Kikuo Iwata: Japan's economy and monetary policy

Speech by Mr Kikuo Iwata, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Okayama, 2 December 2015.

*   *   *

Accompanying charts can be found at the end of the speech and on the Bank of Japan's website.

Introduction

It is my pleasure to have the opportunity today to exchange views with administrative, financial, and business leaders in Okayama Prefecture. I would like to take this chance to express my sincerest gratitude for your cooperation with the activities of the Bank of Japan's Okayama Branch.

Today, I would like to have your views on the actual situation of the local economy as well as your candid opinions about the Bank's policies and activities.

Before exchanging views with you, I will briefly explain the recent economic developments at home and abroad, and then touch on some points regarding monetary policy.

I. The current situation of Japan's economy and its outlook

Looking at Japan's economy, exports and production are affected by the slowdown in emerging economies, particularly China. However, with firms having seen record profits, a virtuous cycle from income to spending in both the corporate and household sectors is in place, and Japan's economy has continued to recover moderately. In the following, I would like to elaborate on this issue.

A. Developments in exports and overseas economies

Japan's exports have been more or less flat recently (Chart 1). Breaking these down by region, exports to advanced economies such as the United States and Europe have maintained their moderate increasing trend, but those to emerging economies have shown weaker developments, particularly to East Asia. The background to this is that the decelerated situation for the Chinese economy is continuing with downward pressure from excess capacity and inventory adjustments in the manufacturing sector, and that the effects of the Chinese economy have been spreading to other emerging and commodity-exporting economies through trade. In this situation, Japan's production also has been more or less flat.

As for the outlook for overseas economies, it is likely that the effects of the slowdown in emerging economies will remain for the time being, but that moderate growth, mainly in advanced economies, will continue, and this will positively affect emerging economies. The Chinese economy is expected to generally follow a stable growth path with a variety of economic stimulus measures being implemented. As shown in the October 2015 World Economic Outlook (WEO) published by the International Monetary Fund (IMF), global growth for this year is projected to decline somewhat to 3.1 percent, but for 2016, it is projected to moderately accelerate on the whole and register 3.6 percent (Chart 2).

In this situation, Japan's exports and production are expected to remain more or less flat for the time being, but after that they are likely to increase moderately. Nevertheless, taking account of the decline in growth expectations for and excess capacity in emerging and commodity-exporting economies, risks for the time being seem to continue to skew to the downside, and this warrants close attention.

B. Developments in domestic private demand

Despite the lackluster developments in exports and production I have outlined, corporate profits are at record high levels (Chart 3). The improvement in corporate profits is partly due to a fall in commodity prices – particularly crude oil prices – and to the rise in repatriated income from overseas business through dividends and interest, which has accelerated partly as a result of the correction of excessive appreciation of the yen.

In addition, what can be pointed out as a characteristic of the recent economic recovery is the fact that the recovery of the nonmanufacturing sector has been marked on the back of the resilience in domestic demand. In the past economic recoveries, the general course of events was an increase in exports leading to a rise in production and rises in corporate profits and business fixed investment in the manufacturing sector; this time, however, different developments are being seen. According to the September *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the diffusion index for business conditions in the nonmanufacturing sector improved to a level exceeding that seen during the economic recovery period in the mid-2000s, while some cautiousness has been observed in the manufacturing sector.

An improvement in corporate profits is producing a virtuous cycle that is spreading to domestic private demand through the corporate and household sectors. First, the corporate sector is maintaining its positive fixed investment stance. This can be confirmed by the high year-on-year rate of growth in fixed investment plans for all enterprises and industries for fiscal 2015; namely, 6.4 percent, as shown in the September *Tankan*.

Turning to the household sector, the employment and income situation has been improving steadily. Labor market conditions have continued to tighten and the active job openings-to-applicants ratio is at a high level last seen in 1992. The unemployment rate for October has declined to 3.1 percent, a low level last seen in 1995.

Under this circumstance, upward pressure is being exerted on wages. Scheduled cash earnings in the *Monthly Labour Survey* have been positive on a year-on-year basis for three consecutive quarters since the turn of the year, with base pay being raised for two years in a row (Chart 4). Private consumption has been resilient, as evidenced by a clear increase on a quarter-on-quarter basis for the July-September quarter against the background of steady improvement in the employment and income situation.

That said, a virtuous cycle in both the corporate and household sectors has been maintained in Japan's economy. The real GDP growth rate for the July-September quarter was slightly negative for a second consecutive quarter, but this is mainly due to the progress in inventory adjustments, and final demand as a whole has been increasing. Turing to the outlook, Japan's economy through fiscal 2016 is likely to continue growing at a pace above its potential, which is estimated to be around 0.5 percent or lower recently. As shown in the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) released at the end of October, the outlook in terms of the median of the Policy Board members' forecasts of the real GDP growth rate was 1.2 percent for fiscal 2015 and 1.4 percent for fiscal 2016.

II. Monetary policy and price developments in Japan

As I have explained, Japan's economy is likely to continue growing at a pace above its potential. In this situation, how are prices expected to develop? Next, I would like to talk about price developments in Japan after touching on the Bank's monetary policy.

A. Change in policy regime

The Bank is implementing quantitative and qualitative monetary easing (QQE) that aims at converting people's deflationary mindset, which has been formed firmly amid the prolonged period of deflation, to one that moderate inflation is to be expected. That is, it is preparing a foundation on which people can act on the assumption that prices will continue to rise moderately.

QQE consists of two pillars. The first is a clear commitment under which the Bank will achieve the price stability target of 2 percent in terms of the year-on-year rate of change in the consumer price index (CPI) at the earliest possible time, with a time horizon of about two years.

The second pillar is the Bank's thorough communication of its measures and implementation of them to achieve the price stability target. These measures are to massively increase the "quantity" of the monetary base through the Bank's large-scale asset purchases – mainly the purchase of Japanese government bonds (JGBs) – and to change the "quality" of its asset purchases, mainly through the purchase of long-term government bonds that entail relatively large risks (Chart 5).

By pursuing QQE, the Bank aims at decreasing expected real interest rates through exerting downward pressure on nominal interest rates across a wide range of maturities and raising peoples' inflation expectations toward 2 percent (Chart 6). The decline in expected real interest rates will lead to a rise in prices of risky assets such as equities and hence to an increase in private consumption through the wealth effect. In addition, with the excessive appreciation of the yen being corrected, real exports have increased, albeit moderately, and exporting companies' earnings have improved, due partly to an improvement in profitability. In this situation, the number of foreign visitors to Japan has also increased noticeably. Moreover, households and firms, which have devoted their efforts to increase their savings, are expected to expand housing investment or business fixed investment in view of the decline in expected real interest rates and the improvement in their income and financial conditions.

As illustrated above, QQE aims at raising the observed inflation rate toward 2 percent by increasing aggregate demand through several transmission channels in which its effects start with the decline in expected real interest rates brought about by the drastic change in the policy regime.

B. Developments in the underlying trend in inflation

In the Bank's current outlook for prices, the timing in which the year-on-year rate of change in the CPI (all items less fresh food) reaches around 2 percent is projected to be around the second half of fiscal 2016. Comparing the current projection to the previous one, the timing is likely to be delayed. That said, the delay is mainly due to the effects of the decline in crude oil prices, and the underlying trend in inflation itself can be judged to be improving steadily as the transmission mechanism of policy effects has worked as expected. Here, I would like to discuss developments in the underlying trend in inflation from the following three perspectives: (1) those in consumer prices; (2) those in the output gap, which is a gap between aggregate demand and supply capacity of the economy as a whole; and (3) those in medium- to long-term inflation expectations.

1. Developments in consumer prices

To begin with, let me talk about developments in consumer prices. The year-on-year rate of change in the CPI for all items less fresh food has been about 0 percent recently. However, in the case where crude oil prices decline by about 50 percent in a short period, as they did for some months starting from last summer, the CPI excluding fresh food and energy (hereafter, the CPI excluding energy) becomes a more important indicator in assessing the underlying trend in inflation.

To verify this point, I would like to break down the year-on-year rate of change in the CPI for all items less fresh food (hereafter, the CPI including energy) into two components: the contribution of energy items and the contribution of the CPI excluding energy (Chart 7).

Until the introduction of QQE, the year-on-year rate of change in the CPI including energy had mostly been hovering within slightly negative territory, with a positive contribution of energy items being offset by a negative contribution of the CPI excluding energy. This means that, if price developments had been assessed on the basis of the CPI excluding energy instead of the CPI including energy, they should have been judged as being deeper in deflation.

By contrast, after the introduction of QQE, the negative contribution of the CPI excluding energy started to lessen. Its contribution turned positive in early autumn 2013 and moved further into positive territory until around April 2014 when the consumption tax rate was raised. During the same period, with the positive contribution of energy items, the year-on-year rate of change in the CPI including energy – excluding the direct effects of the consumption tax hike – also continued to rise and reached 1.5 percent in April 2014. In other words, annual CPI inflation had continued to rise steadily toward 2 percent from the introduction of QQE until around April 2014 when the consumption tax rate was raised.

Thereafter, until early 2015, partly due to the effects of the consumption tax hike, the positive contribution of the CPI excluding energy – and also excluding the direct effects of the consumption tax hike – shrank. Moreover, since around the summer of 2014, a substantial decline in crude oil prices has become a factor that decreases the year-on-year rate of increase in the CPI. In light of these developments, the Bank decided at the end of October 2014 to expand QQE in order to preempt manifestation of a risk that conversion of the deflationary mindset might be delayed and to maintain the improving momentum of expectation formation.

Looking at the developments after the expansion of QQE, the positive contribution in the CPI excluding energy stopped decreasing in early 2015 and then resumed an uptrend. The positive contribution has been about 1 percentage point recently, thus marking the largest size since the introduction of QQE. During the same period, the year-on-year rate of change in the CPI including energy has declined, which can be attributed mainly to an increase in the negative contribution of energy items.

Given these developments, it can be judged that the underlying trend in inflation, which was on the verge of returning to deflation due to the consumption tax hike, has come back since the turn of 2015 on a rising path toward 2 percent thanks to the effects of the expansion of QQE.

2. Output gap

Next, I would like to talk about developments in the output gap, which can be defined as a gap between the aggregate demand and supply capacity of Japan's economy. In short, the output gap is likely to improve steadily against the backdrop of an expansion of demand such as business fixed investment and private consumption.

With regard to business fixed investment, as I have explained, surveys including the *Tankan* suggest that firms' fixed investment plans for fiscal 2015 have been at high levels. Although firms' actual fixed investment has been somewhat weaker than planned so far, possibly in view of high uncertainty over prospects regarding the slowdown in emerging economies, for example, it is expected to take place firmly sometime soon.

With regard to private consumption, the employment and income situation is the key. On this point, labor market conditions have continued to tighten, as I have mentioned, and a rise in wages has started to spread across industries and by size of firms. Looking ahead, reflecting historical high corporate profits and the tight labor market, wages are expected to gradually rise further, which will underpin resilience in private consumption.

Therefore, increases in business fixed investment and private consumption are likely to lead to an improvement in the output gap and thereby push up prices moderately. Such a virtuous cycle is likely to become more evident going forward.

On this point, looking at the recent developments in fixed investment and wages in relation to corporate profits, it is true that these give the impression that the paces of increase in fixed investment and wages were still relatively slow when considering that firms have been making record profits (Chart 8). However, this situation has started to change as the output gap has continued to improve moderately and is expected to turn to excess demand.

3. Medium- to long-term inflation expectations

Lastly, I would like to talk about inflation expectations. Looking from a somewhat longer-term perspective at results of various surveys such as those conducted of firms and households, these expectations started to increase around the introduction of QQE (Chart 9). Although there are some indicators that show relatively weak developments recently, firms' price-setting behavior clearly has changed, particularly since the start of this fiscal year. Firms' price-hiking behavior has become widespread and sustained. Looking ahead, as the observed inflation rate rises toward 2 percent, which itself will push up inflation expectations, medium- to long-term inflation expectations are also likely to rise toward 2 percent.

As I have explained, an examination of all three developments – namely, those in the CPI, the output gap, and inflation expectations – confirms that the underlying trend in inflation has been improving steadily toward achieving the price stability target of 2 percent. On this basis, the year-on-year rate of increase in the CPI including energy is projected to reach around 2 percent around the second half of fiscal 2016, taking into account such developments as those in crude oil futures prices.

Of course, in reality, there are various uncertainties in the global economy. The most significant risk at this moment is that a further slowdown in the emerging economies, particularly China, and commodity-exporting economies will exert negative effects on Japan's economy, which will exert downward pressure to the underlying trend in inflation. As for the future monetary policy management, if the manifestation of such risk leads to a deterioration of the underlying trend in inflation, the Bank will make adjustments without hesitation.

Concluding remarks

In conclusion, let me touch on the economy of Okayama Prefecture.

The prefecture is privileged not only for being a transport node that connects the Chugoku and Shikoku regions, but also for experiencing natural disasters less frequently than others; industries taking advantage of this geography have been underpinning the economy of the prefecture through the ages.

Specifically, many factories of iron and steel products, motor vehicles, and chemical products are located in Okayama Prefecture, and Mizushima Coastal Industrial Area in particular, and about 30 percent of gross product in the prefecture is by manufacturers.

Nonmanufacturers saw consecutive construction starts of large distribution centers covering the whole of the Chugoku and Shikoku regions making use of the highway network, and the floor area of warehouses has increased by slightly less than 20 percent in the last ten years. Initiatives to start up new businesses have been observed in sectors with growth potential; for example, in Maniwa City, which is located in the north of the prefecture, a biomass power station – using timber from forest thinning for fuel – co-funded by local businesses has started to operate in April this year.

Moreover, Okayama Prefecture is endowed with tourist attractions such as Korakuen, the Kurashiki Bikan historical quarter, and the Shizutani School. I have heard that these are attracting many visitors within Japan and from abroad. Last month, the first Okayama marathon was held in Okayama City and many people from all over Japan have participated in it. In May next year, the Summit Education Minister's Meeting will be held in Kurashiki City. Through these opportunities, I hope the fascination with Okayama Prefecture will further expand within Japan and to abroad.

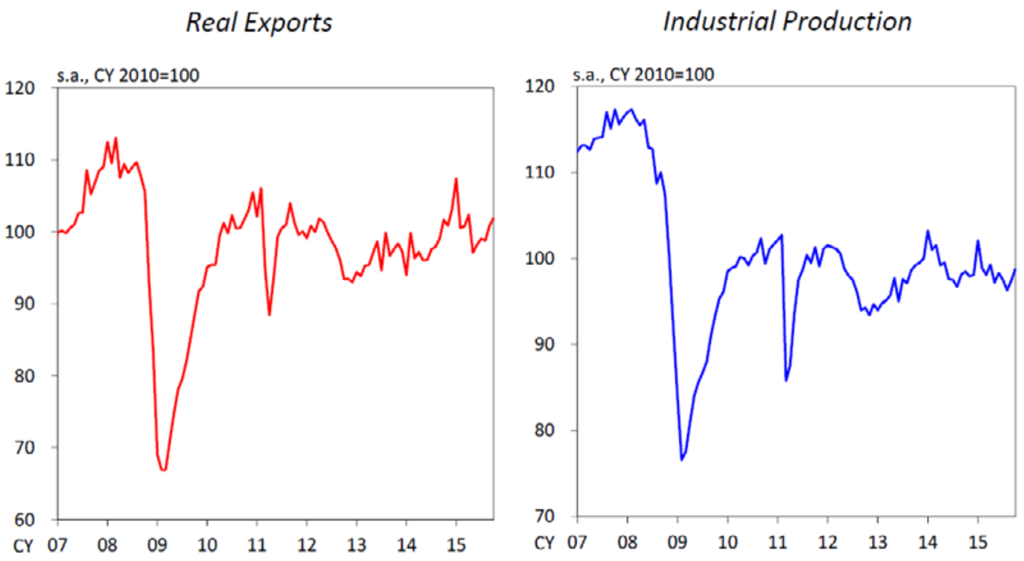
I believe people in Okayama Prefecture have already been tackling new challenges while fully exploiting the inherited merits of geographical conditions and rich tourism resources. I would like to encourage the staff at the Okayama Branch to contribute to these developments in this region through their analysis of the regional economy and dissemination of information.

In closing, I wish you all the best for the further development of the regional economy.

Thank you.

Chart 1

Exports and Production

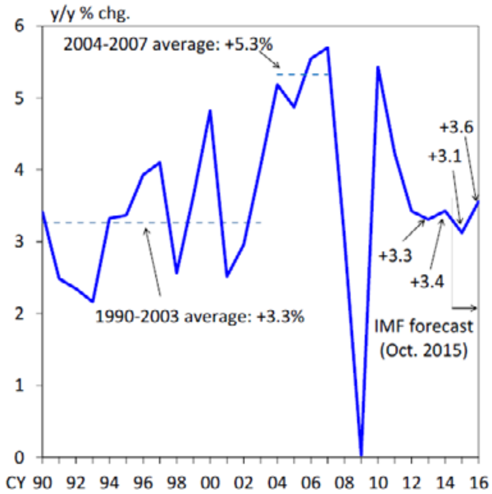


Sources: Ministry of Finance, "Trade Statistics"; Bank of Japan, "Corporate Goods Price Index"; Ministry of Economy, Trade and Industry (METI), "Indices of Industrial Production."

Chart 2

World Economic Outlook

Real GDP Growth Rate



Projections for Major Economies (as of Oct. 2015)

y/y % chg.

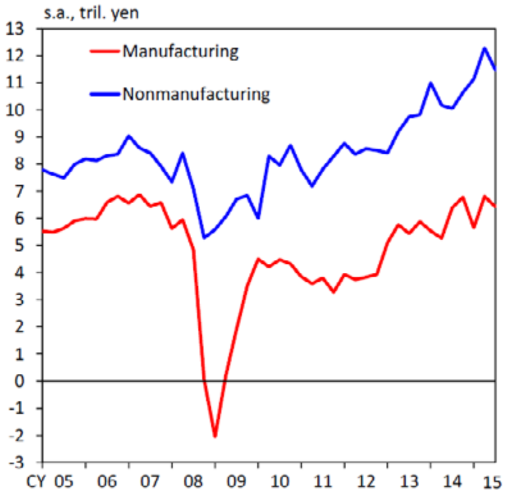
	2013	2014	Projections 2015	Projections 2016
World	3.3	3.4	3.1	3.6
Advanced Economies	1.1	1.8	2.0	2.2
United States	1.5	2.4	2.6	2.8
Euro Area	-0.3	0.9	1.5	1.6
Japan	1.6	-0.1	0.6	1.0
Emerging Market and Developing Economies	5.0	4.6	4.0	4.5
China	7.7	7.3	6.8	6.3
ASEAN5	5.1	4.6	4.6	4.9

Note: ASEAN5 are Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam.
Source: IMF, "World Economic Outlook."

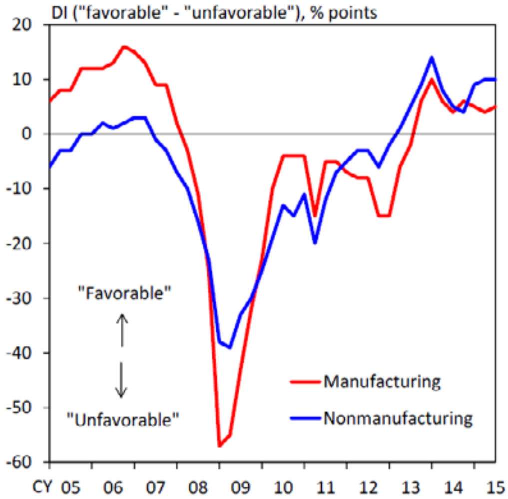
Chart 3

Corporate Profits and Business Sentiment

Current Profits



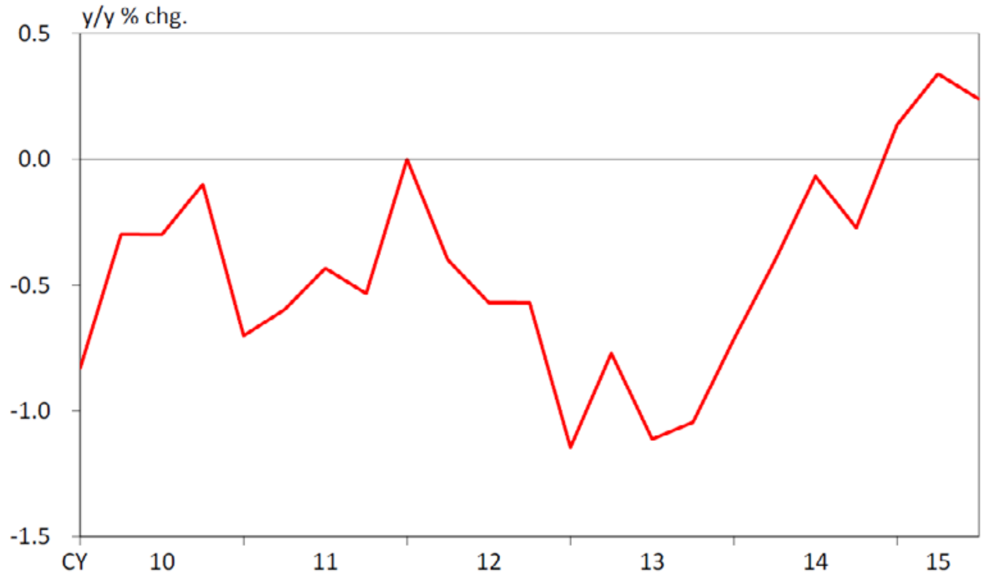
Tankan: Business Conditions DI



Note: Figures for current profits exclude those for the finance and insurance industries.
Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly"; Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan."

Chart 4

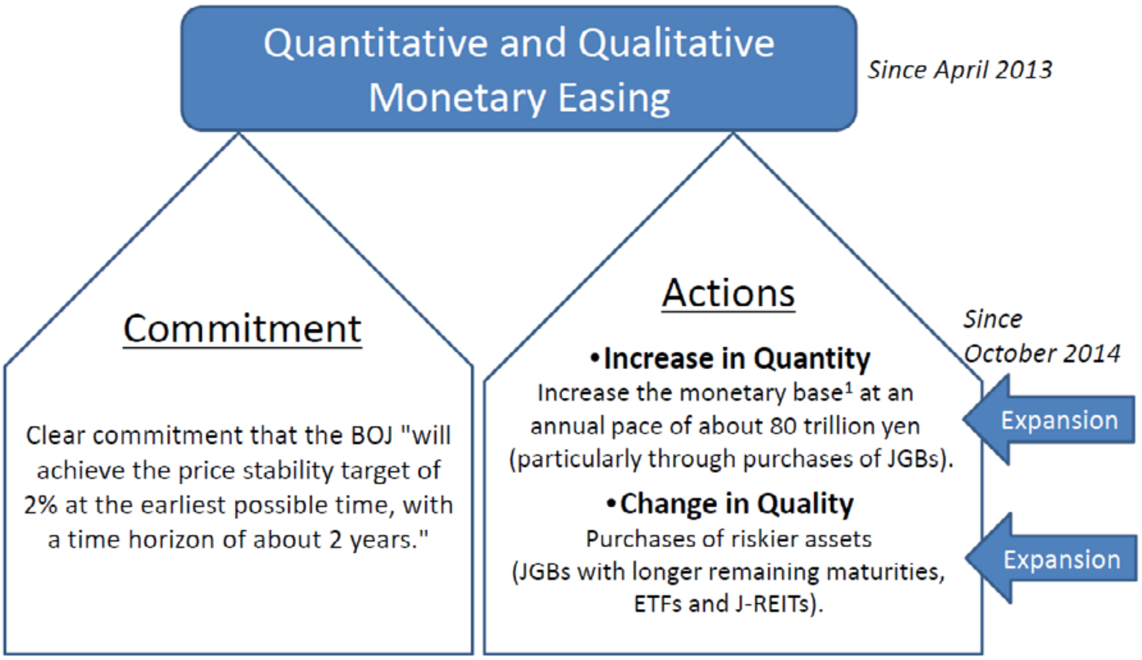
Scheduled Cash Earnings



Source: Ministry of Health, Labour and Welfare, "Monthly Labour Survey."

Chart 5

Tangibility of "Policy Regime Change"



Note: 1. Money supplied directly from the central bank to the financial system.

Chart 6 Lowering Expected Real Interest Rates through Working on Inflation Expectations

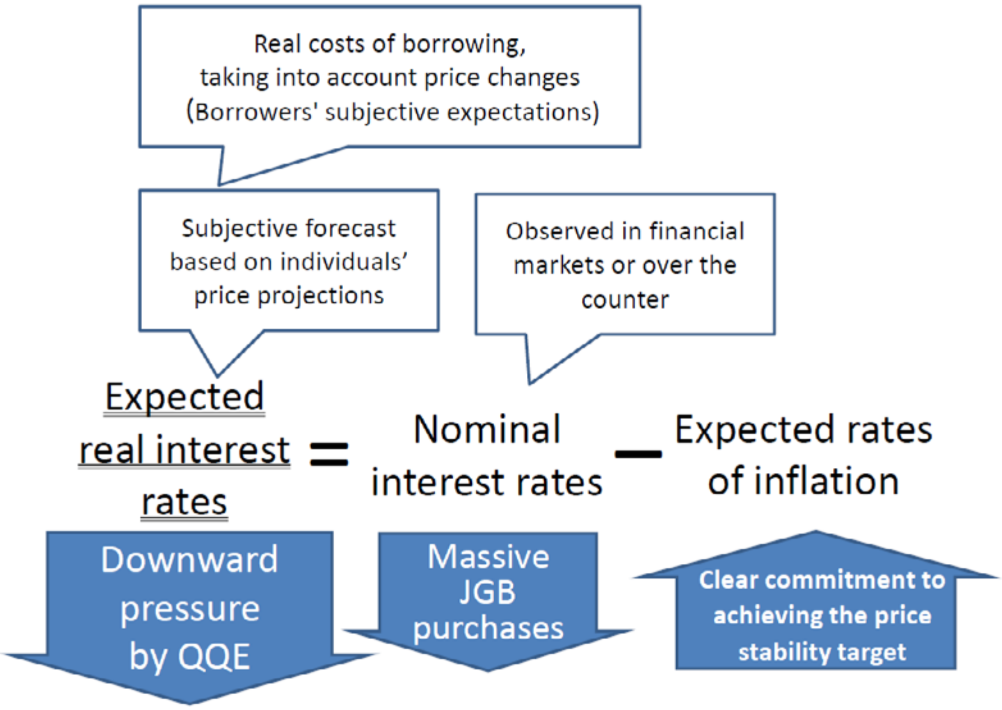
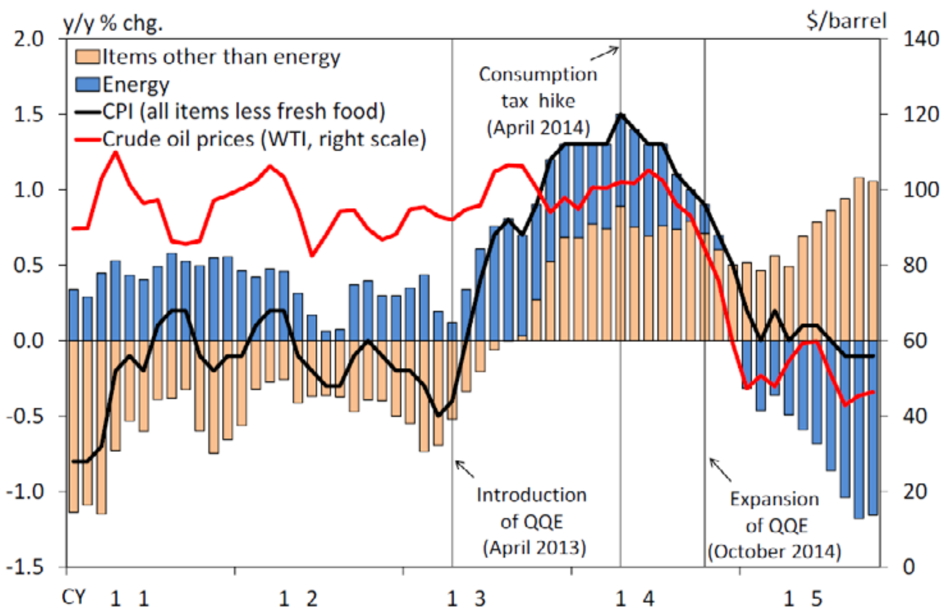
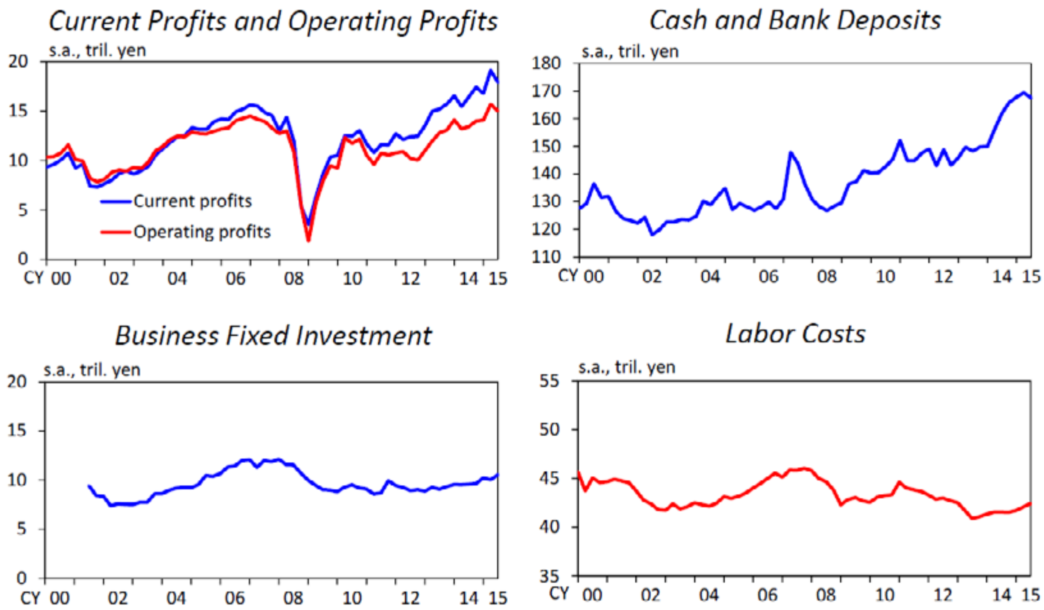


Chart 7 Consumer Prices



Note: Figures for consumer prices are adjusted to exclude the estimated effect of changes in the consumption tax rate.
Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index"; Bloomberg.

Chart 8 Corporate Profits, Business Fixed Investment, and Labor Costs



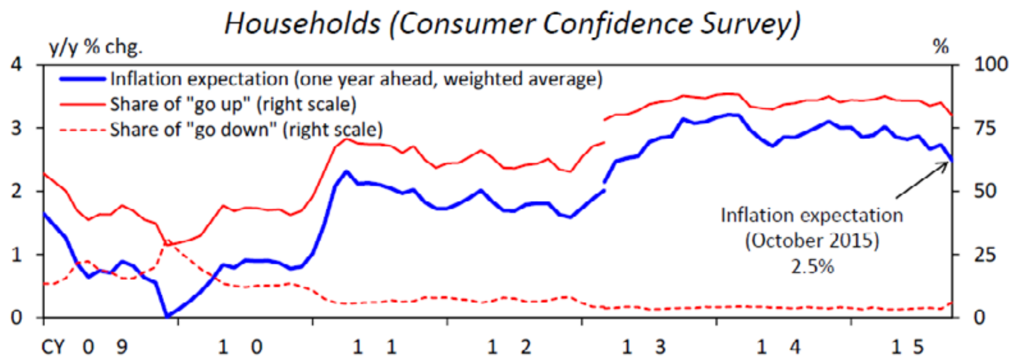
Notes: 1. Excluding the finance and insurance industries.
2. Figures for business fixed investment include software investment, and exclude those for the goods rental and leasing industry.

Chart 9 Inflation Expectations

Enterprises (Tankan: Outlook for General Prices)

y/y % chg.

	1 year ahead			3 years ahead			5 years ahead		
	All enterprises	Large enterprises	Small enterprises	All enterprises	Large enterprises	Small enterprises	All enterprises	Large enterprises	Small enterprises
Mar. 15	1.4	1.0	1.6	1.6	1.2	1.7	1.6	1.2	1.8
Jun. 15	1.4	1.0	1.5	1.5	1.2	1.7	1.6	1.1	1.8
Sep. 15	1.2	0.9	1.3	1.4	1.1	1.6	1.5	1.1	1.6



Note: The Consumer Confidence Survey asks households to provide their price expectations one year from now. Figures are for all households. The inflation expectation (one year ahead, weighted average) is calculated based on the following assumption: survey responses chosen by households as their expected inflation rates -- "-5% or below," "from -5% to -2%," "from -2% to 0%," "from 0% to +2%," "from +2% to +5%," and "+5% or above" -- indicate inflation rates of -5%, -3.5%, -1%, +1%, +3.5%, and +5%, respectively.
Sources: Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan"; Cabinet Office, "Consumer Confidence Survey."