Takahide Kiuchi: Recent developments in economic activity, prices and monetary policy

Speech by Mr Takahide Kiuchi, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Gunma, 5 March 2015.

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I. Developments in economic activity and prices

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

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

Japan's economy has continued its moderate recovery trend. The first preliminary estimate of the real GDP growth rate for the October-December quarter of 2014 – which was released in February 2015 – was 2.2 percent on an annualized quarter-on-quarter basis, and thus turned positive for the first time in three quarters. Industrial production also has turned positive in the October-December quarter on a quarter-on-quarter basis for the first time in three quarters, and recently recovered to the level of the peak prior to the consumption tax hike in April 2014. With regard to the outlook, industrial production is expected to increase moderately, reflecting the developments in demand both at home and abroad on which I will elaborate shortly, and the economy is expected to continue its moderate recovery trend.

Looking at domestic demand, private consumption as a whole has remained resilient with the employment and income situation improving steadily, although recovery in some areas has been sluggish. As for durable consumer goods, which had exhibited a notable decline in demand following the front-loaded increase prior to the consumption tax hike, the number of new passenger-car registrations almost bottomed out in the July-September quarter of 2014, and since then has shown some signs of picking up, albeit with large fluctuations in the number of small cars with engine sizes of 660cc or less. Sales of household electrical appliances in real terms have tended to pick up at a moderate pace, as they have registered a quarter-on-quarter increase for two consecutive quarters since the July-September quarter.

As for the employment and income situation, which underpins private consumption, labor market conditions have continued to improve steadily and employee income has risen moderately. Looking at recent developments, the unemployment rate has declined to around 3.5 percent and the active job openings-to-applicants ratio has been above 1.0. Scheduled cash earnings on a year-on-year basis have been on a positive trend as well, mainly due to the effects of the rise in base pay in spring 2014, and such earnings as a whole have been picking up. As for the outlook, employee income is expected to continue increasing moderately, in line with the recovery in economic activity and business performance. Underpinned by this employment and income situation, private consumption is expected to remain resilient.

Business fixed investment has been on a moderate increasing trend. The aggregate supply of capital goods on a basis excluding transport equipment – a coincident indicator of machinery investment – has been on a moderate uptrend, with the fluctuations smoothed out; it was temporarily flat in the July-September quarter of 2014, but rose again in the October-December quarter. Machinery orders on a basis excluding orders for ships and those from electric power companies – a leading indicator of machinery investment – have been increasing since the July-September quarter, and business fixed investment plans are generally favorable as well. Taking these factors into account, business fixed investment is projected to continue a moderate increasing trend as corporate profits follow their improving trend.

Regarding the environment surrounding exports, overseas economies – mainly advanced economies – have been recovering, albeit with a lackluster performance still seen in part. Looking at movements by major region, the U.S. economy has continued to recover, led by domestic demand, since the firmness in the household sector has been feeding through to the corporate sector, together with the effects of monetary easing and the decline in crude oil prices. Momentum for the recovery in the European economy has remained weak, although a further slowdown has been staved off. As for the Chinese economy, stable growth has continued as a trend; however, growth momentum has recently slowed with downward pressure from excessive capital stock in the manufacturing sector and adjustments in the real estate market. Apart from China, emerging and commodity-exporting economies as a whole have continued to lose pace.

In this situation, Japan's exports have been picking up. Real exports, after turning positive in the July-September quarter of 2014 on a quarter-on-quarter basis, have risen for two consecutive quarters. As for the outlook, exports are expected to increase moderately (1) as overseas economies are likely to continue recovering moderately, led mainly by advanced economies – the United States in particular – although there are risks such as the outcome of European debt problem, including the situation in Greece, and (2) on the back of the enhancement of competitiveness and somewhat of a shift back from overseas production to domestic production due to the yen's depreciation.

Turning to price developments, the year-on-year rate of increase in the consumer price index (CPI, all items less fresh food, and the same hereafter) has been slowing, mainly reflecting the significant decline in crude oil prices since autumn 2014. The rate of increase for January 2015 – the latest figure available – was 0.2 percent. With regard to the outlook, the rate of increase is likely to slow for the time being, reflecting the decline in energy prices.

B. Outlook through fiscal 2016

So far, I have illustrated recent developments in economic activity and prices. Let me now turn to the Bank's interim assessment of the October 2014 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), which was made in January 2015. In this assessment, the Bank revised the forecasts for economic activity and prices through fiscal 2016.

According to the median of the Policy Board members' forecasts, the real GDP growth rate is projected to be minus 0.5 percent for fiscal 2014, which is lower than the forecast presented in the October 2014 Outlook Report. However, the rate is projected to be 2.1 percent for fiscal 2015 and 1.6 percent for fiscal 2016, which is higher in both cases than the forecasts presented in October, and the economy is likely to grow at a pace clearly above its potential. This upward revision reflects the significant decline in crude oil prices and the effects of the government's economic measures. With regard to the CPI, the outlook for the underlying trend is unchanged from the October forecasts, but the year-on-year rate of increase will likely be lower toward fiscal 2015, due to the significant decline in crude oil prices. The rate of increase for fiscal 2016 will likely be more or less unchanged from the October forecast. This is because the year-on-year rate of increase in the CPI is projected to accelerate gradually as the effects of the decline in crude oil prices dissipate on a year-on-year basis, on the assumption that Dubai crude oil prices will rise moderately from 55 U.S. dollars per barrel.

II. Major points to be considered with regard to the outlook for economic activity and prices

Although I share the view that the economy will continue recovering moderately, I hold a more cautious view on the outlook for economic activity and prices compared with the forecasts in the baseline scenario in the Outlook Report that I just mentioned. Let me share some of my considerations regarding the outlook with you.

A. Growth potential of Japan's economy

Now let us look at the potential growth rate of Japan's economy, which represents – from the supply side – the pace of growth that is consistent with the economy's growth potential. According to the Bank's estimates, the rate has recently been in the range of 0 to around 0.5 percent, and thus remains at a low level. The potential growth rate is unlikely to rise markedly in the short term, considering, for example, that the pace of firms' accumulation of capital stock remains moderate, although business fixed investment has turned to an increasing trend. On the other hand, the Bank's estimates of the output gap in Japan have generally been at the neutral level of around zero recently. The output gap is also at a favorable level on an international comparison using the estimates made by the Organisation for Economic Co-operation and Development (OECD). Labor market conditions remain very tight. Of course, such estimates are subject to a considerable margin of error. However, if, under these circumstances, the economy continues to grow at a pace well above the potential growth rate, supply-side constraints such as labor shortages will become more pronounced. In my view, stable economic and price conditions are most likely to be maintained, as Japan's economy will probably continue growing moderately at a pace that does not diverge considerably from the potential growth rate.

B. The decline in crude oil prices and the global economy

The decline in crude oil prices facilitates income transfers from oil-producing countries to oil-consuming countries. The net effect of the decline will likely tend to be positive in terms of the global economy as a whole due to the difference in price elasticity of demand between these countries. Nevertheless, financial markets often shift to a "risk-off" mode. This is probably because the decline in crude oil prices is associated with signs of oil-producing countries' currency depreciation and of the heightening in their economic and fiscal risks. Another reason seems to be that market participants are still uncertain about the extent of positive effects stemming from the crude oil price decline.

In measuring the extent of these effects, the degree to which the decline in crude oil prices will benefit the U.S. economy warrants attention. In this regard, the decline in such prices might not push up private consumption by as much as anticipated due to structural changes in the United States such as an increase in energy efficiency. The fall in crude oil prices could also lead to a reduction in fixed investment in the oil-related industries and to a decline in U.S. exports because of weaker-than-expected overseas economic growth, including that of oil-producing countries. Besides, it should be noted that the International Monetary Fund (IMF) revised downward its latest forecast for global growth from the previous forecast. The downward revision is mainly attributable to investment weakness caused by diminished expectations about medium-term growth in many advanced and emerging economies, despite the expectation for positive effects of the decline in crude oil prices. Taking these factors into account, I am personally paying closer attention to downside risks to overseas economies, developments in which are a key determinant of Japan's exports.

C. Private consumption

Relatively weak developments have been observed in indicators of consumer sentiment since summer 2014, although these indicators have recently shown some signs of improvement. Behind this, there seems to be concern over a decline in real wages caused by the divergence between the rate of increase in prices and that in wages. In this regard, in a situation where the inflation rate has recently shown a declining trend, if increases in wages, including those in base pay, are realized this coming spring, as happened last spring, the divergence between the two rates will narrow or dissipate; this in turn will exert positive effects on consumer sentiment, and hence on private consumption. However, even if major firms raise their base pay to a reasonable degree, the rate of increase in scheduled cash earnings within the overall economy could diverge from that in the base pay of these firms. Here are some of the reasons. First, developments in wage increases by small firms also determine the course of wages in Japan. Second, many non-regular employees are not eligible for base pay increases. And third, the uptrend in the proportion of non-regular employees, for whom wage levels are relatively low, has in part exerted downward pressure on the average wage level. On this basis, despite a continuing trend of improvement in labor market conditions, the pace of improvement in real income will likely remain moderate and private consumption will probably continue to increase at a moderate pace that is consistent with the pace of increase in real income.

D. Outlook for prices

Regarding the outlook for prices, in the October 2014 Outlook Report, I formulated a proposal to change the expression that the year-on-year rate of increase in the CPI is likely to reach around 2 percent in or around fiscal 2015. Since then, I have maintained a more cautious view than the forecast in the Bank's baseline scenario.

Considering the relationship between the price outlook and the output gap in light of the Phillips curve, in order for the year-on-year rate of increase in the CPI to reach around 2 percent, it is necessary that the rate respond relatively clearly to an improvement in the output gap – that is, the steepening of the slope – and that the Phillips curve shift upward, reflecting a rise in medium- to long-term inflation expectations.

It should be noted that the negative output gap has narrowed significantly since the introduction of quantitative and qualitative monetary easing (QQE) in April 2013 and has generally stayed at the neutral level for the past nearly one year, and the depreciation of the yen has progressed over this period. However, the pace of increase in prices remains moderate, even in terms of the CPI for all items less food and energy, which is not susceptible to the decline in crude oil prices. Assuming this situation continues, even if the effects of the decline in crude oil prices dissipate and the output gap improves further, the pace of increase in prices is likely to remain moderate.

III. Conduct of monetary policy

At the Monetary Policy Meeting held on October 31, 2014, the Bank decided to expand QQE. Specifically, the Bank decided to (1) accelerate the annual pace of increase in the monetary base from about 60–70 trillion yen to about 80 trillion yen, (2) increase its Japanese government bond (JGB) purchases so that the amount outstanding of its holdings would be increased from an annual pace of about 50 trillion yen to about 80 trillion yen, and (3) triple the annual paces of increase in the amounts outstanding of its holdings of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs).

Some Policy Board members held an opposing view regarding the expansion of QQE, but its implementation ultimately was decided by a majority vote. I cast a dissenting vote on that decision because I considered that the positive effects that could be brought about by the expansion would not be worth the accompanying costs and side effects, in a situation where QQE had already exerted a reasonable effect and, judging from the growth potential of Japan's economy, economic and price conditions had generally regained stability. I have continued to cast a dissenting vote at the subsequent Monetary Policy Meetings, considering that it was appropriate for the Bank to change the guidelines for money market operations and asset purchases back to those employed before the expansion of QQE. The idea behind this is closely related to the proposal I have been submitting at each meeting since the introduction of QQE – that is, (1) not to restrict the time frame for achieving the 2 percent price stability target to about two years, but to aim to achieve it in the medium to long term and (2) to designate QQE as an intensive measure with a time frame of about two years, and thereafter to review the monetary easing measures in a flexible manner. Next, I will express my personal views on some points of discussion regarding the conduct of monetary policy, as well as the background to my proposal.

A. Price stability target

The Bank's price stability target of 2 percent aims to maintain the inflation rate of around 2 percent in a stable manner. In order to achieve this, it is necessary that firms' and households' medium- to long-term inflation expectations – on which basis they carry out their economic activities – be stable at about 2 percent. However, there is still a substantial divergence from that level.

In my view, medium- to long-term inflation expectations in Japan are mainly determined by supply-side factors such as the potential growth rate. Therefore, to achieve the price stability target of 2 percent, it is necessary that a wide range of economic entities make effective use of the benign economic and financial environment brought about by QQE and make continuous efforts to strengthen the economy's growth potential. I hold the view that, even if such efforts proceed smoothly, it will require considerable time for the target to be achieved. This is why I have continued to propose at Monetary Policy Meetings not to restrict the time frame for achieving the 2 percent price stability target to about two years, but to aim to achieve it in the medium to long term.

It is important that monetary policy consistently provide indirect support for these efforts to strengthen the economy's growth potential by maintaining accommodative financial conditions. As I mentioned earlier, the output gap has been around zero recently, due in part to the effects of monetary policy – which has a function of working on the demand side of the economy – while the potential growth rate remains at a low level. In this situation, if monetary easing is strengthened excessively to push prices higher in the short term than levels justified by the economy's growth potential, this could in turn impair the stability in economic activity, and hence in prices. In order to ensure both the sound development of the national economy and credibility in the conduct of monetary policy, I consider it desirable to make the time frame for achieving the price stability target flexible, thereby achieving prolonged economic recovery, albeit moderate, while at the same time providing support from the financial side for steady progress in efforts to increase the productivity growth rate and the potential growth rate.

Meanwhile, the growth potential of the economy will likely increase as efforts to strengthen the foundations for economic growth make progress, and so will the price level that is sustainable and consistent with the growth potential. It should be noted that, in the short term, however, prices might face downward pressure, for example, when those in certain industries decline due to deregulation, which represents one such effort. This is one of the reasons why I consider that the conduct of monetary policy with a price stability target has to be flexible.

B. Expansion of QQE

When the Bank introduced QQE in April 2013, I supported the concrete measures of QQE, judging that the scale was one in which the associated positive effects would just about outweigh the side effects when confined to a certain time period. Since the time of introduction, however, I have considered that, if such large-scale monetary easing policy were to be protracted or such policy strengthened, the associated side effects would instead outweigh the positive effects, and this would heighten the risk of undermining economic and price stability in the long run. Therefore, in considering the expansion of QQE, I judged that the accompanying positive effects would not be worth the costs and side effects.

With regard to possible positive effects of the expansion of QQE, even if additional measures further lower interest rates, room for a further decline in real interest rates – which generates policy effects – is considered to be small, as nominal interest rates are already at historically low levels and inflation expectations are less likely to rise not only in Japan but also worldwide. It also should be noted that, although QQE could probably elicit reasonable effects through people's expectations at the time of introduction, additional measures are likely to only have limited effects through this channel compared with when it was introduced.

On the other hand, in terms of the costs and side effects of the expansion, a possible further impairment of market functioning and possible effects of a further decline in interest rates on financial institutions' profits and on their intermediation function warrant particular attention. For example, if liquidity in the JGB market were to decline drastically, the market would become less resilient against negative shocks and thereby become unstable more easily, such that volatility would increase. In addition, the Bank has raised the pace at which it purchases JGBs so that their amount outstanding will increase at an annual pace of about 80 trillion yen, implying that it is purchasing a large proportion of the JGBs issued on a flow basis. Therefore, there is concern about a higher potential risk that such a move will be perceived as effectively financing fiscal deficits. I also believe that even greater attention should be given to a risk that the mechanism of maintaining fiscal discipline through interest rates will be impaired, reflecting overly heightened expectations that the stability in the JGB market will be ensured by the Bank's JGB purchases. When the credit ratings of JGBs were downgraded in December 2014, the JGB market showed no notable reaction, but should this suggest an impairment of market functioning – which is supposed to reflect the fiscal condition – then the situation requires attention. Considering that the JGB market serves as the basis for a range of price formation in financial and asset markets, it is necessary to be fully vigilant against the risk of a buildup of various types of financial imbalances in a situation where the Bank's presence becomes overwhelming in the JGB market and interest rates remain at very low levels.

It also should be noted that, if interest rates decline further, this could add to difficulty for institutional investors that place priority on gaining stable interest income in finding favorable investment opportunities and discourage them from selling their JGB holdings. I consider that the feasibility of continuing JGB purchases into the future warrants attention, even though it seems technically possible to continue such purchases for some time.

C. Achieving fiscal consolidation and maintaining financial system stability

To ensure the smooth conduct of QQE, efforts to achieve fiscal consolidation are crucial. The Bank's large-scale JGB purchases are solely conducted for the purpose of achieving the price stability target. However, if the credibility of fiscal management were to wane and QQE to become widely perceived in financial markets as financing fiscal deficits, this could entail a risk that the effects of QQE will be constrained by a rise in interest rates brought about by an increase in risk premiums. Particular attention therefore should be given to this as a potential risk, because fiscal conditions are severe in Japan compared with other countries. Fiscal consolidation is also extremely important with regard to achieving the smooth normalization of monetary policy in the future.

Judging whether QQE will succeed or not in the end depends on whether monetary policy can follow a smooth path toward normalization while maintaining a stable economic and price environment. In order to achieve this, not only securing the credibility of fiscal management that I mentioned earlier but also ensuring financial system stability is highly significant. In the future, when the time comes for the Bank to seek to normalize monetary policy with a view to ensuring price stability, it should avoid falling into a situation where it is forced to shift its policy priority from ensuring price stability to stabilizing the financial system by maintaining stability of interest rates, with a view to ensuring stability of the financial system – one of the Bank's missions along with that of achieving price stability. The Bank is therefore required to conduct monetary policy with utmost deliberation so that financial institutions' profit base would not be impaired for a protracted period, or that their resilience to the risk of a rise in interest rates would not decline noticeably.

In order to properly monitor economic and price developments as well as the financial system in a well-balanced manner, I consider it necessary for the Bank to continue its policy conduct flexibly, giving greater consideration to its policy framework of "two perspectives." Specifically, the first perspective is examining, as regards economic activity and prices over the next two years or so, whether the outlook deemed most likely by the Bank is reasonable judging from the growth potential of Japan's economy at each point in time. In this regard, the inflation rate that the Bank should aim at achieving through monetary policy over roughly the next two years is expected to climb gradually, as the economy's growth potential rises along with the progress in structural reforms. That rate could possibly reach around 2 percent eventually; however, I consider it important to conduct monetary policy taking into account that the appropriate level at this point is still lower than 2 percent. The second perspective involves examining, over a longer term, various risks that are most relevant to the conduct of monetary policy aimed at achieving sustainable economic growth under price stability. In doing so, it is important to not focus too much on short-term developments in economic activity and prices but to pay close attention to an emergence of financial imbalances and thereby aim to achieve economic and price stability in the long run.

D. Making effective use of a wide range of policy tools

It is my understanding that an unconventional policy such as the asset purchase policy implemented under QQE can be regarded as an exceptional and somewhat temporary tool to generate upward momentum in economic activity and prices and affect the direction of such momentum under the zero lower bound on nominal interest rates. The Bank's current asset purchase policy, which continuously increases the amount outstanding of its asset holdings, has the effect, by its nature, that as long as the Bank continues with the purchases, accommodative financial conditions will be strengthened in a cumulative manner as the amount outstanding of its asset holdings increases. Compared with other policy tools, it will likely take considerable time for monetary policy to be normalized with the unwinding of QQE. Therefore, it is important to implement QQE in a forward-looking manner while fully taking into consideration the manifestation of its medium- to long-term effects. On the other hand, a conventional interest rate policy can be regarded as a usual, fine-tuning tool that is used when it is time to encourage economic activity and prices to reach desirable levels, instead of temporarily generating strong momentum for economic activity and prices.

My assessment of the current situation is as follows: QQE has already exerted a reasonable effect. In addition to this, in a situation where prices – which had long been on a declining trend – have started to increase against the background of improvement in economic conditions, and the underlying trend in prices has been unchanged thereafter, policy effects generated by maintaining virtually zero interest rates are being added to the effects of QQE.

Furthermore, with a view to encouraging firms and households to make full use of the accommodative financial conditions, the Bank established the Loan Support Program and has been providing long-term funds at a low interest rate. At the Monetary Policy Meeting held on January 19 and 20, 2015, the Bank made the following decisions regarding the program, which was due to expire shortly: (1) extending it by one year; (2) introducing a new framework for enabling financial institutions that do not have a current account at the Bank to use the program through their central organizations; and (3) with regard to the main rules for the fund-provisioning measure to support strengthening the foundations for economic growth under the program, increasing the maximum amount of funds that the Bank can provide to each financial institution from 1 trillion yen to 2 trillion yen, and also increasing the maximum amount outstanding of its fund-provisioning as a whole from 7 trillion yen to 10 trillion yen.

As I mentioned earlier, whether QQE will succeed or not in the end depends on whether monetary policy can follow a smooth path toward normalization while maintaining a stable economic and price environment. To this end, I personally consider it important for the 13 Bank to continue to provide consistent support from the financial side to achieve desirable economic and price conditions in the medium to long term, while simultaneously making effective use of a range of policy tools based on its assessment of economic and price developments from its policy framework of "two perspectives." In this regard, taking into consideration the nature of QQE that I mentioned earlier, I think that it will be necessary at some point to examine the option of gradually starting to shift the focus of monetary policy conduct from the asset purchase policy to other policy tools.