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, Aomori, 3 September 2015.

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I. Economic activity and prices

A. Recent developments 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 to recover moderately. The first preliminary estimate of the real GDP growth rate registered negative growth for the first time in three quarters, at minus 1.6 percent on an annualized quarter-on-quarter basis for the April-June quarter of 2015. Industrial production also dropped in that quarter on a quarter-on-quarter basis for the first time in three quarters, mainly due to the effects of the slowdown in overseas economies toward around spring 2015, as well as to inventory adjustments of small cars with engine sizes of 660cc or less. However, it has been picking up, albeit with some fluctuations. With regard to the outlook, industrial production is expected to increase moderately – albeit with some fluctuations – reflecting the developments in demand both at home and abroad on which I will elaborate shortly. In this situation, the economy is expected to continue recovering moderately.

Looking at domestic demand, private consumption has been resilient, with the employment and income situation improving steadily. The number of new passenger-car registrations excluding small cars with engine sizes of 660cc or less has moved upward in the April-June quarter of 2015, but declined in the July-August period relative to that quarter. Sales of household electrical appliances in real terms have trended moderately upward, supported by increased sales of smartphone products and a rise in sales to foreign visitors to Japan. However, sales of household electrical appliances have shown somewhat weak movements, due in part to lackluster sales of air conditioners as a result of irregular weather in the early summer. Sales at department stores have remained firm, due in part to the wealth effects as a result of the rise in stock prices and to improvement in consumer sentiment, but fell in the April-June quarter, affected mainly by irregular weather. Meanwhile, as for service-related consumption, outlays for travel have been firm on the domestic side, although those in overseas travel have fallen, and sales in the food service industry have remained steady.

As for the employment and income situation, labor market conditions have continued to improve steadily, and employee income has risen moderately. The unemployment rate has been at a low level of 3.3 percent or slightly higher, and has continued on a moderate improving trend, with the fluctuations smoothed out. The improving trend in the active job openings-to-applicants ratio has become evident recently, as seen in the fact that it recorded 1.21 in July, a high level since that in February 1992. Scheduled cash earnings on a year-on-year basis as a whole – including those of part-time employees – have increased moderately, since the rate of increase in scheduled cash earnings of full-time employees has accelerated at a moderate pace, mainly due to the effects of the rise in base pay. As for the outlook, employee income is expected to continue increasing moderately, in line with the recovery in economic activity and business performance. With the employment and income situation continuing to improve steadily as described, private consumption is expected to remain resilient.

Business fixed investment has been on a moderate increasing trend as corporate profits have improved. The aggregate supply of capital goods (excluding transport equipment) – a coincident indicator of machinery investment – has been trending moderately upward, albeit with fluctuations. Looking at leading indicators, machinery orders (private sector, excluding orders for ships and those from electric power companies) have increased at a moderate pace, notably in manufacturing. Moreover, construction starts (floor area, private, nondwelling use) have started to pick up, albeit with fluctuations, since the turn of the year. In these circumstances, business fixed investment plans are projected to grow further for fiscal 2015 from the previous fiscal year. Taking these factors into account, business fixed investment is projected to continue increasing moderately as corporate profits follow their improving trend.

Let me turn to overseas demand. 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, assisted by household spending, although adjustments have been seen in the industrial production sector, mainly on the back of the decline in crude oil prices and the appreciation of the U.S. dollar. The European economy has been on a moderate recovery trend. The Chinese economy has maintained its stable growth as a trend but there has been downward pressure from an overhang in supply capacity in the manufacturing sector and adjustments in the real estate market. Apart from China, emerging and commodity-exporting economies as a whole have shown sluggish growth, due in part to the effects of the slowdown in the Chinese economy.

In this situation, Japan's exports have been picking up, albeit with some fluctuations. Real exports had increased for three quarters in a row starting with the July-September quarter of 2014, and fell in the April-June quarter of 2015. They have shown sluggishness recently due to the effects of the slowdown in overseas economies toward around spring 2015. As for the outlook, exports are expected to increase moderately, albeit with some fluctuations, as overseas economies, mainly advanced economies, are expected to continue recovering moderately – although there are issues that require attention, such as the outcome of the European debt problem, including the situation in Greece, and developments in emerging and commodity-exporting economies.

Turning to price developments, the year-on-year rate of increase in the consumer price index (CPI, all items less fresh food) is about 0 percent. With regard to the outlook, it is likely to be about 0 percent for the time being, due to the effects of the decline in energy prices.

B. Outlook for economic activity and prices

So far, I have illustrated recent developments in economic activity and prices. Let me now turn to the Bank of Japan's interim assessment of the April 2015 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), which was made in July 2015. In this assessment, the Bank revised the forecasts for economic activity and prices through fiscal 2017.

In the Bank's interim assessment, the median of the Policy Board members' forecasts for the real GDP growth rate was revised somewhat downward to 1.7 percent for fiscal 2015, mainly due to the sluggishness in exports, but was more or less unchanged at 1.5 percent and 0.2 percent for fiscal 2016 and 2017, respectively, from the forecasts presented in April.

In other words, Japan's economy is likely to continue growing at a pace above its potential through fiscal 2016 and maintain its positive growth in fiscal 2017, although with a slowing in its pace, due mainly to the effects of the consumption tax hike planned in April 2017. With regard to the year-on-year rate of increase in the CPI (all items less fresh food), the median of the Policy Board members' forecasts was more or less unchanged at 0.7 percent for fiscal 2015, 1.9 percent for fiscal 2016, and 1.8 percent for fiscal 2017, from the April forecasts. The year-on-year rate of increase in the CPI (all items less fresh food) is likely to be about 0 percent for the time being, but the rate will likely accelerate gradually, on the assumption that Dubai crude oil prices will rise moderately from 60 U.S. dollars per barrel.

II. Keys to assessing the outlook for economic activity and prices

I believe that Japan's economic and price conditions have already regained stability consistent with the economy's growth potential, mainly due to the effects of almost two and a half years of quantitative and qualitative monetary easing (QQE). I expect that such stable conditions will continue through fiscal 2017 – the projection period covered in the Bank's April 2015 Outlook Report and its interim assessment in July. However, I hold a more cautious view on the outlook for Japan's economic activity and prices compared with the aforementioned forecasts in the Policy Board members' baseline scenario regarding that activity and prices in the July interim assessment. Let me share some of my considerations regarding the outlook with you.

A. Output gap, potential economic growth rate, and outlook for the growth rate

According to the estimates the Bank presented in the April 2015 Outlook Report, 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, has been around 0.5 percent or lower, and thus remains at a low level. The Bank also estimates Japan's output gap, which represents the degree of utilization of labor and production capacity, at 0.1 percent for the January-March quarter of 2015. The output gap has maintained a neutral level of around 0 percent since the end of 2013. I would like to note that the output gap in Japan is also at a favorable level compared with those in other major countries, according to the estimates made by the Organisation for Economic Co-operation and Development (OECD). While these estimates are subject to a considerable margin of error, they generally have been in line with developments in the weighted average of the diffusion indices for production capacity and employment conditions in the Bank's *Tankan* (Short-Term Economic Survey of Enterprises in Japan). The active job openings-to-applicants ratio and other indicators also suggest that supply and demand conditions in the labor market are tightening further, rather than being neutral. However, in a situation where the economy enters a phase in which the negative output gap almost closes, it is considered that it becomes more difficult for the economy to grow at a pace well above its potential compared with the early stage of economic recovery when the output gap is wide. I also consider the possibility that supply-side constraints such as labor shortages will have the effect of constraining economic activity.

Based on these developments, as I will describe in more detail later, my assessment is that the economy will continue to grow at a moderate pace as a trend through fiscal 2017, which is roughly equivalent to its growth potential, and that – although lower than the Policy Board members' baseline scenario in the July interim assessment – stable economic activity and prices will be maintained. This is because the cumulative effects of QQE will continue to exert a positive impact on the economy, while on the demand side of the economy, there is downward pressure on exports, business fixed investment, and private consumption.

B. Overseas economies and Japan's exports

The latest forecasts for global economic growth for 2015 released by international organizations such as the International Monetary Fund (IMF) were revised downward from those made at the end of last year. This was mainly due to weaker-than-expected growth in the United States and China, which are Japan's major trading partners.

The U.S. economy has been picking up on the whole, after being sluggish in the January-March quarter of 2015, reflecting effects such as of the severe winter weather and the labor disputes at West Coast ports. However, the sluggishness remains, particularly in private consumption. The average growth rate in the first half of 2015 fell below the past trend, and it is still uncertain whether the pace will recover in the second half. If the growth in labor productivity continues to follow a downtrend, this would increase anticipation of a downward deviation in the growth trend, and an optimistic view on the economic outlook consequently would seem unlikely to spread on the basis of support from a favorable employment situation alone. Meanwhile, the growth in the Chinese economy has also continued to trend downward, and considering the deterioration in the employment situation and the decline in the inflation rate, it cannot necessarily be said that the economy is currently in a stable condition that is neutral to the output gap. The rate of economic growth appears to be slowing faster than the rate of decline in potential growth. As for Asian economies with vulnerabilities arising from the high-level accumulation of private-sector debt, their downtrend may become more evident amid the spreading effects of the weaker-than-expected economic growth in the United States and China.

In this environment, Japan's real exports for the April-June quarter of 2015 turned negative on a quarter-on-quarter basis for the first time in three quarters, registering minus 3.6 percent, and I consider that this has become one of the factors behind the weaker-than-expected real GDP growth rate for the April-June quarter – that is, the temporary lull in the economy. Real exports are expected to increase on a quarter-on-quarter basis in the July-September quarter, albeit moderately. Thereafter, however, they are likely to continue to lack momentum for some time and overall economic growth is expected to be quite modest as a result of the adverse effects on production and employment in manufacturing.

C. Growth expectations and business fixed investment

Business fixed investment has continued to be on an increasing trend on the back of improvement for the situation in corporate profits and of higher capacity utilization rates. However, firms' cautious investment stance still has not changed considerably, particularly in terms of business fixed investment in Japan. This seems contrary to firms' active stance toward hiring new employees, due in part to strong concern over future labor shortages.

In this situation, for firms to become more active in their fixed investment, it is essential to bring about a clear rise in medium- to long-term growth expectations – underpinned as well by the government's growth strategy and measures to respond to the population decline. Meanwhile, focusing on the capital stock cycle of business fixed investment, I consider that fixed investment is likely to increase in fiscal 2015, and thereafter the pace of increase is likely to generally peak out toward fiscal 2017, on the assumption that the current growth expectations will be maintained.

D. Expectations of price rises and private consumption

Private consumption has continued to lack momentum, despite the favorable environment evidenced by such factors as improvement in the employment and income situation and accommodative financial conditions. One factor behind this may be consumers' expectations of price rises for the time being. Since April 2015 in particular, a rise in prices of daily necessities such as food has been widely observed. In my view, comments by respondents in the recent *Economy Watchers Survey* and the sluggishness in the consumer confidence index in the *Consumer Confidence Survey* are evidence that this rise has negatively affected consumer sentiment.

Let me consider this situation together with the effects of monetary easing. While real interest rates continued to decline due to the policy effects of QQE at the time of its introduction, there was no significant change in the outlook for real income. Therefore, a monetary easing effect emerged temporarily – that is, the bringing forward of future consumption. However, in the current phase, the decline in real interest rates has come to a halt, and a view seems to be spreading among consumers that the rate of increase in wages will not easily catch up with that in prices. Therefore, if expectations spread of a rise in prices of daily necessities in the near future, the outlook for real income for the time being may deteriorate, thereby further constraining consumption activity. This trend may be observed more clearly among elderly households, including those of pensioners, and low-income households.

E. Price developments and the outlook

Turning to price developments, retail price statistics released by the private sector show a clear uptrend, particularly in prices of food. However, no significant changes have yet been observed in CPI statistics released by the Ministry of Internal Affairs and Communications, which cover a wider range of goods and services. In terms of the CPI for all items less food and energy – which tend to fluctuate largely – or the core-core CPI, the year-on-year rate of increase may have started to accelerate somewhat. However, it still cannot be judged that there has been a clear change in the underlying trend; this is partly because, in 2014, the rate of increase in prices had slowed after the consumption tax hike, and the rate of increase in that index reflected this effect. Comparing the recent situation with that from 2013 through the beginning of 2014 – when the year-on-year rate of increase in the CPI accelerated markedly – there is a large difference in the pace of improvement in the output gap and of the rise in prices of electronic appliances, which has been relatively stable recently even amid the depreciation of the yen. Under these circumstances, the effects of the depreciation of the yen so far on price rises seem to have weakened on the whole compared with those observed last year.

Supermarkets have recently been passing on increases in costs by food manufacturers to sales prices and refraining from holding discount sales that are intended for sales promotion, as food sales do not decline even when prices are increased. However, this can be regarded as an overvaluation by retail stores that the relatively high level of the year-on-year rate of increase in sales since April 2015 – which actually is due to the base effect of the decline in demand after the consumption tax hike in 2014 – is an indication of the firmness in sales. Furthermore, one reason behind the fact that sales of food are less likely to decline despite the rise in sales prices may be that the necessity for food is high and the price elasticity of its consumption is considered to be relatively low. It is necessary to take into consideration the possibility that the rise in prices of daily necessities such as food will intensify consumers' defensive attitude toward spending and, as a result, restrain price increases.

Under these circumstances, I expressed dissent from the description presented in the April 2015 Outlook Report regarding the year-on-year rate of increase in the CPI (all items less fresh food) that the timing of reaching around 2 percent is projected to be around the first half of fiscal 2016. Even now, I still hold the view that the year-on-year rate of increase in the CPI (all items less fresh food) will be about 0 percent for the time being, and thereafter accelerate very moderately, and consider that the rate of increase is unlikely to reach 2 percent even in fiscal 2017.

III. Conduct of monetary policy

In April 2013, the Bank introduced QQE with a view to achieving the price stability target of 2 percent in terms of the year-on-year rate of change in the CPI at the earliest possible time, with a time horizon of about two years. Furthermore, in October 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).

Despite supporting the introduction of QQE, I cast a dissenting vote on the decision to expand it in October 2014. Moreover, since April 2015 – that is, two years after the introduction of QQE – I have continued to submit a proposal to change the guidelines for money market operations and asset purchases, including a reduction in the pace of asset purchases. Next, I would like to explain in detail my policy stance and the idea behind it from the viewpoint of positive effects and side effects of QQE.

A. My view on QQE

The Bank introduced QQE in April 2013 and decided on the following guidelines for money market operations and asset purchases: accelerate the annual pace of increase in the monetary base to about 60–70 trillion yen and purchase JGBs so that the amount outstanding of the Bank's holdings would be increased to an annual pace of about 50 trillion yen. I supported these guidelines employed at the time of introduction, 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. In the meantime, however, I have considered that the associated side effects would outweigh the positive effects over time. Therefore, I have continued to submit a proposal – that is, 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 – since the introduction of QQE in April 2013 through the Monetary Policy Meeting (MPM) held in March 2015. This was because, while I personally considered it difficult to achieve the price stability target of 2 percent in a short period of time, I was concerned that, if the Bank carried out QQE with the rigid purpose of achieving the 2 percent price stability target, the policy decided at the time of introduction would be protracted or would strengthen and the side effects would increase in a cumulative manner. Based on this view, in deciding the expansion of QQE in October 2014, I judged that the timing of the associated side effects outweighing the positive effects would be moved forward due to increases such as in the amount outstanding of the Bank's JGB holdings from an annual pace of about 50 trillion yen to about 80 trillion yen. I therefore cast a dissenting vote on the measure and insisted that it was appropriate for the Bank to continue with the guidelines employed at the time of the introduction of QQE. Since then, I have continued to cast a dissenting vote on the current guidelines.

On this basis, I submitted another proposal at the MPM held on April 7 and 8, 2015 – that is, to (1) reduce the annual paces of increase in the monetary base and in the amount outstanding of the Bank's JGB holdings from the current ones of about 80 trillion yen to about 45 trillion yen, which are levels below the initial pace employed at the time of the introduction of QQE; (2) change back the average remaining maturity of the Bank's JGB purchases from the current one of about 7–10 years to the initial one of about seven years; and (3) reduce the annual paces of increase in the amounts outstanding of the Bank's holdings of ETFs and J-REITs from the current ones of about 3 trillion yen and about 90 billion yen, respectively, to the initial ones of about 1 trillion yen and about 30 billion yen. Since then, I have continued to submit the same proposal through the most recent MPM held on August 6 and 7. This proposal was formulated based on the judgment that the associated side effects would outweigh the positive effects even under the guidelines employed at the time of the introduction of QQE, in terms of such aspects as the pace of the Bank's JGB purchases. This judgment was formed on careful examination of whether the side effects of QQE are outweighing the positive effects now that two years have passed since the time of the introduction, a milestone that had been borne in mind over that period. I also considered that, if the Bank changed the current guidelines so that the annual pace of increase in the amount outstanding of the Bank's JGB holdings would be about 45 trillion yen – a level below the initial pace employed at the time of the introduction of QQE – excessive pressure on the JGB market would be eased considerably, as the Bank's JGB purchases on an annual basis would be reduced to a level equivalent to below about half the amount of JGBs planned to be issued in scheduled auctions from April 2015 to March 2016 (calendar base).

The proposal I just mentioned is intended only to reduce the pace of the Bank's asset purchases, and not in any way reduce the amount outstanding of its asset holdings. Even if the paces of increase in the monetary base and of the Bank's JGB purchases were to be reduced, accommodative financial conditions would be strengthened in a cumulative manner as the amount outstanding of its asset holdings increases. I personally consider it appropriate, first of all, to proceed with phased reductions, aiming to stabilize the amounts outstanding of the monetary base and of the Bank's JGB holdings at certain levels. However, this does not mean that the Bank will end QQE. It will take considerable time before the end of QQE – that is, when excess reserves are depleted and the amount outstanding of the Bank's JGB holdings is normalized. I consider my proposal as a first step toward somewhat lowering the weight of QQE in the overall policy package and shifting to a flexible policy conduct using a combination of a range of policy tools, including virtually zero interest rates and the fund-supplying measure to stimulate bank lending (the Stimulating Bank Lending Facility).

B. Positive effects of QQE

I would now like to explain the idea behind my proposal in more detail from the viewpoint of positive effects and side effects of QQE.

Firstly, as was stated in "Quantitative and Qualitative Monetary Easing: Assessment of Its Effects in the Two years since Its Introduction," released by the Bank in May 2015, QQE has been effective in increasing domestic private demand through a decline in long-term real interest rates, thereby continuing to exert positive effects on Japan's economy as a whole. In addition, I think that the cumulative effects of the policy have already firmly taken hold in the economy.

I consider that this is evident judging from the degree of narrowing of the following three gaps. First, when the economy faces a shortage of demand, it is considered an important role of monetary policy to close the negative output gap by stimulating the economy from the demand side. As I explained earlier, according to the Bank's estimate, the negative output gap in Japan seems to have almost closed at around the end of 2013, and thereafter the output gap has been at a neutral level. Second, Japan's economy had long been in an undesirable situation because the observed inflation rate had been sluggish whereas the medium- to long-term expected rates of inflation, on which basis firms and households carry out their economic activities, had generally been positive. Since the introduction of QQE, the gap between the medium- to long-term expected rates of inflation and the observed inflation rate has narrowed. Third, reflecting the narrowing of the output gap and the rise in the inflation rate, some estimates indicate that the level of the policy interest rate derived from the Taylor rule has risen from negative territory to around 0 percent, and that the gap between the actual short-term interest rates – which are virtually at around 0 percent – and the derived policy interest rate has almost closed. This suggests the possibility that QQE is overcoming the negative effects of the zero lower bound of interest rates.

However, I consider that the additional effects of QQE have been diminishing since around the middle of 2014, given that the decline in long-term real interest rates, which is considered to be the main source of policy effects, has come to a halt. With regard to nominal interest rates, the declining trend in yields on 10-year JGBs observed through 2014 seems to be coming to a halt. While these developments are affected in part by developments in overseas interest rates, I think that they also stem from a domestic factor of the significant decline in term premiums on JGBs in recent years already having approached its limit. Meanwhile, there have not been major changes in medium- to long-term inflation expectations so far, judging from various surveys and market indicators; these expectations have been relatively stable at a level that remains far from that deemed to be consistent with the price stability target of 2 percent. Given that the global disinflationary trend is likely to persist, I think that it is difficult to encourage medium- to long-term inflation expectations to continue rising solely by presenting the Bank's policy stance of exerting influence on expectations.

C. Side effects of QQE

The side effects of QQE are not necessarily evident at present because they are mostly potential effects. However, due attention needs to be paid to the risk that, once the side effects materialize at some point in the future, it will become difficult to handle them appropriately, and it may become too late to take action. Given this feature of the side effects, I personally pay particular attention to a range of problems arising from excessive impairment of functioning of the JGB market caused by the Bank's large-scale purchases and holdings of JGBs. In other words, these problems are potential risks that could lead to instability in the financial system – such as impairment of functioning of the JGB market, including decreased liquidity or impairment of the price-discovery function.

For example, if liquidity in the JGB market were to decline substantially, the market would become less resilient against negative shocks and thereby become unstable more easily, such that volatility in the market would increase. In particular, since JGB prices affect the price formation of many financial products and assets, risks already may have accumulated in such a way that drastic fluctuations in JGB prices could lead to revisions to prices of a wide range of financial products and assets, thereby exerting severe effects on the financial system and economic activity. In addition, attention should be given to (1) the possibility of a higher risk that the Bank's large-scale JGB purchases will be perceived as central bank financing of fiscal deficits and (2) 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. Furthermore, considering that there is a limit to the amount of JGBs and that the Bank cannot purchase from the market all JGBs issued, a problem regarding the sustainability of the policy of purchasing JGBs may materialize sooner or later. It is very difficult to predict when a limit to the Bank's JGB purchases will arise, but if the purchases were to be hindered suddenly, this could impair the credibility of monetary policy and rapidly increase uncertainty regarding the future monetary policy conduct, thereby leading to a sudden heightening of instability in financial markets.

In addition to these problems related to the JGB market, I am concerned about another side effect of QQE; namely, the risk that the Bank's profits might be reduced in the course of normalizing monetary policy in the future, which could impair its capital or increase the public burden. For example, if the Bank reduced the amount outstanding of its JGB holdings in line with the pace of redemption, its interest income on JGBs would decrease, while its payment of interest on financial institutions' accumulated excess reserves would increase. As a result, the environment for the Bank's profits might deteriorate, thereby impairing its capital. It is necessary to bear in mind that, if such a situation were to occur, this could (1) generate uncertainty about the Bank's financial soundness and impair the stability in the value of the currency and (2) ultimately cause unexpected increases in the public burden as a result of a possible decrease in the Bank's payment to the government and capital injection into the Bank.

I think that such side effects of QQE have not diminished but rather have been increasing with the continuation of QQE. In addition, even if the Bank starts to normalize QQE, it will take considerable time for this to be completed; given this, it is important to fully take into account the side effects of QQE that may emerge over a considerable period of time and conduct monetary policy in a more forward-looking manner than when conducting the conventional interest rate policy. Relative to other economic measures, the side effects of monetary policy are difficult to grasp until they actually materialize. Therefore, I believe that the Bank should thoroughly explain the side effects of QQE widely to the public and show that it conducts policy paying full attention to these effects. I believe that this will enhance the credibility of the Bank's policy, and thereby boost the policy effects.

D. Examination and comparison of positive effects and side effects of QQE

So far, I have described in detail the positive effects and side effects of QQE. My understanding is that, while the positive effects are largely determined by the amount outstanding of the Bank's JGB holdings – that is, the stock of its JGB purchases – the side effects, such as the decline in JGB market liquidity, are considerably affected not only by the stock of the Bank's JGB purchases but also by the pace of such purchases – that is, the flow of these purchases. It is already the case that long-term real interest rates have become less likely to decline despite the increase in the amount outstanding of the Bank's JGB holdings, and therefore additional effects of QQE clearly have been diminishing. Given this situation, I consider that a reduction in the pace of Bank's JGB purchases will reduce the side effects of QQE without significantly constraining the positive effects, thereby enabling the balance between the positive effects and the side effects to improve marginally.

As I mentioned earlier, my policy proposal is not to reduce the stock of the Bank's JGB purchases but to reduce the flow of such purchases. In my view, the cumulative effects of QQE have already firmly taken hold in the economy, and such effects will not diminish significantly unless the Bank reduces the amount outstanding of its JGB holdings. If normalization of QQE – such as the measure to reduce the pace of the Bank's JGB purchases – is postponed in fear of a negative market reaction, this could further increase the potential risk of financial markets becoming unstable, which consequently could ruin the positive results of QQE gained so far. The success of QQE will be judged at the time when its normalization is completed smoothly, and this should be kept in mind.

E. Progress toward achieving the price stability target

As explained so far, I have been proposing at MPMs a change to the guidelines for money market operations and asset purchases, including a reduction in the pace of asset purchases. I also have been submitting a proposal 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.

The Bank's price stability target of 2 percent aims to maintain the 2 percent inflation rate in a stable manner, and not to merely reach it temporarily. In order to achieve this, it is a necessary condition that firms' and households' medium- to long-term inflation expectations – on which basis they carry out their economic activities – increase to about 2 percent and remain stable at that level. I consider that firms' and households' medium- to long-term inflation expectations are mainly determined by supply-side factors – or, the economy's growth potential – such as the potential growth rate and the labor productivity growth rate, rather than by factors such as the following: the level of the Bank's price stability target; the supply and demand balances in goods and services, as well as in the labor market; and developments in the observed inflation rate. From this point of view, I think that the price stability target of 2 percent is well above the level that is consistent with the current growth potential of Japan's economy. Therefore, in my view, it is difficult at this point to achieve the 2 percent target in a stable manner through monetary policy alone, unless structural changes that would increase the underlying trend in inflation make further progress. In this situation, if excessive monetary easing is to continue in order 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 prices.

Moreover, to raise the growth potential of the economy, it is necessary for firms to make technological innovations, as well as active fixed investment, so that such innovations lead to increased productivity. In order to encourage firms to make active fixed investment in Japan and increase the economy's growth potential through accumulation of capital stock, it also is necessary to take measures to increase firms' medium- to long-term expectations for the growth rate of domestic demand. From such a viewpoint, it is important to address structural issues such as population decline and massive government debt, both of which can hinder expansion of domestic demand in the medium to long term. Efforts toward achieving fiscal consolidation are also important not only in terms of ensuring the stability in financial markets and thereby creating an environment in which the effects of QQE will be maximized, but also in terms of enabling smooth normalization of QQE in the future.

As mentioned earlier, my assessment is that QQE has exerted a considerable effect in light of the role originally expected of monetary policy. In this current situation, the future role that monetary policy should play in the overall economic policy is to shift the focus, while maintaining favorable financial conditions, toward consistently providing indirect support for efforts by the government and firms so that the productivity growth rate and the potential growth rate will increase to levels consistent with the 2 percent inflation rate. To this end, it is important to conduct monetary policy with the aim of achieving prolonged economic recovery, albeit moderate, at a pace consistent with the economy's growth potential – that is, the potential growth rate – by reducing the side effects of monetary easing that could lead to financial market turmoil, thereby working to lessen future risks and uncertainty. My proposal to change the guidelines for money market operations and asset purchases, which I have been submitting at MPMs, is based on such a viewpoint. I believe this proposal is a quicker way of achieving the 2 percent price stability target.

In the future conduct of monetary policy, I consider it necessary for the Bank to conduct its policy 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 relation to this, 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 potential growth rate and the sustainable inflation level rise due to efforts by entities such as the government and firms. Such an inflation rate could possibly reach around 2 percent in the medium to long term, but I consider it important to conduct monetary policy based on a reasonable level consistent with the economy's growth potential at each point in time. The second perspective places importance on thoroughly 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 instead to pay close attention to medium- to long-term risks that could lead to instability in the financial system, and thereby aim to achieve economic and price stability in the long run. This contributes to the sound development of the national economy, thereby maintaining and enhancing the credibility of the Bank's policy into the future.