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

Speech by Mr Koji Ishida, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Fukuoka, 18 February 2016.

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I. Developments in economic activity and prices

At the Monetary Policy Meeting held on January 28 and 29, 2016, the Bank of Japan produced the *Outlook for Economic Activity and Prices* (Outlook Report) and published its projections for Japan's economic activity and prices through fiscal 2017.

I would like to explain the Bank's view on economic activity and prices by presenting the main content of the Outlook Report.

A. Overseas economies

Overseas economies – mainly advanced economies – have continued to grow at a moderate pace, despite the slowdown in emerging economies. Production and trade in the manufacturing sector had been weak on a global basis in the first half of 2015, but have generally picked up somewhat, albeit with some weakness still seen in emerging economies.

In the outlook, the pace of growth in overseas economies is expected to accelerate moderately as the positive effects of the recovery in advanced economies gradually spread to emerging economies. A similar projection is presented in the *World Economic Outlook* (WEO) *Update* released in January by the International Monetary Fund (IMF). However, given the decline in expected growth in emerging and commodity-exporting economies and the protracted low commodity prices, the capital stock that accumulated amid the higher expected growth rates and higher commodity prices in the past is likely to continue to be excessive. Thus, firms' restrained stance toward fixed investment expenditure is likely to be seen globally for some time. Reflecting such circumstances, business sentiment within major economies' manufacturing sectors has generally deteriorated.

Looking at developments by major region, the U.S. economy has continued to steadily recover, reflecting the firmness in household spending. As for the outlook, the economy is expected to continue its firm recovery centered on the private sector, underpinned by accommodative financial conditions.

The European economy is projected to continue to see moderate recovery, mainly on the back of improvement in the employment and income situation, as well as accommodative financial conditions.

The Chinese economy has continued to be in a state of deceleration due to downward pressure from an overhang of production capacities and inventory adjustments in the manufacturing sector. However, the economy is likely to broadly follow a stable growth path – albeit at a somewhat slower pace, mainly in the manufacturing sector – as authorities proactively carry out policy measures to support economic activity.

Overall, emerging economies other than the Chinese economy and commodity-exporting economies also remain in a situation of deceleration, as the effects of the slowdown in the Chinese economy have spread to them and as the decline in commodity prices has been protracted. These economies as a whole are expected to gradually see a rise in their growth rates, due mainly to the effects of the recovery in advanced economies and of economic stimulus measures.

B. Japan's economy and price developments

1. Current situation

Now I would like to discuss developments in economic activity and prices in Japan.

Japan's economy has continued to recover moderately, although exports and production have been affected by the slowdown in emerging economies. On the domestic demand side, business fixed investment has been on a moderate increasing trend as corporate profits have continued to improve markedly. According to the December 2015 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), firms have generally continued to plan to increase fixed investment firmly despite the slowdown in emerging economies. Against the background of steady improvement in the employment and income situation, private consumption has been resilient and housing investment has been picking up. Industrial production has continued to be more or less flat against the background of the prolonged inventory adjustments of small cars with engine sizes of 660cc or less and some capital goods. Exports have been picking up, reflecting the developments in overseas economies that I mentioned earlier, although sluggishness remains in some areas.

With regard to prices, the year-on-year rate of increase in the consumer price index (CPI) for all items less fresh food has been about 0 percent due to a substantial fall in energy prices, reflecting the decline in crude oil prices.

2. Outlook

Japan's economy is likely to be on a moderate expanding trend. The improvement in corporate profits is expected to continue as the favorable external environment, owing to the low crude oil prices and the low yen rate, is likely to continue to support the income-generating mechanism, and as overseas economies are expected to see a moderate rise in their growth rates. Employee income is also projected to continue to increase moderately on the back of an improvement in corporate profits and the tightening of labor market conditions. Domestic demand is likely to follow an uptrend against the backdrop of income generated by this virtuous mechanism and of the monetary easing effects. Thus, Japan's economy is likely to continue growing at a pace above its potential through fiscal 2016. In fiscal 2017, although demand related to hosting the Olympic Games will underpin the economy, the growth rate is expected to slow to around a level somewhat below the potential, mainly because of a fall in household spending due to the consumption tax hike. Looking at the medians of the Policy Board members' forecasts in the January 2016 Outlook Report, the real GDP growth rate is projected to be 1.1 percent for fiscal 2015, 1.5 percent for fiscal 2016, and 0.3 percent for fiscal 2017.

Looking at the outlook in detail by major component, business fixed investment is projected to continue to see a moderate increase on the back of a marked improvement in corporate profits and accommodative financial conditions. Private consumption is projected to generally remain resilient, reflecting the developments in real disposable income. Housing investment is expected to continue picking up, underpinned by the continued steady improvement in the employment and income situation and the low levels of housing loan rates. Industrial production is likely to start picking up as the inventory adjustments progress, and thereafter is likely to follow a moderate increasing trend, supported by an increase in final demand at home and abroad. Exports, which have been picking up, are expected to head toward a moderate increase for the time being since automobile-related exports are likely to continue increasing on the back of firm sales developments in the United States, Europe, and China. However, in the longer run, exports are expected to tend to mark a fall rather than a clear increase, given the decline in expected growth in emerging and commodity-exporting economies, protracted low commodity prices, and the resulting excess in production capacity related to materials and energy.

On the price front, the year-on-year rate of increase in the CPI (all items less fresh food) is likely to be about 0 percent for the time being, due to the effects of the decline in energy prices. Nevertheless, as the underlying trend in prices steadily rises and the effects of the decline in crude oil prices dissipate, the rate is likely to accelerate toward 2 percent – the price stability target. Looking at the medians of the Policy Board members' forecasts in the January 2016 Outlook Report, the year-on-year rate of increase in the CPI (all items less fresh food), excluding the direct effects of the consumption tax hike, is projected to be 0.1 percent for fiscal 2015, 0.8 percent for fiscal 2016, and 1.8 percent for fiscal 2017.

Upside and downside risks to the Bank's baseline scenario regarding economic activity are (1) developments in overseas economies, (2) the effects of the consumption tax hike, (3) firms' and households' medium- to long-term growth expectations, and (4) fiscal sustainability in the medium to long term. The risks to the Bank's baseline scenario regarding prices are (1) developments in firms' and households' medium- to long-term inflation expectations, (2) developments in the output gap, (3) responsiveness of inflation to the output gap, and (4) developments in import prices.

II. The bank's monetary policy

Next, I would like to talk about the Bank's monetary policy.

The Bank decided to introduce "Quantitative and Qualitative Monetary Easing (QQE) with a Negative Interest Rate" at the Monetary Policy Meeting held on January 28 and 29, 2016. This policy framework is designed to enable the Bank to further pursue monetary easing by making full use of possible measures in terms of three dimensions – quantity, quality, and an interest rate – in which a negative interest rate is added to the existing options of QQE conducted to date.

Specifically, on the interest rate side, the Bank will partially apply a negative interest rate of minus 0.1 percent to current accounts that financial institutions hold at the Bank. This will exert further downward pressure on interest rates across the entire yield curve, in combination with the continuation of large-scale purchases of Japanese government bonds (JGBs) conducted in terms of quantity and quality.

Under the new scheme introduced in January, the Bank adopted a multiple-tier system in which it applies a negative interest rate of minus 0.1 percent to a marginal increase in current accounts that financial institutions hold at the Bank, while continuing to apply a positive interest rate of 0.1 percent to the average outstanding current account balance that each financial institution held during the past year. The Bank devised the scheme by taking into account the following unique circumstances of Japan: an extremely large outstanding balance of current accounts at the Bank and the necessity for the Bank to proceed smoothly with large-scale purchases of assets even under the negative interest rate scheme.

As described in the January 2016 Outlook Report, Japan's economy has continued to recover moderately and the underlying trend in prices has been rising steadily. Recently, however, global financial markets have been volatile against the backdrop of the further decline in crude oil prices and uncertainty such as over future developments in emerging and commodity-exporting economies, particularly the Chinese economy. In this situation, the Bank judged that there was an increasing risk that an improvement in the business confidence of Japanese firms and conversion of the deflationary mindset might be delayed and that the underlying trend in prices might be negatively affected. To preempt the manifestation of this risk and to maintain momentum toward achieving the price stability target of 2 percent, the Bank decided to introduce "QQE with a Negative Interest Rate."

I have explained the outline of the Bank's assessment presented in the January 2016 Outlook Report and the new monetary policy scheme introduced in January. Next, I would like to touch upon several features of economic and price developments.

III. Several features of economic and price developments

As I mentioned earlier, global stock markets and foreign exchange markets have been in turmoil recently, especially since the turn of the year, and such volatile movements have started to negatively affect financial markets in Japan. Investors have become increasingly risk averse due to several factors that have been reinforcing each other: (1) the shift toward monetary tightening in the United States, (2) the economic slowdown in China as well as the turmoil in Chinese stocks and the yuan rate, (3) a sharp decline in crude oil prices, and (4) the sluggishness in emerging and commodity-exporting economies. I believe that the recent volatile movements in global financial markets are less likely to induce instability in the global financial system, unlike in the past. Nevertheless, attention should be paid to the possibility that, if volatile movements are protracted, this may affect confidence among individuals and firms and ultimately economic activity.

A continuation of monetary tightening in the United States would indicate that economic conditions there are deemed to be favorable. If the momentum of economic activity is judged as weak, the rate rise will be postponed. As for China, there is room for adequate fiscal and monetary measures. I do not expect that these developments will intensify negative impacts on emerging and commodity-exporting economies or on Japan's economy. In contrast, the substantial decline in crude oil prices has been exerting an extremely large impact on recent developments in the global economy and financial conditions worldwide, regardless of whether such decline was the cause or the consequence of these developments.

A. Decline in crude oil prices

The decline in crude oil prices has had a negative influence on a wide range of corporate activities. For example, firms have substantially reduced their fixed investment related to crude oil production, which accounts for a large share of global business fixed investment. Firms that provide oil-related facilities and services have been particularly affected. Furthermore, oil-producing countries, which had been in excess of funds, are now in shortage of funds, and this has caused a reversal in the flow of funds, creating considerable stress not only on the economic activity of these countries but also on global stock markets and foreign exchange markets.

As I have described, the substantial decline in crude oil prices has had large negative impacts; however, when viewed in the somewhat longer term, these will be net positive effects on the global economy, because income will be transferred from economies with a low propensity to consume to those with a high propensity to consume, and from capital-intensive industries to more labor-intensive industries. I consider that the overall positive effects on Japan – for which the self-sufficiency rate of crude oil is extremely low – are particularly large, although the magnitude of the effects, both positive and negative, differs by firm and industry.

Hikes in crude oil prices have often caused global economic recessions. However, there have never been recessions stemming from a decline in these prices. The immediate negative effects of the decline in these prices – such as those on financial markets – have been more pronounced than the positive effects, which will take time to become apparent, but it is my view that we do not need to be overly concerned about the present situation.

B. Prices

A substantial decline in crude oil prices leads to a fall in energy prices, and consequently pushes down the level of overall prices. Some say that developments in individual prices do not affect the level of overall prices, because such developments cause prices of other items to move inversely to these individual prices. For example, even if energy prices decline, real income will increase accordingly, and thus prices other than energy prices will rise through an increase in spending. While this may be true in the long run, such an outcome is unlikely to occur within about two years, the time horizon that central banks typically consider as appropriate in conducting monetary policy. As noted in the January 2016 Outlook Report, the projected timing of the year-on-year rate of increase in the CPI (all items less fresh food) reaching the price stability target of 2 percent has been delayed as the overall inflation rate will be pushed down due to the substantial decline in crude oil prices. Nevertheless, a decline in crude oil prices by nature is a considerable positive factor for Japan's economy, and its effects on overall prices eventually will dissipate. Thus, I consider that the delay itself is acceptable.

Also, in terms of monetary policy, I believe that it is appropriate to exclude the effects of energy prices as temporary factors and grasp the underlying trend in prices.

The year-on-year rate of increase in the CPI (all items less fresh food) for December 2015 was 0.1 percent but that for all items less fresh food and energy – which indicates the underlying trend in prices – was 1.3 percent. The Bank projects that, in a situation where Japan's economy is likely to continue growing at a pace above its potential, the year-on-year rate of increase in the CPI (all items less fresh food) will likely rise closer to 2 percent through fiscal 2017 when the negative contribution of energy items dissipates.

Inflation expectations are referred to as a factor that largely affects the price outlook, but it is difficult to actually assess them. It can be said that the inflation expectations of both firms and consumers have been rising from a somewhat longer-term perspective – as suggested by the recent price-setting behavior of firms and the subsequent purchasing behavior of consumers, or by rises in base salaries for two consecutive years. In addition, I consider that two indicators – the inflation swap rates and break-even inflation (BEI) rates for JGBs, both of which are frequently used to assess inflation expectations and are compiled based on financial market data – have not sufficiently reflected the actual inflation expectations in Japan, unlike in the cases of the United States or Europe, given the size and liquidity of Japanese financial markets. Therefore, these indicators should be regarded only as a reference.

Let me note here that prices are normally determined when consumers accept the prices set by firms.

Since spring 2015, manufacturers have been raising the wholesale prices of their standard products, due mainly to the rise in costs, and this has led to a rise in sales prices. In addition, prices of general services have been rising due to labor shortages. These factors have been pushing up the underlying trend in prices. It is the second year of such price increases, which raises difficult issues including the following: (1) whether manufacturers can raise the prices of their standard products again; (2) whether manufacturers will implement a de facto price increase by developing new products with value added or those similar to the previous ones; (3) whether manufacturers will raise the prices of goods for which they have postponed increases so far; (4) whether the cost that has been absorbed by the distribution sector will be passed on to sales prices; and (5) whether the services sector can continue to pass the rise in labor costs on to final prices.

That being said, many firms are experiencing less room for further cost reductions. In these circumstances, they need to increase sales in order to maintain or raise the level of profits in the face of upward pressure on labor costs. In the current situation of it being difficult to expect an increase in sales volumes as the aging population and declining birthrate have progressed, the only solution is to raise the unit prices of goods and services.

As firms start to increase prices, the focus is on whether consumers will accept such increases. In this regard, I consider that the key to a continued steady rise in the underlying trend in prices is whether consumers will be optimistic about future developments in income and wages.

C. Wages

Recently, labor market conditions have been extremely tight, and an increasing number of firms are experiencing labor shortages. In textbook theory, wages are determined by the supply-demand balance in the labor market, but statistics show that the pace of increase in wages as a whole has remained only moderate. This is because regular employees' wages, which account for a major part of total employee income, have been rising only moderately, although the hourly pay of non-regular employees has been rising markedly, reflecting tight labor market conditions.

One major cause behind this situation is the framework for regular employees in Japan, although it is gradually changing. It is unique to Japan because of the country's systems and practices.

Let me elaborate on this point. In Japan, where it is difficult to discharge regular employees, excesses and shortages of regular employees are balanced by the number of new graduates to be hired. New graduates go through in-house training so that they become well suited to their individual firms. The salaries and other benefits available to regular employees throughout their careers are significant as long as they are regular employees. These factors lower their labor mobility to move from one firm to another. If regular employees do not change jobs despite some dissatisfaction with their salary levels, employers will have less incentive to raise the levels of salaries to secure suitably qualified employees. Thus, employers take the initiative in setting regular employees' wages. Even if corporate profits are increasing, employers tend to be reluctant to increase wages, particularly base salaries, given the uncertainty regarding the outlook for profits. They also may be reluctant to allocate profits obtained through overseas operations to an increase in wages in Japan. As has been evident so far, regular employees' wages do not rise smoothly because each firm negotiates wages with its own union amid the low mobility of regular employees.

Although it has been pointed out that an increase in labor productivity is necessary for wages to rise, it is difficult to expect proper operation of the mechanism in which productivity in the economy as a whole increases. This is because, with low labor mobility, wages do not work as the intermediary function to smoothly correct the differences in productivity among firms.

In order to increase productivity and the economic growth rate in Japan, a change in the employment framework is necessary so that labor is transferred smoothly – through an increase in wages – from firms with low productivity and profits to those with high productivity and profits. This will take time, but if the economy continues to grow at a pace exceeding its potential, firms may face more acute labor shortages and an immediate issue of securing suitably qualified employees. In addition, the decline in energy prices will underpin corporate profits, including those of small firms. Reflecting such a situation, the wage level can be expected to rise gradually among many firms.

The Bank, for its part, will maintain the accommodative financial conditions through the conduct of monetary policy so that the virtuous cycle from corporate profits to wages, and in turn to consumption, operates properly.

Given that the effects of tighter labor market conditions are not spreading to wages smoothly, some may voice various opinions about the government's recent action to encourage wage increases, but I understand that such action is necessary.