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Bank of Japan

# Recent Developments in Economic Activity, Prices, and Monetary Policy

*Speech at a Meeting with Business Leaders in Kushiro*

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## I. Current Assessment of Overseas and Domestic Economies and Their Prospects

### A. Gradual Pick-Up in Overseas Economies

I would like to start my speech with a look at overseas economies. Overseas economies as a whole are gradually heading toward a pick-up, although a lackluster performance is partly seen. In general, while the momentum of emerging and commodity-exporting economies has slowed, advanced economies have been on an improving trend.

The U.S. economy has been on a moderate recovery trend against the backdrop of steady private demand, and the improving trend in the housing and labor markets has become more evident. Economic activity in the euro area remains weak but has recently begun to bottom out. The real GDP growth rate for the April-June quarter of 2013 turned positive for the first time in seven quarters, reflecting a bottoming out of exports and an improvement in business and consumer sentiment. The Chinese economy continues to see stable growth as domestic demand remains firm, but the pace of growth has been slowing recently, mainly due to inventory adjustments in materials industries and weakness in exports, and this slowdown seems to be restraining growth in other Asian economies to some extent. Furthermore, in some emerging and commodity-exporting economies with a current account deficit, currencies have depreciated and stock prices have declined due in part to speculation about the direction of U.S. monetary policy, leading to downward pressure being exerted on these economies through the tightening of their financial market conditions and rises in prices.

While there are considerable differences in the current state of overseas economies by region, these economies as a whole are expected to gradually pick up. In general, emerging and commodity-exporting economies are likely to continue on a slowing trend for the time being. On the other hand, the pick-up trend in the U.S. economy is likely to strengthen as restraints on economic activity from the fiscal side gradually ease and as financial conditions remain accommodative. The U.S. economy is expected to become the driving force of the global economy.

### B. Moderate Recovery in Japan's Economy

Japan's economy is recovering moderately. Since the beginning of 2013, the economy has registered relatively high growth, led primarily by domestic demand; the real GDP growth rates for the January-March and April-June quarters were 4.1 percent and 3.8 percent on an annualized quarter-on-quarter basis, respectively.

Exports have generally been picking up, mainly reflecting the aforementioned developments toward a pick-up in overseas economies. Private consumption has been resilient, assisted by the improvement in consumer sentiment, owing in part to the rise in stock prices since the end of 2012, and by some improvement observed in the employment and income situation. Moreover, business fixed investment is starting to pick up as corporate profits have improved. Reflecting these developments in demand both at home and abroad, production is increasing moderately.

As for the outlook, Japan's economy is expected to recover moderately, with positive developments spreading through the economy. For example, as corporate profits continue to improve, business fixed investment is projected to follow a moderate increasing trend, and the improving trend in the employment and income situation is expected to gradually become more evident.

As for prices, the improving trend has recently become pronounced. The year-on-year rate of change in Japan's consumer price index (CPI; all items less fresh food) turned positive in June 2013 for the first time in 14 months and rose somewhat in July. The year-on-year rate of increase in the CPI is likely to rise gradually on the back of an improvement in the aggregate supply and demand balance as well as a rise in inflation expectations due to the economic recovery.

Let us look at the outlook for Japan's economy and prices in terms of the median of the Bank's Policy Board members' forecasts in the interim assessment of the April 2013 *Outlook for Economic Activity and Prices*, released in July. The real GDP growth rate is expected to be at a high level of 2.8 percent for fiscal 2013. Thereafter, even taking account of the effects of fluctuations in demand stemming from the two scheduled consumption tax hikes, the growth rate is expected to maintain a relatively high level of 1.3 percent for fiscal 2014 and then rise to 1.5 percent for fiscal 2015. As for the year-on-year rate of increase in the CPI, excluding the direct effects of the consumption tax hikes, it is expected to rise steadily, registering 0.6 percent for fiscal 2013, 1.3 percent for fiscal 2014, and 1.9 percent for fiscal 2015.

## II. Downside Risks to the Economic Outlook

### A. Uncertainty regarding Overseas Economies

With respect to the aforementioned baseline scenario of the outlook for economic activity and prices in Japan, I do expect that, while the economy will be affected by the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hikes, a virtuous cycle in the economy will basically be maintained. However, I personally consider the downside risks to be rather large. The main reason is heightened uncertainty regarding overseas economies, particularly emerging economies.

Looking back at the revisions made to the World Economic Outlook released by the International Monetary Fund (IMF) in the recent past, the forecast for global economic growth made in April 2012 has continued to be revised downward in the updates released thereafter. This seems to reflect the fact that the slowdown in emerging economies was not fully anticipated at the time of such forecast. Furthermore, the prolonged depreciation of currencies and declines in stock prices observed recently in some emerging and commodity-exporting economies seem to reflect an adjustment of economic and financial imbalances that have built up since the Lehman shock, reflecting excessive expectations for economic growth. Such a buildup of imbalances is clearly apparent in the accumulation of private-sector debt in emerging and commodity-exporting economies. According to data released by the World Bank, the ratio to GDP of domestic credit provided to the private sector in low- and middle-income economies has increased sharply since around 2009.

Meanwhile, uncertainty remains as to whether growth in advanced economies -- particularly in the United States -- can compensate for the slowdown in emerging economies and sufficiently underpin the global economy in the future. From this viewpoint, I am paying particular attention to recent developments in U.S. long-term interest rates and crude oil prices, as well as to the decline in the growth rate of labor productivity in the United States. The year-on-year growth rate of U.S. labor productivity in the nonfarm business sector for

2013, estimated using first-half data, remained almost flat, and is at the lowest level since 1993. Under the slowdown in the labor productivity growth trend, expectations for income increases may not rise easily even in a situation where employment continues to increase stably, and private consumption -- a key determinant of the outlook for the U.S. economy -- may not regain momentum soon. Therefore, I will carefully monitor these developments.

### B. Effects of the Correction in the Yen's Appreciation and of the Rise in Stock Prices as well as Developments in Business Fixed Investment

In terms of downside risks to the outlook for Japan's economy, I am paying close attention not only to risks of slowdown in overseas economies that I have just mentioned but also to the following developments: to what extent business fixed investment -- the recovery in which has been delayed somewhat compared with that in private consumption, housing investment, and public investment -- will grow; to what degree wages, particularly the levels of base salaries, will increase; and whether this wage increase will lead to a more sustainable rise in private consumption.

Looking at recent developments in Japan's economy, a trend of improvement has at last begun to be observed in a wider range of areas, such as a rise in employment and a pick-up in business fixed investment. On the other hand, from what I understand, the effects of the correction in the yen's appreciation and of the rise in stock prices, both of which have played a leading role so far in the process of economic recovery by boosting private consumption and exports, have started to show signs of waning. The current economic recovery has been following a pattern that differs from typical ones in the past, with private consumption being the driving force of rapid economic recovery, but now the pattern seems to be gradually shifting back to the more typical ones.

Private consumption generally remains resilient, as suggested by GDP statistics and indicators related to consumer confidence. In demand-side statistics, however, there are signs that stimulative effects on consumption from the wealth effects stemming from the rise in stock prices are starting to wane. For example, according to the *Family Income and Expenditure Survey*, real consumption expenditures fell in July 2013 to a level similar to that marked at the end of 2012, after having increased sharply in the January-March quarter of 2013. I will closely monitor whether private consumption will signal a halt to the expansionary trend.

Turning to exports, they have generally been picking up. However, real exports for July declined substantially and the improvement in the component for new export orders in Japan's Purchasing Managers' Index (PMI) came to a halt. Moreover, some uncertainties surround overseas economies, as I have mentioned earlier. Taking these into account, it is possible that export conditions cannot be expected to improve by as much as before.

Under these circumstances, the key is the extent to which business fixed investment will grow. In this regard, as corporate profits have improved, the figures for business fixed investment in the *Financial Statements Statistics of Corporations by Industry, Quarterly* rose at an accelerated pace in the April-June quarter compared with the two previous quarters. In addition, business fixed investment plans in the June *Tankan* (Short-Term Economic Survey of Enterprises in Japan) suggested a marked increase. However, I consider it necessary to examine forthcoming hard data.

## III. Developments in Prices and Wages

Now I will elaborate on my personal view regarding developments in prices and wages.

The Bank has set forth its aim of 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, with a time horizon of about two years. As I stated in my speech at a meeting with business leaders in Kanagawa on February 28, 2013, I consider it important to increase credibility regarding the Bank's decision on the price stability target of 2 percent from the viewpoint of overcoming deflation. However, related to my proposal on the Bank's conduct of monetary policy, on which I will elaborate later, I think the most important thing is not to achieve the 2 percent price stability target in two years, but rather to achieve a moderate rise in the rate of price increases as a result of an economic upturn, by encouraging movement toward realizing the sound development of the national economy -- which could be regarded as the ultimate target of the Bank's monetary policy conduct.

The recent rise in prices is partly attributed to some strength in demand, such as in the form of an increase in hotel charges; however, looking back, rises in prices to date have largely been attributed to other factors -- for example, increases in energy prices, such as electricity charges and petroleum product prices, and the effects of changes in foreign exchange rates. In order to achieve sustainable price increases together with economic improvement, a rise in wages -- especially employees' scheduled cash earnings -- is considered to be the key. However, employees' scheduled cash earnings are still declining at present. Large firms that have raised lump-sum payments, such as bonus payments, seem to remain cautious about increasing the levels of base salaries, which are very similar in nature to fixed costs. Some large firms may raise the levels of base salaries in the future, but it is small firms that determine the course of wages in Japan. In order for an increasing number of firms in the corporate sector as a whole to actively raise wages -- including the levels of base salaries -- and for prices to be on an uptrend as a result, supply and demand conditions in the labor market must improve further through a heightening of growth expectations. Since developments in employment and wages tend to lag behind economic growth, a considerable time lag is expected until the inflation rate rises together with the wage increase.

Even in a situation where wages and prices increase in a balanced manner over time, considering the recent price developments overseas, I see that prices in Japan would still rise only moderately. According to the Organisation for Economic Co-operation and Development (OECD), Japan's inflation rate has remained at a consistently low level while moving in tandem with the inflation rates of other advanced countries for a long period. The year-on-year rate of change in the CPI has been about 2 percentage points lower than the average rate for the G-7 countries for two 15-year periods: one from 1982 to 1997, which includes Japan's bubble period; and the other from 1998 to 2013, which includes the period of deflation. Taking into account that the disinflationary trend is continuing in other advanced countries, Japan's inflation rate may still be susceptible to downward pressure.[1]

[1] For historical developments in Japan's inflation rate and a comparison with other major economies, see "Recent Developments in Economic Activity and Prices, and Future Monetary Policy," a speech by Takahide Kiuchi at a meeting with business leaders in Kanagawa on February 28, 2013, available on the Bank's web site (http://www.boj.or.jp/en/announcements/press/koen_2013/ko130319a.htm/).

## IV. Conduct of Monetary Policy

About half a year has already passed since the Bank introduced quantitative and qualitative monetary easing at the Monetary Policy Meeting (MPM) held on April 3 and 4, 2013. So far, this policy has exerted positive effects on Japan's economy. However, while supporting the concrete measures of quantitative and qualitative monetary easing, I have continued to propose changing the expression representing the Bank's commitment in the Statement on Monetary Policy, although the view that such a change should be made has been held by a minority of the Policy Board members. I would first like to provide an outline of quantitative and qualitative monetary easing and the background to its introduction, and then explain the intention of my proposal as well as my personal views on some points of discussion.

### A. Introduction of Quantitative and Qualitative Monetary Easing

The Bank introduced a new regime of monetary easing called quantitative and qualitative monetary easing 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, with a time horizon of about two years. As represented in the wording "quantitative and qualitative," this policy aims to overcome deflation through both a "quantitative" increase and "qualitative" changes in the Bank's balance sheet.

First, in terms of "quantity," through purchases of various financial assets, mainly Japanese government bonds (JGBs), the Bank aims to double the monetary base in two years from 138 trillion yen at end-2012 to 270 trillion yen at end-2014.

Second, on the "quality" front, JGBs with all maturities were made eligible for purchase. As a result, the average remaining maturity of the Bank's JGB purchases is now more than double, to about seven years. By working on interest rates across the yield curve, it is expected that the effects of monetary easing on financial conditions and economic activity will be strengthened. In addition, in order to affect premiums of risk assets, the amounts of purchases of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) have been increased.

While the Bank recognized the significant side effects of quantitative and qualitative monetary easing, it decisively embarked on the introduction of this policy. The rationale for the introduction was the Bank's view that, with favorable developments gradually emerging in economic activity and financial markets, it was a great opportunity for the Bank to positively influence the expectations of financial markets and of firms and households through a large monetary policy change, thereby maximizing such policy effects.

From now on, it is important to firmly support the virtuous cycle in which the inflation rate gradually rises, as economic activity improves in a balanced manner accompanied by an increase in corporate profits as well as employment and wages. On this point, it is expected that this virtuous cycle will strengthen further if economic policy measures that induce positive movements by private economic entities and thus strengthen the growth potential of Japan's economy are implemented at the same time.

In addition to the implementation of quantitative and qualitative monetary easing, through which the Bank generates extremely accommodative financial conditions, the Bank has been employing a facility called the Loan Support Program to further support such positive movements from the financial side. The facility is composed of two measures. One is the fund provision for economic growth, which provides funds for financial institutions' loans and investment that contribute to Japan's economic growth. The second is the fund provision to stimulate lending, which provides long-term funds at low interest rates for financial institutions' incremental lending, in order to support their efforts to increase lending. The facility aims to promote financial institutions' initiatives toward finding demand for funds in high-growth firms and business fields.

## B. Proposal to Change the Expression in the Statement on Monetary Policy

1. Formulation of the proposal

In order to create an opportunity for Japan's economy to head steadily in a positive direction, even at a slow pace, and aim to realize the sound development of the national economy -- which could be regarded as the ultimate target of the Bank's monetary policy conduct -- I gave my support for the concrete measures of quantitative and qualitative monetary easing.

However, I have proposed changing the expression in the Statement on Monetary Policy entitled "Introduction of the 'Quantitative and Qualitative Monetary Easing,'" which was decided by a majority vote among the Policy Board members at the MPM held on April 3 and 4, 2013.

The statement says, "The Bank will achieve 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, with a time horizon of about two years," and "The Bank will continue with quantitative and qualitative monetary easing, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner."

However, in light of my view regarding prices, which I mentioned earlier, I have come to consider that it is not always appropriate to aim at achieving such a high price stability target of 2 percent in a short time frame of about two years. More importantly, as I will explain later, the combination of the two policy commitments -- namely, (1) that the Bank will achieve the price stability target of 2 percent at the earliest possible time, with a time horizon of about two years, and (2) that the Bank will continue with quantitative and qualitative monetary easing, as long as it is necessary for maintaining that target in a stable manner -- involves the potential risk of increasing the side effects of quantitative and qualitative monetary easing.

Therefore, I have formulated a proposal to change the expression in the Statement on Monetary Policy regarding the time frame for achieving the 2 percent price stability target, and for continuing quantitative and qualitative monetary easing, and have submitted my proposal at every MPM, including the most recent one held on September 4 and 5, 2013.

2. Key points of the proposal

My proposal is to replace the expression in the Statement on Monetary Policy with a new expression stating that "the Bank will aim to achieve the price stability target of 2 percent in the medium to long term. On this basis, it will designate quantitative and qualitative monetary easing as an intensive measure with a time frame of about two years, and thereafter will review the monetary easing measures in a flexible manner." There are two points to my proposal. The first is that it does not restrict the time frame for achieving the 2 percent price stability target to about two years. The second is that it clearly states the idea that the time frame for continuing quantitative and qualitative monetary easing should be about two years, and that when this time frame comes to an end, the Bank will review the monetary easing measures in a flexible manner, as necessary.

As shown in the minutes of the MPM held on April 3 and 4, 2013, the reasons behind this proposal were that (1) achieving the price stability target of 2 percent with a time horizon of about two years entails high uncertainty; and (2) in such a situation there is concern that, if a rise in expectations -- namely, that quantitative and qualitative monetary easing would continue for a protracted period -- were to occur, this could lead to a buildup of financial imbalances, for example, given that the Bank's purchases of financial assets would be unprecedented in scale. In the minutes, other potential risks were also pointed out: the possibility of a rise in speculation that the Bank is engaged in financing fiscal deficits, the possibility that the financial system would become more vulnerable to risks with financial institutions' profits being squeezed, and the possibility that market functioning would be impaired considerably.

While fully recognizing these potential risks, I have nonetheless supported the concrete measures of quantitative and qualitative monetary easing because I have judged that its positive effects on the economy outweigh, albeit slightly, the associated potential risks or side effects. However, if the current large-scale monetary easing were to be protracted or strengthened, there would be an increased possibility that the side effects would instead outweigh the positive effects. In this regard, one cannot rule out the possibility that, under the current policy commitment, the Bank will inevitably extend or strengthen its monetary easing driven by such external factors as expectations in financial markets. Taking this possibility into account, I have proposed to designate quantitative and qualitative monetary easing as an intensive measure with a time frame of about two years based on the recognition that it is appropriate to secure an opportunity for the Bank to thoroughly examine, after a certain period of time, whether the side effects of the large-scale monetary easing are not outweighing the positive effects and review the easing measures in a flexible manner depending on economic and financial conditions at the time.

3. Communication with financial markets

I consider that this proposal will also contribute to an improvement in communication between financial markets and the central bank.

It seems that the prominent view in the Japanese bond market at this point is that it will remain difficult to achieve the 2 percent price stability target in about two years. Thus, there is a considerable gap between the market's view and the information communicated by the Bank regarding the time frame for achieving the price stability target. I consider this gap to have the potential to destabilize prospects for future monetary policy in the bond market. In this regard, if the time frame for achieving the 2 percent price stability target is changed to the "medium to long term" rather than specifying it as "about two years," I believe that it will promote the spontaneous formation in the bond market of expectations for future economic activity and prices, as well as the future course of interest rates. This will in turn contribute to an improvement in communication between the bond market and the central bank, thereby leading to stability in the market.

**C. Importance of Fiscal Consolidation**

Next, I will touch on the relationship between the Bank's monetary easing and the government's fiscal consolidation. A very significant part of quantitative and qualitative monetary easing includes the purchases of JGBs of various maturities on a large scale. These purchases are solely conducted for the purpose of achieving the price stability target. However, in a situation where the Bank continues to purchase a large amount of JGBs, if the government's efforts to achieve fiscal consolidation through structural reforms -- both in terms of revenues and expenditures -- were to weaken or such speculation were to permeate the financial markets -- mainly reflecting overly heightened expectations that stability in the bond market will be ensured by the Bank's JGB purchases -- long-term interest rates could rise due to concerns about financing fiscal deficits. This could in turn worsen fiscal conditions and substantially constrain the effects of quantitative and qualitative monetary easing. This point should be given particular attention as a potential risk, because fiscal conditions are severe in Japan compared with other countries. As specified in the joint statement by the government and the Bank released in January 2013, the implementation of fiscal consolidation measures is an important prerequisite for the success of quantitative and qualitative monetary easing and is essential for Japan's economy in overcoming deflation and achieving sustainable growth.

**D. Combination of Policy Tools**

In closing, I would like to present my view on the future conduct of monetary policy from a somewhat longer-term perspective, by referring to the Federal Reserve's policy stance.

The Bank's monetary policy has been conducted through a combination of the conventional policy of interest rate policy and the unconventional policy of asset purchases. Taking the Federal Reserve's practice of these two types of policy tools as an example, my understanding is that the Federal Reserve regards the asset purchase policy as a measure to generate upward momentum in economic activity and prices and affect the direction of such momentum under the non-negativity constraint on nominal interest rates, while regarding the interest rate policy as a measure to encourage economic activity and prices to reach desirable levels. Such division of roles between the two policy tools in the United States will likely serve as a reference in considering Japan's future monetary policy.

Going forward, if economic and price conditions see relatively steady improvement owing to the success of quantitative and qualitative monetary easing, the effects of the zero interest rate policy on the economy are expected to cumulatively increase, mainly through a rise in the expected rate of return. When an expansionary momentum of economic activity and prices becomes sufficiently strong as a result of the asset purchase policy, it will be important to find the most appropriate balance between the two types of policy tools by carefully weighing the associated positive effects and side effects that differ between the two policy tools, while paying due attention to the increased effects on the economy of the zero interest rate policy.