Makoto Sakurai: Economic activity, prices, and monetary policy in Japan

Speech by Mr Makoto Sakurai, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Saga, 25 May 2017.

* * *

I. Economic Activity at Home and Abroad: Recent Developments and the Outlook

A. Overseas Economies

Let me start with developments in overseas economies.

The decelerating trend in overseas economies that had continued since the global financial crisis has at long last come to a halt, and a recovery is starting. Since the latter half of 2016, trade has been recovering globally, due partly to a rise in IT-related demand for smartphones and data centers as well as progress in inventory adjustments in emerging economies. Prices of crude oil and other commodities have been stable, and this is also helping to underpin economic activity, especially in commodity-exporting economies. Under these circumstances, business sentiment has been improving rapidly in many regions. Going forward, overseas economies are likely to continue to recover for the time being. According to the April 2017 *World Economic Outlook* (WEO) released by the International Monetary Fund (IMF), global growth is expected to rise from 3.1 percent in 2016 to 3.5 percent in 2017, and 3.6 percent in 2018, picking up pace for the first time in three years. The April 2017 estimate also represents an upward revision from the previous estimate made in January 2017.

Let me elaborate on developments by region, starting with advanced economies. The U.S. economy has continued to recover firmly, mainly due to a recovery in household spending, owing to a steady improvement in the employment and income situation. While monetary policy has started to be tightened, it is likely that the federal funds rate will be raised only gradually, so that it is unlikely that monetary tightening will restrain economic activity excessively. As for the economic policies of the new U.S. administration, optimistic expectations have receded somewhat, but the majority view still appears to be that expansionary fiscal policies will be implemented, albeit at a later date than previously expected. In this situation, the U.S. economy is expected to continue to see firm growth for the time being, driven mainly by domestic demand, and lead the recovery of the global economy.

The European economy has continued to grow moderately, driven mainly by the household sector. There remains uncertainty associated with political issues, such as negotiations on the United Kingdom’s exit from the European Union (EU) and elections in major countries, as well as uncertainty associated with debt problems including those in the financial sector. While such uncertainty is likely to continue to weigh on the economy, it is highly likely that the European economy will continue to grow moderately as a trend.

Let me turn to emerging economies. The Chinese economy has continued to see stable growth and is expected to remain on a stable growth path on the whole. This is due to the flexible fiscal and monetary policy conduct by the authorities, although factors such as adjustments of excess production capacity are likely to exert downward pressure on the economy. Many other emerging Asian economies have recently shown a sharp increase in exports. In commodity-exporting economies such as Russia and Brazil, positive developments, including improvements in the trade balance and in business and consumer confidence indicators, have been observed following the bottoming out of commodity prices. As for the outlook, emerging and commodity-exporting economies are expected to grow moderately, supported mainly by the effects of the recovery in advanced economies and of economic stimulus measures gradually taking root.

Needless to say, the outlook is not free from uncertainty. As I mentioned earlier, there is persistent uncertainty over issues such as U.S. economic policies, negotiations on the United Kingdom's exit from the EU, and elections in major European countries. Given that economic fundamentals have recently been sound, it is relatively unlikely that markets will become excessively risk averse in the near term. In fact, contrary to previous expectations, markets reacted favorably to the outcome of the U.S. presidential election. Over the long term, however, economic activity around the world will inevitably be affected if uncertainty over the issues I mentioned heightens further. I believe that particular attention needs to be paid to the fact that this uncertainty is linked to signs of a growing protectionist mood. Over the past few decades, global economic growth has been driven by the expansion of trade and direct investment, spurred by technological innovation. Today, complex supply chains have been established at the global level. If the protectionist mood gains traction, this will restrain trade and direct investment, making it necessary to rebuild existing supply chains. This could cause significant disruption to the global economy and deprive it of its main growth engine. For the global economy to maintain stable growth over the long term, it is essential to ensure the freedom of trade and direct investment.

B. Japan's Economy

Next, I will discuss developments in Japan's economy.

The economy has been turning toward a moderate expansion amid the recovery in overseas economies. The annual real GDP growth rate in fiscal 2016 was 1.3 percent, higher than the potential growth rate, which is estimated to be in the range of 0.5-1.0 percent, and the output gap has clearly climbed into positive territory. Going forward, Japan's economy is likely to continue its moderate expansion for the time being, on the back of the continuing recovery in overseas economies as well as progress in the implementation of the government's economic stimulus measures, helped, moreover, by a strengthening of synergy effects between economic stimulus measures and accommodative financial conditions. In the Bank's April 2017 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), the median of Policy Board members' forecast of real GDP growth was 1.6 percent for fiscal 2017 and 1.3 percent for fiscal 2018. As the economy is likely to continue growing at a relatively high pace above its potential, the positive output gap is also expected to steadily widen.

Let us look at Japan's growth by expenditure item. Since the latter half of 2016, the growth momentum of exports has become more pronounced in line with the recovery in overseas economies. Exports to emerging economies — which had continued to be relatively sluggish — have recently shown a marked increase, led by exports of electronic parts and capital goods to Asia. Going forward, exports are expected to follow a moderate increasing trend in line with the moderate rise in growth in overseas economies.

Corporate profits have been at historically high levels, supported not only by the increase in demand at home and abroad but also by the depreciation of the yen since late 2016. Under these circumstances, business sentiment has steadily improved. In the Bank's March 2017 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the diffusion index for business conditions for all industries and enterprises (the proportion of firms responding that business conditions were "favorable" minus the proportion of those responding that they were "unfavorable") suggested that business conditions have improved for three consecutive quarters, reaching a level last seen in March 2014 just prior to the consumption tax hike to 8 percent. As for the outlook, corporate profits are projected to follow a steady increasing trend, supported by the rise in demand at home and abroad on the back of the improvement in overseas economies and the effects of economic stimulus measures.

Business fixed investment has been on a moderate increasing trend as corporate profits have improved. In the March 2017 *Tankan*, business investment — based on a definition similar to that employed in the GDP statistics, i.e., including software as well as research and development investment, but excluding land purchasing expenses, in all industries including the financial industry — increased by 1.3 percent in fiscal 2016, and business fixed investment plans for fiscal 2017 signal an increase of 1.9 percent. This latter figure is well above the average growth rate of planned business fixed investment for the next fiscal year in the March *Tankan* in previous years; the average rate from fiscal 2004 through 2015 stands at minus 0.9 percent. As corporate profits continue to improve, business fixed investment is expected to continue increasing moderately, supported by the synergy effects between accommodative financial conditions and the government’s economic stimulus measures.

Supply and demand conditions in the labor market have tightened further, with the active job openings-to-applicants ratio reaching 1.45, which is close to the peak of 1.46 observed during the asset price bubble in the late 1980s. The unemployment rate is 2.8 percent, which essentially represents full employment. In this situation, wages have been rising, albeit at a moderate pace. In the annual spring labor-management wage negotiations in 2017, many firms are likely to have raised their base pay for the fourth consecutive year. While the rate of increase is more or less the same as in the previous year, wage increases have become more widespread, as shown by the notable wage increases at small firms, which are experiencing particularly acute labor shortages. Given that small firms account for a large share of employment, it is expected that the wage growth for employees as a whole will accelerate.

Meanwhile, growth in private consumption had been slow following the consumption tax hike in 2014. However, private consumption has recently been resilient due to the improvement in the employment and income situation as well as the wealth effect resulting from the rise in stock prices. Private consumption is expected to gradually become firmer on the back of continued improvement in the employment and income situation.

Turning to the outlook for Japan’s economy, some argue that the tightening of labor market conditions limits the room for growth. Personally, I do not agree with this view. Firms have been addressing immediate labor shortages by, for example, closing unprofitable stores, shortening business hours, and limiting orders for their services. I believe that rather than signaling that firms have given up hopes for growth, these steps represent efforts to use labor more efficiently. Furthermore, some firms have decided to invest in labor-saving machinery and equipment such as self-checkout machines. The fact that tighter labor market conditions are encouraging firms to improve productivity seems to be desirable for economic growth over the long term. From a historical perspective as well, labor shortages are not a significant problem in terms of economic growth. In past episodes, the main factor underlying economic growth was not an increase in the labor force. Rather, past economic growth can be explained mostly by improvements in productivity. Also, a sustainable rise in wages achieved through productivity improvements encourages households to be proactive in spending and this, I believe, will likely lead to a stable rise in prices. In this respect, I see these activities by firms in a positive light also from the viewpoint of monetary policy management.

C. Prices

The year-on-year rate of change in the consumer price index (CPI) for all items less fresh food has recently been about 0 percent. Although prices of petroleum products have turned up, housing rent and public utility charges have continued to make negative contributions to CPI inflation. In addition, the reduction in mobile phone prices and charges has also put downward pressure on prices.

Compared with the improvements in the output gap and corporate profits, the recent pace of increase in inflation and wages seems somewhat unsatisfactory. One of the factors behind this situation is that in Japan, where the inflation rate has remained very low for the past few decades, it is difficult for people to imagine prices to rise to some extent every year. Recently, price hikes in some services and other industries have received intense media coverage by newspapers and television programs. Based on this reaction, I feel that in Japan, price hikes still tend to be rather exceptional, and the country has not yet reached a stage where people accept such hikes as a matter of course. Moreover, concerns regarding, for example, the growth potential of Japan's economy seem to be strengthening households' tendency to save their income as well as firms' cautious wage-setting stance. I will return to this point later.

That being said, upward pressure on prices is expected to increase further as the moderate economic expansion continues. Going forward, Japan's positive output gap is expected to widen further on the back of (1) an improvement in capital utilization rates brought about by the increase in exports and production, and (2) a tightening of labor market conditions due to the effects of various economic stimulus measures taking hold. If the observed inflation rate — as a result of the past rise in energy prices and the depreciation of the yen — rises, people's inflation expectations are likely to change gradually through the adaptive formation mechanism. The Bank's pursuit of monetary easing through its strong commitment to achieving the price stability target is also expected to contribute to a rise in people's inflation expectations. Under these circumstances, prices are likely to gradually turn to a clear uptrend. In terms of the median of Policy Board members' forecasts in the April 2017 Outlook Report, the rate of increase in the CPI for all items less fresh food is projected to steadily accelerate to 1.4 percent for fiscal 2017 and 1.7 percent for fiscal 2018. I feel comfortable with this outlook and believe that the momentum toward achieving the price stability target of 2 percent is intact.

II. Monetary Policy

In September 2016, the Bank introduced Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control as a new framework for strengthening monetary easing. The framework consists of the two components of an inflation-overshooting commitment and yield curve control.

Under the inflation-overshooting commitment, the Bank commits itself to continuing to expand the monetary base until the observed year-on-year rate of increase in the CPI for all items less fresh food exceeds the price stability target of 2 percent and stays above the target in a stable manner. Let me note that the effects of monetary policy spread through the economy with a certain time lag. Therefore, central banks in general conduct monetary policy in a forward-looking manner based on projections for economic and price developments. In this respect, the inflation-overshooting commitment is an extremely strong commitment in that it is linked to observed CPI inflation. As I mentioned earlier, in Japan, the expectation — shaped by past experience — that prices will not rise much in the future is deeply entrenched. In this situation, I believe that a strong commitment like this is necessary in order to try to enhance public confidence that the price stability target will be achieved and thereby raise inflation expectations.

Under yield curve control, the Bank facilitates the formation of short- and long-term interest rates that are considered most appropriate in light of the 2 percent price stability target. In the current guideline for market operations, the target level for the short-term policy interest rate is set to minus 0.1 percent and the target level for yields on 10-year Japanese government bonds (JGBs) is set to around 0 percent. As part of the interest rate control, the Bank also formulates the guideline of the approximate amount of JGBs to be purchased; currently, the guideline sets out an annual pace of increase in the amount outstanding of the Bank's JGB holdings of about 80 trillion yen. Interest rate control and JGB purchases are two sides of the same coin. However, while the target for JGB purchases is set as an approximate amount, the interest rate target is a clear-cut commitment. This may lead to the conclusion that the focus is on the control of interest rates. Nevertheless, there is no change in the Bank's stance of continuing with monetary easing from both a quantitative and an interest rate perspective.

In my view, the introduction of yield curve control has made it possible for the Bank to implement monetary easing measures more flexibly, taking account, for example, of the effects on financial intermediation, and the sustainability of these measures has been enhanced. I should also note that, as a secondary effect, it has become easier to understand the effects of the Bank's policies. The policy measures implemented prior to QQE with Yield Curve Control — which had set the monetary base as the operating target for monetary policy — also had the effect of lowering interest rates, but people, other than market participants, were probably less familiar with these policy measures. Yield curve control, which directly sets a target level for 10-year JGB yields, more clearly demonstrates accommodative financial conditions to a wider range of economic entities. Let me highlight that even though long-term interest rates have been rising around the globe since the U.S. presidential election, 10-year JGB yields — which the Bank's yield curve control focuses on — have been firmly kept at the target level. I believe that this has provided an effective demonstration of the positive impact of Japan's monetary policy.

Until now, many central banks have set short-term interest rates as the operating target for monetary policy. Controlling long-term interest rates is a new challenge, and the introduction of this policy framework has involved a certain degree of uncertainty. However, since the introduction of the framework, the Bank has been able to maintain 10-year JGB yields at the target level without particular problems. Going forward, it is important for the Bank to continue to conduct monetary policy with care while accumulating experience through the fine-tuning of operations based on day-to-day market conditions and through close communication with market participants as well as the general public.

Let me emphasize that the Bank will work toward the formation of the yield curve that is deemed appropriate for maintaining the momentum toward achieving the 2 percent price stability target. Given that long-term yields overseas have started to rise, some market participants have argued that the Bank in the near future might start considering to raise the long-term interest rate target level. However, given that the recent pace of increase in prices is still moderate and there is lingering uncertainty regarding overseas economies, the Bank, for the time being, should support economic entities' initiatives by persistently pursuing monetary easing under the current policy framework.

III. Challenges Facing Japan's Economy

Japan's economy has recently been recovering steadily. On the other hand, rises in prices and wages have been relatively moderate. There are various factors behind this, with one example being the previously mentioned concerns among households and firms regarding the future. It seems that households have tended to save their income due to a lack of confidence that income rises are permanent while firms — in anticipation of a possible deterioration in their earnings environment — remain cautious about raising wages, particularly base pay, due to downward wage rigidity. Factors behind the rise in concerns regarding the future likely include: (1) doubts over Japan's economic growth potential stemming from the low birth rate and aging population and doubts over the sustainability of the social security system, including pensions, (2) relatively unfavorable working conditions for non-regular employees, and (3) the growing protectionist mood across the globe.

Given these factors, what policy actions should be taken? As I already mentioned, the current economic situation is favorable, and the positive output gap is likely to widen steadily for the time being. Under these circumstances, it is unnecessary to implement additional policy measures to forcibly push up short-term demand. Doing so would only increase fluctuations in economic activity and thereby do more harm than good; for example, it could hamper efficient resource allocation. It is important to keep in mind that the Bank's goal is to achieve the price stability target in a stable manner and in that situation realize sustainable economic growth. Even if forcibly boosting short-term demand might succeed in achieving 2 percent inflation, such inflation would not be sustainable.

In my view, if people's concerns regarding the future are rooted in the longer-term challenges that I cited earlier, the only solution is to make steady efforts to address each of these challenges in earnest, although resolving them might take time. For example, in order to raise the economic growth potential amid the low birth rate and aging population, it is important to provide policy support for firms' efforts to improve productivity and accelerate innovation. Of course, initiatives to expand the labor force should also continue, such as creating a work environment favorable to women and the elderly. To enhance confidence in the social security system, it is necessary to work on fiscal consolidation. The government's initiatives for working-style reforms, which include an improvement in working conditions for non-regular employees, are a very significant policy challenge. I would also like to note that although the importance of free trade is widely recognized in the global community, if the protectionist mood gains traction in the future, it will be necessary to reaffirm the value of free trade and direct investment at international forums.

Addressing these long-term challenges takes time and may sometimes be a painful process. That is why it will be more difficult to address these challenges in times of recession. Although the current economic situation is favorable, the economy goes through cycles of expansion and recession. It is obviously impossible to maintain economic growth above potential forever. Therefore, it is important to do the utmost to tackle long-term challenges before the economy enters recession. Such efforts will more firmly ensure long-term economic stability and alleviate concerns regarding the future among households and firms, thereby contributing to a rise in inflation and in wages in the near term.