

Ryuzo Miyao: Economic activity and prices in Japan and monetary policy

Speech by Mr Ryuzo Miyao, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Nagasaki, 12 November 2014.

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The charts can be found at the Bank of Japan's [website](#).

Introduction

Thank you for giving me this opportunity to exchange views with people representing Nagasaki Prefecture, who have taken time to be here despite their busy schedules. Please allow me to express my gratitude for your cooperation with the activities of the Bank of Japan's Nagasaki Branch.

Today, I will review economic activity and prices in Japan, whose economy has been recovering moderately, and then discuss the Bank's monetary policy. My concluding remarks will touch briefly on the economy of Nagasaki Prefecture. Following my speech, I would like to listen to your views on the actual situation of the local economy and to your candid opinions.

I. Recent developments in economic activity and prices

A. Continued moderate recovery in Japan's economy

Japan's economy has continued to recover moderately as a trend, although some weakness, particularly on the production side, has been observed, due mainly to the effects of the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike (Chart 1).

I will elaborate on the recent developments related to Japan's economy. Overseas economies – mainly advanced economies – continue to recover, although a lackluster performance has still been partly seen (Chart 2). Specifically, the recovery in the U.S. economy is increasingly taking hold, as household spending has been firm, reflecting a favorable employment situation, and such movements are spreading to the corporate sector. The European economy continues on its moderate recovery trend, supported mainly by the resilience in private consumption, although the adjustment pressure associated with the debt problem remains and a downtrend in the inflation rate has been observed. The Chinese economy has continued to grow stably on the whole, due mainly to an improvement in external demand and the stimulus measures by the government, albeit under downward pressure from an overhang in supply capacity in the manufacturing sector and adjustments in the real estate market. The NIEs have been improving somewhat due to a rise in exports to the United States, although differences by country stand out. On the other hand, the ASEAN economies as a whole have been lacking growth momentum despite an improvement in exports and private consumption.

Reflecting this situation, Japan's economy has continued to recover moderately as a trend. Regarding external demand, exports have been relatively weak on the whole recently, due to such factors as the continued weakness in exports to the ASEAN economies, the sluggish growth in exports to China, and the materialization of the effects of downward pressure on exports to the United States resulting from the expansion of overseas production, mainly by automakers. Meanwhile, public investment maintains its high level, mainly due to the effects of the early implementation of the initial budget for fiscal 2014. As for the corporate sector, business sentiment and corporate profits have generally maintained favorable levels despite being affected by the decline in demand following the front-loaded increase. As a result, business fixed investment has been on a moderate uptrend, albeit with some fluctuations. In

the household sector, private consumption has been resilient as a trend, with the employment and income situation improving steadily. It can be assessed that private consumption has been affected mainly by the decline in demand following the front-loaded increase, and the effects, which were clearly seen in the April-June quarter of 2014, have been waning on the whole when excluding the somewhat prolonged impact on sales of durable goods such as automobiles and household electrical appliances, as well as housing investment.¹ Reflecting this situation, industrial production declined substantially in the April-June quarter and has been showing some weakness thereafter due in part to inventory adjustments, mainly in durable goods and construction goods.

On the price front, the year-on-year rate of increase in the consumer price index (CPI, for all items less fresh food and excluding the direct effects of the consumption tax hikes) has generally been around 1¼ percent in the first half of fiscal 2014. The rate of increase in the CPI less food and energy has been in the range of 0.5–1.0 percent (Chart 3).

B. Outlook for economic activity and prices

I will now turn to the baseline scenario of the outlook for economic activity and prices in Japan from fiscal 2014 through fiscal 2016 and its underlying mechanism (Chart 4).

1. Outlook for economic activity

With regard to the outlook for economic activity, as domestic demand is likely to maintain firmness, exports are expected to head for a moderate increase, and a virtuous cycle from income to spending is likely to be maintained in both the household and corporate sectors.

I will elaborate on the background to this outlook. First, overseas economies 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. In particular, the U.S. economy is expected to gradually accelerate its pace of recovery as the firmness in the household sector spreads to the corporate sector. In this situation, exports are expected to head for a moderate increase partly because of foreign exchange rate developments. Japanese major exporting firms' continued efforts to increase production and procurement on a global basis could contribute to restraining the pace of increase in exports. On the other hand, further improvements are expected in two areas: exports of goods, such as capital goods and electronic parts and devices, that maintain high competitiveness, and travel credit, a component of services in the current account, in accordance with an increase in the number of foreign visitors to Japan (Chart 5).²

Second, on the back of improvements on the supply side of the economy, the resilient trend in consumption is likely to be maintained.³ Although it warrants attention that consumption of durable goods and other goods has been affected by the decline in demand following the front-loaded increase for a somewhat prolonged period, it deserves special mention that consumption – which has been posting higher growth – has been the driving force of

¹ Demand-side statistics, such as the *Family Income and Expenditure Survey*, show that there has been some weakness in recent developments in private consumption that cannot be explained by the decline in demand following the front-loaded increase. For example, developments in household nominal income exhibited by the *Family Income and Expenditure Survey* have shown a substantial downward deviation from those in total cash earnings shown in the *Monthly Labour Survey*, and this could be attributable to sample bias.

² There has been an increasing number of foreign visitors to Japan with diverse backgrounds and interests, and efforts to capture their various demands for sightseeing have been progressing. For specific details of the situation in each region, see the October 2014 issue of the *Regional Economic Report* released by the Bank (only the summary of the report is available in English).

³ For a more detailed explanation of the improvements on the supply side of the economy, see Ryuzo Miyao, "Japan's Economy and Monetary Policy," Speech at the 2014 Autumn Annual Meeting of the Japan Society of Monetary Economics, Bank of Japan, October 18, 2014.

economic recovery over the past two years or so without being accompanied by notable increases in exports and business fixed investment, which had previously been the driving factors of economic recovery (Chart 6). Meanwhile, there have been improvements in the various aspects of the supply side, or in other words, the potential strength of the economy, and the economy's capacity to generate income – as represented by corporate profits, employment and income, and labor force participation – has been increasing on the whole with the progress in positive efforts by firms and households (Charts 7 through 9). Since this basic trend will likely continue, expectations for permanent income in the economy as a whole will improve and anxiety and uncertainty regarding future employment conditions will decline further. The recovery trend in consumption will therefore be maintained.⁴

Third, the decline in crude oil prices since summer 2014 will positively affect the real economy in terms of both corporate profits and households' real income (Chart 11). The decline in crude oil prices to date seems to be attributable to both the demand factor of slack in global demand and the supply factor of production increases in, for example, the United States. It is difficult to make an accurate forecast of developments in crude oil prices, but based on the assumption that these prices will start to rise moderately from the current level in line with the pace of growth in the global economy, the positive effects exerted through the underpinning of corporate profits and household income are expected to materialize to a certain degree, while downward pressure on the year-on-year rate of change in the inflation rate will remain for the time being.

Fourth, financial conditions are likely to become more accommodative. As the Bank steadily pursues quantitative and qualitative monetary easing (QQE), which was expanded on October 31, 2014, upward pressure on nominal long-term interest rates will likely be contained and asset prices accordingly will be underpinned, together with improvements in fundamentals such as the accelerating pace of recovery in the U.S. economy and the improving trend in corporate profits in Japan. These factors will support the accommodative financial conditions as a whole, and such a trend is likely to strengthen (Chart 12).

Based on these assessments, a virtuous cycle of economic activity will be maintained, supported by a firm increase in domestic demand and a moderate increase in exports of goods and services, and the economy is expected to continue growing at a pace above its potential, while fluctuations in demand stemming from the scheduled second consumption tax hike are anticipated in fiscal 2015.

2. *Outlook for prices*

In assessing price developments, it is necessary to consider the following three aspects: the aggregate supply and demand balance (the output gap), which shows the utilization of labor and capital; medium- to long-term inflation expectations; and import prices.

First, the output gap, estimated by the Bank, has recently been around zero, which is the historical average, despite being affected by the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike (Chart 13). Firms seem to regard the decline in demand as temporary, and are maintaining their positive hiring stance. More firms have faced insufficient capacity, mainly in nonmanufacturing. Therefore, a trend in which the output gap will be positive (in excess demand) is likely to take root, and from

⁴ Firms' stance toward research and development investment is also important in assessing the potential strength of the supply side of the economy. Survey results show that major firms in Japan have been making active efforts in research and development investment recently (Chart 10). Although most of this investment is not currently covered in the estimates of GDP, it is likely to steadily push up GDP, and in turn the potential growth rate of the economy. Research and development investment is a component of GDP in the 2008 System of National Accounts (SNA), a new framework of the SNA, and in the United States and the European Union, where the 2008 SNA has already been introduced, such investment has pushed up GDP. In Japan, work is in progress for the 2008 SNA to be adopted in 2016.

fiscal 2015 onward, the gap is expected to move further into excess demand territory and upward pressure on prices is likely to steadily increase.

Second, medium- to long-term inflation expectations appear to be rising on the whole from a somewhat longer-term perspective, and are likely to gradually converge to around 2 percent – the price stability target – as the Bank pursues QQE, which was expanded on October 31, 2014 (Chart 14).

Third, as for import prices, while the recent depreciation of the yen will exert upward pressure on consumer prices, a decline in international commodity prices, including crude oil prices, will exert downward pressure on consumer prices. In particular, the effects of the decline in crude oil prices – based on the outlook for these prices, to which I referred earlier – will continue to exert a considerable degree of downward pressure on consumer prices until around summer 2015, as these effects will spread to electricity and gas prices, in addition to prices of petroleum products such as gasoline (Charts 11 and 15).

Considering the above points, the year-on-year rate of increase in the CPI (for all items less fresh food and excluding the direct effects of the consumption tax hikes) is likely to reach around 2 percent in or around fiscal 2015. I personally hold the view that the rate of increase in the CPI will likely be kept at around the current level of around 1 percent until summer 2015, mainly because downward pressure associated with the decline in crude oil prices will contain upward pressure on prices. Thereafter, the rate of increase is likely to accelerate gradually toward the second half of fiscal 2015 and reach around 2 percent – the price stability target – in or around that half, as the effects of the decline in crude oil prices will dissipate and the output gap will continue expanding in positive territory (Chart 16).

3. *Balance of risks*

Risks to the Bank's aforementioned baseline scenario regarding economic activity include the following: developments in overseas economies, particularly the U.S., European, and emerging economies, and their effects on Japan's exports; the effects of the two rounds of consumption tax hikes; and firms' and households' medium- to long-term growth expectations. Risks regarding prices include developments in medium- to long-term inflation expectations, in the output gap, and in import prices. I view these upside and downside risks to economic activity, as well as to prices, as generally balanced.

II. **Monetary Policy**

A. ***Expansion of QQE***

At the Monetary Policy Meeting held on October 31, 2014, the Bank decided to expand QQE, in order to ensure that the price stability target of 2 percent would be achieved at the earliest possible time (Chart 17).

Specific measures of the expansion are as follows. First, the Bank will accelerate the annual pace of increase in the monetary base from about 60–70 trillion yen to about 80 trillion yen. Second, it will increase purchases of Japanese government bonds (JGBs) so that the amount outstanding of its holdings will be increased by about 30 trillion yen from an annual pace of about 50 trillion yen to about 80 trillion yen. The average remaining maturity of the Bank's JGB purchases will also be extended from the former period of about seven years to a flexible range of about seven to ten years. Third, the amount outstanding of the Bank's holdings of risk assets such as exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) will be tripled to an annual pace of about 3 trillion yen and about 90 billion yen, respectively. The Bank will make ETFs that track the JPX-Nikkei Index 400 eligible for purchase.

The Bank introduced a price stability target of 2 percent in terms of the year-on-year inflation rate of the CPI in January 2013, as well as QQE in April 2013, to achieve the target at the earliest possible time, with a time horizon of about two years. With the aim of achieving the

target, the Bank decided to continue with QQE, as long as it was necessary for maintaining that target in a stable manner.

More than one and a half years have passed since the introduction of aggressive monetary easing, and in the meantime it has strongly supported the recovery in economic activity from the financial side. As a result, the year-on-year rate of change in the CPI, which was minus 0.5 percent in March 2013 immediately before introducing QQE, is now around 1¼ percent.

To be sure, weak developments in demand following the consumption tax hike and the substantial decline in crude oil prices have been exerting downward pressure on prices, and the year-on-year rate of increase in the CPI slowed to 1.0 percent in September. A temporary weakness in demand has already started to wane, and a decline in crude oil prices will have positive effects on economic activity from a somewhat longer-term perspective and push up prices. Nevertheless, if the current downward pressure on prices remains, albeit in the short term, there is a risk that conversion of the deflationary mindset, which has been progressing steadily so far, might be delayed.

Deflation has continued for a protracted period in Japan and, unlike countries such as the United States, where inflation expectations have already been anchored at around 2 percent, Japan is in the process of raising, to around 2 percent, the inflation rate that the general public perceives as representing price stability. In this process, if the actual rate of increase does not accelerate – even for a short term – there is a risk that the momentum for inflation expectations thus far will lose steam. It is also necessary to pay attention to the point that adaptive expectation formation – where the inflation rate for previous periods affects people’s formation of the expected inflation rate – is prominent to some degree in Japan. To prevent the manifestation of such risks and maintain the improving momentum of expectation formation, the Bank judged it appropriate to expand QQE and decided such expansion.

Before the expansion, JGB purchases had been conducted with an average remaining maturity of about seven years; as a result, there had been a substantial decline in yields in the somewhat short-term zone, while yields in the somewhat longer-term zone remained at relatively higher levels. Now that the average remaining maturity has been extended and set within a flexible range, this will put further downward pressure on interest rates across the entire yield curve. Furthermore, in order to conduct flexible JGB purchases, the Bank decided to announce the monthly schedule and details of JGB purchases for the following month on the last business day of each month.⁵

B. Effects and costs of the expansion of QQE

I would now like to explain how I assessed the expected effects as well as the potential costs and risks of the expansion of QQE before voting in favor of the decision.

Let me first describe the effects of the expansion of QQE. With the introduction of QQE in April 2013, which has put further downward pressure on interest rates across the yield curve and strongly influenced asset prices, financial conditions in Japan have become more accommodative, and this has strongly supported improvements in corporate profits, employment, and wages. Amid increasing capacity of firms and households to generate income and a widening acknowledgment of the prospects for a sustainable improvement in demand, upward pressure on prices has been increasing.⁶ A baseline scenario for the outlook for economic activity is that a virtuous cycle from income to spending will be maintained, and improvements on the supply side of the economy, which represent the

⁵ See “Outline of Outright Purchases of Japanese Government Bonds,” released by the Bank on October 31, 2014.

⁶ For more details of the increasing upward pressure on prices and the effects of QQE so far, please refer to Ryuzo Miyao, “Japan’s Economy and Monetary Policy,” Speech at the 2014 Autumn Annual Meeting of the Japan Society of Monetary Economics, Bank of Japan, October 18, 2014.

potential strength of the economy, are expected to progress steadily in areas such as firms' profitability and households' labor supply. In this situation, the expansion of QQE is expected to produce stronger effects.

Specifically, given an increase in firms' profitability, extremely accommodative financial conditions will drive their positive efforts and risk-taking activities, thereby further heightening economic stimulus effects. Large-scale purchases of JGBs can exert downward pressure on longer-term interest rates and upward pressure on asset prices. If fundamentals such as corporate profits improved at the same time, asset price rises will become more sustainable and justified. With the heightening strength of the economy, the recent expansion of QQE will promote sustainable increases in spending and is expected to produce sustainable policy effects (Chart 12).

So, how should we assess the potential costs and risks of the expansion of QQE? For example, regarding the risk that expansion of unconventional easing measures, such as the purchases of JGBs, will only cause a temporary asset price bubble and thus make the economy unstable, I think that the key is whether the expansion of such measures is coupled with improvements in the growth potential of the supply side and in firms' competitiveness, and whether a structural transformation in the economy – such as restructuring of unprofitable businesses – will, after being postponed, be stimulated. On this point, as I have emphasized on many occasions, I judge that this risk has been mitigated, since firms' positive efforts to heighten the potential strength of the economy have progressed steadily and this trend is likely to continue. As I have just explained, asset price rises that accompany improvements in fundamentals become more sustainable and justified, and the potential negative side effect of accumulation of financial imbalances will likely be suppressed.

For the same reason, I consider that the risk of economic rejuvenation being delayed – in other words, the risk that monetary easing would allow funds to circulate among firms, including nonviable firms – will likely be mitigated to a certain degree. That is, if firms' ability to proceed with the postponed disposal of the negative legacies and business succession increases as decisive measures produce further positive effects, and if such measures strongly support these firms' efforts, business fixed investment, a structural transformation in the economy, and economic rejuvenation are likely to progress.⁷ As a result, I think that this may then accelerate a virtuous cycle that bolsters the potential strength of the economy and the effectiveness of the policy measures.

The economic recovery in Japan seems to have strengthened its sustainability, as corporate profits have been on an improving trend and potential strength has heightened further through the implementation of the measures in 2013. Corporate profits have increased while monetary easing has been strengthened and stock prices remain on a rising trend, and a similar situation has been observed in the United States (Charts 12 and 18). Given these improvements, it is likely that firms' positive efforts to improve profits and strongly proceed with a structural transformation of unprofitable businesses have been encouraged by the extremely accommodative financial conditions. I think that the expansion of QQE strongly supports such efforts.

⁷ It is not always evident *ex ante* whether strong monetary easing stimulates firms' positive efforts and a structural transformation of businesses. However, if the Bank takes risks and consequent rises in asset prices and other factors increase firms' strength, this will strongly support (1) the risk-taking activities of firms that have been willing to strengthen the growth potential of the economy, and (2) efforts toward a structural transformation by firms that previously have been unwilling and postponed such a move. As a result, firms' profitability and competitiveness are expected to strengthen. In fact, such effects seem to have been observed steadily, at least so far, as suggested by the improving trend in corporate profits.

C. *Prospects for an exit*

Some argue that it has become more difficult to envisage an exit from monetary easing due to the expansion of QQE. However, I do not completely agree with this argument. Let me explain my thinking behind this view.

One of the important aims of the expansion of QQE was that the 2 percent target would likely be achieved earlier than would be the case without such expansion, and that it would provide a better outlook for the feasibility of achieving the target. Due to the expansion of QQE, I personally think that it is quite probable that the 2 percent target will be achieved in a balanced manner – accompanying improvements in corporate profits, employment, and wages – in the second half of fiscal 2015. In fact, I expect that the rate of inflation will accelerate from summer 2015, with the waning effects of the decline in crude oil prices in 2014 (Chart 16).

If this scenario materializes, it will become possible in the second half of fiscal 2015 to expect with greater certainty that the 2 percent target will be achieved in a stable manner. Consequently, with the expansion of QQE, I see it as highly likely that there will be a start to discussions of a specific exit strategy – for example, how to slow the pace of asset purchases, just as the Federal Reserve had been doing until recently, and how to take steps to return to an interest rate policy – in the second half of fiscal 2015, when the 2 percent target will likely be achieved.

Nominal interest rates are formed based on the outlook for economic activity and prices as well as term premiums. The Bank has been exerting downward pressure on interest rates with purchases of JGBs. However, if upward pressure on interest rates strengthens in line with improvements in economic activity and prices, interest rates may stop declining or even start rising even if the Bank continues to purchase JGBs.

At the Monetary Policy Meeting held on October 31, 2014, the Bank carefully examined the outlook for economic activity and prices. It assessed that downside risks to prices had increased and thus it had become necessary to take additional policy action. With a clear commitment to supporting the economic recovery in the form of implementing drastic additional easing at this juncture, when a virtuous cycle is being maintained, stronger effects of the policy can be expected. As a result, it may be possible to achieve the 2 percent target and start discussing an exit strategy sooner – to be specific, as early as in the second half of fiscal 2015. After carefully examining the expected effects as well as costs and risks, I judged it appropriate to decide in favor of the additional easing.

D. *Significance of the joint statement of the government and the bank*

I would now like to call attention to the significance of the joint statement of the government and the Bank on overcoming deflation and achieving sustainable economic growth that was released in January 2013. The main points of the statement are as follows.

(1) The Bank, based on the recognition that efforts by a wide range of entities toward strengthening the competitiveness and growth potential of Japan's economy will make progress, sets the price stability target at 2 percent in terms of the year-on-year rate of change in the CPI, and will aim to achieve this target at the earliest possible time.

(2) The government will not only flexibly manage macroeconomic policy but also formulate measures for strengthening the competitiveness and growth potential of Japan's economy – including all possible decisive policy actions, such as carrying out bold regulatory and institutional reforms and better utilizing the tax system – and promote them strongly. In addition, in strengthening coordination between the government and the Bank, the government will steadily promote measures aimed at establishing a sustainable fiscal structure.

It is clearly expressed in the statement that the Bank and the government will jointly make these efforts toward the same end. The Bank decided on the additional easing to show its

heightened determination to overcome deflation early and achieve sustainable economic growth with price stability in line with the statement. The Bank strongly expects that the government's efforts will also continue to progress vigorously and steadily in line with the statement.

Concluding remarks: the economy of Nagasaki prefecture

My concluding remarks will touch on the economy of Nagasaki Prefecture.

For hundreds of years, Nagasaki has been an international hub of cultural exchanges and open to the world, as epitomized by Dejima – an artificial island that was the only place authorized by the government for direct trade and exchange between Japan and the outside world during the Edo period. While nurturing a unique regional culture, Nagasaki has played a major role in the modernization and development of *monozukuri*, or manufacturing, mainly in heavy industry such as shipbuilding. In addition to such history and tradition, it is blessed with ample tourism resources, such as remote islands, hot springs, and fresh agricultural and marine products, as well as an appealing food culture.

In the shipbuilding industry, which is a key industry of the prefecture, the “Year 2014 Problem” – referring to a situation whereby a substantial decline in order backlogs for new shipbuilding might result in empty docks in 2014 – had been a matter of concern until about two years ago. However, it now seems that, due to the depreciation of the yen and a rise in the reputation of Japan's energy-saving, high-quality ships, the shipyards in Nagasaki have regained their competitiveness and seen an upswing in demand. Now, they face shortages of workers and staff due to the continuing high operating ratio.

In another key industry, tourism, there are two sets of candidate sites in Nagasaki for placement on the UNESCO World Heritage List under the category of culture. Specifically, in 2014, “Churches and Christian Sites in Nagasaki” was added as a candidate by the government, following the endorsement of “Sites of Japan's Meiji Industrial Revolution” in 2013. To promote tourism in Nagasaki, various measures have been taken to attract visitors from home and abroad; for example, it has one of the world's top three nightscapes, and the construction of the Nagasaki route of the Kyushu Shinkansen bullet train is heading toward completion in 2022. Given these factors, I expect that the prefecture will have a golden opportunity to increase its number of visitors.

Meanwhile, the population in Nagasaki, particularly in remote islands, has been declining, and, above all, the prefecture faces continuing outflows of young people to other prefectures. Moreover, I have heard that there are other challenges. Specifically, the weakening of business bases for various local industries – such as fisheries, as evidenced by a decline in catches – and for small firms has yet to show any improvement. Needless to say, these are common problems that many other regional economies in Japan face.

The Nagasaki prefectural administration has implemented measures to address these problems. To raise the income of residents in the prefecture so that young people can enjoy living in the region, the prefecture has been making efforts to capture external demand, mainly from Asian neighbors, such as by actively promoting the arrival of international cruises, while further strengthening the competitiveness of manufacturing and tourism as well as agriculture, forestry, and fisheries, all of which have advantages and are the pillars of the local industries. In support of such initiatives, I have heard that lively discussions have been held at Nagasaki Summit, organized through an industry-academia-government collaboration, and this has been playing a critical role in the revitalization of local economy and communities.

The joint efforts toward attracting external demand and tapping domestic demand have been steadily bearing fruit. We at the Bank wish you every success in these efforts and will continue to provide support as much as possible as the central bank.