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, Ishikawa, 23 June 2016.

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I. Economic activity and prices in Japan

A. The Bank of Japan's view

The Bank of Japan explains its assessment of the current situation and outlook for Japan's economic activity and prices in the Statement on Monetary Policy, which is released after each Monetary Policy Meeting (MPM), and in the *Outlook for Economic Activity and Prices* (the Outlook Report), which is published four times each year. Therefore, I will first give you an overview of its assessment of the current situation and outlook based on the latest Outlook Report and Statement on Monetary Policy.

Japan's economy has continued its moderate recovery trend, although exports and production have been sluggish, due mainly to the effects of the slowdown in emerging economies. The outlook through fiscal 2018 envisages that, although sluggishness is expected to remain in exports and production for the time being, domestic demand is likely to follow an uptrend, with a virtuous cycle from income to spending being maintained in both the household and corporate sectors, and exports are expected to increase moderately. Thus, Japan's economy is likely to be on a moderate expanding trend.

As for prices, the year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is likely to be slightly negative or about 0 percent for the time being, due to the effects of the decline in energy prices, and thereafter accelerate toward 2 percent. Meanwhile, assuming that crude oil prices will rise moderately from the recent level, the timing of the year-on-year rate of change in the CPI (all items less fresh food) reaching around 2 percent – the price stability target – is projected to be during fiscal 2017. Thereafter, the year-on-year rate of change in the CPI (all items less fresh food) is likely to be around 2 percent on average.

B. My personal view

I believe that Japan's current growth rate and inflation rate are generally stable, in light of the economy's growth potential, and that there is a relatively high probability of this situation continuing during the projection period in the April 2016 Outlook Report.

However, when expressed in figures, my view is fairly cautious compared with the medians of the Policy Board members' forecasts. This is mainly because I believe that (1) there is not a driving force from the demand side – including in terms of the effects of monetary easing – that will bring about economic growth at a pace clearly higher than its potential; (2) there are downside risks to the medians of the Policy Board members' forecasts in terms of demand both at home and abroad; and (3) as a result of these factors, the output gap is expected to remain more or less at a neutral level, making it difficult to expect that the underlying trend in inflation will rise markedly.

Next, I will mention several points of attention regarding the outlook for economic activity and prices based on my view.

1. Stagnant potential growth rate

According to the Bank's estimates, 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 still at a low level in the range of 0.0–0.5 percent. No notable improvement has been observed in the past several years, either. In particular, in line with the sluggish rate of increase in total factor productivity (TFP), which reflects technological advances, the rate of increase in labor productivity – which considerably affects firms' wage-setting behavior, which in turn impacts private consumption and prices – has continued to be stagnant.

However, the output gap, which represents the degree of utilization of capital and labor, has generally maintained a neutral level over the past several years. This means that Japan's economy has continued to show stable growth that is more or less consistent with its growth potential.

2. Medium- to long-term growth expectations and business fixed investment

Although business fixed investment has been on a moderate increasing trend, it has not grown as strongly as had been expected when considering the high levels of corporate profits.

I think that the fact behind this situation is that, while the high levels of profits in recent years had been brought about largely by improvement in price factors that cannot necessarily be considered sustainable – namely, improvement in the terms of trade reflecting changes in the exchange rates and commodity prices – the prospects for future sales volume have not improved. In this respect, the potential growth rate is still at a low level and is expected to improve only very moderately; therefore, firms may not significantly change their cautious stance on business fixed investment in the domestic market.

3. Sluggish private consumption

Private consumption has been resilient, but I think that it is still sluggish. It seems that price-related factors that once curbed private consumption, such as the consumption tax hikes and price increases for food and daily necessities, have been fading away recently. However, wages have not improved by as much as had been expected, as seen in the fact that the base pay increase resulting from the labor-management wage negotiations this spring seems to have been somewhat lower than the level in 2015. This has led to households' cautious outlook for wages, which might be one factor restraining private consumption.

I would note that these developments in wages might be attributable to persistent concerns among firms that a rise in labor costs, including an increase in base pay, may undermine the future situation for corporate profits amid the lack of a rise in the expected productivity growth rate and in the expected medium- to long-term economic growth rate.

In addition to households' cautious outlook for wages arising from firms' stance of curbing labor costs, future concerns that are rooted in the fiscal condition and the social security system may be another factor restraining private consumption among a broad range of age groups.

4. Overseas economies and downside risks to Japan's exports

The expectations for a global economic downturn that mounted at the beginning of 2016 have receded somewhat recently, reflecting improvements in U.S. and Chinese economic indicators and the stabilization of crude oil prices. However, it is difficult to expect the U.S. economy in its current status to act as a strong driving force of the global economy. Therefore, the scenario of advanced economies leading the global economic recovery has remained unrealized.

In emerging economies, business fixed investment has been weak due to excess production capacity and excess debt, eroding the global economy's current recovery potential. These problems could destabilize global financial markets, particularly through adjustments in the corporate bond markets in emerging economies that may be triggered by, for example, changes in the flow of funds caused by the U.S. monetary policy. Moreover, I am paying attention to the possibility that, if the global economy shows signs of a slowdown again, resulting in a decline in energy prices, there will be growing risks on the financial front, including (1) adjustments in the markets for high-yield bonds, mainly those issued by energy-related firms, and (2) heightened credit risk involved in financial institutions' exposure to these firms.

In light of this export environment, I have continued to regard developments in overseas economies and global financial markets as the most serious downside risks to Japan's economy.

5. Developments in the underlying trend in inflation

Since the beginning of fiscal 2016, the year-on-year rate of change in retail prices of consumer goods – mainly processed food – has tended to shift downward. Presumably, this is because at the beginning of the fiscal year, the price increases did not spread as much as in the past two years owing to (1) the depreciation of the yen having come to a pause, (2) private consumption having been sluggish, partly due to the effects of irregularly warm weather, and (3) the pace of wage increases having remained only moderate.

Under these circumstances, I expect that the year-on-year rates of change in the indicators of the underlying trend in prices, such as the CPI (all items less fresh food and energy) and the CPI (all items less food and energy), will decelerate somewhat over the next several months. Moreover, I do not assume that the year-on-year rate of change in the CPI (all items less fresh food) will reach the price stability target of 2 percent by fiscal 2018, the last year of the projection period in the April 2016 Outlook Report.

Even so, as the expected decline in the underlying trend in inflation for the time being is largely attributable to the disappearance of temporary factors such as the depreciation of the yen, I expect that prices will generally stay stable. While the level of the underlying trend in inflation – represented by, for example, the year-on-year rate of change in the CPI (all items less fresh food and energy) – is lower than the price stability target of 2 percent, I do not believe that this is causing any particular problem for current economic activity because the rates do not deviate widely from firms' and households' medium- to long-term inflation expectations.

II. Conduct of monetary policy

The Bank introduced Quantitative and Qualitative Monetary Easing (QQE) in April 2013 and then QQE with a Negative Interest Rate in January 2016, 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.

Against these decisions, I have been insisting on a change to QQE – including a reduction in the pace of the Bank's asset purchases – and a review of the negative interest rate policy, based on an examination and a comparison of positive effects and side effects of these measures. Furthermore, I think that enhancement of facilities to provide liquidity is important, in order to maintain financial system stability through securing the smooth functioning of financial markets and financial intermediation.

I would like to explain the organization of the thinking behind my policy stance.

A. Rebalancing of Two Mandates of the Bank's Policy

The two mandates of the Bank's policy are to ensure price stability and financial system stability. Monetary easing measures in recent years – such as QQE and the negative interest rate policy – have proceeded with emphasis placed on price stability, based on the recognition that financial system stability has been sufficiently secured.

I admit that the financial system can be assessed as being generally stable at present. However, potential vulnerability in the financial system has increased under the prolonged low-interest rate environment, and this trend has been augmented by the large-scale monetary easing. Therefore, I think that the outlook is by no means optimistic.

From this viewpoint, I have continued to cast a dissenting vote on the negative interest rate policy since its introduction through the most recent MPM held in June 2016. I have considered that negative interest rates would decrease the functioning of financial markets and financial intermediation, as well as impair the stability of the JGB market and smooth conduct of the Bank's JGB purchases, and therefore an interest rate of 0.1 percent – the same rate as before – should be applied to all current account balances excluding the amount outstanding of the required reserves held by financial institutions at the Bank.

Moreover, I think it is time for the Bank to shift the focus of its policy from price stability to financial system stability. I believe that such a shift will eventually benefit the Bank in pursuing the ultimate goal of contributing to the sound development of the national economy through achieving the intermediate objectives, i.e., the Bank's two mandates, in a well-balanced manner.

B. Necessity to maintain the sound functioning of financial intermediation

In recent years, financial institutions' profitability – represented by operating profits from core business – and loss-absorbing capacity have been declining, particularly among regional financial institutions. Downward pressure on their net income also seems to have increased recently, due in part to the fact that profit taking, mainly through sales of investment trusts, has become difficult in a situation where changes have been observed in the depreciating trend of the yen and the increase in stock prices that continued to be seen over the past several years. Furthermore, there is concern that the profit environment for financial institutions might become increasingly severe, mainly due to a further narrowing of interest rate margins on loans and a greater reduction in yields on securities – both of which followed the introduction of the negative interest rate policy – as well as to a rise in credit costs.

In this situation, banks may take excessive risks at a time of profit deterioration in an attempt to increase their profits, but they may become excessively risk averse in the future, mainly because losses will be incurred by a possible worsening of economic and financial developments. This could negatively affect economic activity and financial markets by exacerbating firms' and households' borrowing constraints and through banks' fire sales of assets.

Furthermore, from a longer-term perspective, the impairment of banks' financial soundness might also have negative effects on the efficiency and productivity of the economy. To give an example, banks with declining loss-absorbing capacity might postpone appropriate treatment of borrowers with weak performance amid a continued decline in banks' profitability. This may cause a situation in which capital and labor are being allocated to inefficient firms, and thus result in pushing down the rate of increase in TFP in the overall economy over the long term.

With these points taken into account, the malfunctioning of financial intermediation through the impairment of banks' financial soundness might further push down the potential growth rate of the economy, which is currently at a low level in the range of 0.0–0.5 percent. Monetary policy is usually thought to affect the demand side of the economy. However, if the policy impairs financial system stability, the supply side of the economy – for example, the productivity growth rate and the potential growth rate – may also be adversely affected, causing losses in social welfare.

C. Concerns about the stability of the JGB market and smooth conduct of the bank's JGB purchases

Since the introduction of the negative interest rate policy, the JGB market has been increasingly unstable – as evident from heightened volatility of JGB yields. I consider that this has exerted negative effects on the stability of financial markets as a whole. In this situation, there have been adverse effects on the smooth conduct of the Bank's JGB purchases. For example, the bid-to-cover ratios of its JGB purchasing operations have declined somewhat and there is a growing tendency for the bid rates to fall below the market rates.

Before the introduction of the negative interest rate policy, financial institutions did not face particular problems in selling JGBs to the Bank and in turn increasing funds in their current accounts at the Bank to which an interest rate of 0.1 percent was applied without their taking interest rate risk. However, given that many financial institutions attach more importance to obtaining stable income gains rather than having temporary capital gains, I consider that they have become significantly discouraged to sell JGBs to the Bank and increase funds in their current accounts at the Bank. This is because the difference between the yields of JGBs held by financial institutions and the interest rates applied to current accounts at the Bank has widened with the introduction of the negative interest rate policy.

In addition, with the introduction of the negative interest rate policy, the Bank adopted a multiple-tier system in which the outstanding balance of each financial institution's current account at the Bank is divided into tiers, with different interest rates – including a negative interest rate – being applied to each tier. Because of this, financial institutions, particularly at the beginning of the introduction of the policy, have tended to reduce or not increase the Policy-Rate Balance, to which a negative interest rate is applied. As a result, they are proceeding with purchases of JGBs, particularly those with super-long maturities that are still offered with positive yields, and I think that this is one of the factors behind further tightening of the JGB market conditions and somewhat unstable conduct of the Bank's JGB purchases. Given this, I consider that the decline in JGB yields, particularly those on JGBs with super-long maturities, since the introduction of the negative interest rate policy is not necessarily evidence that the policy has been exerting positive effects stably.

I would like to note that, with the increase in the amount outstanding of its JGB holdings, the Bank is also increasing the amount of reinvestment in JGBs resulting from redemption. Thus, even though the target for the pace of increase in the amount outstanding of its JGB holdings remains the same, the gross amount of the Bank's JGB purchases has been increasing. Also, fiscal 2016 marks an important point in considering the supply-demand balance of JGBs. It is the year in which the gross amount of the Bank's JGB purchases is expected to almost reach the gross amount of JGB issuance by the government. This implies that it is becoming difficult for the Bank to maintain the pace of increase in the amount outstanding of its JGB holdings solely by purchasing from the market the equivalent amount of JGBs issued by the government. It is considered that the Bank increasingly will need to purchase JGBs from financial institutions before redemption of such JGBs up to the amount needed for it to maintain the pace of increase in the amount outstanding of its JGB holdings. Given this, it is necessary to sufficiently recognize that it was at this exact timing that the negative interest rate policy – which discourages financial institutions to sell JGBs – was introduced.

D. Future conduct of monetary policy

My assessment is that QQE, which focuses on JGB purchases, already has exerted a considerable effect, as evidenced by the closing of the negative output gap at an early stage and the subsequent correction of the weak prices.

However, I consider that the additional effects of QQE have been diminishing, given that the continued decline in long-term real interest rates, which is considered to be the main source of policy effects, already has come to a halt. On the other hand, numerous side effects of QQE arising from the Bank's JGB purchases have not diminished; rather, they seem to be increasing steadily. These side effects include (1) various problems stemming from the distortion of the JGB market – for example, a risk of instability in the financial system caused by impairment of the proper functioning of the JGB market in terms of liquidity and the price-discovery function, and a risk that drastic fluctuations in JGB prices will cause revisions to prices of other financial products and assets; (2) a limit to the Bank's JGB purchases and increased volatility in the market in case of arising concerns among market participants about such a limit; and (3) deterioration in the Bank's financial soundness in the course of normalizing monetary policy.

Under these circumstances, I believe that, by reducing the pace of the Bank's JGB purchases – or the annual pace of increase in the amount outstanding of its JGB holdings – the balance between the positive effects and side effects of QQE could be improved while ensuring stability in the JGB market. In the meantime, if the Bank does not reduce the amount outstanding of its JGB holdings, it will be possible to avoid a rise in long-term real interest rates – a factor that leads to a decline in policy effects – thereby firmly ensuring the accumulated effects of the Bank's JGB purchases. On this basis, I have been proposing since April 2015 to reduce the annual pace of increase in the amount outstanding of the Bank's JGB holdings. In proceeding with the reduction, I think that it is possible to diminish its effects on financial markets by providing a thorough explanation, or forward guidance, to the markets that the reduction will actually enhance the stability and sustainability of the Bank's JGB purchases.

Moreover, I think that measures such as the review of the negative interest rate policy give due consideration to the stability of the functioning of financial markets and financial intermediation, which are critical infrastructures of economic activity. Implementation of such measures will bring about efficient resource allocation through appropriate operation of said functioning, and thereby support positive efforts by the government and firms toward increased productivity so that such efforts lead to a higher potential growth rate and ultimately to an improvement in people's lives.

Lastly, I believe that improving communication with financial markets and enhancing flexibility are the immediate challenges for the Bank in the conduct of monetary policy.

As the Bank has emphasized its stance of achieving the price stability target of 2 percent at the earliest possible time, overly heightened expectations for additional monetary easing tend to be observed in financial markets whenever there is an expectation that the Outlook Report will present a delay in the projected timing of the year-on-year rate of change in the CPI (all items less fresh food) reaching around 2 percent. In addition, since the introduction of the negative interest rate policy, views have become increasingly widespread that the Bank will launch unforeseen easing measures at an unexpected timing. I presume that these phenomena not only have become one of the factors behind reduced predictability of monetary policy and increased volatility in financial markets, but also have led to impairment of the credibility of the Bank's monetary policy conduct. For this reason, I consider it important that the Bank thoroughly communicate with financial markets regarding its conduct of monetary policy and bear in mind the need to provide a detailed explanation so as to narrow the perception gap between them.

In order to achieve the 2 percent price stability target, I think that it is vital to have a positive change in economic structure that would increase the underlying trend in inflation – through, for example, efforts by the government and firms – and that a considerable period of time will be required for this to take place. Therefore, rather than aiming to achieve the 2 percent price stability target through monetary policy alone in the short term, I believe that resetting the time frame for achieving the target to the medium to long term and conducting monetary policy in a flexible manner – coupled with an improvement in communication with financial markets – will lead to maintaining economic and financial market stability. This will result in reaching the Bank's ultimate goal of contributing to the sound development of the national economy.