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Bank of Japan

Japan's Growth Potential and Quantitative and Qualitative Monetary Easing

Remarks at a Panel Discussion at
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My name is Kikuo Iwata and I am the Deputy Governor of the Bank of Japan. I would like to thank the Bank of Korea for giving me the opportunity to be part of this panel discussion.

Before starting my remarks, let me extend my condolences for those lost in the recent ferry accident and offer my deep sympathies to their families.

I would like to take this opportunity to offer you my thoughts on the relationship between the Bank of Japan's monetary policy and the strengthening of Japan's growth potential, which is the topic of this panel discussion.

I. The Bank of Japan's Monetary Policy

A. Outline of Quantitative and Qualitative Monetary Easing

Let me start by briefly explaining the monetary policy framework the Bank of Japan has been pursuing (Chart 1).

The Bank has set a price stability target of 2 percent in terms of the year-on-year rate of increase in consumer prices. To achieve this target, the Bank since April 2013 has been pursuing aggressive monetary easing called quantitative and qualitative monetary easing, dubbed QQE.

QQE has two major pillars.

The first pillar is a commitment to achieve the 2 percent price stability target as swiftly as possible. Specifically, in addition to committing itself to the price stability target, the Bank provided a time frame, pledging that it would achieve the price stability target of 2 percent at the earliest possible time, with a time horizon of about two years.

The second pillar consists of underpinning the first pillar -- the commitment -- with specific actions. The main action is to double the monetary base in two years through massive purchases of government bonds, including those with longer remaining maturities. As the wording *quantitative and qualitative* indicates, QQE is a monetary easing policy that uses

both an expansion of the quantity and changes in the quality of assets on the balance sheet of the Bank.

B. The Transmission Mechanism of QQE

A key transmission mechanism of QQE is the lowering of expected real interest rates (Chart 2). The clear commitment by the Bank to achieve the inflation target and the large-scale monetary easing to underpin that commitment will raise inflation expectations. In addition, with short-term nominal interest rates almost at 0 percent, the policy will exert downward pressure on expected long-term real interest rates by containing upward pressure on long-term nominal interest rates through the massive purchases of long-term government bonds.

As a result of the stimulus provided by the decline in expected real interest rates, the output gap, which is thought to be the cause of deflation, will disappear. In addition, QQE is expected to give rise to a virtuous cycle in which closing the output gap will lead to a rise in observed inflation, which in turn will further increase inflation expectations toward the price stability target.

Skeptics argue that achieving the 2 percent price stability target will be difficult without a further depreciation of the yen. However, the point of QQE is to achieve the target through the mechanism just mentioned, that is, through a virtuous cycle of a rise in inflation expectations and an improvement in the output gap. QQE does not rely on an increase in import prices due to depreciation of the yen.

A key challenge in Japan is that, with deflation having taken hold since the second half of the 1990s, people's inflation expectations have declined and *deflationary expectations* have become entrenched. Against this background, one of the core aims of QQE is to work directly on people's inflation expectations to dispel deflationary expectations and raise people's inflation expectations.

C. The Current State of Japan's Economy

One year and two months have passed since the introduction of QQE. So far, QQE has been having the intended effects. Surveys on various economic entities and indicators such as break-even inflation rates observed in the government bond market suggest that Japan's inflation expectations have been rising on the whole (Chart 3). As for nominal interest rates, yields on Japanese government bonds have been hovering stably at low levels.

Against such accommodative financial conditions, Japan's economy has continued to recover moderately accompanied by a virtuous cycle among production, income, and spending (Chart 4). Regarding prices, for example, the year-on-year rate of change in the consumer price index (CPI) excluding fresh food has moved from negative territory to 1.5 percent as of April, excluding the direct effects of the consumption tax hike (Chart 5). Therefore, Japan's economy looks to be on course toward achieving the 2 percent price stability target, and we feel that developments under our policy are promising.

II. The Relationship Between Monetary Policy and the Government's Growth Strategy

So, what is the relationship between the Bank of Japan's monetary policy and the growth potential of Japan's economy (Chart 6)?

The Japanese government has been pursuing a three-pronged strategy that comprises bold monetary easing, flexible fiscal policy, and a growth strategy that aims to spur private investment. These policies are often referred to as the *three arrows of Abenomics*.

The role of monetary policy in this policy mix, in an immediate sense, boils down to overcoming deflation. However, it is also linked to Japan's potential growth rate. The relationship between the two can be summarized as follows.

The first role of monetary policy in this context, needless to say, is to stimulate aggregate demand through large-scale monetary easing, fill the output gap, and thereby bring Japan's economy back to its potential growth path; in other words, to break the vicious cycle between deflation and recession by overcoming deflation.

During the process of the output gap diminishing as a result of QQE, Japan's potential growth rate is likely to rise to some extent. The reason is that workers will be able to work more efficiently, and capital investment will increase and technological innovation advance as firms, reflecting the improved business sentiment, become more willing to take risks. However, raising the growth potential further is not the role of the central bank and its monetary policy, but of the government and policy measures it can take, such as deregulation.

Therefore, the second role of monetary policy is to prepare, by overcoming deflation, the environment necessary for the government to pursue economic structural reforms through its growth strategy to shift the potential growth path upward.

Unless the economy is more or less in good shape, the government cannot promote structural reforms to enhance the efficiency and dynamism of the economy to raise productivity. The reason is that in a deflationary recession there will be strong resistance to the pain that pro-competition policy measures through deregulation might bring. You will have heard of the term *creative destruction*. When deflation continues, destruction will not be followed by creation.

If structural reforms under the growth strategy make progress, these reforms are basically supply-side measures that increase the aggregate supply capacity of Japan's economy. Such increases in supply capacity could result in generating deflationary pressure unless they are accompanied by corresponding increases in aggregate demand. Therefore, to mitigate any deflationary pressure stemming from structural reforms, support through appropriate monetary easing is indispensable.

III. Future Challenges

While the Japanese government aims at achieving 2 percent growth in real GDP, if the growth strategy stalls and strengthening of the growth potential does not move ahead, achievement of the price stability target could lead to *a low real growth rate with mild inflation*. Of course, overcoming protracted deflation itself is a great achievement, but in terms of revitalizing Japan's economy, it will not be enough. The Bank strongly hopes the

government will further enhance its growth strategy in order to strengthen Japan's growth potential.

On the other hand, if the potential growth rate rises as a result of structural reforms under the growth strategy, the output gap might temporarily worsen, leading to downward pressure on prices. However, since the Bank, based on the aim of achieving the price stability target of 2 percent, will continue with QQE as long as necessary to ensure price changes remain in line with the target in a stable manner, such downward pressure on prices can be staved off.

We at the Bank are optimistic that Japan will be able to achieve higher economic growth with a stable inflation rate of about 2 percent before long, and will continue to pursue our policy of QQE to that end.

This concludes my remarks. Thank you for your attention.

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Chart 1

Two Pillars of the QQE

Quantitative and Qualitative Monetary Easing

Commitment

Clear commitment that the BoJ "will achieve the price stability target of 2 % at the earliest possible time, with a time horizon of about 2 years."

Actions

•Increase in Quantity

Increase monetary base at annual pace of about ¥60-70 trillion (mainly through purchases of JGBs)

•Change in Quality

Purchasing assets with higher risk profile (JGBs with longer duration, ETFs and J-REITs)

Chart 2

Transmission Channels of the QQE

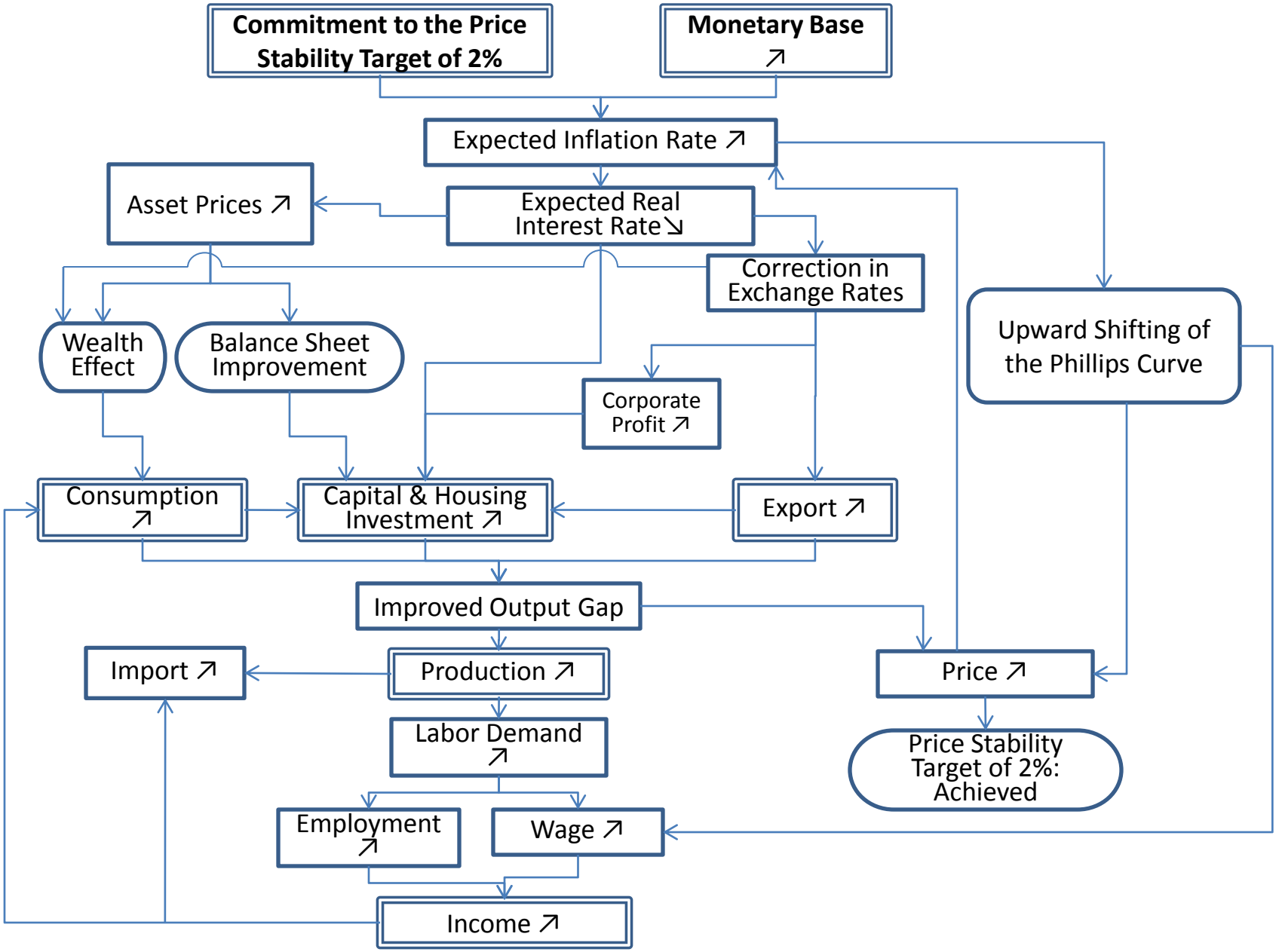
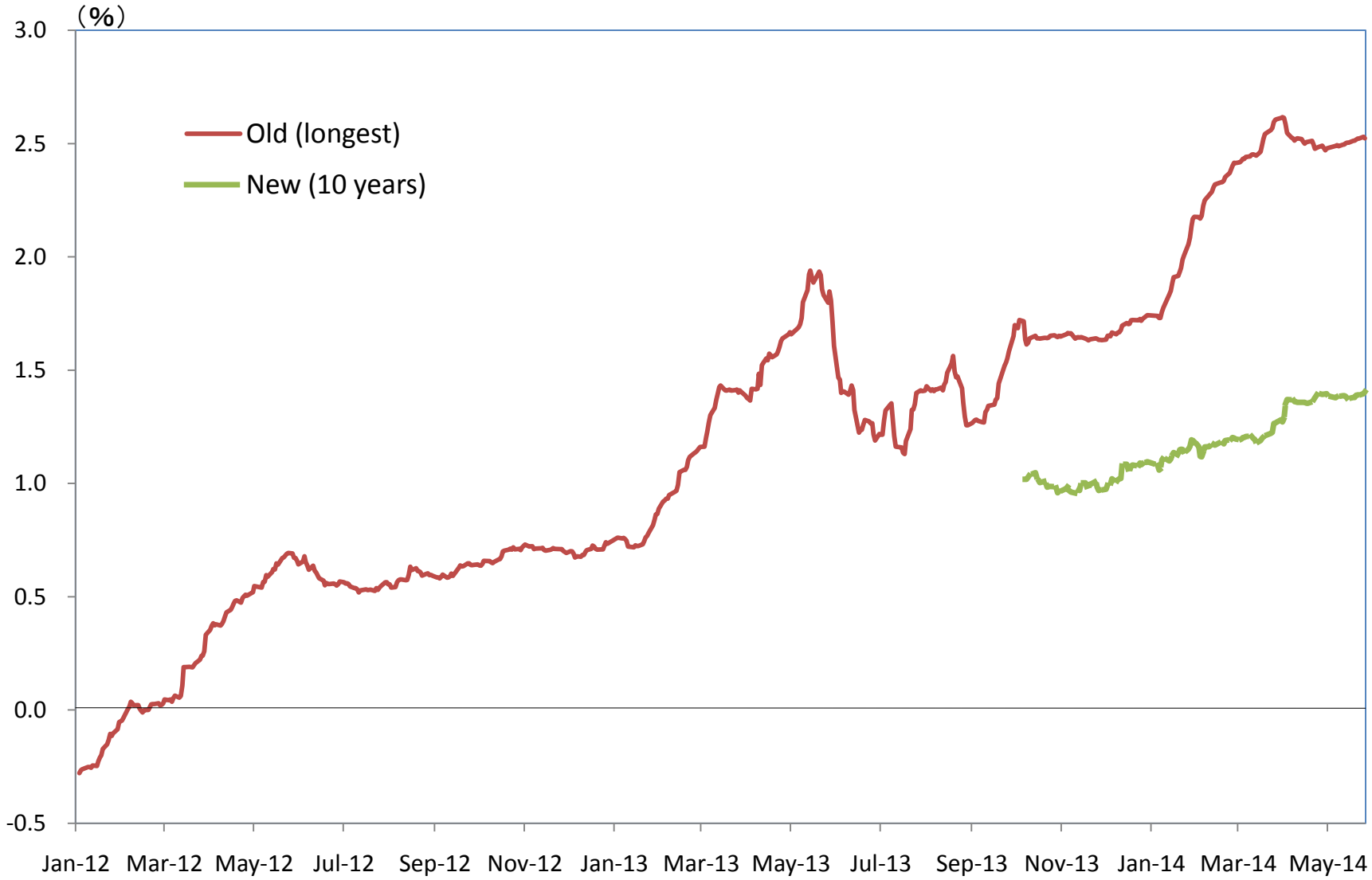


Chart 3

BEI for Inflation-Indexed JGBs



Source: Bloomberg.

Note: Yield spreads between fixed-rate coupon-bearing JGBs and inflation-indexed JGBs. Inflation-indexed JGBs issued since October 2013 are designated as "new," while the rest as "old." Figures for "old (longest)" are calculated using yield data for issue No. 16 of the inflation-indexed JGBs, which matures in June 2018.

Chart 4

Real GDP Growth

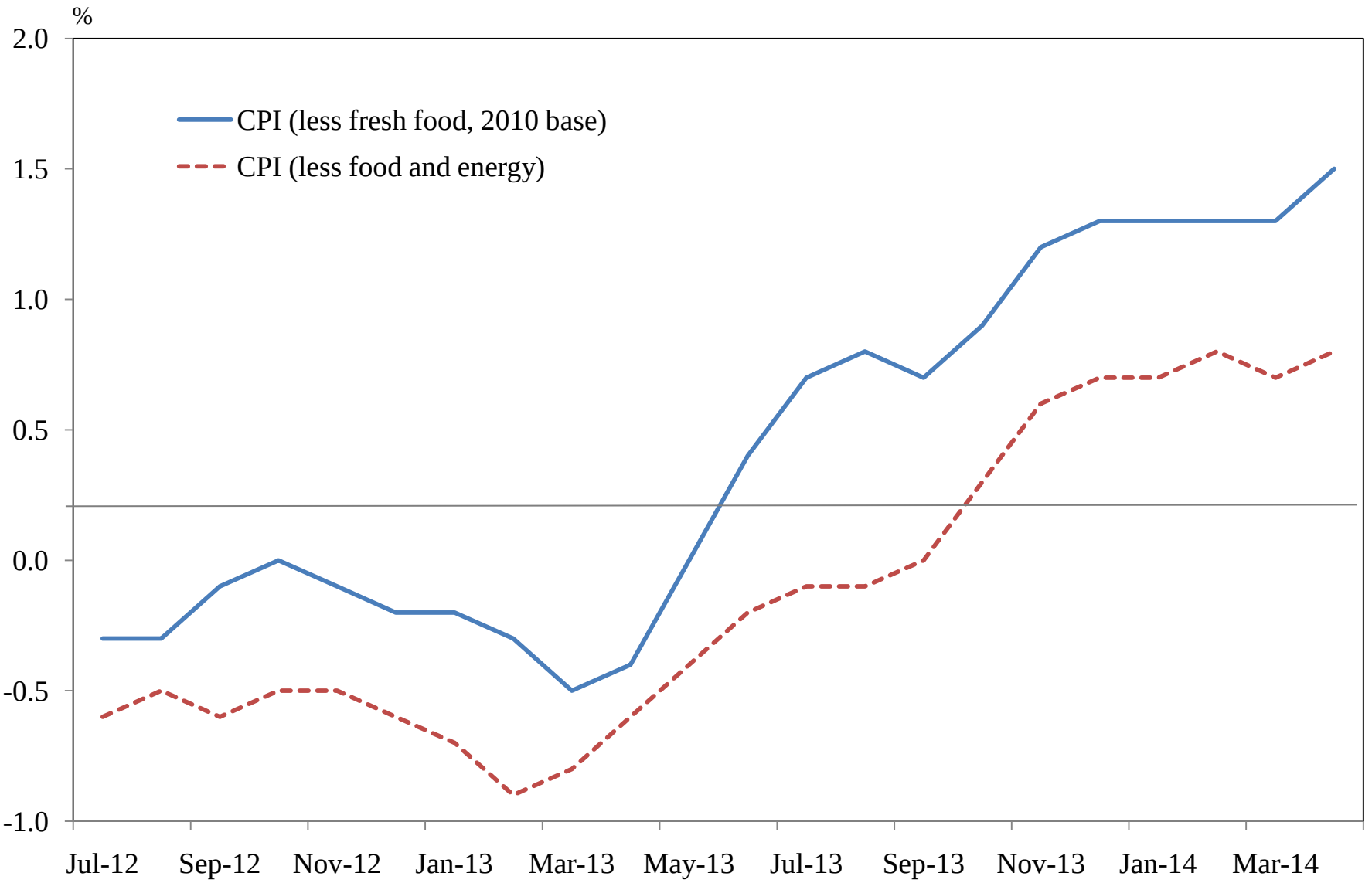
s.a.; q/q % chg.

	2013				2014
	Q1	Q2	Q3	Q4	Q1
Real GDP	1.2	0.9	0.3	0.1	1.5
<Annual rate>	＜4.9＞	＜3.5＞	＜1.3＞	＜0.3＞	＜5.9＞
Private Consumption	1.0	0.7	0.2	0.4	2.1
Residential Investment	1.8	0.8	3.3	4.3	3.1
Non-Resi. Investment	▲2.0	1.0	0.7	1.4	4.9
Government Consumption	0.9	0.7	0.2	0.3	0.1
Public Investment	4.5	6.4	6.9	1.2	▲2.4
Exports	4.3	2.9	▲0.7	0.5	6.0
Imports	1.1	1.8	2.4	3.7	6.3

Source: Cabinet Office, “National Accounts.”

Chart 5

Consumer Prices



Source: Ministry of Internal Affairs and Communications, "Consumer Price Index."
Note: Figures for April 2014 exclude the direct effects of the consumption tax hike.

Chart 6

Respective Roles of Monetary Policy and Growth Strategy