their assessment that private consumption as a trend has continued recovering. In the corporate sector, business fixed investment has clearly increased against the backdrop of the improvement in corporate profits. The recently released June *Tankan* survey (Short-Term Economic Survey of Enterprises in Japan) indicates that developments in business fixed investment plans are favorable, even in the manufacturing sector, which has been lagging.

While domestic demand remains firm, exports have recently been sluggish. The sluggishness in exports is essentially due to the slow growth in overseas economies such as the emerging economies, as explained earlier. In addition, temporary factors, such as the effects of the unusually severe winter weather in the United States and the fact that firms prioritized domestic shipments in response to the front-loading of demand prior to the consumption tax hike, put downward pressure on exports until around early spring. However, even taking these factors into account, the pace of recovery in Japan's exports has been slower than in the past when considering the pace of recovery in overseas economies and the exchange rate of the yen. In this regard, I would like to mention three points.

The first point is that, since the global financial crisis triggered by the collapse of Lehman Brothers, global trade patterns have changed, and this may have had a negative effect especially on Japan's exports. Looking at the decline in trade in advanced economies immediately after the global financial crisis, Japan was one of the countries whose exports declined the most, despite the fact that the fallout of the crisis on Japan's financial system was relatively minor. It has been pointed out that this is due mainly to the fact that the decline in global demand triggered by the financial crisis was particularly pronounced for high value-added products such as capital goods and durable consumer goods. As you know, high quality, high value-added products are a strength of Japan's manufacturing sector. Reflecting this fact, the decline in global final demand hit Japan's real economy, in particular the manufacturing sector, harder than other countries. This fact may also be a reason for the recent sluggishness of Japan's exports. During the recent recovery phase, global business fixed investment has been notably slower to recover than in past recoveries, and this has substantially affected Japan's exports. Recently, however, machinery orders statistics suggests that external demand has been on an increasing trend. If global investment demand starts to follow a recovery trend, this will accordingly have favourable effects on Japan's exports.

The second point is that Japanese firms' global competitiveness has eroded, although there are different views on this point, since the concept of *global competitiveness* itself is the subject of considerable debate. Looking at exports from Japan by item, exports of IT-related goods as well as capital goods and parts, in which Japanese firms have traditionally had a competitive advantage, have been sluggish. While competition in markets for these goods has intensified due mainly to the rise of emerging economies, there still remain many areas, particularly in high value-added products, where Japanese firms retain global competitiveness. In fact, quite recently, exports of IT-related goods, particularly parts for high value-added products, seem to have been showing signs of a pick-up, which is a welcome development.

The third point is the effect of the relocation of production overseas, particularly in the manufacturing sector. It is clear that during the period when the Japanese yen was overvalued, firms relocated production overseas and that this has resulted in structural change. However, given the time lag between the decision to relocate production and the actual subsequent shift of production, it seems likely that the correction of the overvaluation of the yen will restrain the pace of the relocation of production overseas going forward.

Bearing these three points in mind, with global financial markets remaining stable and the recovery of overseas economies, including business fixed investment, gaining strength, it seems likely that the factors hampering Japan's exports will gradually disappear. Therefore, real exports are expected to increase moderately. Of course, since exports as a whole have yet to pick up, continued attention without undue optimism is warranted.

Based on the recent economic situations just outlined, the Bank at the Monetary Policy Meeting held this month conducted an interim assessment of the outlook for economic activity and prices through fiscal 2016 included in the *Outlook for Economic Activity and Prices* (Outlook Report) released in April this year. The assessment concluded that the outlook remained essentially unchanged from that in April. Namely, a virtuous cycle among production, income, and spending has been in place, and Japan's economy as a trend is likely to continue growing at a pace above the growth potential. The year-on-year rate of increase in the consumer price index (CPI) after excluding the direct effects of the consumption tax hike is likely to be around 1¼ percent for some time, and reach around 2 percent in or around fiscal 2015 (Chart 4).

### *Developments in prices and the Bank's monetary policy*

Let me next talk about developments in prices. The year-on-year rate of increase in the CPI (excluding fresh food) in April and May this year, after excluding the direct effects of the consumption tax hike, registered plus 1.5 percent and 1.4 percent, respectively. Inflation remains on a moderate upward trend even after the consumption tax hike. Recently, there has been considerable focus on the monthly figures for the CPI. However, in terms of achieving the price stability target, more important than the monthly figures is whether the mechanism underlying the upward trend in inflation remains in place. The trend in inflation is determined by two factors, namely, the output gap of the economy and inflation expectations.

With regard to the first factor, the unemployment rate and the active job openings-to-applicants ratio have recovered to the levels prior to the global financial crisis, and the capacity utilization rate has been increasing. The output gap seems to have recently exceeded 0 percent, that is, the long-term average (Chart 5). As for the outlook, with the economy expected to continue growing at a pace above its potential, the improvement in the output gap is likely to exert upward pressure on trend inflation.

The second factor, *inflation expectations*, with which you may not be familiar, refers to the extent to which people expect prices to rise in the future. In Japan, with deflation continuing for nearly 15 years, the expectation that prices will not rise had taken hold. Breaking out of the status quo and achieving the price stability target of 2 percent in a stable manner means that firms' and households' behavior is based on the expectation of continued inflation of around 2 percent. In this regard, there have been signs of changes in corporate behavior, such as the fact that an increasing number of firms have raised base pay in the annual wage negotiations this spring, and that some firms have changed their price-setting strategy from putting priority on low prices to putting priority on quality and reflecting increases in costs in sales prices. In fact, according to surveys of households, firms, and economists, as well as market indicators, inflation expectations appear to be rising on the whole (Chart 6).

The QQE policy introduced in April last year aims to raise trend inflation by bringing about an improvement in the output gap and encouraging a rise in inflation expectations with large-scale asset purchases and a clear commitment. The policy has been having its intended effects. Under the Bank's large-scale purchases of government bonds, long-term interest rates have been stable. At the same time, inflation expectations have been rising on the whole, so that real interest rates – that is, nominal long-term interest rates minus the expected rate of inflation – have declined, thereby stimulating private demand. As a result, the output gap has improved and inflation has accelerated. Looking ahead, with this mechanism at work, the year-on-year rate of increase in the CPI and inflation expectations are expected to increase. As I mentioned before, Japan's economy is likely to achieve an inflation rate of about 2 percent in or around fiscal 2015, and thereafter gradually shift to a growth path that sustains such inflation in a stable manner. Therefore, the conquest of deflation in Japan is now in sight. We are, however, only halfway toward achieving the price stability target of 2 percent. 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. But, as I have consistently said, if the outlook changes due to the manifestation of some risk factors, the Bank will make adjustments without hesitation if it is judged necessary for achieving the price stability target.

## II. Current situation in and challenges facing the financial system

Let me next turn to the financial system.

For Japan's economy to achieve sustained growth, it is critical to enhance the *functioning* of financial intermediation, through which the financial system supports the economic activities of firms and households, while also maintaining the *stability* of the financial system.

In what follows, let me explain the current situation in and challenges facing the financial system in terms of its stability and functioning.

At present, there are no significant problems concerning the stability of the financial system. Japanese financial institutions as a whole have a sufficient capital base, and even if there should be a large domestic financial or economic shock, the likelihood that financial intermediation will be significantly impaired is very small.

However, at the global level, following the experience of the global financial crisis, there have been calls to prepare for potential risks in international financial markets and the financial system in order to prevent any shocks from spreading. Against this background, requirements of financial institutions to ensure their soundness and improve their business management have become more stringent. Both international financial regulations such as Basel III and national regulations have been successively introduced and implemented, and discussions have been ongoing that could lead to internationally active financial institutions being required to hold more capital.

The Bank of Japan is deeply committed to the aims underlying this review of international financial regulations, namely, to further strengthen the soundness and business management of financial institutions and to further enhance the stability of the financial system. At the same time, if such regulations excessively constrain financial institutions' activities, this might hamper the smooth transmission of monetary policy effects or weaken the ability to provide support to the economy from the financial side, which warrants due consideration in designing specific regulations. In addition, the fact that institutions and circumstances surrounding the financial system differ across countries should be borne in mind. The Bank will actively participate in international discussions so that these will lead to the formulation of appropriate regulations taking account of the aforementioned considerations.

Let me next touch on the functioning of the financial system.

With economic activity and prices improving, firms' demand for funds has also been increasing gradually and become more widespread in terms of industries and regions, and financial institutions are trying to actively respond to such demand. In this respect, we at the Bank judge that the financial system has been functioning steadily to encourage economic recovery. At the same time, the financial system is expected to play a more important role in supporting firms' and regions' initiatives to address the medium- to long-term challenges of a declining and aging population.

I have heard that, also in this region, there are efforts to create new industries or industrial clusters, taking advantage of technologies accumulated in the past and of the highly developed transportation infrastructure. In addition, while the expansion of overseas business by local firms can be regarded as *hollowing out*, such overseas activities will lead to the growth of these firms through the expansion of sales networks and the greater international division of labor, and will deepen ties between regional economies and overseas economies, providing new business opportunities. I am convinced that regional financial institutions' initiatives in new areas, such as supporting firms' innovation and expansion of overseas business, will eventually lead to a revitalization of regional economies.

Through its on-site examinations and off-site monitoring as well as seminars, the Bank will stand ready to help financial institutions' initiatives to support firms in areas such as financial business practices, risk management, and the development of effective frameworks.

Another topic I would like to touch on in relation to the functioning of the financial system in Japan is the enhancement of payment and settlement services.

In order for Japan's economy to achieve sustained growth, it is critical to enhance payment and settlement services in response to diverse settlement needs and globalized financial services. One of the issues included in the government's revised growth strategy is the enhancement of funds and securities settlement at financial institutions and firms, while utilizing the extended operating hours of the Bank of Japan Financial Network System (BOJ-NET).

The new BOJ-NET that the Bank has been developing should contribute to the revitalization of financial markets and the enhancement of financial services, with financial institutions making the most of the new BOJ-NET function. From this perspective, the Bank decided, for the time being, to extend the operating hours until 21:00 from February 2016 for financial institutions that hold current accounts at the Bank's head office. It is up to individual financial institutions whether to use the new BOJ-NET during the extended operating hours and how to make the most effective use of it.

In the process of examining the extension of operating hours, the Bank held a forum involving major market players and industry representatives. At the forum, various innovative ideas for taking advantage of the extended operating hours of the BOJ-NET were presented. These ideas include the same-day settlement of corporate customer transfers from their Asian bases to domestic bases and the same-day settlement of Japanese government bonds (JGBs) used as collateral in cross-currency repo transactions in Europe.

Developing an infrastructure that will enable the settlement of the Japanese yen and JGBs, anytime, anywhere, will support the globalization of the yen – a longstanding challenge – from the settlement aspect. In providing financial and settlement services to firms that have expanded their businesses to Asia, I hope that individual financial institutions will make the most of the new BOJ-NET, leading them to further develop their own businesses.

Other issues included in the revised growth strategy are the real-time processing of payments in bank transfers and the attachment of invoice information to payment messages. The provision of settlement services is one of banks' core operations, and improvements in its infrastructure can lead to the provision of new services by banks to their corporate customers. I believe that the banking and industry community will discuss the specifics of these issues, and the Bank – together with the government – will support such discussions.

## Concluding remarks

In concluding, let me touch on the economy of Shizuoka Prefecture.

The economy of Shizuoka Prefecture has been recovering moderately. Against the backdrop of a moderate improvement in the employment and income situation, the decline in private consumption following the consumption tax hike has been broadly in line with expectations and there have recently been promising signs of improvement. In addition, due mainly to the good performance of businesses, business fixed investment has increased, while public investment has been hovering at a high level. These developments are backed up by the business sentiment indicator for the region in the June *Tankan* survey, and the economy in the region is likely to continue its improving trend.

That being said, the recovery in Shizuoka Prefecture has been lacking vigor compared to the rest of the country. This is due mainly to the decline in production and exports in the region. Specifically, triggered by the yen appreciation in the wake of the global financial crisis, major manufacturing industries, such as the transport equipment and electrical machinery industries, have accelerated the relocation of production and, as a result, Shizuoka Prefecture's manufacturing sector shipments have declined by about 4 trillion yen. Given this change in economic structure, the business sentiment of small and medium-sized enterprises remains generally gloomy.

Against this background, the imminent challenge facing Shizuoka Prefecture is to create new industries to more than compensate for the decline in production and exports after the global financial crisis. I am quite encouraged to hear that promising and ambitious initiatives have already been launched.

These include, for example, plans for new industrial clusters in the prefecture. For example, *Pharma Valley* in the east of the prefecture aims to gather firms from the medical and health care industries, *Food Science Hills* in the center of the prefecture aims to gather firms in industries related to functional foods contributing to the promotion of health, and *Photon Valley* in the west of the prefecture aims to gather firms from the optical and electronics industries. In addition, the *Inland Frontier Policy* aiming at inviting enterprises to areas along the Shin-Tomei Expressway, which is less susceptible to disaster risks, has been launched.

Now is also a golden opportunity to promote the attractiveness of Shizuoka Prefecture as a tourist destination, with its history and culture, to people at home and abroad. Mt. Fuji, the most notable sight in Shizuoka Prefecture, was registered as a World Cultural Heritage in June last year, and an event commemorating Ieyasu Tokugawa, who was the first Shogun of the Tokugawa government and had a close relationship with Shizuoka Prefecture, 400 years after his death, is scheduled for next year. Moreover, the Rugby World Cup 2019 and the Tokyo 2020 Summer Olympic and Paralympic Games will be major events that are expected to bring various business opportunities to the regional economy, including the use of game stadiums, training camps for players and parties concerned, and accommodation for spectators. I am looking forward to seeing how Shizuoka Prefecture will seize these opportunities.

Needless to say, for these opportunities to bear fruit, even stronger coordination among four groups of "players" is critical, namely, representatives of industries in the region, the administration that links parties concerned at home and abroad, academics and research institutions that provide the necessary technical seeds for the development of industries, and regional financial institutions to support these activities from the financial side. In this regard, the *Council on an Industrial Growth Strategy for Shizuoka Prefecture*, chaired by Governor of Shizuoka Prefecture Heita Kawakatsu, was established in March this year, providing a platform for the aforementioned four players to develop growth strategies for the region in a unified fashion. I have learned that concrete measures toward achieving structural change are scheduled to be compiled in autumn this year. I strongly hope that an effective growth strategy will be formulated and initiatives will be implemented swiftly under the strong leadership of related parties.

The Bank of Japan is striving to achieve stable growth of Japan's economy with QQE. In pursuing QQE, it is essential to carefully examine regional economies, including the performance of small and medium-sized firms, through the Bank's nationwide branch network, including the Bank's Shizuoka branch. In this respect, information that is kindly provided to us from industry and financial institutions in this region is invaluable. I would like to continue to seek your cooperation with respect to research and other activities of the Shizuoka branch.

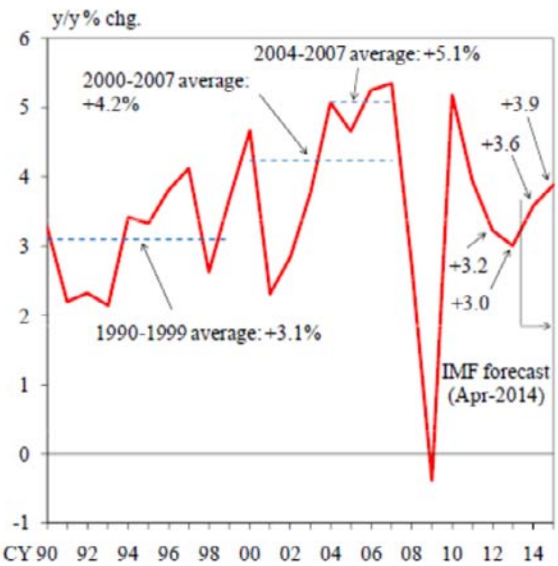
I sincerely hope that the various initiatives in Shizuoka Prefecture will bear fruit and the region will enjoy further growth in the future.

Thank you.

Chart 1

# 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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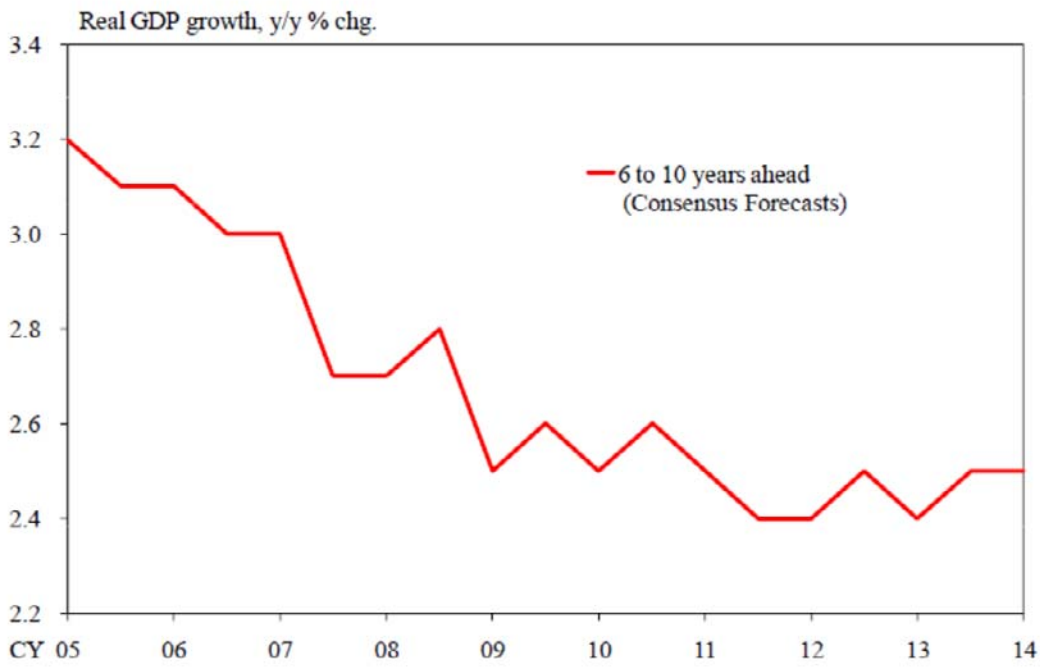
Chart 2

# Medium to Long-Term Growth Outlook for the U.S.




Source: Consensus Economics Inc.

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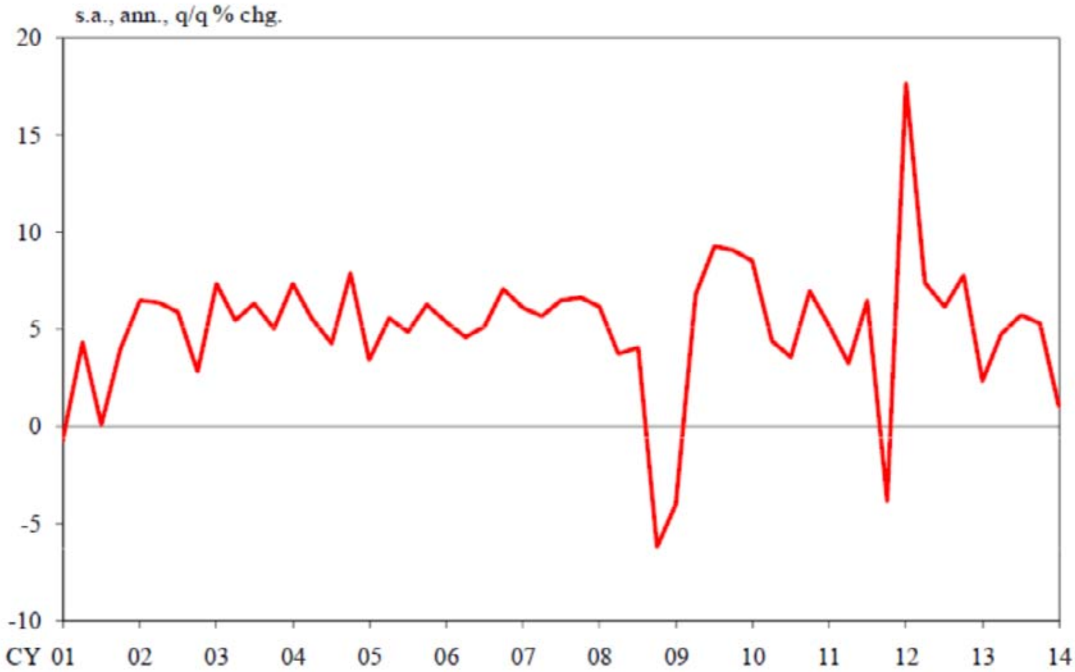
Chart 3

## Real GDP Growth Rate of the ASEAN Economies




Note: Figures are calculated using GDP growth rates based on purchasing power parity (PPP) shares of the world total from the IMF.
Sources: CEIC; IMF.

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Chart 4

## Outlook for Economic Activity and Prices (as of July 2014)

y/y % chg.

| | Real GDP | CPI (all items less fresh food) | Excluding the effects of the consumption tax hikes |
|---|---|---|---|
| Fiscal 2014 | +1.0 | +3.3 | +1.3 |
| Forecasts made in April 2014 | +1.1 | +3.3 | +1.3 |
| Fiscal 2015 | +1.5 | +2.6 | +1.9 |
| Forecasts made in April 2014 | +1.5 | +2.6 | +1.9 |
| Fiscal 2016 | +1.3 | +2.8 | +2.1 |
| Forecasts made in April 2014 | +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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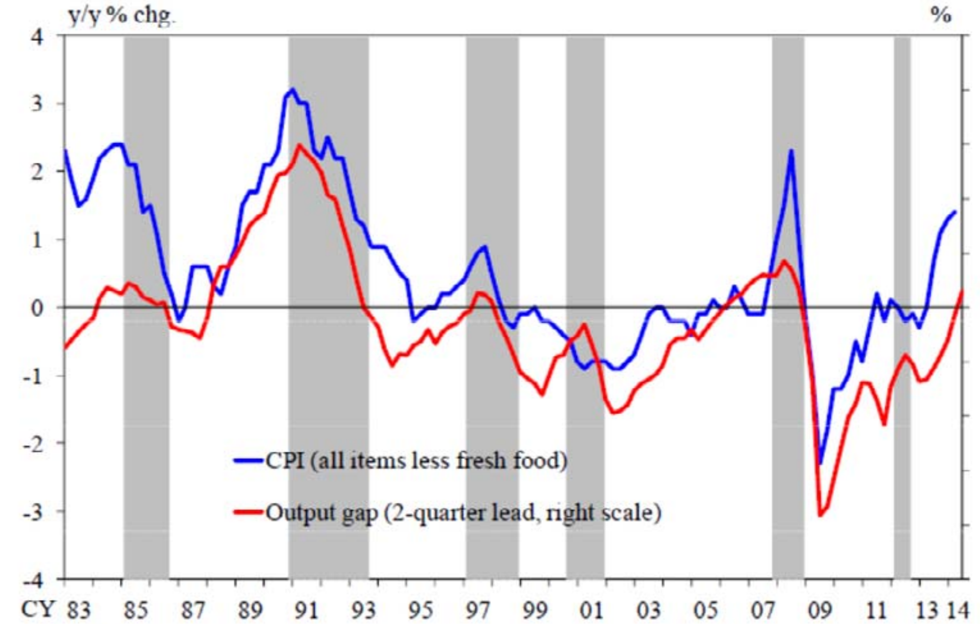
Chart 5

## Output Gap and Inflation Rate




Notes: 1. Shaded areas indicate recession periods.
2. 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.
3. Figures for the CPI are adjusted to exclude the effect of changes in the consumption tax rate. The figure for 2014/Q2 is the April-May average.
Sources: Ministry of Internal Affairs and Communications; Cabinet Office; Bank of Japan, etc.

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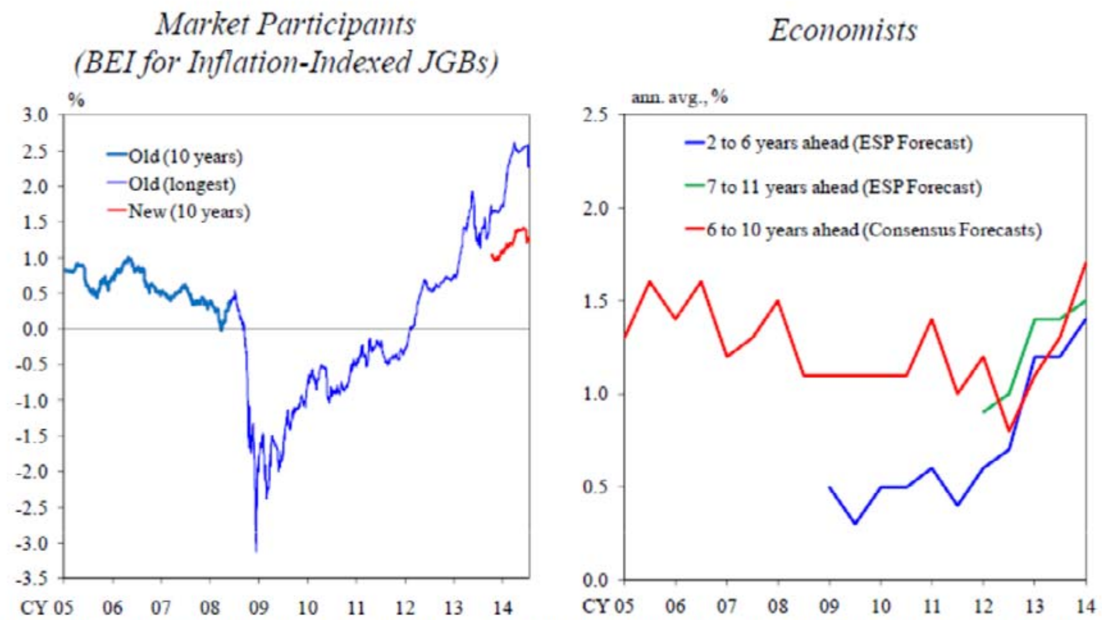
Chart 6

## Inflation Expectations




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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