

## Haruhiko Kuroda: Japan's economy – responding to cautious views

Speech by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at the Economic Club of New York, New York, 8 October September 2014.

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### Introduction

Thank you for your kind introduction. I am greatly honored to have the opportunity today to speak at the Economic Club of New York.

In April last year, the Bank of Japan introduced quantitative and qualitative monetary easing, dubbed QQE. One and a half years have passed since then, and QQE has been producing its intended effects. The year-on-year rate of change in the consumer price index, or the CPI, excluding volatile food, which was minus 0.4 percent in April last year, has recently become around 1¼ percent excluding the direct effects of the consumption tax hike. Japan's economy has been on a path suggesting the 2 percent price stability target will be achieved as expected.

Meanwhile, cautious views concerning Japan's economy seem to be spreading, with the consecutive releases of somewhat weak economic indicators after the consumption tax hike in April. That being said, the Bank's assessment is that with the mechanism of economic recovery operating steadily, Japan's economy is expected to continue its recovery, weathering the temporary slowdown in economic growth due to the consumption tax hike.

Today, I will talk about the current situation of Japan's economy under QQE and future challenges.

### I. QQE and the recovery of Japan's economy

#### *The mechanism of QQE*

Let me start by discussing briefly the mechanism of QQE.

QQE consists of two pillars. One is a strong and clear commitment to achieve the price stability target of 2 percent at the earliest possible time and the other is a large-scale monetary easing to underpin the commitment. Specifically, inflation expectations will be raised through a strong and clear commitment to achieve the price stability target and at the same time, downward pressure will be put on the entire yield curve through massive purchases of government bonds. As a result, real interest rates will decline, thereby stimulating private demand such as business fixed investment, private consumption, and housing investment. There will be upward pressure on prices if private demand increases and the output gap, in other words the slack of the economy as a whole, narrows. If actual inflation rates accelerate, expected inflation rates will rise and the aforementioned series of processes will be reinforced.

The mechanism of QQE has so far been operating as anticipated. 10-year government bond yields have been in the range of 0.5–0.6 percent in recent months. An average commercial bank lending rate on new loans has declined to a historic low level of around 0.8 percent. At the same time, medium- to long-term inflation expectations gauged from the *Consensus Forecasts* have climbed to 1.6 percent. Thus real interest rates have clearly been negative up to long-term ones.

In a nutshell, with QQE producing its intended effects, a virtuous cycle from income to spending has been operating steadily as a high level of confidence is maintained in both the household and corporate sectors.

### ***Effects of the consumption tax hike***

In contrast to the view that I just mentioned, there has recently been concern that Japan's economic recovery might have been losing momentum, reflecting the recent weak economic indicators due partly to the effects of the consumption tax hike. In particular, the GDP statistics released last month showed that real GDP in the April-June quarter fell substantially at a rate of 7.1 percent on an annualized quarter-on-quarter basis, garnering people's attention.

The substantial decline in the April-June quarter followed the front-loaded demand in the January-March quarter, in which real GDP had grown significantly at a rate of 6.0 percent, and thus was expected in advance. Excluding such fluctuation of the front-loaded increase and the subsequent decline in demand prior to and after the consumption tax hike, the annualized growth rate of real GDP in the January-June period this year over the July-December period last year is 1.0 percent. It is not necessarily a high growth rate, but exceeds Japan's potential growth rate, which is estimated to be around 0.5 percent. As I will discuss in the following, since the virtuous cycle of economic recovery has been operating steadily, the growth rate of real GDP in the July-September quarter is expected to return to the clearly positive one.

### ***The virtuous cycle in both the household and corporate sectors***

Next, let me explain the mechanism of economic recovery in both the household and corporate sectors.

In the household sector, with QQE producing its intended effects, the output gap has improved substantially, and the economic slack has almost been absorbed. The labor market has been tight, and the unemployment rate was 3.5 percent, declining to roughly the same level as the structural unemployment rate. If I borrow the terminology used by the Federal Reserve Board and the Bank of England, in Japan, there is almost no slack in the labor market and spare capacity in firms and the labor market is zero. Those developments have also been putting upward pressure on wages. On wages' front, the practice of increasing base pay annually, which had been lost during the period of deflation, was revived for the first time in more than a decade in wage negotiations between management and labor this spring. An increase in nominal wages has been evident since this spring, and along with a steady increase in the number of the employees, employee income has increased above 2 percent year on year. The recent decline in private consumption is due to the temporary decline in demand following the consumption tax hike, and as the effects of such decline wane, private consumption is likely to remain resilient with the employment and income situation improving steadily. In fact, the latest economic indicators show that the effects of the decline following the consumption tax hike have been waning, except for durable goods including automobiles.

Some people view a statistical negative growth in real wages as a problem, but it is due to a one-time increase in the inflation rate resulting from the consumption tax hike. The consumption tax hike was scheduled in advance, and it is not an additional factor putting downward pressure on economic activity and prices.

While the year-on-year rate of increase in the CPI has been around 1¼ percent excluding the direct effects of the consumption tax hike, that in nominal wages has been in the range of 1–2 percent and that in employee income has been above 2 percent recently. The recent developments in nominal wages have been mostly consistent with those suggested by the wage Phillips curve, which shows the historical relationship between the wage growth rate and the unemployment rate. Unlike in the United States, we don't see a phenomenon in Japan that the wage increase falls short of what has been suggested by the level of the unemployment rate. With those in mind, there is no reason to believe that developments in wages will adversely affect Japan's economic activity.

Let me move on to the corporate sector. Corporate profits have continued to improve, with the ratio of current profits to sales for major firms exceeding the level prior to the global financial crisis. In the current economic recovery, some people point to the sluggishness in exports. It is affected partly by the structural changes including relocation of production sites overseas. Corporate profits on a global basis have been favorable. As shown in the September *Tankan* survey released last week, business sentiment as a whole has maintained its favorable level, despite being affected by the decline in demand following the consumption tax hike. It suggests that many firms basically regard the decline in demand following the consumption tax hike as a temporary one. Reflecting the favorable corporate performance, stock prices have remained resilient.

In that situation, firms have been taking a positive stance in their business fixed investment plans, and it has remained unchanged in the latest *Tankan* survey. The increase in business fixed investment might be attributable to several factors. Corporate profits have been favorable and financial conditions have been accommodative. As a result of restrained investment for some years, capital stock has become outdated, prompting increasing demand for renewal investment. There is also increased demand for investment in labor-saving machinery and equipment due to the labor shortage I mentioned before.

Therefore, Japan's economy is expected to continue growing at a pace above its potential as a trend since the virtuous cycle from income to spending has been operating steadily in both the household and corporate sectors.

### **Price developments**

Next, I will talk about the price developments in Japan. Trend inflation is considered to be determined by the output gap of the economy as a whole and inflation expectations. As for the output gap, with the labor market tightening as I mentioned before, the slack has been almost absorbed. Looking at the developments since the introduction of QQE, inflation expectations have been rising on the whole, albeit with monthly fluctuations. Against such a backdrop, the year-on-year rate of change in the CPI, excluding volatile food, which was minus 0.4 percent in April last year, has recently become 1.1 percent excluding the direct effects of the consumption tax hike.

The CPI inflation has more or less leveled off in a narrow range of around 1¼ percent for eight months since the beginning of this year. Looking at such leveling-off inflation rates, some view that increasing momentum for the CPI inflation has been lost after accelerating strongly last year.

The leveling-off CPI inflation is due to the dissipating base effect. The effects of yen depreciation and the energy price increase that exerted upward pressure on consumer prices in the previous year have been falling off, compared with a year earlier. By contrast, trend inflation rates have continued to increase steadily. In fact, the developments in the inflation rates so far have been mostly in line with the Bank's projection. The fact that the inflation rate has not declined too much but remained resilient despite the dissipating base effect suggests that the improvement in the output gap and the rise in inflation expectations have been working as trend inflationary pressure.

Looking ahead, the output gap and inflation expectations are expected to continue improving. Since the dissipating base effect is expected to run its course, the year-on-year rate of increase in the CPI is expected to follow an uptrend again from the second half of this fiscal year and reach about 2 percent, that is, the price stability target, in or around fiscal 2015.

## **II. Bank's monetary policy management and Japan's growth potential**

In this way, Japan's economy has been on a path suggesting that the 2 percent price stability target will be achieved as expected. Yet, we need to raise inflation rates and inflation expectations further toward 2 percent and thus we are only halfway there. The Bank will

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 risk factors and it is judged necessary for achieving the price stability target, the Bank will make adjustments without hesitation. Let me emphasize that our commitment is result-oriented. It means that the Bank will continue with QQE to achieve the target, and the Bank will make adjustments if necessary so that the target will be achieved.

In closing, let me talk about Japan's growth potential. As I have mentioned earlier, Japan's potential growth rate is estimated to be around 0.5 percent.

Japan's potential growth rate in the late 1990s that is estimated to be about 2 percent has thereafter been declining gradually due to such factors as aging, the declining population, and the slowdown in capital stock accumulation during the period of protracted deflation. Those facts are well recognized, and both government and private entities are making efforts to raise the potential growth rate. As a growth strategy to stimulate private investment, the government formulated the Japan Revitalization Strategy and revised it in June. The Bank strongly expects that the measure will be steadily carried out, and thereby firms will aggressively undertake initiatives.

Raising medium- to long-term economic growth potential is basically an issue of the supply side of the economy and thus monetary policy does not play a main role in that regard, but it can make important contributions. That is, by dispelling the deflationary mindset. When the deflationary mindset is widespread, cash hoarding and maintaining the status quo are considered rational. Proactive behaviors by taking risks do not result in rewarding a sufficient return. In fact, under the period of protracted deflation, firms have become reluctant to take risks, such as investing in capital stock and in research and development, resulting in a decline in the potential growth rate.

Dispelling the deflationary mindset and creating an economy, in which private entities can act based on an assumption of 2 percent inflation, will lead to reviving the animal spirits of firms that were lost in the prolonged deflationary period and thereby enhancing growth potential. That is evident if you recall that positive developments have become widespread among firms since last year as prices started to rise. The Bank will firmly support such positive developments through achieving the price stability target of 2 percent at the earliest possible time.

While some question whether it will be desirable to increase prices when the potential growth rate is low, my answer will be a clear "yes." Overcoming deflation and raising growth potential is not an issue of which comes first. Overcoming deflation is an important prerequisite for raising growth potential. The Bank will achieve the price stability target of 2 percent. In that situation, I am convinced that Japan's economy will achieve a higher potential growth rate.

Thank you.