Koji Ishida: Japan's economy, price developments and monetary policy

Speech by Mr Koji Ishida, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Kyoto, 30 July 2015.

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I. Developments in economic activity and prices

A. Overseas economies

Overseas economies – mainly advanced economies – have been recovering, albeit with a lackluster performance still seen in part. Aggregate real GDP growth rate for major economies, weighted by value of exports from Japan, decelerated to around 2.5 percent in the January-March quarter of 2015 due to the slowdown in the U.S. and Chinese economies. Although low crude oil prices since summer 2014 had been expected to push up consumption, the growth rate has been decelerating on a quarterly basis recently – resulting in somewhat sluggish economic conditions.

The projection of global economic growth in the *World Economic Outlook* (WEO) *Update* released in July by the International Monetary Fund (IMF) has been revised somewhat downward for 2015 relative to the April 2015 WEO, but the projection that the growth rate will accelerate toward 2016 is unchanged. Although overseas economies might continue to lack momentum for the time being, the Bank expects that they will continue to recover moderately, as advanced economies will continue to recover firmly and as the positive effects gradually spread to emerging economies.

Looking at movements by major region, the U.S. economy has been recovering, following its exit from the slowdown observed last winter, which was affected mainly by the severe weather. According to U.S. employment statistics for June 2015, the unemployment rate has been decreasing and the number of employees has been increasing firmly. In addition, consumer confidence has been improving. As for the outlook, although attention should be paid to the effects of low crude oil prices and the appreciation of the U.S. dollar, the economy is likely to continue to see growth led mainly by private demand, with robust household spending assisted by the favorable employment and income situation.

Economic activity in the euro area seems to have continued to recover moderately, although there was still tension in financial markets regarding the debt problem in Greece. Private consumption has been increasing, supported in part by the improvement in the labor market, and business sentiment as well as production activity have been recovering moderately. As for the outlook, the euro area economy is likely to maintain its moderate recovery as the effects of the depreciation of the euro and monetary easing will permeate the economy, but close attention should continue to be paid to such risk factors as the debt problem in Europe, including developments in political and economic conditions in Greece.

As for the Chinese economy, the year-on-year growth rate of real GDP for the April-June quarter was 7.0 percent, generally maintaining its stable growth. However, its growth momentum remains sluggish against the backdrop of the deceleration in fixed asset investment, particularly that in real estate, and continued inventory adjustments in manufacturing. Stock prices have been volatile as well. As for the outlook, the economy is likely to follow a generally stable growth path, albeit at a somewhat reduced pace, due to policy measures carried out by the authorities to support economic activity from both the fiscal and monetary sides. However, the nominal GDP growth rate has been declining, and the acceleration of the disinflationary trend as well as the excess debt problem continue to require attention.

Emerging economies have been somewhat weak. Asian economies continue to be underpinned by the positive effects of the recovery in advanced economies and monetary easing, but recently weakness has been seen in exports and production of IT-related goods due to downward pressure from the slowdown in the Chinese economy. Economic activity in Russia and Brazil – that is, the countries facing structural problems and political unrest – continues to be severe. As for the outlook, emerging economies as a whole are likely to gradually increase their growth rates, but the pace is highly uncertain as several economies are facing various structural problems.

B. Japan's economy and price developments

1. Current situation

Now I will discuss developments in economic activity and prices in Japan.

Japan's economy has continued to recover moderately. In the corporate sector, the diffusion index (DI) for business conditions (the proportion of firms responding that business conditions were "favorable" minus the proportion of those responding that they were "unfavorable") in the June 2015 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), which was released at the beginning of July, has improved for large firms in both manufacturing and nonmanufacturing – recovering to a level close to that seen prior to the consumption tax hike in 2014. The DI for small firms has been unchanged for all industries, but it continues to be at a relatively high level. As for business fixed investment, firms have maintained their positive investment stance, as suggested by, for example, the upward revision of their fixed investment plans for fiscal 2015 in the June *Tankan*, with corporate profits increasing to a historical high. In the household sector, despite the effects of irregular weather, private consumption has been resilient, reflecting steady improvement in the employment and income situation, as seen in, for example, the continued improvement in the active job openings-to-applicants ratio. In addition, housing investment has started to pick up. Given these developments, a virtuous cycle from income to spending is expected to continue operating steadily in both the corporate and household sectors.

With regard to prices, the year-on-year rate of increase in the consumer price index (CPI) for all items less fresh food had slowed toward the end of fiscal 2014, due in part to the effects of low crude oil prices. Excluding the direct effects of the consumption tax hike, the rate has been about 0 percent recently.

2. Outlook

Japan's economy is expected to continue recovering moderately. On the price front, the year-on-year rate of increase in the CPI is likely to be about 0 percent for the time being, due to the effects of the decline in energy prices. Nevertheless, as the underlying trend in prices steadily rises and the effects of the decline in crude oil prices dissipate, the rate is likely to accelerate toward 2 percent – the price stability target.

Risks to the outlook are those that primarily stem from overseas factors. Specifically, these include developments in emerging and commodity-exporting economies, the prospects regarding the debt problem and the momentum of economic activity and prices in Europe, and the pace of recovery in the U.S. economy.

The Bank compiles and releases the Policy Board members' forecasts for economic activity and prices on a quarterly basis. Looking at the medians of the members' forecasts released in July 2015, the real GDP growth rate is projected to be 1.7 percent for fiscal 2015, 1.5 percent for fiscal 2016, and 0.2 percent for fiscal 2017. The year-on-year rate of increase in the CPI (all items less fresh food), excluding the direct effects of the consumption tax hikes, is projected to be 0.7 percent for fiscal 2015, 1.9 percent for fiscal 2016, and 1.8 percent for fiscal 2017. The Bank projects that the timing of the rate reaching around 2 percent will be around the first half of fiscal 2016, assuming that crude oil prices will rise moderately from the recent level.

3. *Keys to assessing the outlook*

Next, I will discuss the three keys to assessing economic activity and prices for the time being. These are developments in various components of the economy.

a. Exports and production

The first is developments in exports and production. Real exports had increased for three quarters in a row since the July-September quarter of 2014, but registered negative growth of 3.6 percent in the April-June quarter of 2015, mainly because the slowdown in overseas economies during the first half of the year weighed down on them with some time lag. Industrial production has shown sluggishness recently, partly due to domestic inventory adjustments of small cars with engine sizes of 660cc or less and an accompanying weakness in automobile-related industries – namely, materials – in addition to the slowing in exports.

While the sluggishness in exports and production is likely to exert downward pressure on the real GDP growth rate for the April-June quarter of 2015, which will be released in August, what matters is whether both exports and production will emerge from the pause and trend moderately upward again from summer. At the moment, it seems likely that both will increase moderately, albeit with some fluctuations, due to the rebound in the U.S. economy and the progress in inventory adjustments at home. However, exports could come under downward pressure due to concern over a slowdown in the Chinese economy and a subsequent spreading of its effects to emerging economies, as well as a global decline in business fixed investment related to energy brought about by low crude oil prices. Production is also subject to some uncertainty regarding the pace of progress in inventory adjustments in materials industries. In any event, I would like to closely monitor the pace of improvement in exports and production while paying attention to underlying downside risks.

b. Private consumption and real income

The second key is developments in private consumption and real income, which have a significant impact on prices. Some recent indicators with respect to private consumption have been relatively weak, due partly to adverse weather conditions. Nevertheless, private consumption is likely to remain resilient for the time being, as it is expected to be underpinned by an improvement in the income situation; namely, a rise in base pay this spring and an increase in summer bonus payments. That being said, in a situation where price rises are expected to take hold from the second half of fiscal 2015 onward, improvement in real wages should become an important key to ensuring continued resilience in private consumption.

Looking back on developments in fiscal 2014, the year-on-year rate of change in real wages has remained substantially negative as improvement in wages has not been able to keep up with the substantial price increases, which reflected the effects of the consumption tax hike. This seems to have led to consumers' defensive attitude toward spending, bringing about sluggishness in private consumption and weakness in the supply side's price-setting stance, which until then was starting to show confidence.

Since the turn of fiscal 2015, the year-on-year rate of increase in the CPI (all items less fresh food) has been about 0 percent, but the Nikkei-UTokyo Daily Price Index – which is mainly comprised of daily necessities and food products – has been trending upward, and there has been no sign so far that the trend in price rises will stall as it did last year. This indicates firms' aggressive stance of setting higher prices on the sales front, evidencing the resilience in private consumption. Having said that, although the year-on-year rate of change in real wages – which greatly affects the sustainability of consumption – had recently been rising rapidly, it has just reached close to 0 percent. Thus, I would like to pay attention to the future pace of improvement in real wages.

In assessing developments in private consumption, consumption by pensioners warrants attention. With the aging of the population, the number of pensioners has reached close to

40 million, and the effects their behavior exert on overall private consumption have become significant. From a relatively longer-term perspective, a cut in real pension benefits, owing in part to the introduction of the macroeconomic slide formula, might exert downward pressure on pensioners' consumption. Thus, I believe that even greater attention should be given to future developments.

c. Business fixed investment

The third key is developments in business fixed investment. For part of 2014, growth in business fixed investment was sluggish relative to that in corporate profits and firms' fixed investment plans, partly due to the effects of the decline in demand following the front-loaded increase prior to the consumption tax hike and heightened uncertainty regarding developments in foreign exchange rates and crude oil prices. However, the rate of change in business fixed investment on a real GDP basis turned noticeably positive for the January-March quarter of 2015. Thereafter, the June 2015 *Tankan* showed that firm's fixed investment plans have been relatively strong, particularly of large manufacturing firms, and machinery orders – a leading indicator of machinery investment – have increased as well, indicating a clear improvement in firms' investment stance.

As for the outlook, business fixed investment is likely to continue increasing moderately on the back of an improvement in corporate profits, accommodative financial conditions, and an increase in domestic investment by manufacturing firms in view of developments in foreign exchange rates. However, I presume that there is a risk that the recent deceleration in overseas economies and the accompanying sluggishness in exports and production will weaken business sentiment, which is starting to become aggressive. I believe that the pace of increase in business fixed investment for the time being will be determined by the extent to which firms will be able to gain confidence and certainty regarding the outlook for developments in demand both at home and abroad amid continued moderate recovery in Japan's economy.

II. The Bank's monetary policy

A. The current conduct of monetary policy

Thus far, I have outlined developments in economic activity both at home and abroad and price developments in Japan. Next, I would like to discuss the Bank's monetary policy. I will start by briefly explaining the Bank's current conduct of monetary policy.

1. Quantitative and qualitative monetary easing (QQE)

QQE, which the Bank continues to pursue, has entered the third year since its introduction in April 2013. At the end of October 2014, the Bank decided to expand QQE to preempt the manifestation of a risk that the emergence from the deflationary mindset might be delayed, due mainly to a substantial decline in crude oil prices. The specific measures of the expansion were as follows. First, the Bank decided to accelerate the pace of increase in the monetary base it provides from an annual pace of about 60–70 trillion yen to an annual pace of about 80 trillion yen. Second, it decided to raise the pace of increase in the amount outstanding of the Bank's holdings of Japanese government bonds (JGBs) from an annual pace of about 50 trillion yen to an annual pace of about 80 trillion yen. At the same time, the Bank decided to extend the average remaining maturity of its JGB purchases from about seven years to a flexible range of about seven to ten years. And third, it decided to triple annual purchases of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their amounts outstanding would increase by about 3 trillion yen and about 90 billion yen, respectively.

2. The Loan Support Program and other measures

Prior to the introduction of QQE, the Bank established – on its balance sheet – the Loan Support Program, with the aim of making the effect of monetary easing permeate the entire economy. Through this program, it has been providing support for private financial institutions' efforts to strengthen the foundations for economic growth and to increase their lending. Meanwhile, the Bank has also been conducting the funds-supplying operation to support financial institutions in disaster areas affected by the Great East Japan Earthquake.

Since the establishment in 2010 of the measure that later constituted the Loan Support Program, the Bank has been enhancing the program by, for example, increasing the maximum amount outstanding of its fund provisioning and extending the application period of the program. As a result, the amount outstanding of loan disbursement under the program has reached about 29 trillion yen as of mid-July 2015. Through these efforts, the Bank will further promote financial institutions' lending, as well as stimulate firms' and households' demand for credit and continue to support the efforts of financial institutions in disaster areas toward rebuilding.

B. Assessment of the underlying trend in prices

I will now move on to discussing price developments – a crucial factor in making the Bank's policy decisions – with a particular focus on how to assess the underlying trend in prices in an environment where fluctuations in energy prices observed since 2014 have been exerting a substantial influence on overall prices.

When assessing the underlying trend in prices, I consider it appropriate to also examine for the time being the CPI (all items less energy), given that price fluctuations of energy items since 2014 have been exerting a significant effect on the year-on-year rate of increase in the CPI for all items. There is a view that it is necessary to pay attention to a similar index, the year-on-year rate of increase in the CPI (all items less food and energy). However, in Japan, food expenditures account for a quarter of total household expenditures, which is quite high among advanced economies. Therefore, I personally consider it inappropriate to examine the price index that excludes food, considering the extent to which food expenditures affect households.

In assessing the underlying trend in prices, I also consider it necessary to take note of the characteristics of the components of the CPI basket in Japan. For example, prices of public services and rent in Japan are sticky by nature, and less susceptible to developments in economic activity compared to those in the United States. In addition, imputed rent does not represent households' actual expenditures and the existence of bias in its index has been pointed out due, for example, to the fact that the index does not incorporate deterioration in housing quality. Given the limitations of respective price indexes in accurately grasping prices, I believe it is necessary to make a comprehensive assessment of price developments in the policy conduct, keeping in mind how the CPI is affected by factors such as the characteristics of its components, items on which households actually spend, and people's perceptions of inflation.

C. Transmission effects of monetary policy and financial system stability

Before closing my remarks, I would like to briefly touch on the subject of the transmission effects of monetary policy and the financial system stability.

The Bank has been implementing QQE with the aim of achieving the price stability target of 2 percent. Under QQE, naturally, the Bank has been able to bring about various transmission effects on corporate financing conditions, financial markets, and a variety of asset markets.

Financial institutions have been advancing so-called portfolio rebalancing. While decreasing the amount of their holdings of Japanese government securities (JGSs), they have been increasing various risk assets including foreign currency assets. With QQE's strong monetary easing effects, long-term interest rates have stably remained at extremely low levels. While this has brought down yields on financial institutions' interest-earning assets, firms' funding costs have declined substantially. Moreover, through an improvement in economic activity and corporate profits, stock prices have been rising and real estate transactions have become active.

All of these developments are effects that have emerged with the mechanisms that were intended with QQE's introduction and basically can be regarded positively. To achieve sustainable economic growth with price stability, any large imbalances or overheating on the financial front should be clearly identified. In this regard, I believe that there have been no signs of financial imbalances or overheating to date.

Nevertheless, to ensure financial system stability under QQE, it is necessary to thoroughly examine, from a longer-term perspective and without holding a predetermined view, whether risks are accumulating in the financial system due to excessive strength in financial activity and overheating in economic activity.