Kikuo Iwata: Japan's economy and monetary policy – growing uncertainties surrounding overseas economies and enhancement of monetary easing

Speech by Mr Kikuo Iwata, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Kanagawa, 4 August 2016.

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

Introduction

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

At the Monetary Policy Meeting (MPM) held at the end of last week, the Bank released the *Outlook for Economic Activity and Prices* (Outlook Report) and published its projections for Japan's economic activity and prices through fiscal 2018. At the same time, taking account of heightened uncertainties surrounding overseas economies, including those associated with the United Kingdom's vote to leave the European Union (EU), the Bank decided to further enhance monetary easing in order to prevent these uncertainties from leading to a deterioration in business confidence and consumer sentiment as well as to ensure smooth funding in foreign currencies by Japanese firms and financial institutions, thereby supporting their proactive economic activities. Today, I would like to first explain the Bank's view on Japan's economic and financial developments, followed by the Bank's thinking on the monetary policy management, including the policy measures taken this time.

I. Developments in overseas economies

More than half this year has already passed: since the turn of the year, Japan's economy has been significantly affected by the developments in overseas economies.

In early 2016, global financial markets were volatile against the backdrop of the further decline in crude oil prices and uncertainties over future developments in emerging and commodity-exporting economies, particularly the Chinese economy. In order to preempt the manifestation of the risk that conversion of the deflationary mindset might be delayed, resulting from such uncertainties about overseas economies and financial markets, the Bank decided to introduce "Quantitative and Qualitative Monetary Easing (QQE) with a Negative Interest Rate" at the MPM in January.

Thereafter, global financial markets gradually regained some calmness and a situation where market turbulence would lead to the substantial slowdown in the global economy was avoided, partly reflecting additional monetary easing by the European Central Bank (ECB) and others and also strong determination shown by the G20 to use all policy tools – monetary, fiscal, and structural – to achieve sustainable growth under price stability.

The referendum in the United Kingdom in late June, however, brought the result that a majority of voters supported leaving the EU – the so-called Brexit – which led to global financial markets destabilizing again, manifested in such developments as the rapid depreciation of the pound sterling. In foreign exchange markets, the yen rapidly appreciated; stock prices globally declined considerably, including in Japan. In addressing the situation, the relevant authorities, including those in the G7 countries, swiftly took actions: they issued a statement that they would consult closely on financial stability and cooperate as appropriate, and central banks in major economies also showed their readiness to take steps to ensure adequate liquidity, including U.S. dollar funding.

The market developments following the referendum suggest that markets have been regaining their calmness, partly reflecting (1) an improved perception of the outlook for the U.S. economy after the better-than-expected employment data released in early July, and (2) the early start of the new Cabinet of the United Kingdom. However, the impact of Brexit on the global economy still entails uncertainties, which should be carefully monitored going forward. It seems the negotiations between the United Kingdom and the EU for building their new relationship will last a long period of some years. We should be prepared for heightened uncertainties politically and economically for a prolonged period of time. The World Economic Outlook (WEO) Update released earlier by the International Monetary Fund (IMF) revised down the global growth forecast by 0.1 percentage point for 2016 and 2017, respectively, based on the relatively benign assumption that arrangements between the United Kingdom and the EU will avoid a large increase in economic barriers, but it also presented an estimation that the global economy would experience a more significant slowdown under more severe assumptions (Chart 1).

We will continue to closely monitor the uncertainties surrounding overseas economies, which could not only directly affect Japan’s economy through exports and imports, but also exert influence on firms’ and households’ sentiment and restrain spending behavior, such as business fixed investment and consumption.

II. Economic activity in Japan

As explained, uncertainties surrounding overseas economies have heightened; nonetheless, the baseline scenario of the outlook for economic activity in Japan has instead improved compared to the previous Outlook Report in April (Chart 2).

In sum, although exports and production have been sluggish, due mainly to the effects of the slowdown in emerging economies, a virtuous cycle from income to spending is being maintained in both the household and corporate sectors, and, looking ahead, Japan’s economy is likely to be on a moderate expanding trend.

To start with the corporate sector, despite the headwind from overseas economies explained earlier, corporate profits have remained at high levels, especially in the nonmanufacturing sector, and business fixed investment has been on a moderate increasing trend on the back of such favorable profits. This also was evidenced in the June Short-Term Economic Survey of Enterprises in Japan (*Tankan*), although most responded to the survey prior to the United Kingdom’s referendum (Chart 3).

In the household sector, the employment and income situation has continued to improve steadily. Labor market conditions have continued to tighten and the active job openings-to-applicants ratio stood at 1.37 in June, which is the highest since 1991. The unemployment rate has been at a low level in the range of 3.0–3.5 percent recently (Chart 4). Wages have been rising moderately. In the annual spring labor-management wage negotiations, base pay was raised for a third consecutive year, but to a smaller extent than last year, and wage increases have been spreading steadily to small firms and non-regular employees.

Under these circumstances, private consumption has been resilient, although relatively weak developments have been seen in some indicators. This seems to be due to the negative wealth effects brought about by the decline in stock prices since the turn of the year, as well as the negative impact on consumer sentiment resulting from the Kumamoto Earthquake and the United Kingdom’s vote to leave the EU. Given the continued solid increase in employee income, private consumption is projected to pick up with financial markets regaining their calmness.

Moreover, a “stimulus package” decided by the Cabinet recently is of a significantly large scale, amounting to over 28 trillion yen in project size, and is expected to stimulate the economy considerably in both fiscal 2016 and 2017. The upward revision to the growth rate compared to the April Outlook Report is mainly attributable to the effects of such economic measures.

III. Price developments in Japan

Let me now turn to the price developments in Japan. The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is slightly negative due to the effects of the decline in energy prices, but that in the CPI (all items less fresh food and energy) has remained positive for 33 consecutive months since October 2013. The underlying trend in inflation has steadily improved since the introduction of QQE (Chart 5).

However, the year-on-year rate of change in the CPI (all items less fresh food and energy), which reached more than 1 percent in the latter half of last year, saw a deceleration in its rate of increase recently, and was 0.8 percent in June. This is due to the yen's appreciation and the delay in the timing of improvement in inflation expectations.

Inflation expectations have weakened recently, although they appear to be rising on the whole from a somewhat longer-term perspective. Not only market indicators but also survey results regarding inflation expectations have declined. The decline in inflation expectations seems to have been brought about – through an "adaptive formation mechanism" of inflation expectations – by the observed CPI having been at about 0 percent on a year-on-year basis for over a year due in part to the decline in energy prices. In countries such as the United States, people's inflation expectations are anchored at the level around the target set by the central bank, and medium- to long-term inflation expectations are little affected by the decline in the observed CPI; on the other hand, in Japan, where deflation has dominated for a prolonged period of time, formation of inflation expectations tends to be strongly affected by the observed CPI. In addition, relatively weak developments in private consumption observed recently seem to affect firms' price-setting stance. Putting off of price increases by some firms has been observed since the turn of the year, mainly in goods such as food products and durable consumer goods.

Looking ahead, however, the rate of increase in the observed inflation rate is expected to accelerate again. As explained earlier, the employment and income situation has been improving steadily and the unemployment rate is expected to decline further. Against this background, as employee income increases and private consumption picks up, firms' price-setting stance is expected to revert to raising prices. In addition, the "stimulus package" by the government is expected to further tighten the already tight labor market conditions, lead to an increase in wages, and stimulate household spending through the increase in employee income. Many firms want to raise sale prices reflecting the increase in costs such as wage increases, as long as demand such as private consumption can maintain its resilience. Under such circumstances, the mechanism in which inflation rises moderately accompanied by wage increases is expected to continue to operate steadily going forward. Moreover, as downward pressure of energy prices on the CPI is expected to dissipate, the observed CPI is projected to rise, which will likely have a positive impact on inflation expectations.

Given these projections, the baseline scenario is that the timing of the year-on-year rate of change in the CPI reaching around 2 percent will be during fiscal 2017. However, this is accompanied by considerable uncertainties, taking account of heightened uncertainties over the outlook for overseas economies and weakened inflation expectations, as I explained earlier.

IV. Heightened uncertainties

Next, I will touch on risks that warrant attention going forward. Since the Outlook Report discusses these risks in detail, I will explain them briefly and focus on important points.

For economic activity, uncertainties regarding developments in overseas economies are most important. At the beginning, I pointed out uncertainties over future developments in emerging and commodity-exporting economies as well as those growing overseas following the United Kingdom's vote to leave the EU. In addition, the following warrant attention: developments in the U.S. economy and the influences of its monetary policy response to them on the global financial markets, and prospects regarding the European debt problem including the financial sector.

For prices, developments in medium- to long-term inflation expectations in particular need to be closely monitored. I explained earlier that, in Japan, formation of inflation expectations still tends to be strongly affected by the "adaptive formation mechanism." In a case where the rate of increase in the all-item CPI will be low for the time being, the improvement in the expected inflation rates can be contained more than envisaged. Uncertainties surrounding the economic outlook, mainly for overseas economies, can also restrain firms' willingness to increase prices and wages. As the developments in inflation expectations act as an important factor in defining the underlying trend in inflation, they need to be carefully monitored.

V. Thinking behind current monetary policy

I would now like to turn to the Bank's monetary policy.

In light of heightened uncertainties surrounding overseas economies, such as those stemming from the United Kingdom's vote to leave the EU, the Bank at the July 2016 MPM decided to enhance monetary easing in order to prevent these uncertainties from leading to a deterioration in business confidence as well as consumer sentiment, and to ensure smooth funding in foreign currencies by Japanese firms and financial institutions, thereby supporting their proactive economic activities. Specifically, measures taken by the Bank are threefold (Chart 6 [1]).

The first is an increase in Bank's purchases of exchange-traded funds (ETFs). Specifically, the amount of purchases will be almost doubled from an annual pace of about 3.3 trillion yen to an annual pace of about 6 trillion yen. This measure aims at preventing the deterioration in business confidence and consumer sentiment and promoting their proactive risk-taking.

The second is an expansion of the size of the Bank's lending program to support growth in U.S. dollars (the Special Rules for the U.S. Dollar Lending Arrangement to Enhance the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth Conducted through the Loan Support Program). Under this lending program, the Bank will provide back-to-back financing in U.S. dollars to financial institutions by using its U.S. dollar funds in cases where these financial institutions make foreign currency-denominated investments and loans to firms, which contributes to the strengthening of the foundations for economic growth. The duration of the Bank's lending can be up to 4 years through rollovers. The size of the lending program had been 12 billion U.S. dollars since it was introduced in April 2012, and at the end of 2014, the amount outstanding reached the upper limit. Thereafter, the Bank provided new lending within unused allowances made by financial institutions' prepayment of lending. As the loans under the program enable firms to receive stable funding in U.S. dollars over the long term, the potential demand for these loans must be substantial. On this basis, with a view to supporting firms' U.S. dollar funding, the size of the program was doubled and raised to 24 billion U.S. dollars.

The third is an expansion in the amount of collateral that can be pledged under the Bank's U.S. dollar funds-supplying operations. The Bank has been carrying out U.S. dollar funds-supplying operations weekly with U.S. dollar funds raised through a bilateral liquidity swap line with the Federal Reserve. With this operation, financial institutions can raise U.S. dollar funds on a full allotment basis up to the amount of collateral pledged by each institution. The U.S. dollar operations, which were introduced at the time of the global financial crisis, have functioned as a backstop for U.S. dollar funding. At the MPM last month, the Bank decided to establish a new facility in which it lends Japanese government securities (JGSs) to counterparties of these operations against their current account balances with the Bank. Under the current monetary policy, many financial institutions hold a substantial amount of current account balances with the Bank. As these financial institutions become able to borrow JGSs from the Bank – that can be pledged as collateral – against their current account balances, they will be able to raise U.S. dollar funds when necessary without any concern about the amount of collateral they hold. By giving a sense of security, this new facility will further enhance effectiveness of the U.S. dollar funds-supplying operations as a backstop.

Half a year has passed since the Bank introduced "QQE with a Negative Interest Rate." During this period, JGB yields substantially declined across the entire yield curve, and lending rates as well as issuance rates for CP and corporate bonds fell to new record lows (Chart 7). Meanwhile, new developments in corporate finance have been taking place. For example, the amount of issuance of super-long-term corporate bonds, such as 20-year corporate bonds, has been increasing. Positive effects of these highly accommodative financial conditions seem to have been spreading to the real economy gradually. As I mentioned before, business fixed investment plans are firm despite the heightened uncertainties surrounding overseas economies. This is brought about by the significant improvement in overall economic conditions under QQE over the last three years, further supported by the unprecedentedly accommodative financial conditions. Moreover, with regard to housing investment, demand for housing loans has been increasing. This was confirmed by the result of the July 2016 *Senior Loan Officer Opinion Survey on Bank Lending Practices at Large Japanese Banks* released recently. Going forward, positive effects of the negative interest rate policy on the real economy will become more evident. The Bank will continue with "QQE with a Negative Interest Rate," aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will examine risks to economic activity and prices, and take additional easing measures in terms of three dimensions – quantity, quality, and the interest rate – without hesitation if it is judged necessary for achieving the price stability target.

Let me also talk about the relationship between the Bank's monetary policy and the government's fiscal policy, which has been discussed from various perspectives recently.

As I have said, the government has been undertaking fiscal and structural policy initiatives, including a large-scale "stimulus package" that was announced recently. In order for Japan's economy to achieve sustainable economic growth with price stability, the Bank welcomes these initiatives, which are indeed timely. In addition, the Bank believes that highly accommodative financial conditions under "QQE with a Negative Interest Rate" and the government's policies will exert synergy effects on the economy (Chart 6 [2]).

As you may have learned during an introductory course of macroeconomics, when the government increases fiscal expenditures by issuing government bonds, interest rates on government bonds will rise, discouraging private-sector investment. This effect is called "crowding out." In this context, if the central bank is pursuing monetary easing at the same time, the rise in interest rates will be contained, thereby preventing "crowding out" effects. This combination of fiscal and monetary policy is called a "policy mix," which is a widely accepted idea in macroeconomic policy management.

This idea can be applied to the current situation in Japan. Market interest rates in Japan have been in negative territory across a wide range of maturities due to the effects of the Bank's "QQE with a Negative Interest Rate." In this situation, when the government expands fiscal expenditure, its effects of stimulating the economy will be very powerful due to the synergy effects. This "policy mix" is different from "helicopter money," which is an expansionary fiscal policy financed by a permanent increase in the central bank's money, and from "deficit financing," in which the central bank purchases government debts for the sake of facilitating the government's financing. As "helicopter money" has been widely debated in the financial market, it is not productive to discuss pros and cons of "helicopter money" without defining it clearly. What is important is the fact that a "policy mix" comprised of flexible management of fiscal policy and QQE has been implemented in Japan over the last three years; this "policy mix" is very powerful among the measures implemented in modern history, and it will be strengthened further with the new large-scale fiscal "stimulus package" in combination with "QQE with a Negative Interest Rate."

At the latest MPM, the Bank acknowledged that there were considerable uncertainties over prices going forward, which could be significantly affected by developments in overseas economies and the global financial market and, reflecting this, developments in medium- to long-term inflation expectations. Against this background, with a view to achieving the price stability target of 2 percent at the earliest possible time, the Bank decided to conduct a comprehensive assessment at the next MPM of the developments in economic activity and prices under "QQE" and "QQE with a Negative Interest Rate" as well as these policy effects (Chart 6 [3]). The Bank's staff will prepare for deliberation at the next MPM. Let me share with you our thinking and motivation behind this project.

Since the introduction of QQE in April 2013, Japan's economic activity and inflation have improved substantially, and Japan's economy is no longer in deflation. There is no doubt that a clear commitment to the price stability target of 2 percent and large-scale monetary easing that underpinned this commitment under QQE have been very effective for Japan's economy to move toward getting out of deflation. That said, the price stability target of 2 percent has not been achieved yet, despite unprecedentedly large-scale monetary easing. With this in mind, we would like to re-examine the transmission mechanism of policy effects and possible factors that may have hampered this mechanism. In addition, "QQE with a Negative Interest Rate," which was introduced in January 2016, has already exerted substantial downward effects on interest rates through a combination of the negative policy rate and JGB purchases. At the same time, it has had a variety of impacts on financial institutions and markets. We also would like to assess the mechanism of this policy as well as its effects and influences on the real economy and the financial side.

This is our thinking and motivation behind the comprehensive assessment. Naturally, the emphasis may vary among Policy Board members depending on his/her view. Let me make it clear that we do not have any specific future directions of monetary policy at this moment. We would like to work with an open mind so that we can make an assessment from various perspectives and have a discussion in a productive manner on what should be done for the price stability target of 2 percent to be achieved at the earliest possible time. We intend that the comprehensive assessment will contribute to planning monetary policy going forward.

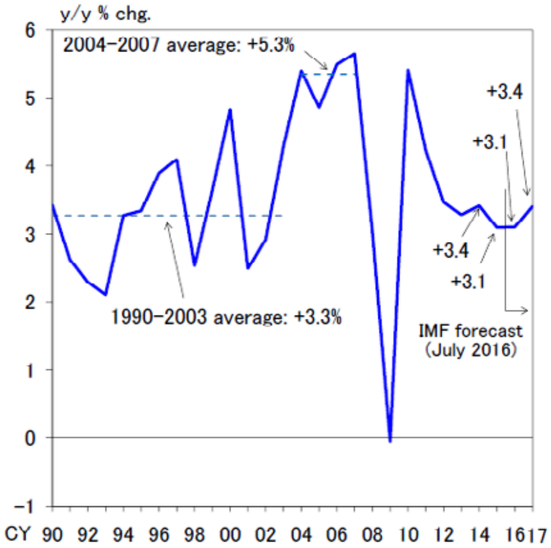
Let me conclude my speech by touching on the local economy of Kanagawa Prefecture. The prefecture is endowed with a variety of tourist attractions such as the Yokohama Minato Mirai area, Kamakura, Enoshima-Shonan, and Hakone. In addition, I have heard that it is receiving a lot of good news about the prefecture being an international tourism region. This includes the news that it succeeded in bids to host global sports events, such as the Rugby World Cup 2019, and that one of its cities is going to host sailing competitions during the 2020 Olympic Games. In closing, I wish all the best for the further growth and development of the economy of Kanagawa Prefecture, fully taking advantage of its geographic significance – that is, being located in the Tokyo metropolitan area – as well as its wide-ranging potential.

Thank you.

Chart 1

World Economic Outlook

Real GDP Growth Rate



Projections for Major Economies (as of July 2016)

y/y % chg.

	2014	2015	Projections 2016	Projections 2017
World	3.4	3.1	3.1 (3.2)	3.4 (3.5)
Advanced Economies	1.9	1.9	1.8	1.8
United States	2.4	2.4	2.2	2.5
Euro Area	0.9	1.7	1.6	1.4
United Kingdom	3.1	2.2	1.7	1.3
Japan	0.0	0.5	0.3	0.1
Emerging Market and Developing Economies	4.6	4.0	4.1	4.6
China	7.3	6.9	6.6	6.2
ASEAN5	4.6	4.8	4.8	5.1

Notes: 1. ASEAN5 are Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam.
2. Figures in parentheses are as of April 2016.
Source: IMF.

Chart 2

Outlook for Economic Activity and Prices (as of July 2016)

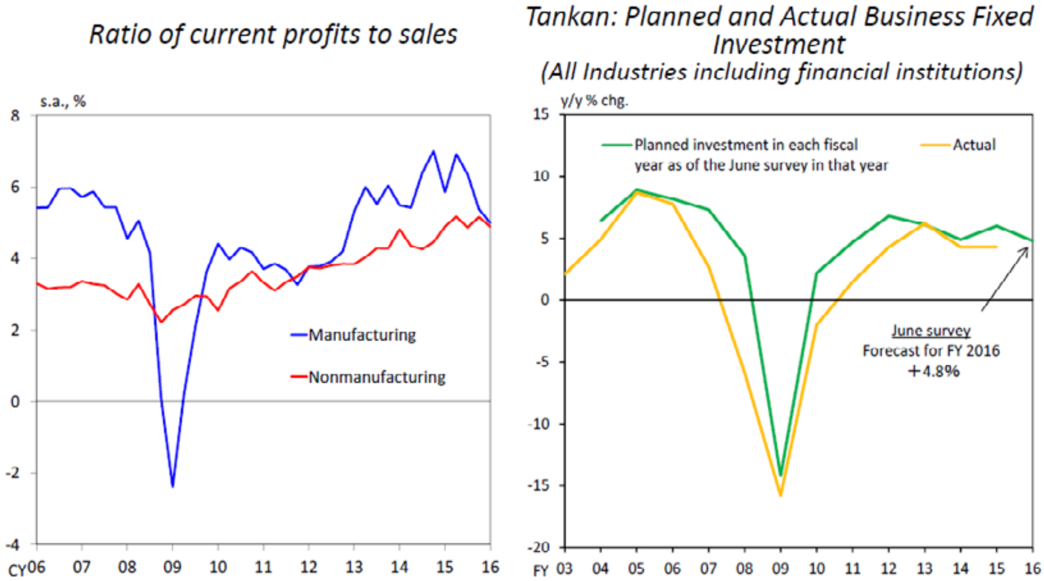
y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2016	+1.0	+0.1	
Forecasts made in April 2016	+1.2	+0.5	
Fiscal 2017	+1.3	+1.7	
Forecasts made in April 2016	+0.1	+2.7	+1.7
Fiscal 2018	+0.9	+1.9	
Forecasts made in April 2016	+1.0	+1.9	

Notes: 1. Figures indicate the median of the Policy Board members' forecasts (point estimates).
2. Real GDP forecasts made in April 2016 factor in the expected front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike that had been planned to take place in April 2017.
Source: Bank of Japan.

Chart 3

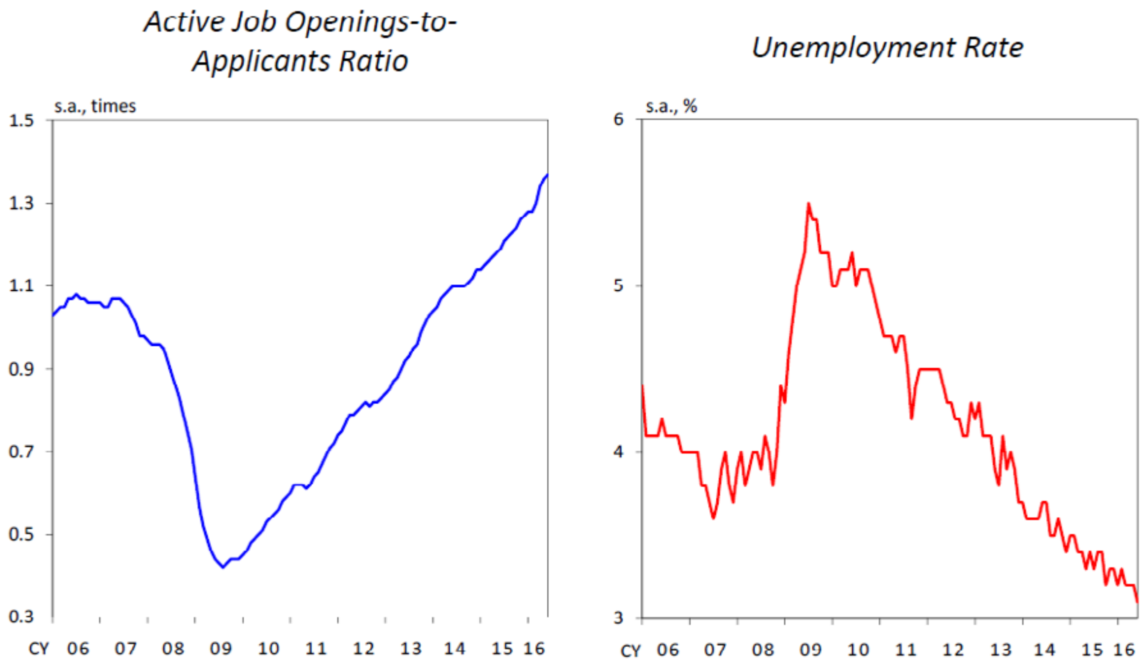
Corporate Profits and Business Fixed Investment



Notes: 1. Figures for ratio of current profits to sales exclude "Finance and Insurance".
2. Figures for business fixed investment include software investment and exclude land purchasing expenses.
Sources: Ministry of Finance; Bank of Japan.

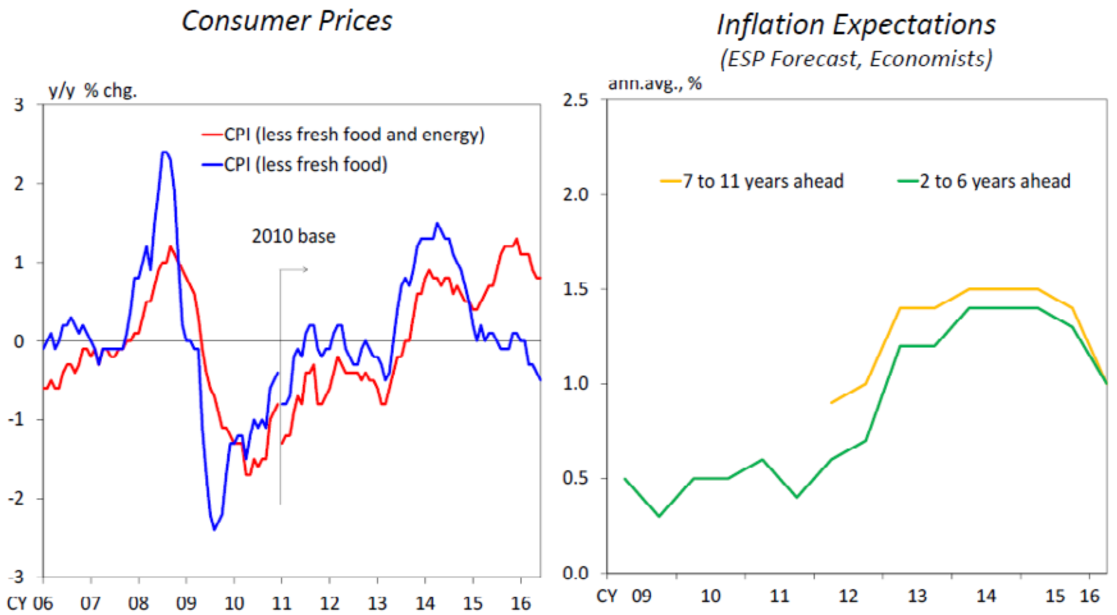
Chart 4

Labor Market Conditions



Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare.

Chart 5
Consumer Prices and Inflation Expectations



Notes: 1. Figures for the CPI (less fresh food and energy) are calculated by the Research and Statistics Department, Bank of Japan.
2. Figures for the CPI are adjusted to exclude the estimated effects of changes in the consumption tax rate.
3. Figures for the "ESP Forecast" are compiled every June and December, and exclude the effects of the consumption tax hikes.

Sources: Ministry of Internal Affairs and Communications; JCER.

Chart 6
Enhancement of Monetary Easing (July 2016)

Against the backdrop of the United Kingdom's vote to leave the European Union and the slowdown in emerging economies, volatile developments have continued in the global financial markets.

The Bank will support proactive economic activities by **preventing a deterioration in business confidence and consumer sentiment** as well as **ensuring smooth funding in foreign currencies by Japanese firms and financial institutions.**

(1) Policy measures decided at the July 29 Monetary Policy Meeting

1. The Bank will purchase **ETFs** so that their amount outstanding will increase at an annual pace of about **6 trillion yen** (almost **double** the previous pace of about 3.3 trillion yen)
2. In order to **ensure smooth funding in foreign currencies**
   (A) For firms: **Double** the size of the Bank's lending program to support growth in U.S. dollars to **24 billion USD**
   (B) For financial institutions (FIs): Establish a new facility in which the Bank lends JGSs to FIs against their current account balances with the Bank. The JGSs can be pledged as collateral for using the U.S. Dollar Funds-Supplying Operations (i.e., virtually, financial institutions are allowed to pledge **cash collateral** for using the operation)

(2) The Bank's view on the relationship between the government's initiatives and monetary policy measures

The Government is undertaking fiscal and structural policy initiatives. The Bank believes that its monetary policy measures and the government's initiatives will produce **synergy effects on the economy.**

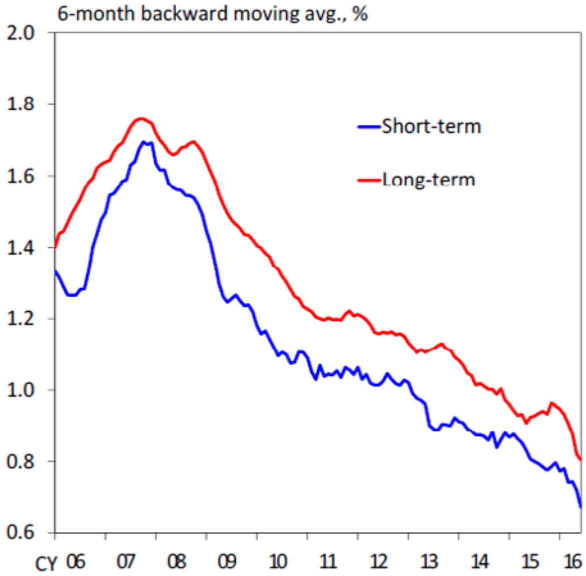
(3) Comprehensive Assessment of the "QQE" and "QQE with a Negative Interest Rate" to be made at the Next MPM

With a view to achieving the price stability target of 2 percent at the earliest possible time, the Bank will conduct **a comprehensive assessment of the developments in economic activity and prices under "QQE" and "QQE with Negative Interest Rate" as well as these policy effects at the next MPM.**

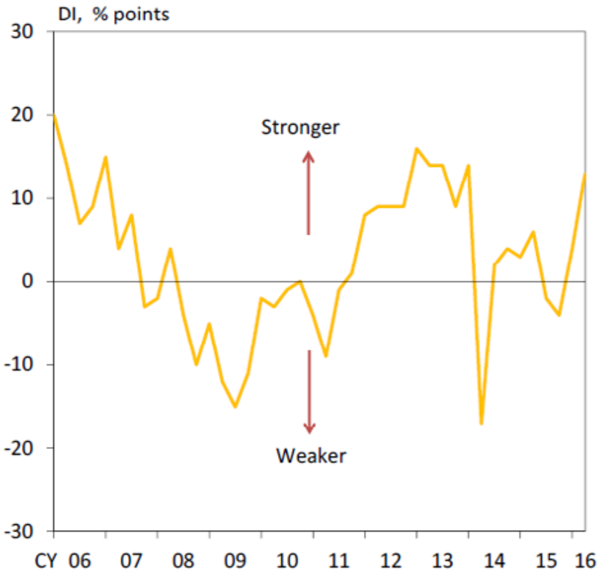
Chart 7

Financial Conditions

Average Contract Interest Rates on New Loans and Discounts



Demand for Housing Loans from Households
(Senior Loan Officer Opinion Survey on Bank Lending Practices at Large Japanese Banks)



Note: DI for demand for housing loans is calculated as follows. DI for demand for housing loans = (percentage of respondents selecting "substantially stronger" + percentage of respondents selecting "moderately stronger" × 0.5) – (percentage of respondents selecting "substantially weaker" + percentage of respondents selecting "moderately weaker" × 0.5)
Source: Bank of Japan.