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

Summary of a speech by Mr Koji Ishida, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, in Yamaguchi Prefecture (held in Shimonoseki), 29 July 2014.

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I. Developments in economic activity and prices

A. Overseas economies

I would like to start my remarks with a look at developments in economic activity and prices.

The Bank of Japan's current assessment is that overseas economies – mainly advanced economies – have been recovering, albeit with a lackluster performance still seen in part. The average of real GDP growth rates of major countries and regions weighted by value of exports from Japan decelerated substantially to a range of 1.0–2.0 percent in the January–March quarter of 2014, although it had continued to register growth of above 4.0 percent until the latter half of 2013.

The growth rate of the U.S. economy for the April–June quarter of 2014 is scheduled for release tomorrow evening – on July 30 – and rates for other economies will be released subsequently. Overseas economic growth seems to be accelerating moderately on the whole. This is because many economic indicators since April, particularly those of the United States and other advanced economies, have improved, and such positive effects appear to be spreading to some of the emerging economies through export channels. I will now look at individual countries and regions.

The U.S. economy registered negative growth in the January–March quarter of 2014 for the first time in three years, due partly to the unusually severe winter weather. Since then, however, a rebound in a number of economic indicators has been observed, such as a steady improvement in the employment situation. As for the outlook, the economy is likely to gradually accelerate its pace of recovery, led mainly by private demand, albeit with uncertainties such as the size of slack that remains in the labor market.

The euro area economy is recovering moderately, registering positive growth for four consecutive quarters. Financial markets have been stable as turmoil arising from the European debt problem has subsided, and private consumption and firms' production activity have been recovering moderately. For the time being, I will pay attention to the effects of further monetary easing by the European Central Bank (ECB) in June, including the introduction of a negative interest rate. The situation in Ukraine and Russia also warrants attention.

The Chinese economy has continued to see stable growth, as shown by the fact that the year-on-year growth rate for the April–June quarter, which was released in July, registered 7.5 percent. The economy has faced downward pressure, such as a slowdown in the real estate market, as authorities have been progressing with structural reforms. On the other hand, the slowdown in growth momentum observed since the beginning of the year has come to a halt due partly to the economic stimulus measures that the authorities have been implementing since the spring. As for the outlook, the Chinese economy is likely to continue to see stable growth, albeit at a slightly slower pace.

Emerging and commodity-exporting economies – mainly the ASEAN economies that are Japan's major export destinations – have continued to lack growth momentum. However, the positive effects of recovery in advanced economies have spread to some emerging economies. Moreover, as the financial markets have been calm on the whole, a pick-up in domestic demand has been observed in some Asian countries. If such developments continue, emerging and commodity-exporting economies should gradually show an improving trend, although a high degree of uncertainty remains.

In the *World Economic Outlook* released by the International Monetary Fund (IMF) in July, the growth rate of the overall global economy for 2014 was revised slightly downward – affected by the deceleration in the January–March quarter – but the projection of the growth rate accelerating toward 2015 remained unchanged. The Bank likewise expects that the global economy will moderately increase its growth rate. This is mainly because, as the Chinese economy is continuing to see stable growth – albeit at a slightly slower pace – positive effects of the firm recovery in advanced economies will gradually spread to emerging economies.

B. Japan's economic activity and prices

1. Current situation

a. Economic activity

Now I will discuss Japan's economic activity and prices.

The Bank's current assessment is that Japan's economy has continued to recover moderately as a trend, although the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been observed. Looking at developments in private consumption since April 2014, despite the decline I just mentioned, many firms have indicated that the degree of the decline has been broadly in line with expectations. In terms of sentiment, the consumer confidence index, which had been relatively weak for some time, has improved for two consecutive months. Yet a wide range of indicators should continue to be monitored closely, as the adjustments in some aspects of housing starts and of automobile sales may be somewhat prolonged, and a decline in real wages could gradually affect consumption as a whole.

As for business fixed investment, some indicators of machinery investment showed a decline following the substantial increase in the January–March quarter of 2014, but business fixed investment plans are strong in the June *Tankan* (Short-Term Economic Survey of Enterprises in Japan) – released at the beginning of July – suggesting that firms are maintaining a positive attitude. Business fixed investment is therefore likely to continue on a moderate increasing trend.

Exports have been leveling off more or less, with a continued lack of momentum. This is largely attributed to the negative growth rate of the U.S. economy in the January–March quarter and the sluggishness in emerging economies – including ASEAN economies with strong ties to Japan's economy. However, it is likely that structural factors have also been at work, such as the shift of Japanese firms' production sites to overseas accompanying their increased local procurement.

The GDP growth rate for the April–June quarter, which is scheduled to be released in August, is likely to register a considerable negative figure due to the effects of the decline in demand following the front-loaded increase prior to the tax hike. However, the Bank considers that a virtuous cycle of the economy has been operating firmly, together with a clear improvement in the employment and income situation, and therefore Japan's economy has continued to recover moderately as a trend.

b. Prices

With regard to prices, the year-on-year rate of increase in the consumer price index (CPI) for all items less fresh food, or the so-called core CPI, was 1.3 percent for June, excluding the direct effects of the consumption tax hike. The rate of increase has recently been hovering at around 1¼ percent, with the waning of upward pressure from energy-related prices generally offsetting the effects of price rises in other items.

2. Outlook for economic activity and prices

In terms of the outlook for Japan's economy, exports are expected to increase moderately while domestic demand is likely to maintain firmness. In this situation, a virtuous cycle among production, income, and spending is likely to be maintained. Therefore, the economy is expected to continue its moderate recovery trend, and the effects of the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike are expected to wane gradually. The year-on-year rate of increase in the CPI is likely to be around 1¼ percent for some time, and follow a rising trend again from the second half of fiscal 2014.

The Bank compiles and releases the Policy Board members' forecasts for economic activity and prices on a quarterly basis. Looking at the medians of the members' forecasts released in July, the real GDP growth rate is projected to be 1.0 percent for fiscal 2014, 1.5 percent for fiscal 2015, and 1.3 percent for fiscal 2016. Japan's economy is expected to continue growing at a pace above its potential rate, which is assumed to be around 0.5 percent. 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 projected to be 1.3 percent for fiscal 2014, 1.9 percent for fiscal 2015, and 2.1 percent for fiscal 2016. The Bank judges that it is likely to reach around 2 percent – the price stability target – around the middle of the projection period, which runs through fiscal 2016.

3. Points that require attention

In terms of Japan's economic activity and prices for the time being and near future, I am paying close attention to the following points.

The first is developments in private consumption. For the time being, close watch should be kept on whether private consumption, which has been driving Japan's recovery so far, will overcome the effects of the decline in demand following the front-loaded increase prior to the consumption tax hike and return to a recovery path as expected from the July–September quarter of 2014.

Let us look at movements in the CPI (all items less imputed rent)[1] – a price index that reflects actual household consumption expenditures and is used to deflate such figures as wages. The year-on-year rate of increase for June 2014 was 4.4 percent, more than 1 percentage point above the core index, which is behind the recent substantial decline in real wages. As for recent developments, the rate of increase – after reaching 1.9 percent in November 2013 – remained around 2 percent through June 2014, excluding the direct effects of the consumption tax hike.

For private consumption to remain resilient in such circumstances, it is vital to have an increase in expectations for future income growth. Factors such as increases in summer bonuses are expected to support private consumption for now, but in the future developments in labor supply and demand conditions are likely to become the key.

Turning to labor supply and demand-related indicators, the unemployment rate has declined to around 3.5 percent, and the active job openings-to-applicants ratio continues to improve as a trend, exceeding 1.00. If the tightening trend continues in labor supply and demand conditions, this could help underpin consumption because of growing confidence regarding job security and expectations for wage increases. Moreover, in the medium to long term, firms' efforts to boost productivity in response to labor shortages, such as investment aimed

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1 Imputed rent is a concept for evaluating owner-occupied homes – which do not involve actual payments and receipts of rent – in terms of general market prices, on the assumption that such homes are rented and thus generating production and consumption of services similar to homes and rooms rented in the usual way. In international comparisons, this concept is very useful in compensating for the difference in housing costs derived from varying home ownership rates. However, such rent is not an actual expenditure from households' perspective.

at labor saving, are likely to lead to a strengthening of Japan's growth potential. Wage increases accompanying growth in labor productivity are expected to occur in the future.

Indicators of labor supply and demand conditions are effective in demonstrating firms' confidence about the future, and for this reason I will pay careful attention to monthly changes, including developments in job openings.

The second point for attention is the price-setting behavior of firms. Movements to pass the past increase in costs onto prices have been spreading steadily, as shown by the fact that in the June 2014 *Tankan* the diffusion index (DI) improved for output prices (the proportion of firms responding that output prices "rise" minus the proportion of those responding that they "fall"). In particular, the DI for small nonmanufacturing firms moved into net "rise" territory for the first time since 1991. The DI for input prices also continued to be in net "rise" territory, suggesting that a certain degree of potential pressure to raise output prices remains. Whether such pressure will materialize as a rise in sales prices depends on economic developments. Therefore, I will pay attention to whether the price-setting behavior of firms becomes even more active after overcoming the effects of the decline in demand following the front-loaded increase prior to the consumption tax hike.

The third point for attention is developments in exports. The environment surrounding exports is expected to gradually improve, as the global economy – mainly advanced economies – recovers. On the other hand, structural factors, such as the shift of Japanese firms' production sites to overseas, are likely to continue exerting downward pressure on exports. Moreover, there is uncertainty about the extent to which the past depreciation of the yen will boost export volume. In the medium to long term, it is hoped that Japanese firms will make progress in developing and supplying new high-value-added products, which in turn will lead exports. For the time being, however, I am paying attention to whether exports will turn to a moderate increase mainly against the background of the recovery in overseas economies.

II. The bank's monetary policy

A. *Quantitative and Qualitative Monetary Easing (QQE) and its effects*

Thus far, I have outlined developments in economic activity and prices. In what follows, I will discuss the Bank's monetary policy.

With a view to achieving the 2 percent price stability target at the earliest possible time, the Bank introduced QQE in April 2013. Since then, it has continued large-scale monetary easing, increasing the monetary base at an annual pace of about 60–70 trillion yen. To this end, the Bank is purchasing Japanese government bonds (JGBs) so that their amount outstanding will increase at an annual pace of about 50 trillion yen. It is also purchasing exchange-traded funds (ETFs), Japan real estate investment trusts (J-REITs), corporate bonds, and CP. As for its future monetary policy stance, the Bank will continue with QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary to maintain the target in a stable manner. It will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate.

Almost a year and four months have passed since QQE was introduced. During this time, Japan's economy has recovered moderately as a virtuous cycle of economic activity has operated steadily. Prices have followed a rising trend, mainly reflecting a rise in import prices and an improvement in the aggregate supply and demand balance, or the output gap.

Moreover, sufficient monetary easing effects have spread to financial conditions and financial markets. Financial conditions have been extremely accommodative. As for firms' funding costs, the average contract interest rates on new loans and discounts have been at historic low levels and the issuance spreads for CP and corporate bonds have also been low. Funding conditions for firms are extremely favorable; according to the June 2014 *Tankan*, which was released at the beginning of July, firms' perception of financial institutions' lending attitude and financial positions of firms improved, including those for small firms.

Regarding financial markets, yields on 10-year JGBs have continued to be extremely low in the range of 0.5–0.6 percent. Given that the year-on-year rate of increase in the CPI is currently around 1¼ percent, long-term real interest rates are presumed to be in negative territory. The U.S. dollar/yen rate has been above the 100 yen level, and the Nikkei 225 Stock Average has recently been moving above the 15,000 yen level.

B. Loan support program[2]

In addition to implementing QQE, the Bank has been employing the Loan Support Program to promote financial institutions' use of the large-scale monetary base – supplied by the Bank through its aggressive monetary easing – for their efforts to increase the amount of lending and strengthen the growth potential of Japan's economy.

Thus far, the Loan Support Program has supported financial institutions' efforts to increase the total amount of their lending and has produced positive effects as a catalyst in regard to firms' and financial institutions' efforts to strengthen the foundations for Japan's economic growth. At the Monetary Policy Meeting held on February 17 and 18, 2014, the Bank decided to enhance the program, including by increasing the scale of the program and extending its application period. The Bank expects that the enhancement will further promote financial institutions' actions as well as stimulate firms' and households' demand for credit.

C. The bank's price stability target

Under the monetary policy I have described, the Bank considers that Japan's economy has been following the path toward achieving the 2 percent price stability target. Recently, questions have often been asked regarding the criteria and approaches for judging whether the price stability target is achieved and whether the target is maintained in a stable manner. I would like to take this opportunity to offer some thoughts on this matter.

As the Bank announced when it introduced the price stability target in January 2013, the target has been set in terms of the year-on-year rate of change in the CPI. With regard to the CPI, the CPI for all items is naturally of prime importance as a price index that comprehensively covers goods and services consumed by households and to which the general public is accustomed. On the other hand, looking at the CPI for all items alone could lead to a misjudgment of the underlying trend of inflation, because this CPI includes items that temporarily show large fluctuations, such as fresh food. In this regard, the CPI for all items less fresh food, or the core CPI, is considered to be the most useful index to identify the trend of the CPI for all items. The Bank in fact uses the year-on-year rate of change in the core CPI when referring to the forecasts of prices presented in the *Outlook for Economic Activity and Prices*, in which it outlines its thinking on the future conduct of monetary policy.

Other indices that demonstrate the underlying fluctuations in the CPI include the CPI (all items less food and energy) and the CPI (10 percent trimmed mean).[3] These indices aim at identifying the underlying fluctuations in the overall CPI by excluding certain items. At the same time, however, they eliminate a certain proportion of items consumed by households, and thus differ somewhat from price indices that comprehensively reflect the structure of household consumption. For example, food expenditures in Japan account for a larger proportion of household consumption expenditures than in other countries; the CPI (all items

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[2] The Loan Support Program consists of two measures: the fund-provisioning measure to stimulate bank lending and the fund-provisioning measure to support strengthening the foundations for economic growth.

[3] The 10 percent trimmed mean is obtained by rearranging year-on-year rates of individual price changes in ascending order, excluding items corresponding to both the upper and lower 10 percent tails of weights and then taking weighted averages of the remaining items.

less food and energy) of Japan covers 68 percent of the total items, which is nearly 10 percentage points below the 77 percent coverage in the United States.

In terms of the effects on economic activity, it is also necessary to monitor developments in the CPI (all items less imputed rent), which – as I mentioned earlier – reflects household consumption expenditures and is used to deflate such figures as wages.

As illustrated, each price index is not necessarily perfect for grasping the underlying trend of the overall CPI or the effects on economic activity. I think you would agree that it is not appropriate to judge whether the price stability target is achieved solely by examining the core CPI, for example. In my view, the achievement of the price stability target should always be judged comprehensively by examining the CPI for all items, the core CPI, and other price-related indicators to identify changes in the underlying trend of the overall CPI.

The same basically holds true for judging whether the target is maintained in a stable manner. There are no quantitative criteria or specific indicators to assess such conditions. Whether the target is maintained in a stable manner should be judged comprehensively by closely monitoring developments in a wide range of price-related indicators and sufficiently examining and assessing the current situation and the outlook for economic activity and prices.

III. Toward the sustainable growth of Japan’s economy

Thus far, I have talked about the Bank’s monetary policy. Japan’s economy has been following a path toward overcoming deflation. In this situation, a trend in which the output gap is positive (representing excess demand) – has begun to take root, albeit with some fluctuations due to the consumption tax hike. This trend is seen in the tightening of labor supply and demand conditions. Given that slack in the economy has shrunk, as widely recognized, it has become increasingly necessary to strengthen supply capacity in order for Japan’s economy to raise its growth potential in the medium to long term.

An economy’s growth potential, from a relatively longer-term perspective, depends on the growth in capital stock and labor input, as well as improvements in productivity through innovation and the like. This indicates that it is private economic entities that play the most important role in efforts to strengthen growth potential and pursue the growth strategy. At the same time, to strengthen growth potential, it is essential to build an environment that enables private economic entities to unleash their creativity and “animal spirits” by (1) increasing the labor participation of women and the elderly, (2) eliminating restrictions to market entry, and (3) carrying out regulatory and institutional reforms. In promoting such an environment from a macroeconomic perspective, the government plays a critical role. In June 2014, the Cabinet decided the new Japan Revitalization Strategy and Basic Policies, which aim to revitalize Japan’s economy. I strongly expect that efforts based on these measures will proceed steadily.