Haruhiko Kuroda: Japan’s economy and monetary policy

Speech by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at a meeting with business leaders, Osaka, 28 September 2015.

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Introduction

It is my great pleasure to have the opportunity today to exchange views with a distinguished gathering of business leaders in Kansai. I would like to take this opportunity to express my sincerest gratitude for your cooperation with the Bank of Japan’s branches in Osaka, Kobe, and Kyoto.

Looking at the recent economic developments, the slowdown in emerging economies, particularly China, has led to the sluggishness in Japan’s exports and production. Financial markets globally were volatile against the background of the decline in Chinese stock prices. Meanwhile, on the price front, the year-on-year rate of increase in the consumer price index (CPI, all items less fresh food) is about 0 percent, due mainly to the effects of the substantial decline in crude oil prices from 2014. Thus, somewhat stagnant developments have been noticeable since summer, but as I will explain, the fundamentals of Japan’s economy are sound and the underlying trend in inflation has been improving steadily. Quantitative and qualitative monetary easing (QQE), which the Bank introduced in April 2013, has been exerting its intended effects toward overcoming deflation.

Today, before exchanging views with you, I would like to explain the Bank’s view on the current situation of and outlook for economic activity and prices, as well as its monetary policy.

I. Economic activity in Japan and abroad

Current situation of and outlook for Japan’s economy

Let me start by discussing the current situation of and outlook for Japan’s economic activity.

Japan’s economy has continued to recover moderately with a virtuous cycle from income to spending operating in both the corporate and household sectors, although exports and production are affected by the slowdown in emerging economies. That is, in the corporate sector, profits have marked a record high and firms’ fixed investment stance has been positive. In the household sector, wages have been growing – as seen in the rise in base pay for two consecutive years in a situation where the unemployment rate has declined to the level that can be regarded as almost corresponding to “full employment” – and private consumption has been resilient.

The real GDP growth rate for the April-June quarter of 2015 was minus 0.3 percent on a quarter-on-quarter basis, registering a negative figure for the first time in three quarters (Chart 1). This is due to weak exports affected mainly by the recent slowdown in emerging economies and to somewhat sluggish private consumption reflective of bad weather. Exports are likely to remain more or less flat for the time being, due to the effects of the slowdown in emerging economies. After that, however, they are likely to increase moderately as emerging economies move out of their deceleration phase.

On this basis, Japan’s economy is expected to continue recovering moderately, as the virtuous cycle from income to spending will continue to operate in both the corporate and household sectors. Now, I would like to touch on two points of note when observing Japan’s economic activity.

Robust domestic private demand

First, domestic private demand has continued to be robust.

In the corporate sector, Japanese firms have been improving their profitability considerably in the face of various adversities that have occurred since the global financial crisis. In addition, with the correction of the excessive appreciation of the yen and with the decline in crude oil prices since summer 2014, Japanese firms have been making record profits, exceeding the peak registered before the global financial crisis (Chart 2). Looking ahead, corporate profits are expected to remain at their high levels.

Under this favorable earnings environment, firms' fixed investment stance is positive. Leading indicators such as machinery orders and construction starts also suggest an increase in business fixed investment. Firms' positive fixed investment stance could be confirmed by various survey results. According to the June *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the business fixed investment plans of large manufacturing firms for fiscal 2015 marked their highest level for this time of the year since fiscal 2004, reflecting in part an increase in domestic investment as it appears that the yen is likely to remain weak, and those of small firms marked roughly the same level as the average since fiscal 2000, suggesting robustness. What is worth noting is that, as the excessive appreciation of the yen is corrected, Japanese firms – which had been prioritizing foreign investment – seem to be increasing their domestic investment. This is a big change. On the back of a marked improving trend in corporate profits and the effects of monetary easing, business fixed investment is projected to continue increasing moderately.

Turning to the household sector, labor market conditions are tight as firms have maintained their positive stance in hiring. The unemployment rate, which was above 4 percent before the introduction of QQE, has declined and recently registered 3.3 percent, a low level last seen in 1997, accompanying increases in both the labor force participation rate and the number of employees (Chart 3). Given that there is always a mismatch to some extent between job openings and job applicants in the labor market, the unemployment rate cannot go down to 0 percent. Estimating based on the past relation between job openings and job applicants in Japan, the recent unemployment rate of 3.0–3.5 percent could be regarded as almost corresponding to "full employment." As labor market conditions are tight, nominal wages have been increasing moderately, albeit with some fluctuations. In the annual labor-management wage negotiations this spring, many firms increased wages, including base pay, which was raised to a larger extent than last year (Chart 4). This development has even spread to small firms. Since the number of employees has been increasing and nominal wages per employee have risen, overall employee income has been increasing moderately.

In terms of household spending, private consumption is somewhat sluggish recently, reflecting bad weather in the April-June quarter. Nevertheless, as the employment and income situation has continued with its steady improvement and consumer sentiment is on an improving trend, private consumption seems to have remained resilient on the whole. Looking ahead, with no consumption tax hikes this fiscal year – unlike last fiscal year – and crude oil prices declining on an annual basis, wage increases are expected to exceed price increases and thereby real wages are expected to rise. In this situation, private consumption is expected to be more resilient. Housing investment, the other component of household spending, having declined following the front-loaded increase prior to the consumption tax hike, has picked up evidently since the turn of the year against the backdrop of steady improvement in the employment and income situation. The pick-up is likely to continue going forward.

Exports and overseas economies

Second, I would like to touch on exports and overseas economies. Exports had increased for three quarters in a row since the July-September quarter of 2014, but have recently been more or less flat, due mainly to the effects of the slowdown in emerging economies (Chart 5).

They are expected to remain more or less flat for the time being, but after that, they are likely to increase moderately, supported by the correction of the appreciation of the yen to date as emerging economies move out of their deceleration phase.

Looking closely at the developments in overseas economies by region, the U.S. economy has continued to recover, underpinned by household spending. In the January-March quarter of 2015, economic growth decelerated significantly due to transitory factors such as the effects of the severe winter weather and the strikes at West Coast ports, but a clear rebound was observed in the April-June quarter, with high growth. Against the backdrop of the continued favorable employment and income situation, the growth momentum seems to be solid. The Federal Reserve's tightening coming into sight also suggests improvement of the U.S. economy. The European economy saw continued growth of nine consecutive quarters and has continued to recover moderately. As the financial assistance to Greece is being implemented, global financial markets' view on the situation has become positive. Going forward, as the effects of the depreciation of the euro and monetary easing permeate, the European economy will likely continue to recover moderately.

While the advanced economies are growing steadily, the emerging economies are slowing. First, as for China, the recent substantial decline in stock prices has had a significant impact on global financial markets. This could be regarded as a correction of the excessive level in stock prices that had more than doubled during about the half-year prior to the decline. Nevertheless, the real economy has also seen somewhat of a slowdown recently. With the increase in income levels, the Chinese economy is experiencing a phase of a shift in its economic structure from one centered on manufacturers to one centered on the services sector, leading to a change from high growth to medium growth. The recent slowdown is considered to be the adjustments of excess investment in manufacturers in this phase. The fact that investment in regional economies has been weak as political, economic, and social structural reform is carried out seems to be another reason for the slowdown. Under this situation, the Chinese authorities have been providing a series of economic stimulus measures both on the fiscal and monetary fronts. With relatively large room for conducting policy measures both on the fiscal and monetary fronts, the Chinese economy is likely to follow a generally stable growth path, albeit at a somewhat reduced pace. Emerging economies other than China are also showing sluggishness, reflecting the spillover effects of adjustments in China and global weakness in IT-related demand. This sluggishness is likely to continue for some time, but as the positive effects of the growth in advanced economies spread, economic growth in those emerging economies is expected to gradually accelerate, with domestic demand picking up, supported by economic stimulus measures.

As a main scenario, overseas economies, particularly advanced economies, are expected to continue to grow moderately, and emerging economies are likely to move out of the deceleration phase. On that basis, although Japan's exports are expected to remain more or less flat for the time being, they are likely to increase moderately thereafter. Needless to say, due attention needs to be paid to risk factors including developments in the emerging economies and in the global financial markets.

II. Japan's price developments

I will next talk about Japan's price developments.

The year-on-year rate of increase in the CPI (all items less fresh food) increased from minus 0.5 percent just before the introduction of QQE to 1.5 percent in April 2014, excluding the direct effects of the consumption tax hike. However, as somewhat weak developments in private consumption continued after the consumption tax hike and crude oil prices declined substantially from summer last year, annual CPI inflation declined and has been about 0 percent since the turn of the year (Chart 6).

The absence of an acceleration in headline CPI inflation can be attributed to the negative contribution of energy prices. Because of this negative effect, the year-on-year rate of increase in the CPI has been pushed down by about 1 percentage point in recent months. Needless to say, unless crude oil prices continue to decline, the negative contribution of energy prices to the year-on-year rate of increase in the CPI eventually will dissipate. Simple arithmetic shows that the negative contribution of energy prices falling off alone will push up the year-on-year rate of increase in the CPI by about 1 percentage point compared with the current level.

In addition, although the effects of the decline in energy prices have made it hard to discern, the underlying trend in inflation has steadily improved. For example, the year-on-year rate of change in the CPI for all items less fresh food and energy has been positive for 23 consecutive months since October 2013, and has increased to 1.1 percent according to the latest figure in August. Behind such steady improvement in the underlying trend in inflation is that firms' and households' views on prices have changed.

The changes in firms' and households' views on prices have been revealed in their wage- and price-setting behavior. To begin with, in the spring wage negotiations between workers and management last year, base pay was increased for the first time in two decades. In this year's negotiations, base pay was raised for the second year in a row, and at many firms the increases were larger than last year (Chart 4). Base pay increases were achieved at more firms than last year and became widespread across industries and firms of different size. As for price setting, an increasing number of firms seem to be able to pass increased costs, including the rise in input prices and personnel expenses, on to sales prices. In addition, it seems that households have started to accept such sales price increases on the back of an increase or prospects for an increase in their wages. There is a variety of evidence that firms' price-hiking behavior has become widespread and sustained since the start of this fiscal year. For example, looking at the items that make up the CPI (all items less fresh food), the share of items for which prices rose minus the share of items for which prices fell has risen markedly since the beginning of this fiscal year and recently has reached the highest level since 2000 (Chart 7). In addition, price indices compiled by the University of Tokyo and Hitotsubashi University by aggregating the prices of food and daily necessities also show clear price increases since April this year on a year-on-year basis, and the increases seem to be accelerating. Many firms attempted to raise their sales prices at the beginning of last fiscal year, but this coincided with the consumption tax hike, which was followed by a decline in demand. Firms therefore were forced to quickly take price rises back. The price changes this year present a clear contrast with those last year. The simultaneous occurrence of base pay increases and price hikes should be regarded as evidence that a positive feedback loop between the increases in employment and wages and the moderate rise in inflation is now in place.

Given these developments, although annual CPI inflation is likely to be about 0 percent for the time being, with the underlying trend in inflation steadily rising and the negative contribution of the crude oil price decline dissipating, annual CPI inflation will accelerate toward the price stability target of 2 percent. The timing of reaching around 2 percent is projected to be around the first half of fiscal 2016, but it should be noted that the timing could be either earlier or later than the projection, depending on developments in crude oil prices.

III. Monetary policy going forward

The Bank has been pursuing QQE, aiming to achieve a state in which the 2 percent inflation rate is maintained in a stable manner. The observed inflation rate could move, reflecting various temporary factors; thus, in order to achieve 2 percent in a stable manner, the underlying trend in inflation is important. As I described earlier, the trend has been improving steadily. However, the positive feedback loop between the increases in employment and wages and the rise in inflation should gain further momentum in order to achieve the price stability target of 2 percent.

The Bank will continue with QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will examine both upside and downside risks to economic activity and prices. The Bank maintains its policy stance that, when there are changes in trend inflation due to manifestation of risk factors, it will make adjustments without hesitation if judged as necessary to achieve the price stability target at the earliest possible time.

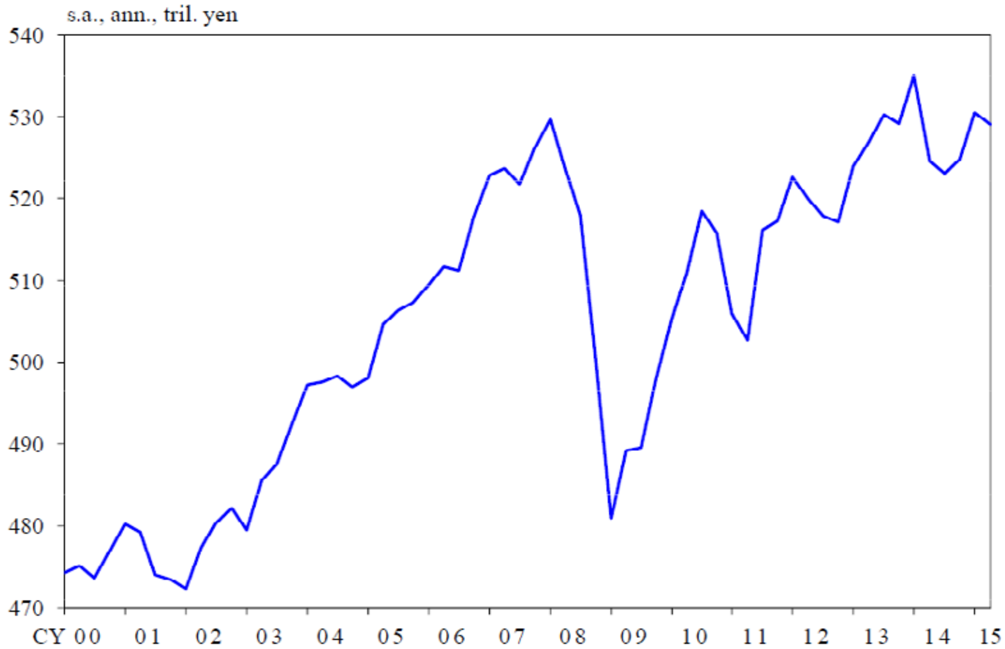
Concluding remarks

Lastly, I would like to touch on the point that I believe is most important to ensuring that a virtuous cycle of the Japanese economy will continue to work. Now firms are enjoying record profits and the labor market is in a full-employment condition. In light of the mechanism of the economy, this naturally would lead to decent economic growth and to moderate increases in wages and prices, a view that I also share. At the same time, it is also true that the pace of increase in fixed investment and wages is lackluster in light of record profits. This is perhaps because deflation has been protracted in Japan and it takes time to change the deflationary mindset of firms and households. With this in mind, the Bank will continue to strongly commit itself to overcoming deflation and to achieving the price stability target of 2 percent. As I have explained on several occasions, in a situation where the 2 percent target is achieved in a stable manner, the current low interest rate environment would not last and the labor shortage would be more acute. Those who act early to move forward to secure opportunities in the future by utilizing profits currently at hand will be rewarded, and I am sure some of you have already started to act. The mechanism of the economy will surely prevail, and the Bank will definitely and decisively play its role. I will conclude my remarks by making this promise.

Thank you.

Chart 1

Real GDP



Source: Cabinet Office.

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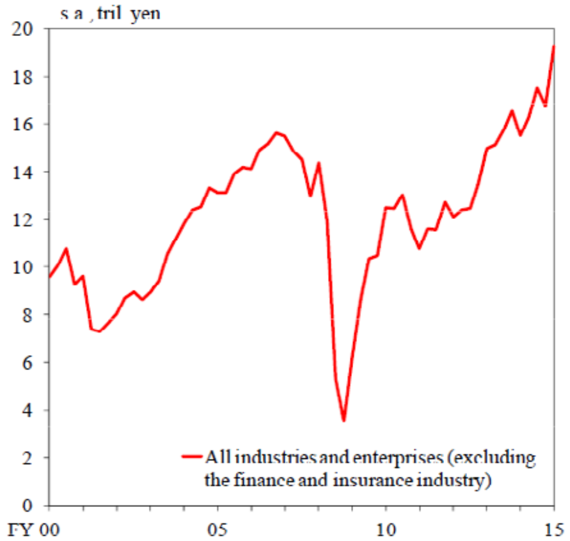
Chart 2

Corporate Profits and Business Fixed Investment

Current Profits



Tankan: Business Fixed Investment Plans

y/y % chg

		FY2014	FY2015 (Forecast)
Large Enterprises	Manufacturing	+ 5.6	+ 18.7
	Nonmanufacturing	+ 6.0	+ 4.7
	All industries	+ 5.9	+ 9.3
Small Enterprises	Manufacturing	+ 9.6	- 9.9
	Nonmanufacturing	- 5.0	- 18.4
	All industries	- 0.8	- 15.7
All Enterprises	Manufacturing	+ 6.8	+ 12.3
	Nonmanufacturing	+ 3.1	- 1.0
	All industries	+ 4.3	+ 3.4

Note: Figures for business fixed investment plans of the *Tankan* include land purchasing expenses but exclude software investment.
Sources: Ministry of Finance, Bank of Japan.

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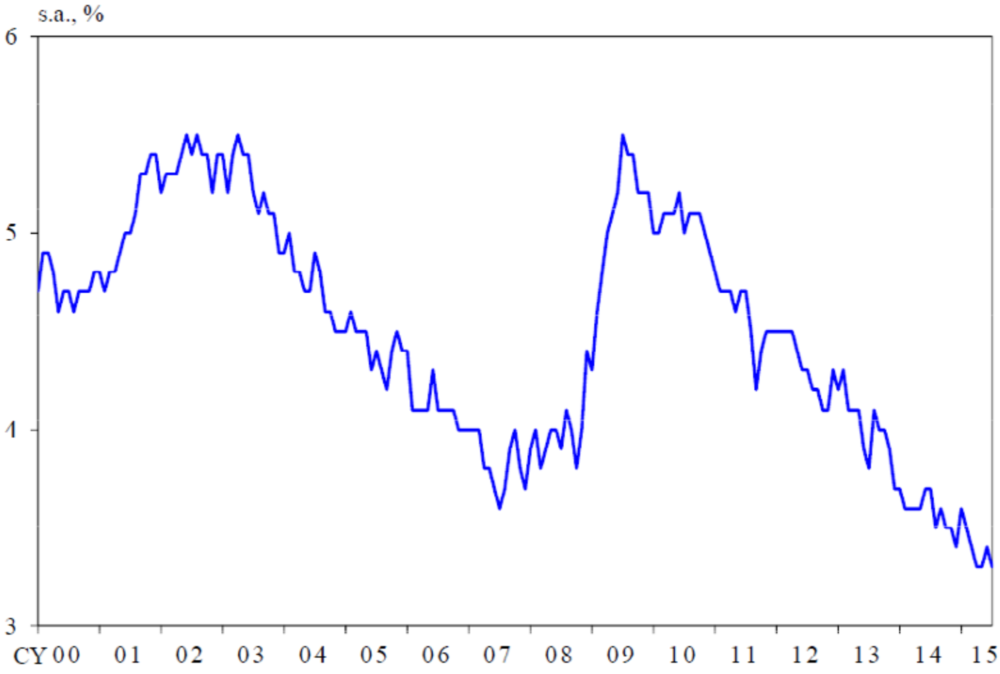
Chart 3

Unemployment Rate



Source: Ministry of Internal Affairs and Communications.

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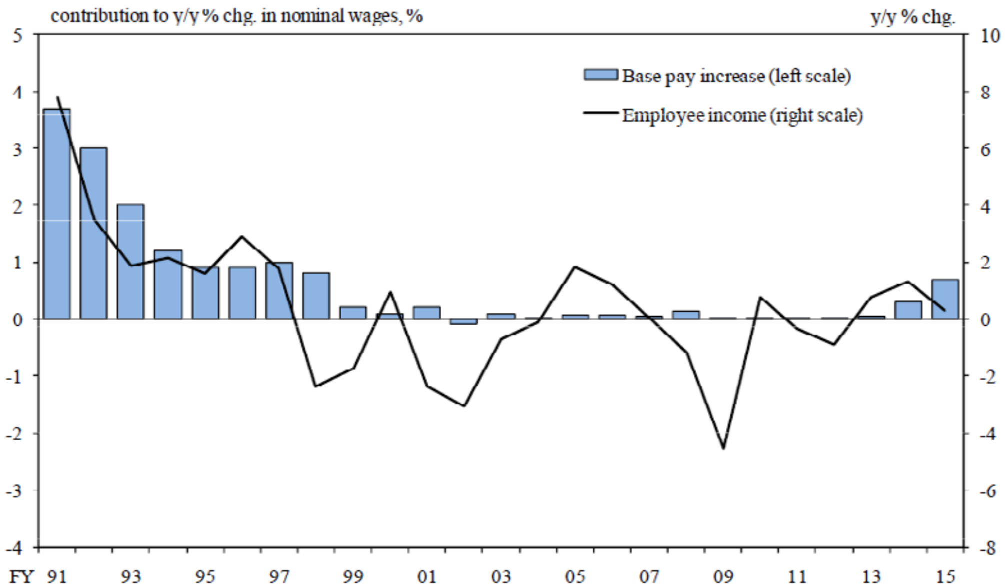
Chart 4

Employee Income and Base Pay Increase



Notes: 1. Figures for "employee income" are calculated as the "number of employees" (Labour Force Survey) times "total cash earnings" (Monthly Labour Survey).
2. The figure for fiscal 2015 for employee income is the April-July average.
3. Figures for the base pay increase up through fiscal 2014 are taken from the Central Labour Relations Commission, and the figure for fiscal 2015 is taken from the Japanese Trade Union Confederation (RENGO).

Sources: Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications, Central Labour Relations Commission, Japanese Trade Union Confederation (RENGO).

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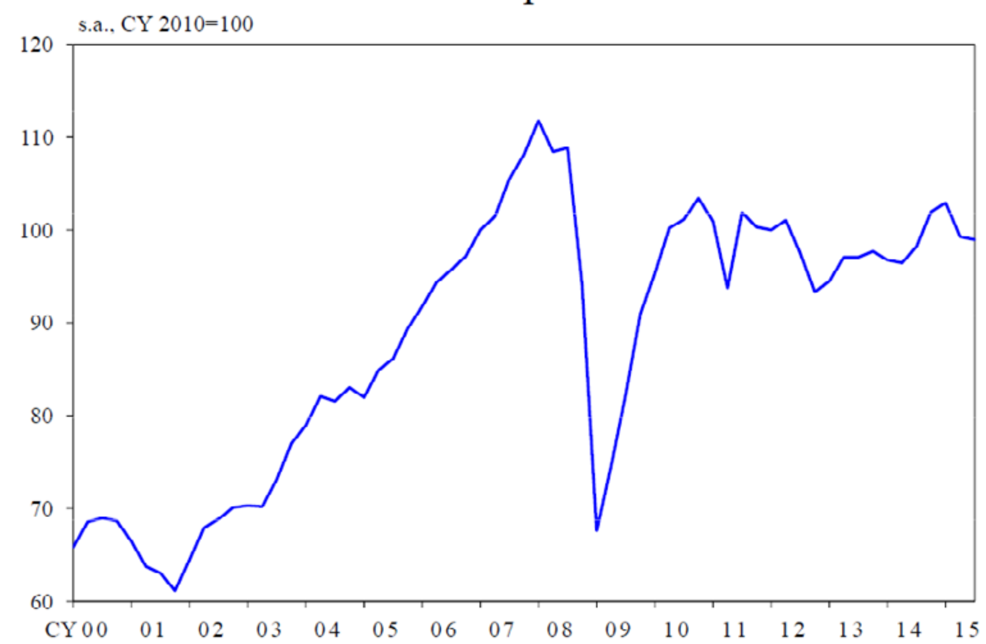
Chart 5

Real Exports



Note: The figure for 2015/Q3 is the July-August average.
Sources: Ministry of Finance; Bank of Japan.

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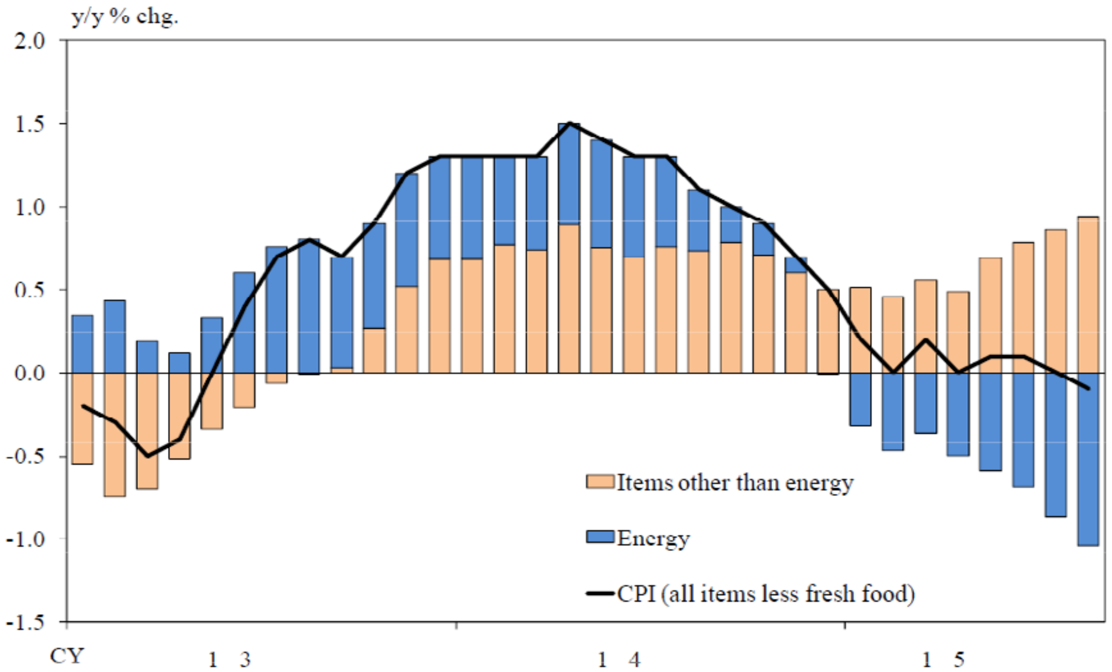
Chart 6

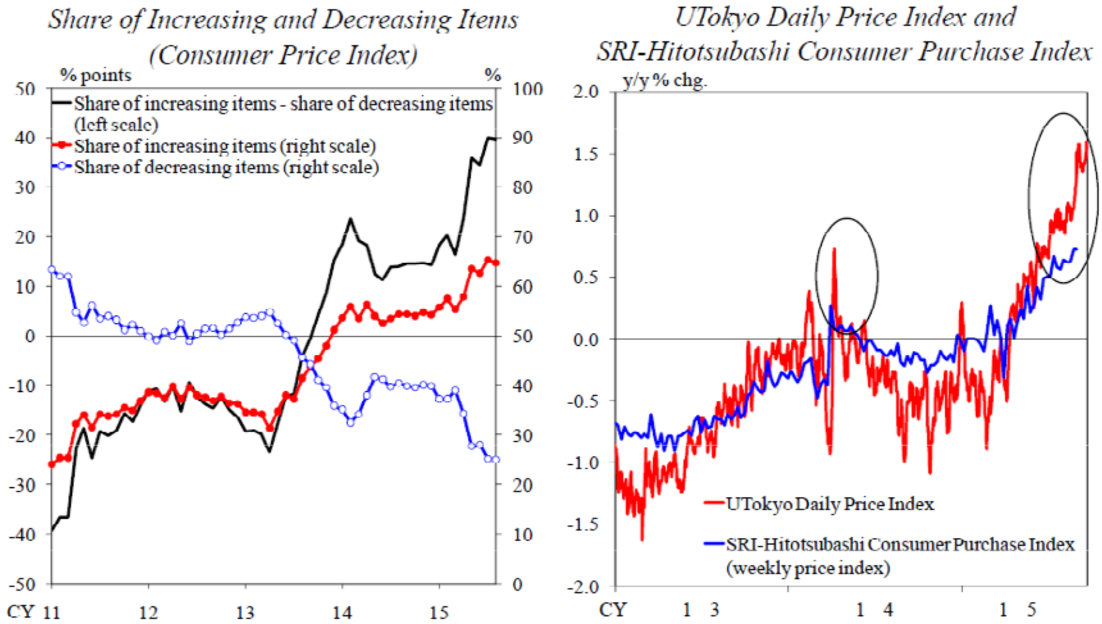
Consumer Prices



Note: Figures are estimated by adjusting the direct effects of the consumption tax hike in April 2014.
Source: Ministry of Internal Affairs and Communications.

Chart 7

Price Developments



Notes: 1. The share of increasing/decreasing items is the share of items in the consumer price index (all items less fresh food) whose price indices increased/decreased from a year earlier. The price indices are estimated by adjusting the direct effects of the consumption tax hike in April 2014.

2. The UTokyo Daily Price Index is a 7-day backward moving average.

Sources: Ministry of Internal Affairs and Communications; UTokyo Daily Price Index Project; Research Center for Economic and Social Risks, Institute of Economic Research, Hitotsubashi University.

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