December 24, 2015

Bank of Japan

At the Turning Point

Speech at the Meeting of Councillors of Nippon Keidanren (Japan Business Federation) in Tokyo

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(English translation based on the Japanese original)

Introduction

It is a great honor to have this opportunity to address such a distinguished gathering of business leaders in Japan today.

2016 is now just a week away. Today, to round off 2015, I would like to take a look back at this year's developments in Japan's economy. Then, from a somewhat longer-term perspective, I would like to show what has been achieved under Quantitative and Qualitative Monetary Easing (QQE) as well as what needs to be addressed in order for Japan to move on to a new phase of economic growth.

I. Japan's Economy in 2015

First, I would like to briefly reflect on this year's developments in Japan. The economy has continued to recover moderately on the back of relatively firm domestic demand. Private consumption has been resilient, reflecting continued steady improvement in the employment and income situation. Labor market conditions remain tight, with the current unemployment rate in the range of 3.0-3.5 percent close to "full employment," that is, a situation where remaining unemployment is due solely to mismatches between job openings and job applicants (Chart 1). In the corporate sector, profits have hit record-high levels against a benign backdrop of firm domestic demand, lower crude oil prices, and the correction of excessive appreciation of the yen. Both large and small firms have benefited, translating into a persistently positive attitude to fixed investment across a broad range of industries. Turning to foreign demand, while exports to the United States and Europe had been generally firm, the slowdown in emerging economies, particularly China, had a negative impact through the second half of this year. Exports as a whole do appear to have been picking up recently, however. Moreover, global financial markets have regained a measure of calm after a somewhat nervous summer triggered by the developments in China.

On the price front, the year-on-year rate of change in the consumer price index (CPI) for all items less fresh food has generally been about 0 percent throughout 2015 (Chart 2). However, this was due mostly to a negative contribution from energy prices, with the underlying trend in inflation steadily improving. The year-on-year rate of change in the CPI excluding energy in addition to fresh food moved above zero in October 2013 and has been positive for 25 consecutive months since then, having reached 1.2 percent recently. This marks the first time that such sustained inflation has been seen since the late 1990s, when Japan's economy fell into deflation. Inflation rates for the daily and weekly price indices reported by the University of Tokyo and Hitotsubashi University based mainly on food and daily necessity prices have been clearly positive since the turn of fiscal 2015, with somewhat of an upward acceleration seen until recently (Chart 3). Moreover, the share of items in the CPI for which prices have risen has been outweighing that for which prices have declined by a widening margin. These developments indicate that price hikes by firms in fiscal 2015 have been widespread and sustained.

Japan's economy is thus well on track to achieve the price stability target of 2 percent while continuing its moderate recovery. What I would like to reemphasize here is that the Bank does not consider positive inflation to be a goal in and of itself; rather, we are seeking to catalyze a benign combination of rising prices, improving corporate profits, and increases in employment and wages. There are of course various determinants of prices, but 2 percent inflation is clearly only sustainable if underpinned by adequate growth in income.

Viewed from this perspective, it seems reasonable to conclude that QQE has been exerting its intended effects. As I have noted earlier, corporate profits are at record-high levels. Labor market conditions remain tight, and wages have clearly started to rise, albeit still only moderately. Japan's economic trend has thus changed markedly under QQE. I would next like to elaborate on this point using some charts.

II. Expanding Economy Redux

Let us begin by looking at Chart 4, which shows the trajectories of the CPI and nominal income over these past fifteen years.

The graph on the left shows the level of the CPI. It is immediately clear that the level of consumer prices started to rise with the introduction of QQE after having fallen for fifteen years. The graph on the right shows national income in nominal terms, or roughly the sum of corporate profits and employee income. Nominal income dropped dramatically after the collapse of Lehman Brothers, but just like the CPI, started to rise clearly under QQE.

Nominal GDP, or total value added produced domestically, also shifted into a clear uptrend. Nominal GNI (gross national income), which includes income repatriated from overseas business activities, has increased even more strikingly, reflecting both an expansion of overseas operations by Japanese firms, and the correction of excessive appreciation of the yen.

These facts are indisputable evidence that QQE has moved Japan closer to our envisaged scenario of rising prices accompanied by improving corporate profits and increases in employment and wages.

Rising prices and rising nominal income are being accompanied by rising real income (Chart 5). What matters is that prices, nominal income, and real income are now all trending higher. In GNI terms, real income alone was on a rising trend during the deflationary period, with nominal income held back as prices kept falling. As I have explained on many occasions, the net upshot was a curtailment of spending activity by both firms and households.

History does not offer all that many examples of economic activity and price trends being dramatically reversed through economic policy action. Two years ago I made a speech here at Nippon Keidanren titled "Overcoming Deflation and After." On that occasion, as an example of people's inflation expectations shifting dramatically within a short period, I showcased the New Deal policies implemented by President Roosevelt in the United States during the Great Depression of the 1930s. Roosevelt was clearly determined to overcome deflation, and did so by implementing bold fiscal policy and taking the dollar out of the gold standard. Prices soon started rising, finally bringing an end to the severe deflation triggered by the Great Depression. Chart 6 shows parallels between now and then -- of course, with a difference in magnitude -- with the V-shaped recoveries in prices and income comparable in trajectory. QQE was launched less than three years ago, but Japan's economy already appears close to completing a true regime change.

In particular, clear changes in the wage- and price-setting behavior of firms during this fiscal year indicate that the moderate increase in prices is the outcome of a change in trend rather than just a transitory phenomenon. In the labor-management wage negotiations this spring, base pay increases were agreed for a second straight year at the aggregate level and also became more widespread in terms of both sector and firm size. As I explained earlier, moves to revise prices upward have become widespread and sustained. These developments suggest that firms' and households' perception of prices has been shifting from "prices tend to decline," as was typical during the deflationary period, to "prices tend to rise moderately."

In this context, some economists argue that recent price increases have been largely attributable to the rise in import prices stemming from the past depreciation of the yen, and will thus be impossible to sustain. However, the current pace of inflation and its persistence go well beyond what can be explained in terms of the macroeconomic effects of the yen depreciation. Indeed, moves to hike prices have by no means been confined to items whose prices tend to be relatively sensitive to exchange rate fluctuations. In light of these observations, it can be reasonably assumed that faster inflation has stemmed from both improvements in the aggregate supply-demand balance, as evidenced by a lower unemployment rate, and changes in firms' and households' perception of prices.

III. Toward a New Phase of Growth

Having reviewed the effectiveness of QQE, let us now consider the current circumstances facing Japan's economy from a somewhat longer-term perspective.

Japan's economy has faced two major challenges since the collapse of the late 1980s asset bubble: the so-called "triple excesses" in debt, capacity, and labor, and mild but extremely stubborn deflation.

It is widely recognized that the "triple excesses" have already been eliminated. For example, bank lending finally ended a run of year-on-year declines in 2006, suggesting that the deleveraging process -- so-called "balance sheet adjustments" -- had been largely completed by that time. The deflation problem persisted for 15 years, but an end to it is now clearly in sight thanks to QQE. Japan is thus moving on from the two "negative legacies" of the bubble economy once and for all, and its readiness to compete is looking the best it has been in around a quarter of a century.

Some may find this surprising, but I would argue that Japan is currently well placed among even the major advanced economies. The United States and Europe, from which the 2008-2009 global financial crisis emanated, are facing debt overhangs stemming from the crisis with current debt levels higher than during the 1990s, and Japan's own experience suggests that the deleveraging process generally has further to run (Chart 7).

Japan does of course have a number of structural issues to deal with including intensifying competition from emerging economies and shrinking of the labor force as the population continues to age. However, Japan is by no means alone among developed economies in this regard, and, having already moved on from the aforementioned "negative legacies," may now have an ideal opportunity to lead the way in addressing its structural issues through proactive spending strategies. So let me now talk about what Japan should be doing to address slowing productivity growth and contraction of the labor force.

It is well known that Japan has suffered a significant productivity deceleration in a situation of the prolonged after-effects of the bubble's collapse, but as can be seen from Chart 8, Western advanced economies have been in a similar predicament since the recent global financial crisis. Indeed, there is now very little difference in productivity growth between Japan, the United States, and Europe. This may help to explain why the so-called "secular stagnation" hypothesis -- the possibility that sluggish growth might be here to stay -- has been such a hot topic of late.

While acknowledging that productivity growth has indeed slowed right across the globe, I do not personally subscribe to the "secular stagnation" hypothesis. Modern history shows us that productivity growth is not necessarily linear, with periods of acceleration and deceleration tending to be interspersed. The 1970s also saw a slowdown in productivity growth globally, and policy makers and academic economists have long argued about the possible causes, with candidates including the impact of the first oil shock and a diminished capacity to innovate. The jury is still out, but we can of course now say that at least some of the brakes on productivity growth proved temporary rather than permanent. In particular, the U.S. economy suffered a loss of competitiveness during the 1980s and found itself battling "twin deficits" (on its trade and fiscal balances), but the IT revolution then paved the way for what has come to be known as the "roaring nineties," with productivity growth surging through the turn of the century. From this long-term perspective, I would argue that with corporate confidence now recovering from the legacy of the global financial crisis, it should once again be possible for entrepreneurial spirit and innovation to bring productivity growth back to previous or even higher levels. Especially for Japan, given that it finally finds itself on an equal footing with other advanced economies, now is surely an ideal time to mount a strong comeback.

Contraction of the Japanese labor force is progressing so rapidly compared to other countries that it must be urgently addressed. For individual firms, labor force contraction will lead to intensifying competition for increasingly scarce human resources. Personnel shortages have worsened over the past three years despite improved participation by women and the elderly, and the battle to secure suitably qualified workers is only set to intensify as firms shake off their deflationary mindset and move on to the offensive (Chart 9). Businesses should thus be looking to meet their personnel needs as quickly as possible and policymakers should offer timely support via, for example, labor market reforms and measures to promote diversification of work styles.

Corporate decision makers of course strive to develop their strategies to invest appropriately in physical and human capital and ensure optimal deployment of resources across the global stage. I do not have much to add to their thinking, but I do believe, and all of us should recognize, that current conditions both at home and abroad are very likely to reward those who act decisively. QQE has clearly led Japanese businesses and households away from the deflationary mindset that proved so paralyzing for so long, and we have already started to see proactive investment by some firms and in some industries through greater investment in overseas subsidiaries and M&A-driven expansion initiatives. Today's audience also includes many corporate leaders who have seized this invaluable opportunity to take a major step forward. But I believe my key point still bears repetition: at a critical juncture such as the present, such decisive action should be taken more broadly.

IV. Supplementary Measures for QQE

With this in mind, the Bank decided to adopt new measures to supplement QQE at the Monetary Policy Meeting held last week. First, the Bank will establish a new program for purchasing exchange-traded funds (ETFs) at an annual pace of about 300 billion yen, on top of the ongoing purchases of ETFs through which their amount outstanding will increase at an annual pace of about 3 trillion yen. Under the new program, the Bank will purchase ETFs composed of stocks issued by firms that are deemed to be proactively investing in physical and human capital. The Bank will commence the new program in April 2016, starting with purchases of ETFs tracking the JPX-Nikkei Index 400. The Bank expects market participants to take the initiative in creating new types of ETFs. Specifically, introducing new stock indices and setting up investment funds that track such indices will be strongly encouraged. The Bank will announce eligibility criteria for the ETFs to be purchased in due course, after soliciting opinions and comments from experts. The Bank intends to make a wide variety of firms eligible for the program. This will include not only firms that are actually increasing business investment, employment, or wages, but also those that are raising productivity and efficiency, or improving working environment. The role of the capital market is to evaluate firms' ability to create value added and link them to investors who demand appropriate returns. Although the amount of ETF purchases planned under the new program is not large compared with the size of the stock market, the Bank is confident that the program will promote awareness regarding the importance of efficient use of cash flows by business management and market participants.

In order to support firms that are proactively investing in physical and human capital, the Bank will enhance one of the existing lending programs, namely the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth, which has been in place since 2010. Considering that the government has introduced various tax incentive schemes to promote firms' physical and human capital investment -- for example, tax incentives to promote capital expenditure on productivity-enhancing equipment, and the income growth promotion tax system -- the Bank is planning to apply simplified procedures in cases where financial institutions are investing in or lending to firms that are entitled to use these tax incentive schemes.

Let me reiterate the Bank's monetary policy stance going forward. The Bank will continue with QQE, 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 make the most appropriate policy decisions by scrutinizing the current situation of economic activity and prices and their outlook, various risk factors, and developments in financial and capital markets at every Monetary Policy Meeting. If judged necessary for achieving the price stability target of 2 percent at the earliest possible time, the Bank will make adjustments without hesitation. At the Monetary Policy Meeting held last week, the Bank decided to take a couple of measures that will enable the Bank to implement large scale asset purchases under QQE more smoothly. First, the Bank will accept a wider range of financial assets from banks as eligible collateral. Japanese government bond (JGB) holdings of financial institutions have decreased as the Bank's massive JGB purchases have progressed. Financial institutions, which use JGBs as collateral not only for central bank credit but also for various financial market transactions, have thus been facing a shortage of collateral. Against this backdrop, the Bank decided to (1) accept foreign currency-denominated loans on deeds as eligible collateral and (2) introduce a new legal framework in which the Bank can accept financial institutions' housing loan portfolios as collateral through a trust scheme. In designing this scheme, the Bank will take account of practices in private transactions. In relation to these measures, let me make a request to business management. The Bank has been providing credit to financial institutions against their yen-denominated loans on deeds as eligible collateral. Under the legal framework in Japan, consent by a debtor without reservation is required when transferring the title of a loan on deed in order to secure the full value of the loan. The Bank would like firms to give that consent to their creditors when they are asked.

In addition, the Bank decided to extend the average remaining maturity of the Bank's JGB purchases and widen its range by changing it to "about 7-12 years" from "about 7-10 years." Under the current guideline for asset purchases where the Bank will purchase JGBs so that its holdings will increase at an annual pace of about 80 trillion yen, the Bank's gross JGB purchases are set to be higher in 2016 than in 2015 due to an increase in scheduled redemptions of JGBs held by the Bank. In this situation, such change is necessary in order to facilitate more flexible and smoother purchases of JGBs while also making due allowance for market liquidity.

These measures should not be regarded as additional monetary easing. Rather, they are designed to enable the Bank to continue with QQE through smoother asset purchases, and if judged necessary, to make appropriate adjustments without technical obstacles.

Concluding Remarks

More than two years have passed since the Bank of Japan introduced QQE. At the outset, many people were skeptical about the prospect of Japan's economy overcoming deflation and achieving the price stability target of 2 percent. Some people may still be skeptical. But as I have mentioned earlier, economic and price trends have clearly changed under QQE (Chart 4). This is an indisputable fact.

"Fortune favors the bold," an old proverb that can be traced back to Ancient Rome, seems like very apt advice for Japan's economy at this turning point. I am convinced that 2016 will be a rewarding year for those who are prepared to march towards a new phase of growth.

Before closing my speech, I would like to reiterate the Bank's unwavering determination to do whatever it takes to overcome deflation and achieve the price stability target of 2 percent. Thank you very much for your attention. I sincerely wish you a Happy New Year.

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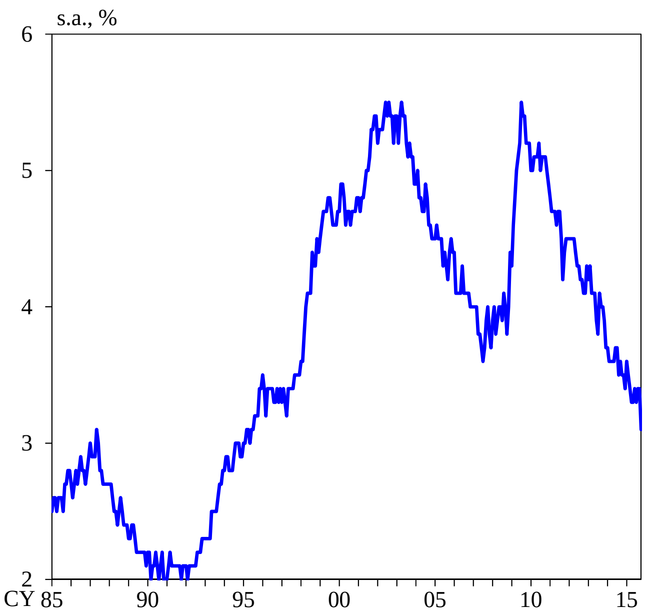
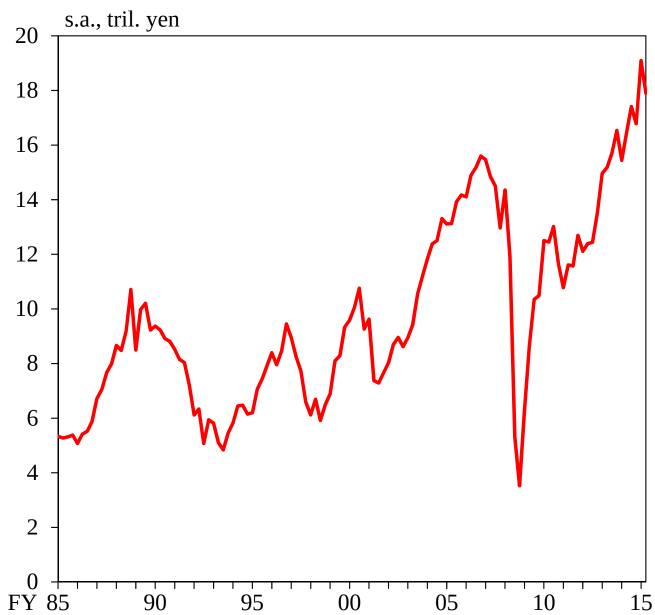
Chart 1

Labor Market and Corporate Profits

Unemployment Rate



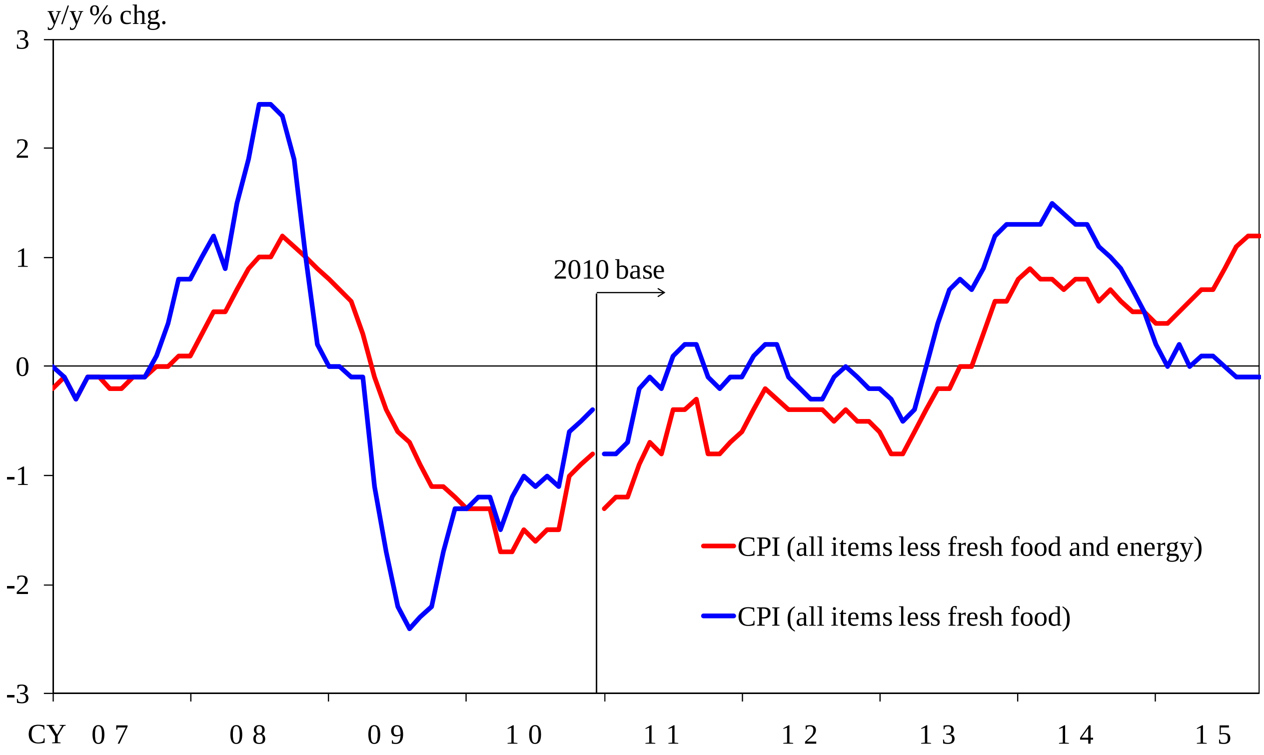
Current Profits



Note: Figures for current profits exclude those for the finance and insurance industries.
Sources: Ministry of Internal Affairs and Communications; Ministry of Finance.

Chart 2

Consumer Prices

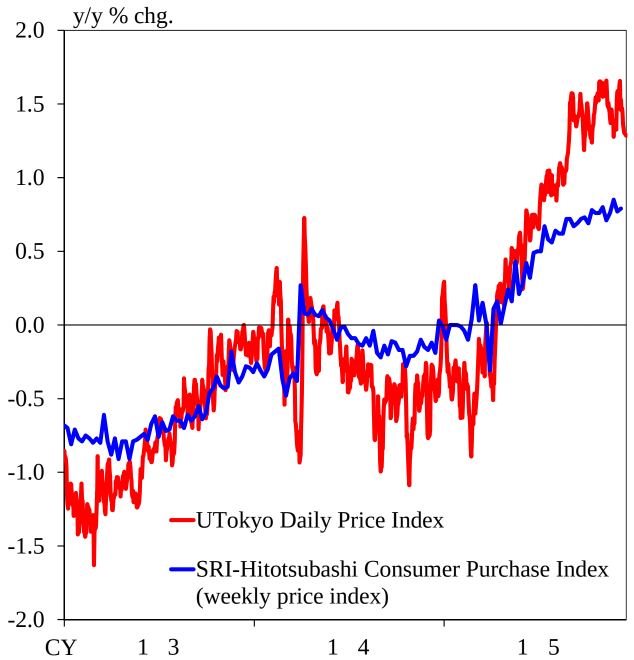


Note: Figures are estimated by adjusting the direct effects of the consumption tax hike.
Figures for the CPI (all items less fresh food and energy) are calculated by the Research and Statistics Department, Bank of Japan.
Source: Ministry of Internal Affairs and Communications.

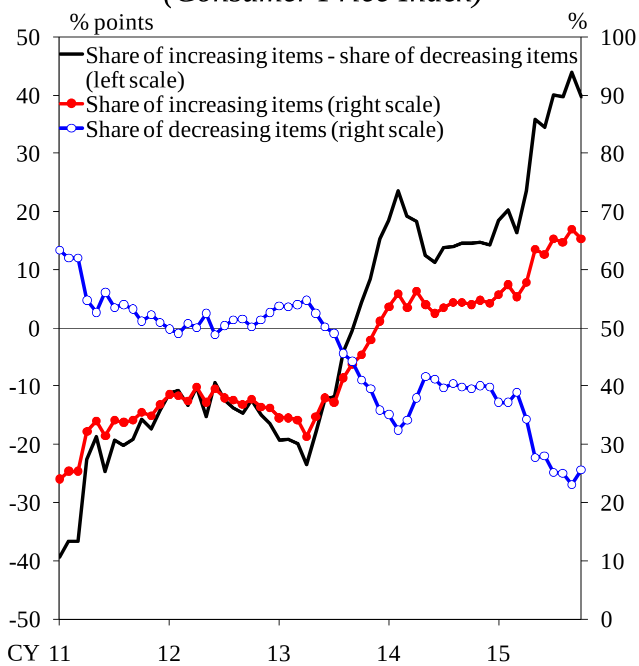
Chart 3

Price Developments

UTokyo Daily Price Index and SRI-Hitotsubashi Consumer Purchase Index



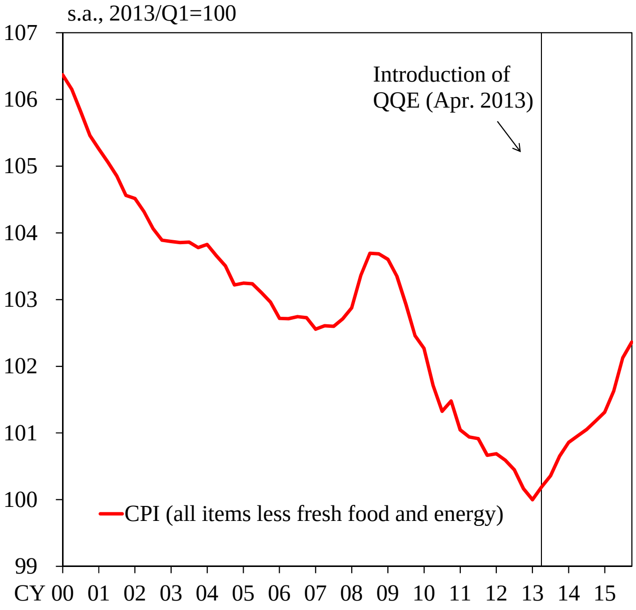
Share of Increasing and Decreasing Items (Consumer Price Index)



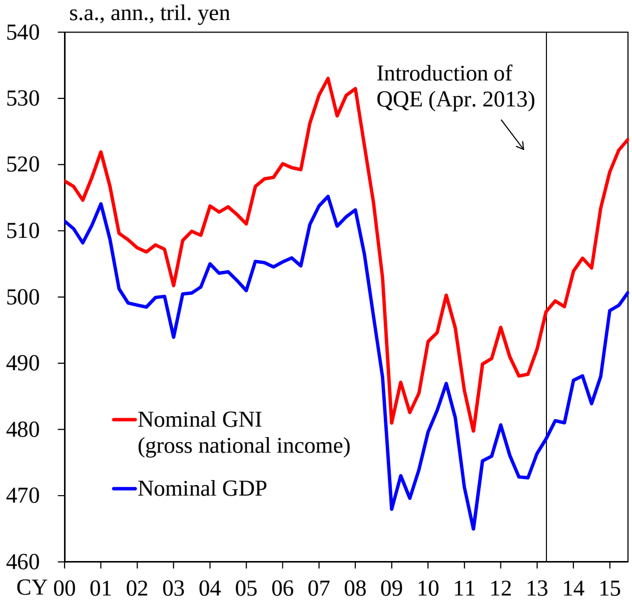
Notes: 1. The UTokyo Daily Price Index is a 7-day backward moving average.
2. The share of increasing/decreasing items is the share of items in the consumer price index (all items less fresh food) whose price indices increased/decreased from a year earlier. The price indices are estimated by adjusting the direct effects of the consumption tax hike.
Sources: UTokyo Daily Price Index Project; Research Center for Economic and Social Risks, Institute of Economic Research, Hitotsubashi University; Ministry of Internal Affairs and Communications.

Prices and Nominal Income

Consumer Prices



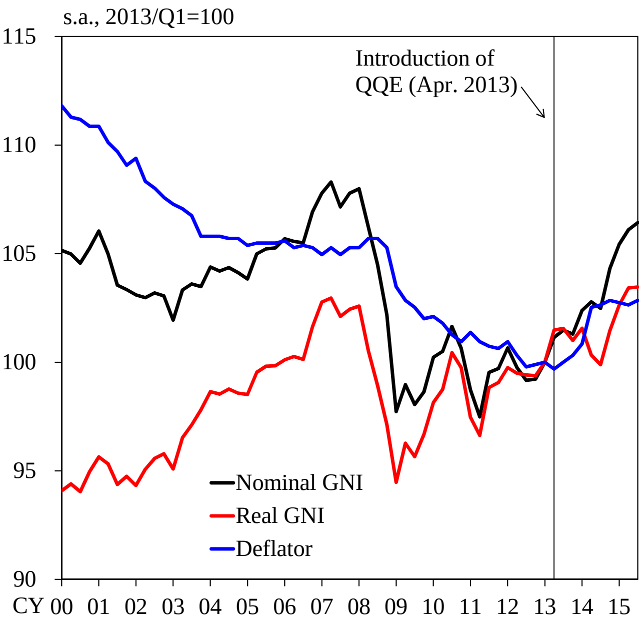
Nominal Income



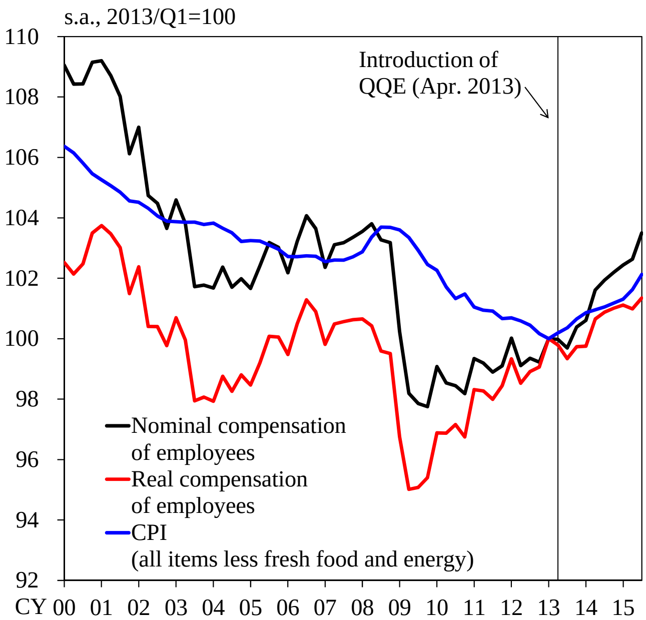
Note: Figures for the CPI (all items less fresh food and energy) are estimated by adjusting the direct effects of the consumption tax hike.
Sources: Ministry of Internal Affairs and Communications; Cabinet Office.

Real and Nominal Income

GNI (Gross National Income)



Compensation of Employees

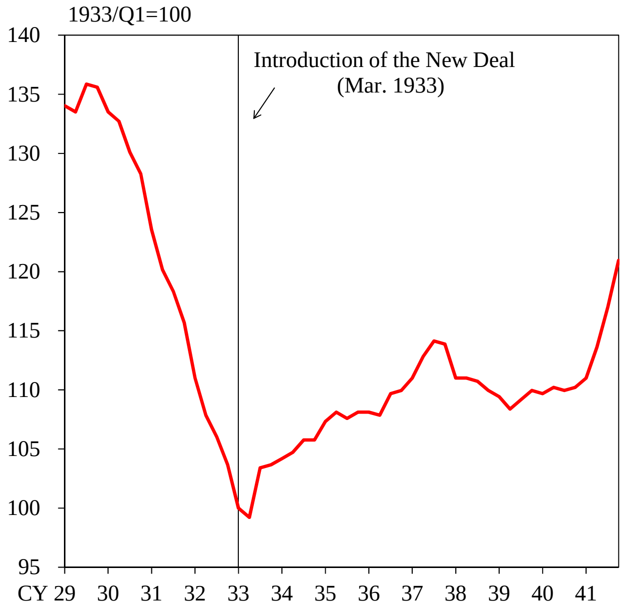


Notes: 1. Figures for the CPI (all items less fresh food and energy) are estimated by adjusting the direct effects of the consumption tax hike.
2. Real compensation of employees are estimated by deflating nominal compensation of employees by the CPI (all items less fresh food and energy).
Sources: Ministry of Internal Affairs and Communications; Cabinet Office.

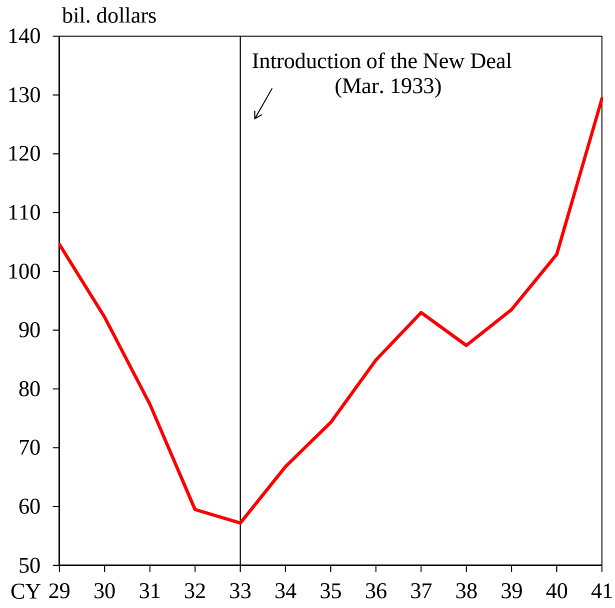
Chart 6

The Great Depression in the United States

Consumer Prices



Nominal GDP

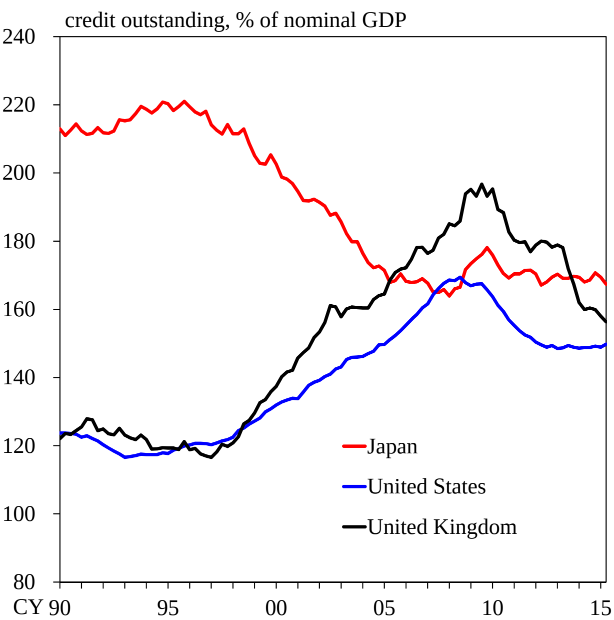


Sources: Bureau of Labor Statistics; Bureau of Economic Analysis.

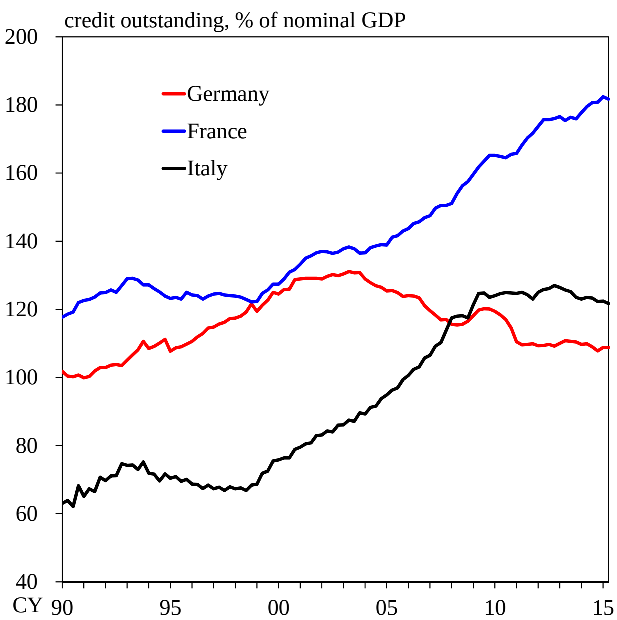
Chart 7

Deleverage

Japan, United States, and United Kingdom



Germany, France, and Italy

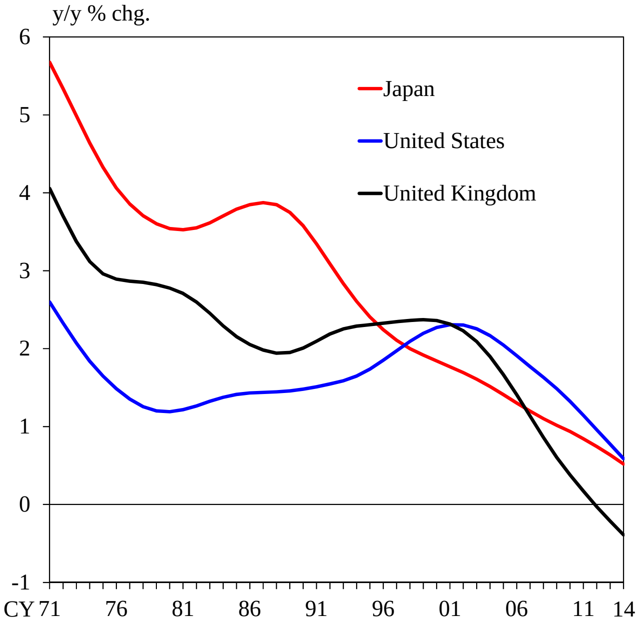


Note: Figures are the amount outstanding of credit obtained by the private non-financial sector.
Source: BIS.

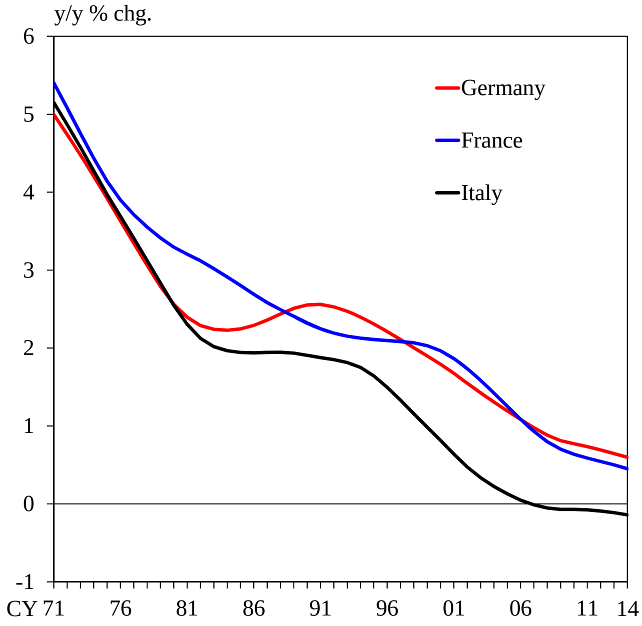
Chart 8

Labor Productivity

Japan, United States, and United Kingdom



Germany, France, and Italy

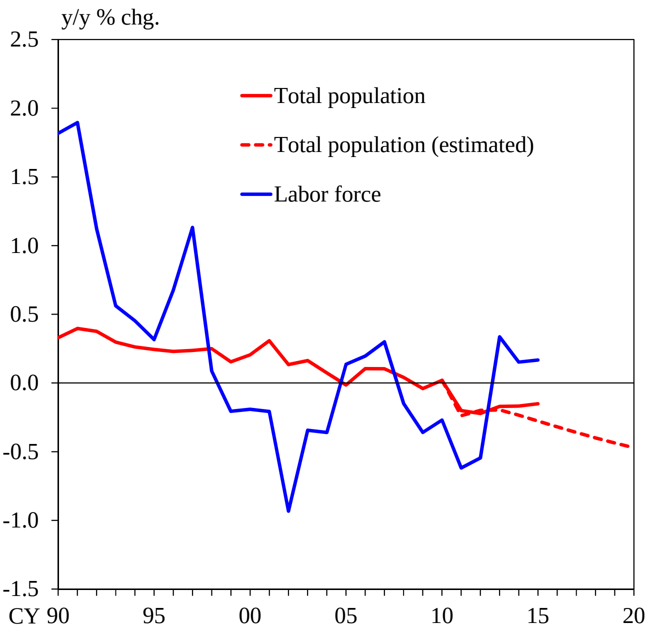


Note: These series show the trends of the year-on-year rates of change in the real GDP per hour worked, derived from the HP filter.
Source: OECD.

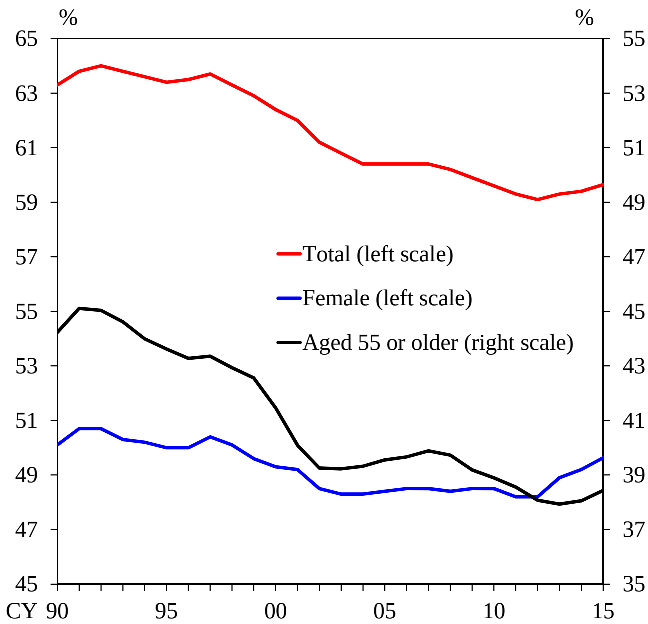
Chart 9

Labor Supply

Demographic Changes



Labor Force Participation Rate



Note: Figures for the labor force and labor force participation rates for 2015 are the January-October averages.
Sources: Ministry of Internal Affairs and Communications; National Institute of Population and Social Security Research.