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, Kagoshima, 25 February 2016.

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I. Economic activity and prices in Japan

A. Current situation

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

Japan's economy has continued to recover moderately. Overseas economies – mainly advanced economies – have continued to grow at a moderate pace, despite the slowdown in emerging economies. In this situation, exports have been picking up, although sluggishness remains in some areas, and industrial production has been more or less flat. On the domestic demand side, business fixed investment has been on a moderate increasing trend as corporate profits have continued to improve markedly, and private consumption has been resilient against the background of steady improvement in the employment and income situation. The first preliminary estimate of the real GDP growth rate for the October-December quarter of 2015 was minus 1.4 percent on an annualized quarter-on-quarter basis. Meanwhile, as for prices, the year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is about 0 percent.

B. Outlook

Against the background of such developments, the Bank of Japan revised the forecasts for both economic activity and prices for the period from fiscal 2015 through fiscal 2017 in its January 2016 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report).

Comparing the median of the Policy Board members' forecasts in the January 2016 Outlook Report with that in the October 2015 report, the projection for the real GDP growth rate was more or less unchanged. In other words, Japan's economy is likely to continue growing at a pace above its potential through fiscal 2016, and thereafter, through fiscal 2017, is likely to maintain its positive growth, although with a slowing in its pace, due mainly to the effects of the consumption tax hike planned in April 2017.

The projection for the year-on-year rate of change in the CPI (all items less fresh food) for fiscal 2016 was revised downward somewhat largely, due to the assumption of lower crude oil prices. Specifically, the projection was revised downward from 1.4 percent in the October 2015 Outlook Report to 0.8 percent in the January 2016 report. For fiscal 2017, however, the projection was more or less unchanged at 1.8 percent. In other words, the year-on-year rate of change in the CPI (all items less fresh food) is likely to be about 0 percent for the time being, due to the effects of the decline in energy prices, but the rate will likely accelerate gradually, on the assumption that crude oil prices will rise moderately.

II. Considerations regarding the outlook

A. Policy board members' baseline scenario and my outlook

I believe that Japan's economy has already regained stability that is consistent with its growth potential, mainly due to the effects of quantitative and qualitative monetary easing (QQE). This can be seen by how the output gap – which represents the degree of utilization of production capacity and labor – recovered to a more or less neutral level at around the end of 2013 from being significantly negative at the time of the introduction of QQE, and has remained at almost the same level thereafter. Moreover, I think that the underlying trend in inflation has also already regained stability that is consistent with the growth potential of Japan's economy. According to my baseline scenario for the outlook, such stable economic and price conditions will continue through fiscal 2017 – the projection period covered in the January 2016 Outlook Report.

However, my view on the outlook for Japan's economic activity and prices, when expressed in figures, is more cautious compared with the median of the Policy Board members' forecasts in the January 2016 Outlook Report. I hold a relatively cautious view based on the following two reasons. First, 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, is currently estimated to be around 0.5 percent or lower, and thus has stayed at a low level. Given this situation, I believe that its pace of improvement is likely to remain moderate. Second, I do not think that there is a strong driving force from the demand side – including in terms of the additional effects of monetary easing – that will even temporarily bring about economic growth at a pace much higher than its potential and clearly improve the output gap.

Let me share some of my considerations regarding the outlook with you.

B. Corporate profits and business fixed investment

Corporate profits have been at high levels, and it has been expected that making active use of corporate funds to increase business fixed investment and wages in Japan would make the virtuous cycle from income to spending operate more effectively. However, I personally consider that fixed investment and wages have not increased to the extent initially expected.

While this situation is largely due to the fact that the recent improvement in corporate profits has been supported by temporary factors, I believe that it also is attributable to firms' assessment that the domestic market has not yet improved sufficiently. For example, while the recent improvement in current profits of large manufacturing firms has been brought about largely by factors that cannot necessarily be considered sustainable, such as the depreciation of the yen and low crude oil prices, the contribution of the increase in domestic sales volume to such profits is limited. Moreover, the potential growth rate has stayed at a low level, and its pace of improvement is likely to remain moderate. Under these circumstances, firms would make active use of their profits in overseas markets – where expectations are high for increases in sales and profits – while in the domestic market, they would maintain their cautious stance toward spending.

Based on these developments, for firms to increase fixed investment relative to cash flow, I think that a rise in their growth expectations for the domestic market is indispensable. However, with strong headwinds such as the population decline with a low birth rate and aging, I personally consider that it would still take considerable time to raise the growth potential of Japan's economy through various measures and thereby raise firms' medium- to long-term growth expectations for the domestic market.

C. Real income and private consumption

In my view, private consumption has continued to lack momentum on the whole, although it has somehow maintained its resilience supported by the favorable environment, such as the improving employment and income situation and accommodative financial conditions. I think that some of the factors behind this sluggishness in consumption have been that, in addition to such temporary factors as bad weather, consumers have been more acutely sensing inflation while their expectations for wage increases have stayed low. Indeed, since around spring 2015 in particular, prices of a wide range of food and daily necessities have been raised while the rate of increase in wages has remained moderate, and this may have negatively affected consumer sentiment to a considerable degree.

Let us look at this situation from the perspective of monetary easing effects. 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 – that is, the bringing forward of future consumption. Currently, however, the pace of the decline in real interest rates has been slowing on the whole, and in this situation, consumers seem to be increasingly expecting that the rate of increase in wages will not immediately catch up with that in prices. Therefore, the outlook for real income may have deteriorated, thereby leading to conservative consumption activity.

In relation to this, according to the Bank's December 2015 *Opinion Survey on the General Public's Views and Behavior* – although the results of the survey are subject to a considerable margin of error due to the limited number of respondents – while the proportion of respondents who described the price rise as "rather unfavorable" was 82.4 percent (82.5 percent in the September survey), the proportion of those who described the price decline as "rather favorable" jumped to 52.4 percent from 23.8 percent in the September survey. I think that these results suggest the possibility that there are concerns among consumers about a decline in real income due to price rises. Going forward, if the positive effects of the decline in energy prices on real income run their course, consumption activity might become even more conservative. This trend may be observed more clearly among elderly households, including those of pensioners, and low-income households, taking into account, for example, the recent improvement in their sentiment reflecting the decline in energy prices.

D. Overseas economies and Japan's exports

Exports have shown signs of picking up. Real exports for the October-December quarter of 2015 have increased for the second consecutive quarter, mainly in those of motor vehicles and IT-related goods, registering an increase of 2.8 percent on a quarter-on-quarter basis. However, I personally consider that, from the January-March quarter of 2016 onward, the pace of growth in exports is likely to slow due to a dissipation of the effects of the introduction of new cars to the market and to weaker-than-expected demand related to new models of smartphones. Accordingly, there is a possibility that the pace of increase in industrial production will decline markedly in and after the April-June quarter.

Regarding the environment surrounding exports, the outlook for overseas economies is not optimistic. In the United States, firmness in private consumption has been maintained supported by the favorable income situation and financial conditions, but production activity in the manufacturing sector has been stagnant accompanied by inventory adjustments, reflecting weak exports bound for emerging economies and sluggish demand of energy-related firms for capital goods. Although we cannot make a simplistic comparison with the past, the current phase of economic recovery in the United States has already lasted for a period longer than the average of past recoveries, and this is a matter of some concern in view of the sustainability of the current recovery.

Excess production capacity and excess debt in emerging economies including China should not be overlooked as downside risks to the global economy as a whole. Since the global financial crisis, corporate debt has increased significantly in countries such as China, Turkey, and Brazil. A breakdown shows that (1) debt related to commodities and energy reflecting excessive expectations for growth in demand for these goods accounts for a considerable share, and (2) not a few countries carry a large share of foreign currency-denominated debt. It cannot be denied that the slowdown in emerging economies could gradually heighten pressure to reduce debt, thereby starting a downward spiral in the economies in a mutually reinforcing manner. Furthermore, I am paying due attention to the risk that the change in the global flow of funds – triggered by the fall in commodity prices as well as the change in financial and economic conditions in the United States – might rapidly heighten pressure to reduce debt, through the depreciation of currencies and the rise in the long-term interest rates in emerging economies.

If growth in overseas economies decelerates due to the materialization of the aforementioned risks and exports clearly turn to a decreasing trend, this might push down production activity in Japan and negatively affect business fixed investment, as well as private consumption through deterioration in employment conditions. Furthermore, I am paying attention to the possibility that volatile movements observed in global financial markets since the beginning of 2016 will cause the economic activity of firms and households to become cautious. I therefore consider the outlook for overseas economies and financial conditions as major downside risks to Japan's economy.

E. Price developments and the outlook

The underlying trend in consumer prices, in terms of the year-on-year rate of change in the CPI for all items less food and energy and that for all items less fresh food and energy, showed some signs of peaking out in the October-December quarter of 2015, after having risen markedly in the first half of the fiscal year. Meanwhile, the year-on-year rate of increase in the trimmed mean – an indicator intended to capture the trends of price movements by mechanically excluding items with large price fluctuations – has been relatively stable at around 0.5 percent recently, a level somewhat higher than before.

As for the outlook, I think that there is not much room for these indicators, which are intended to capture the underlying trend in prices, to see a further rise in their year-on-year rates of increase, given that (1) the effects of the depreciation of the yen on a year-on-year basis have almost run their course; (2) materials prices and the producer price index (PPI), both of which represent upstream prices, have been on a clear declining trend; (3) upward pressure on prices stemming from the output gap is not, in my opinion, likely to increase noticeably; and (4) the rise in medium- to long-term inflation expectations seems to have paused. Furthermore, my impression is that plans to raise sales prices of food and daily necessities – which many firms announced at around the beginning of 2015 – are not so common this year. Therefore, I believe that there is a risk that the year-on-year rates of increase in these indicators around the April-June quarter of 2016 will come in somewhat lower than expected.

In considering the outlook for prices, it also is important to focus on the relationship between prices and wages. Although wages as a whole have risen moderately, I think that wage growth has been weaker than expected despite the extremely tight labor market conditions. The background to this is that, as is the case with business fixed investment, firms remain cautious about raising scheduled cash earnings of their employees as this will lead to an increase in fixed costs, in a situation where their growth expectations for Japan's economy have not risen clearly. I think that this stance by firms is also constraining a rise in households' medium- to long-term expectations for income growth, or in other words, a rise in growth expectations for permanent income. Moreover, it is possible that sluggishness in the outlook for the rate of increase in real income would constrain private consumption, thereby exerting downward pressure on prices.

Taking these factors into consideration, I personally believe that the underlying trend in inflation is likely to maintain a relatively stable level without declining substantially for the time being, albeit growing at a reduced pace. On this basis, I expressed dissent from the description presented in the January 2016 Outlook Report regarding the year-on-year rate of change 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 2017. Even at this point, I still hold the view that the year-on-year rate of change 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 change is unlikely to reach around 2 percent even through fiscal 2017 – the projection period covered in the January 2016 Outlook Report.

III. Conduct of monetary policy

A. My proposals at times of QQE decisions

1. The Bank's decisions leading to QQE with a Negative Interest Rate

The Bank decided to introduce QQE in April 2013 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. In October 2014, the Bank expanded QQE. The specific measures of the expansion included (1) acceleration in the annual pace of increase in the monetary base from about 60–70 trillion yen to about 80 trillion yen, and (2) an increase in the Bank's 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, in December 2015, the Bank adopted the following as supplementary measures for QQE for such purposes as facilitating its smooth implementation: (1) extension of the average remaining maturity of JGB purchases; (2) establishment of a new program for purchases of exchange-traded funds (ETFs); and (3) an increase in the maximum amount of each issue of Japan real estate investment trust (J-REIT) to be purchased.

The Bank took another step forward in January 2016 by introducing QQE with a Negative Interest Rate, under which it would apply a negative interest rate of minus 0.1 percent to some of the outstanding balance of current accounts that financial institutions hold at the Bank.

2. My proposals at times of QQE decisions

I supported the decision to introduce QQE in April 2013, judging that its scale was one in which the associated positive effects would just about outweigh the side effects when confined to a certain time period. At that point, however, I considered that the side effects would outweigh the positive effects over time. I therefore 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 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 more protracted or strengthened than expected and the side effects would increase in a cumulative manner.

On the decision to expand QQE in October 2014, I cast a dissenting vote based on the judgment that the timing of the associated side effects outweighing the positive effects would be moved forward. Since then, I have continued to cast a dissenting vote on the guidelines.

Moreover, I submitted a proposal in April 2015 that included a reduction in 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 would be levels below the initial paces employed at the time of the introduction of QQE. Thereafter, I have continued to submit the same proposal through the most recent MPM held in January 2016, which was formulated based on the judgment that the associated side effects were outweighing 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 were outweighing the positive effects given that two years had passed since the introduction.

Meanwhile, in December 2015, as they were inconsistent with my proposal mentioned earlier, I cast a dissenting vote on adoption of the following supplementary measures for QQE: (1) extension of the average remaining maturity of JGB purchases; (2) establishment of a new program for purchases of ETFs; and (3) an increase in the maximum amount of each issue of J-REIT to be purchased.

In addition, in January 2016, I cast a dissenting vote on the introduction of QQE with a Negative Interest Rate, mainly because it would have adverse effects on the smooth conduct of the Bank's JGB purchases and therefore would only be an appropriate policy measure in a crisis situation.

3. Thinking behind my proposal

My proposal, which I have continued to submit at MPMs since April 2015, has not been intended to reduce the stock of the Bank's asset holdings, but to reduce the pace of increase in such holdings. I have considered the following as consequences of the Bank's change in the current guidelines of the annual pace of increase in the amount outstanding of its JGB holdings to about 45 trillion yen, a level below the initial pace employed at the time of the introduction of QQE: the excessive pressure on the JGB market would be eased considerably, and the Bank's JGB purchases, for the time being, would be more sustainable and stable as the risk that the Bank faces a limit to its JGB purchases at an early stage subsides. Meanwhile, even if the paces of increase in the monetary base and in the amount outstanding of the Bank's JGB holdings were to be reduced, accommodative financial conditions would be strengthened in a cumulative manner as the amount outstanding of its asset holdings increases. Given that 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 – the Bank must be careful when deciding on policies.

Next, I would like to elaborate on the thinking behind my proposal, focusing on policy effects and side effects.

B. Policy effects and side effects

1. Policy effects through long-term real interest rates

I think QQE is effective in increasing domestic private demand, mainly through a decline in long-term real interest rates, bringing forward future real private consumption. In this regard, by way of pushing down long-term real interest rates, the cumulative policy effects already have firmly taken hold in Japan's economy, as especially evident by the following developments: (1) the output gap in Japan recovered to a more or less neutral level at around the end of 2013 and has generally stayed at this level; and (2) the gap has narrowed between the actual inflation rate and the medium- to long-term expected rates of inflation, on which basis firms and households carry out their economic activities.

However, I consider that the additional effects of QQE have been diminishing. This is because long-term real interest rates, which showed a marked decline for about a year after the introduction of QQE, have generally seen a slowdown in their pace of decline since around the middle of 2014, although the levels of these rates were reduced somewhat very recently due to the introduction of QQE with a Negative Interest Rate. Medium- to long-term inflation expectations in various surveys and market indicators have been at a level that remains far from the price stability target of 2 percent, and some recent results showed a downward trend.

Under these circumstances, I believe it remains difficult to encourage a rise in medium- to long-term inflation expectations solely through the Bank's policy measures. Long-term real interest rates have become less likely to decline despite the continued increase in the amount outstanding of the Bank's JGB holdings, and therefore the additional effects of QQE have been diminishing. Given this situation, I consider that a reduction in the pace of the Bank's JGB purchases will only marginally decrease the additional effects of QQE, while it can restrain the increase in its side effects, thereby enabling the balance between the positive effects and the side effects to improve.

2. Attention required to potential side effects of QQE

The side effects of QQE have not yet materialized fully because they are mostly potential effects. However, due attention needs to be paid because, once they do materialize, it will become difficult to handle them appropriately and promptly. Given this, I am personally paying particular attention to the side effects of QQE arising from the Bank's large-scale purchases and holdings of JGBs, which impair the proper functioning of the JGB market.

Specifically, these particular side effects include risks such as the following: (1) the proper functioning of the JGB market – in terms of liquidity and the price-discovery function – will be impaired and financial institutions' profits will deteriorate, both of which could lead to instability in the financial system; (2) interest rates will rise in the course of normalizing monetary policy; and (3) drastic fluctuations in JGB prices will cause revisions to prices of a wide range of financial products and assets, thereby exerting severe effects on the financial system and economic activity. With the Bank's large-scale JGB purchases, I consider that attention should also be given to (1) the further heightening of the possibility that the Bank's large-scale JGB purchases will be perceived as central bank financing of fiscal deficits; and (2) the impairment of the mechanism to maintain fiscal discipline through interest rates, reflecting overly heightened expectations that the stability in the JGB market will be ensured.

3. Sustainability of JGB purchases and stability of interest rates

From the perspective of the side effects regarding the Bank's JGB purchases, I would also like to discuss the sustainability of such purchases and stability of interest rates.

Under QQE, the share of the Bank's holdings in the JGB market has continued to increase. As of September 30, 2015, the Bank held about 30 percent of the total outstanding amount of JGBs issued. Meanwhile, financial institutions in Japan need to hold a certain amount of JGBs for such purposes as collateral for transactions, a safe asset portfolio in asset-liability management (ALM), and compliance with financial regulations. Therefore, it is not possible for the Bank to hold all of the JGBs issued. Looking at the share of central banks' holdings in the respective government bond markets, in 2016, the Bank of Japan's share of holdings will exceed that of the Bank of England at its peak level and proceed into unprecedented territory for a major central bank. In addition, purchasing government bonds in Japan is potentially more difficult than in other countries given that, while the share of overseas investors – who tend to hold JGBs for short-term trading purposes – is small, a large share is held by life insurance companies and pension funds – which tend to hold JGBs to maturity.

So far, the Bank has conducted outright purchases of JGBs smoothly and a technical problem has not materialized. Nevertheless, if financial institutions in Japan become more risk averse due to concerns over overseas financial markets, for example, and increasingly prefer to hold JGBs, this may tighten supply and demand conditions of JGBs and in turn abruptly make it difficult for the Bank to continue with its JGB purchases. I personally believe that such potential risks have increased steadily with the progress in the Bank's large-scale JGB purchases.

I do not think that the economy and financial markets will be negatively affected to a large degree if long-term nominal interest rates rise as improvement in economic and price conditions brings about an increase in medium- to long-term inflation expectations and an upward revision to the outlook for the economic growth rate. However, if long-term nominal interest rates rise due to a rise in term premiums on JGBs – which are determined by factors other than inflation expectations and the outlook for short-term interest rates – caused, for example, by concerns over the sustainability of the Bank's JGB purchases, the subsequent impact on the economy and financial markets could be serious. Therefore, it is important to prevent a significant rise in term premiums.

Based on the thinking that, under the Bank's policy of purchasing JGBs, term premiums are determined not only by the current amount outstanding of the Bank's JGB holdings but also by the projection for the amount outstanding, if market participants suddenly become concerned about a limit to the Bank's JGB purchases, they may revise their forecasts that the time frames for such purchases and for maintaining the amount outstanding of the Bank's JGB holdings will be shorter than expected, or that the peak level of the amount outstanding of its JGB holdings will be lower than expected, thereby leading to a significant rise in term premiums.

In relation to this, I view the mindset that it is acceptable for the Bank to continue with its JGB purchases until a limit comes into sight as inappropriate. Considering that financial institutions need to hold a certain amount of JGBs for such purposes as collateral, as mentioned earlier, there will be a phase in which they will not sell their JGB holdings actively even amid declining interest rates. In this situation, as the responsiveness of interest rates to the level of JGB demand will decline substantially, there is a possibility that interest rates will tend to show large fluctuations, thereby exerting severe effects on financial markets and the economy. When reaching such a phase, it also is likely that the Bank will face difficulties, including in terms of reducing the amount outstanding of its JGB holdings while maintaining financial market stability, and the normalization of QQE will not be an easy process. Furthermore, there is a possibility that fiscal risks will heighten as interest rates fluctuate largely depending on the government's debt issuing policy and its outlook.

4. Financial soundness of the Bank

As another potential side effect that will heighten steadily from maintaining QQE for a protracted period, I am paying attention to the effect on the Bank's profits and balance sheet when it raises interest rates applied to excess reserve balances of financial institutions' current accounts at the Bank in the course of normalizing QQE.

Under QQE, the Bank has conducted large-scale JGB purchases and its annual interest income on JGBs has exceeded 1 trillion yen. Meanwhile, the Bank has financed such purchases at low cost through financial institutions' current accounts at the Bank – to most of which is currently applied a positive interest rate of 0.1 percent – and issuance of banknotes, which entails little cost. Therefore, with the continuation of QQE, the Bank's profits have continued to improve amid the increase in net interest income, which is the difference between interest income on JGBs and interest payments on excess reserve balances of financial institutions' current accounts at the Bank. This net interest income can be regarded as seigniorage under QQE. Most of the Bank's profits are paid to the government and this constitutes government revenue; therefore, seigniorage has the effect of indirectly reducing the tax burden on the private sector.

However, it should be noted that, in the course of normalizing QQE in the future, due to the Bank's current accounting rules under which securities are valued at amortized cost, its interest income on JGBs will increase only moderately despite rises in long-term interest rates. On the other hand, depending on when and how interest rates applied to excess reserve balances of financial institutions' current accounts at the Bank are raised, payment of such interest could increase substantially and a negative spread could occur. This could lead to a deterioration in the Bank's profits and impairment of its capital, and at the same time cause a possible decrease or delay in the Bank's payment to the government, which in turn could decrease government revenue. What is notable here is that the more protracted the period of maintaining QQE and the higher the level of excess reserves at the Bank, the larger the magnitude of such effects.

In the long run, it can be expected that, on the back of a rise in long-term interest rates, the negative spread will be resolved with a gradual increase in the Bank's interest income on JGBs, and the environment for its profits will improve, making it possible for the Bank to restore its capital. As a result, the effects of QQE on the Bank's profits, and ultimately on government revenue, may be considered neutral from a long-term perspective. Nevertheless, the path toward realization of this projection is highly uncertain, as it depends on the actual measures of monetary policy and developments in market interest rates, and also requires considerable time.

I have focused so far on the possibility of a deterioration in the Bank's profits and impairment of its capital deriving from the difference between interest income on JGBs and interest payments on excess reserve balances of financial institutions' current accounts at the Bank. However, attention also needs to be paid to the fact that a similar issue could arise; for example, in case of a fall in the prices of ETFs and J-REITs – of which the Bank's holdings have increased under QQE.

It also is important to note that a decrease in the Bank's payment to the government, by way of causing a decrease in government revenue, could be the trigger for the public to clearly acknowledge the costs of QQE, which had been hard to discern without such a decrease. In other words, it will be widely shared among the public that the Bank, through its pursuit of QQE, is deeply involved in income distribution.

Although the deterioration in the Bank's profits and impairment of its capital that I mentioned earlier may not directly hinder its business operations, the possibility cannot be denied that these could negatively affect the stability in the value of currency in some way. In addition, the Bank has communicated its stance that it will implement the policy measures necessary to achieve price stability while giving consideration to its financial soundness. However, given the Bank's accounting rules under which the capital adequacy ratio is maintained at around 10 percent, within the range of about two percentage points above or below that level, speculation in financial markets could be raised that the Bank might, as economic and price conditions improve, place priority on maintaining financial soundness over price stability and maintain interest rates on excess reserve balances of financial institutions' current accounts at the Bank at relatively low levels.

5. Side effects of QQE with a Negative Interest Rate

QQE with a Negative Interest Rate may have additional negative effects on financial institutions' profits, mainly through a narrowing of interest rate margins on loans and a reduction in yields on financial assets, and this potentially could undermine financial system stability. It also should be noted that financial institutions – to compensate for deterioration in their profits –could pass on costs to their depositors and borrowers by, for example, not only lowering deposit rates but also increasing lending rates and transaction fees. This conversely could lead to monetary tightening effects.

In addition to such side effects, my concern is the possibility of impairing the sustainability and stability of the Bank's JGB purchases, which are the core of QQE. Many financial institutions – regional banks in particular – are said to have a strong tendency to hold JGBs with the aim of obtaining stable income gains rather than having temporary capital gains. For these financial institutions, if the levels of interest rates applied to excess reserve balances of their current accounts at the Bank become lower relative to yields on their current JGB holdings, or if yields on reinvested JGBs decline, this could reduce their incentive for selling JGBs to the Bank. Financial institutions also could become less encouraged to increase funds in their current accounts at the Bank to which a negative interest rate is applied, in view of difficulty in satisfying their stockholders and of reputation risks. Taking these possible effects into account, if an introduction of a negative interest rate leads market participants to become aware that the Bank could face a limit on its JGB purchases sooner than expected, there is a risk of financial market instability, such as a rise in term premiums, which in turn could negatively affect the economy.

In this regard, some may argue that, in the euro area, the negative interest rate policy and the asset purchase program are being pursued simultaneously at present, and thus the Bank can do so as well. However, the example in the euro area is not necessarily applicable to Japan, as there are great differences in the situations between the two, such as the following. First, the scale and the implementation period of asset purchases in the euro area significantly fall below those in Japan. Second, in the euro area, a large share of government bonds are purchased from financial institutions that are not eligible for the deposit facility, and their incentive for selling such bonds is not directly affected by the level of the deposit facility rate.

Therefore, with regard to the negative interest rate policy, I considered that the following two conditions should be met for its introduction. First, that it would be necessary to ensure that the sustainability and stability of the Bank's JGB purchases is enhanced through a reduction in the pace of such purchases. Second, on this basis, that the policy would only be appropriate in a crisis situation, such as when financial and economic conditions deteriorate markedly. Based on the judgment that the two conditions were not being met, I expressed dissent from introduction of QQE with a Negative Interest Rate at the MPM held in January 2016. In addition, I considered that the Bank should have refrained from implementing the measure and saved it for the future, as any additional monetary easing – not limited to the introduction of a negative interest rate – was not necessary, given that economic and price conditions in Japan were stable and that volatile movements in financial markets had not been critical.

C. Future conduct of monetary policy

1. Policy change and market stability

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 annual pace of increase in the amount outstanding of the Bank's JGB holdings. In light of my proposal, how such a reduction, if actually implemented, will affect financial markets in particular has been drawing wide interest. My understanding is that the additional effects of the Bank's JGB purchases have already been diminishing, and that there is a limit to such purchases. I therefore consider that the risk of impairing financial market stability will be smaller if the Bank proceeds with a reduction in the pace of its JGB purchases at an early stage in an orderly manner while closely communicating with the markets, rather than further proceeding with its JGB purchases and then implementing the reduction once such purchases come close to the limit.

It also is possible to reduce the risk of impairing financial market stability by providing a thorough explanation, or forward guidance, to the markets that the reduction in the pace of the Bank's JGB purchases (1) will not in the near future lead to a rise in interest rates applied to excess reserve balances of financial institutions' current accounts at the Bank or a reduction in the amount outstanding of the Bank's JGB holdings, which could weaken the accumulated effects of its JGB purchases, and (2) will instead enhance the sustainability and stability of the Bank's JGB purchases for the time being.

Based on this understanding, with regard to the Bank's future monetary policy stance, I have been proposing at MPMs that it should continue with asset purchases and a virtually zero interest rate policy as long as each of these policy measures is deemed appropriate, in addition to the proposal to change the guidelines for money market operations and asset purchases.

2. Examination of a wide range of policy measures

It should be noted that, although I have been proposing a reduction in the pace of the Bank's asset purchases, I am not ruling out the possibility of implementing additional policy tools in the case of future marked deterioration in financial and economic conditions.

My understanding is that, even if the Bank starts to normalize its asset purchases, it is highly likely that it would take considerable time for this to be completed; given this, it is necessary to fully take into account the side effects of such purchases that may emerge over a considerable period of time and also try to conduct monetary policy in a much more forward-looking manner than when conducting the interest rate policy. I therefore think that it is inappropriate to expand the amount of assets to be purchased, to address short-term changes in financial and economic conditions.

At the same time, I consider it desirable that monetary policy be conducted flexibly and comprehensively with an appropriate combination of various measures. If stability in economic activity and prices, or in financial conditions, were to be undermined significantly, thereby causing a serious situation in which economic, price, and financial conditions could deteriorate in an accelerated manner without a monetary policy response, I personally think it necessary to examine possible additional measures other than expansion in the amount of assets to be purchased – such as those to fully ensure financial system stability by temporarily providing ample funds in yen and foreign currencies regardless of the target for the annual increase in the monetary base.

3. *My view regarding the price stability target*

In addition to the proposal to change the guidelines for money market operations and asset purchases, I 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. I consider it appropriate to implement these two proposals together. Next, I would like to explain my view regarding the price stability target that lies behind such consideration.

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 important to have a positive change in economic structure that is in line with the 2 percent price stability target. In the process of the change in economic structure, firms' and households' medium- to long-term inflation expectations – on which basis they carry out their economic activities – will become stable at around 2 percent, and this will support the actual inflation rate continuing to be stable at around 2 percent. In this regard, 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 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 actual inflation rate.

In light of this view, I think that the price stability target of 2 percent is well above the level that is consistent with the growth potential of Japan's economy. Therefore, it is difficult at this point to achieve the 2 percent price stability target in a stable manner through monetary policy alone, unless further progress is made in economic structural changes that would increase the underlying trend in inflation. In this situation, my concern is that, if the Bank, through monetary policy, tries 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.

Let me note that the joint statement by the government and the Bank released in January 2013 indicated that "the Bank recognizes that the inflation rate consistent with price stability on a sustainable basis will rise as efforts by a wide range of entities toward strengthening competitiveness and growth potential of Japan's economy make progress. Based on this recognition, the Bank sets the price stability target at 2 percent in terms of the year-on-year rate of change in the CPI." In my interpretation, the statement was based on the recognition that a prerequisite for the Bank to set the 2 percent price stability target is a rise in the growth potential of Japan's economy to the level that is in line with price stability at 2 percent inflation through efforts such as by the government and firms.

4. *New role of monetary policy in the future*

In order to raise the growth potential of Japan's economy, it is necessary for firms to make technological innovations, as well as active fixed investment, so that such innovations lead to increased productivity. Moreover, to encourage firms to make active fixed investment in

Japan and increase the potential growth rate through accumulation of capital stock, it is necessary that the government take various measures to increase firms' medium- to long-term expectations for the growth rate of domestic demand.

As mentioned earlier, my assessment is that QQE has exerted a considerable effect. In this current situation, I personally consider that the new role that monetary policy should play in the overall economic policy has shifted to consistently providing, while maintaining favorable financial conditions, indirect support for positive efforts by the government and firms so that the economy's growth potential – which is represented mainly by the potential growth rate and the productivity growth rate – will increase to the level 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 making the utmost efforts to lessen future 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 that this proposal is in fact a quicker way of achieving the 2 percent price stability target.