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Bank of Japan

Recent Developments in Economic Activity, Prices, and Monetary Policy

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I. Economic Developments

I would like to start my speech with a look at developments in Japan's economy. It has continued to recover moderately as a trend, although a subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been observed. With regard to the outlook, the economy is expected to continue its moderate recovery trend, and the effects of the subsequent decline in demand are expected to wane gradually. In the Bank of Japan's interim assessment in July of the April 2014 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), the forecasts for the economic growth rate and year-on-year rate of increase in the consumer price index (CPI, all items less fresh food, and the same hereafter) are broadly in line with the April forecasts.

A. Domestic Demand

Looking at domestic demand, private consumption has remained resilient as a trend, although a subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has recently been observed. For example, sales at department stores increased markedly in the January-March quarter of 2014 due to the front-loaded increase in demand; they fell back considerably in April compared to that quarter as a result of the subsequent decline in demand, but a pick-up has been observed since May. In addition, judging from interviews with firms and other relevant information, there are indications that the degree of the subsequent decline in demand has been broadly in line with expectations.

As for the employment and income situation, supply and demand conditions in the labor market have continued to improve steadily, as evidenced by the fact that the active job openings-to-applicants ratio for June reached the highest level since June 1992. Supported mainly by the improvement in the employment and income situation, private consumption is expected to remain resilient, and the effects of the subsequent decline in demand following the front-loaded increase are expected to wane gradually.

The improving trend in business fixed investment has become increasingly evident. According to the second preliminary estimates of GDP statistics for the January-March quarter of 2014, real business fixed investment showed a quarter-on-quarter increase of 7.6 percent; thus registering a significant rise for the first time in almost two years. This appears to reflect, to a considerable extent, temporary factors such as renewal demand for PCs in line with the ending of support for software; nevertheless, the uptrend in business fixed investment was reaffirmed by the fact that real business fixed investment increased for four consecutive quarters. Business fixed investment is likely to fall back temporarily in the April-June quarter following the substantial increase in the previous quarter, but is projected to follow a moderate increasing trend as corporate profits continue their improving trend.

B. Exports and Overseas Economies

On the other hand, exports have recently leveled off more or less. The slow growth in exports is basically due to the weakness in emerging economies, including ASEAN economies that have strong ties with Japan's economy. In addition, a greater-than-expected slowdown in the U.S. economy in the January-March quarter of 2014, mainly due to the effects of the unusually severe winter weather, as well as continued movements mainly by Japanese automakers to expand their overseas production through the year, may be exerting downward pressure on exports with a time lag.

Regarding the environment surrounding exports, overseas economies -- mainly advanced economies -- have been recovering, albeit with a lackluster performance still seen in part. Looking at movements by major region, in the U.S. economy, the moderate recovery -- led mainly by private demand -- is becoming firm, aided in part by improvement in the employment situation as the effects of the unusually severe winter weather have dissipated. The European economy has been recovering moderately, with business and household sentiment continuing to improve, although the employment and income situation remains severe. The Chinese economy continues to see relatively stable growth, albeit at a somewhat lower level than before. Meanwhile, some emerging economies apart from China and commodity-exporting economies continue to lack momentum on the whole, although signs of improvement have started to be seen in some economies.

As for the outlook, overseas economies are expected to recover moderately, led mainly by advanced economies -- the United States in particular. This is expected to gradually exert positive effects on Japan's export environment.

C. Prices

Next, I would like to talk about price developments in Japan.

The year-on-year rate of increase in the CPI has been around 1¼ percent. The rate of increase was 1.3 percent for four consecutive months from December 2013 through March 2014 and, on a basis excluding the direct effects of the tax hike, marked 1.5 percent for April, 1.4 percent for May, and 1.3 percent for June. The fact that the rate of increase has been generally at around the same level even after April suggests that the tax increase has been passed on to prices on the whole, on the back of resilient private consumption.

With regard to the outlook, the year-on-year rate of increase in the CPI is likely to be around 1¼ percent for some time, as upward pressure from import prices -- in particular energy prices -- will likely wane, while underlying inflationary pressure -- due mainly to the improvement in the output gap -- will increase.

II. Major Points to Be Considered with regard to the Outlook for Economic Activity and Prices

As I have mentioned, earlier this month, the Bank made an interim assessment of the prospects for economic activity and prices through fiscal 2016 presented in the April 2014 Outlook Report. As for the Bank's baseline scenario regarding economic activity, I personally pay attention to the existing risk both on the supply and demand sides that may lead to a weaker-than-expected economic growth rate, although the economy is expected to continue recovering moderately. As for prices, I also hold a more cautious view of the outlook compared with the forecasts in the baseline scenario. Let me share some of my considerations regarding the outlook with you.

A. Output Gap and Potential Economic Growth Rate

The Bank estimates that the output gap in Japan turned positive for the first time in almost six years since 2008, to 0.6 percent for the January-March quarter of 2014. While such estimates are subject to a considerable margin of error, they have been in line with developments in the weighted average of the diffusion indices for production capacity and employment conditions in the Bank's *Tankan* (Short-Term Economic Survey of Enterprises in Japan). Therefore, we can view as confirmed that supply and demand conditions in the economy are gradually tightening further. In particular, a clear tightening trend of supply and demand conditions in the labor market has been observed, as evidenced, for example, by the fact that the active job openings-to-applicants ratio for June 2014 was at a high level, as I mentioned earlier, and that the unemployment rate -- which has been hovering at a low level of around 3¾ percent recently -- registered 3.7 percent the same month.

On the other hand, the potential growth rate of the economy remains at a low level, and therefore supply-side constraints are likely to eventually surface if the economy continues to grow at the current pace. This suggests that, although such constraints will contribute to pushing up wages and prices temporarily, the real economic growth rate might not rise easily.

B. Exports

Although exports were expected to increase from April due to an expansion of firms' spare capacity for exports following the tax hike, they have continued to lack momentum so far. Rather, from a somewhat longer-term perspective, it seems that real exports are not just experiencing temporary weakness, but have been mostly unchanged on average since the Lehman shock. This seems to reflect the following developments. Due to the Lehman shock, appreciation of the yen, Great East Japan Earthquake, and other factors, risks to the cross-border supply chain system became apparent, and this triggered changes in the structure of production and trade, particularly in Asian economies; in this process, the responsiveness of exports to overseas demand has declined significantly. Moreover, it has been pointed out that, since the global financial crisis, the pace of increase in trade has been declining relative to the pace of growth in the global economy. These developments in Japan's exports could also be associated with such a change in the structure of the global economy.

As for developments in overseas economies that are a key determinant of Japan's export environment, I am paying utmost attention to the risk of weaker-than-expected growth for the Chinese economy. It seems to be stable recently, mainly due to the stimulus measures, but if the growth rate declines due to adjustments in the real estate market, this will have negative effects on peripheral Asian economies and in turn on Japan's export environment.

C. Private Consumption

Although it will still take considerable time to accurately determine the effects of the consumption tax hike on private consumption, it is very likely that the decline in consumption following the front-loaded increase in demand prior to the tax hike will be relatively short-lived. It should be noted, however, that the scale of the temporary decline in consumption was considerable. On a seasonally adjusted quarter-on-quarter basis, sales at retail stores for the January-March quarter of 2014 increased by 3.9 percent, but declined by 7.0 percent for the April-June quarter. Moreover, according to the *Family Income and Expenditure Survey*, on a quarter-on-quarter basis, real consumption expenditures for the January-March quarter increased by 4.6 percent, but declined by 9.4 percent for the April-June quarter.

Let us now examine developments in income in relation to those in consumption. For the January-March quarter, the year-on-year rate of change in real compensation of employees registered minus 0.6 percent, which was significantly lower than the 3.7 percent increase in real private consumption. In a situation where real wages per employee are likely to continue declining for the time being, the pace of improvement in real compensation of employees is likely to be moderate. In such a case, the uptrend in private consumption may weaken, leading to a slower rise in the inflation rate. Thus, careful monitoring of future developments is required.

Nevertheless, I personally consider that, even if the uptrend in private consumption weakens slightly, this will not necessarily have negative effects on the economy in the long run. This is because a significant imbalance is currently observed among the paces of increase in the variables of prices, wages, and private consumption; for example, real wages seem to be continuing to decline, even on a basis excluding the temporary effects of the tax hike. In such a situation, if weaker growth in private consumption restrains the rise in the inflation rate, it is expected that real wages will increase and private consumption will continue growing moderately at a pace in line with this wage increase. If demand increases in this way at an appropriate pace in a situation where supply-side constraints are beginning to be acknowledged, a more balanced and prolonged economic recovery, albeit moderate, will likely be achieved.

D. Outlook for Prices

As for the outlook for prices, I take a more cautious view than the forecast in the Bank's baseline scenario. Therefore, I formulated a proposal to change the expression regarding the outlook for prices in the April 2014 Outlook Report, although it was defeated by a majority vote during the Monetary Policy Meeting. Specifically, I proposed to change the expression that the year-on-year rate of increase in the CPI "is likely to be around 1¼ percent for some time, follow a rising trend again from the second half of this fiscal year, and reach around 2 percent around the middle of the projection period" to a new expression that it "is likely to remain generally stable around the current level over time."

I consider that, for the time being, developments in prices will depend mainly on the balance between strengthening of trend inflationary pressure -- due mainly to the improvement in the output gap -- and waning of upward pressure from import prices. On this point, there seems to be uncertainty regarding whether the upward pressure on prices that reflects the improvement in the output gap will outweigh the price decline caused by a fall-off of the effects of the weak yen. This is because (1) it remains uncertain how much the tightening of labor supply and demand conditions will contribute to pushing up overall wages and (2) consumers might find it difficult to accept firms' passing on of increases in wages to sales prices, unlike in the case of a passing on of increases in materials prices to sales prices.

Of course, we cannot rule out the possibility that the rates of increase in wages and prices will be higher than expected against the background of factors such as stronger-than-expected tightening of supply and demand conditions. In such a case, however, the rise in the inflation rate will likely lack sustainability given that the growth rate of the economy would not rise easily, due to its limited growth potential, and that the economy would become unstable. In addition, it is difficult to expect that medium- to long-term inflation expectations will increase in a stable manner in such a case. Therefore, I do not think that such a situation will lead to achieving the price stability target, whereby the Bank aims at maintaining the inflation rate at around 2 percent in a stable manner.

III. Conduct of Monetary Policy

In April 2013, the Bank introduced quantitative and qualitative monetary easing (QQE) 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. In aiming to achieve the price stability of 2 percent, the Bank has committed to continuing with QQE as long as it is necessary for maintaining the target in a stable manner.

More than one year has passed since the introduction of QQE. So far, it has been exerting its intended effects. Since the introduction of the policy, however, while supporting the concrete measures of QQE, I have continued to propose (1) not to restrict the time frame for achieving the 2 percent price stability target to about two years, but to aim to achieve it in the medium to long term and (2) to designate QQE as an intensive measure with a time frame of about two years, and thereafter to review the monetary easing measures in a flexible manner, although my proposal has been repeatedly defeated by a majority vote during the Monetary Policy Meetings. Let me explain the background to my proposal, as well as my personal views on some points of discussion regarding the conduct of monetary policy.

A. Developments in Three Gaps

I have supported the concrete measures of QQE because I considered that they would open up significant opportunities in terms of three aspects. First, the measures would provide an opportunity on the demand side to create a virtuous cycle by stimulating the economy. Second, they would offer an opportunity on the supply side to encourage the government's growth strategy that contributes to strengthening the growth potential of Japan's economy and its fiscal consolidation, as well as positive actions by firms and households. And third, the measures would afford an opportunity to restore the effectiveness of the conventional interest rate policy, as zero interest rates produce stimulative effects on the economy through an improvement in economic and price conditions. In this regard, I consider that

QQE has already made considerable achievements, judging from developments in the following three gaps.

First, when the economy faces a shortage of demand, it is generally regarded that the role of monetary easing measures is to close the negative output gap by stimulating the economy from the demand side. As I explained earlier, the negative output gap in Japan seems to have closed for the first time in almost six years, according to the Bank's estimate.

Second, the gap between the observed inflation rate and the medium- to long-term expected rates of inflation has narrowed. Until recently, although the medium- to long-term expected rates of inflation had generally been in positive territory as a trend, observed prices had long been experiencing a mild decline. Consequently, price stability was not achieved, placing the economy in an undesirable situation. However, observed prices have risen markedly since 2013. I personally take the view, however, that rises in prices to date have been affected significantly by the temporary factor of the weak yen, and that the underlying trend in the observed inflation rate that mainly reflects improvement in the economic environment is more moderate. Still, the gap between the underlying trend in the observed inflation rate -- on a basis excluding the effects of the weak yen -- and the medium- to long-term expected rates of inflation seems to have narrowed to a considerable extent.

Third, it is estimated that (1) reflecting the narrowing of the output gap and the rise in prices, the level of the policy interest rate derived from the Taylor rule has recently been on a rising trend; and thus (2) the negative gap between the actual short-term interest rates -- which are virtually at around zero percent -- and the derived policy interest rate has turned positive and has been widening. This suggests the possibility that the effects of zero interest rates might strengthen gradually.

B. Price Stability Target and Medium- to Long-Term Inflation Expectations

As I have explained, developments in economic activity and prices have been on an improving trend. However, to achieve the price stability target of 2 percent, I think that it is necessary that a wide range of economic entities make use of the benign financial environment brought about by QQE and make continuous efforts to strengthen the economy's growth potential. I personally hold the view that, even if such efforts proceed smoothly, it will require considerable time for the growth potential to increase sufficiently. For this reason, since the introduction of QQE, I have continued to propose at Monetary Policy Meetings not to restrict the time frame for achieving the 2 percent price stability target to about two years, but to aim to achieve it in the medium to long term.

The price stability target of 2 percent aims to maintain the 2 percent inflation rate in a stable manner, and not to merely reach it temporarily. In order to achieve this, it is a necessary condition that firms' and households' medium- to long-term inflation expectations -- on which basis they carry out their economic activities -- increase to about 2 percent and remain stable at that level. I think that medium- to long-term inflation expectations in Japan are mainly determined by supply-side factors such as the potential growth rate and the labor productivity growth rate, rather than by the level of the Bank's price stability target, the supply and demand balances in the goods, services, and labor markets, and the current developments in the observed inflation rate. Therefore, I think that it is natural that the level of a price stability target should vary by country. At least for now, I think that the Bank's 2 percent target -- although close to the average among advanced countries -- is well above the level that is consistent with the growth potential of Japan's economy. In Japan, as a result of an increase in short-term inflation expectations reflecting the rise in observed prices, financial market data indicate that medium- to long-term inflation expectations have also increased moderately. However, I think that there is still a substantial divergence from the 2 percent level.

On the other hand, QQE entails considerable potential risks, in my view; for example, normalization of the measure will not be an easy process, and speculation that the Bank is engaged in financing fiscal deficits could increase. My understanding is that the 2 percent price stability target can be consistent with the growth potential of Japan's economy only from a medium- to long-term perspective. I am therefore paying particular attention to the risk that, if the current large-scale monetary easing policy were to be protracted or such policy strengthened by additional measures, the associated side effects would instead outweigh the positive effects, and this would undermine economic stability in the long run.

In this regard, one cannot rule out the possibility that, under the current policy commitment, if financial markets increasingly view achieving the 2 percent price stability target in about two years as difficult, the Bank will be obliged to extend or strengthen its monetary easing driven by such external factors, even in a situation where it is judged that side effects outweigh positive effects on the economy. This is why I have proposed that the Bank aim to achieve the price stability target of 2 percent in the medium to long term and designate QQE as an intensive measure with a time frame of about two years. My proposal aims at securing an opportunity for the Bank to thoroughly examine, after a certain period of time, whether the side effects of QQE are not outweighing the positive effects and review the easing measures in a flexible manner depending on economic and financial conditions at the time.

C. Strengthening Growth Potential and Monetary Policy

Strengthening the growth potential of Japan's economy has long been recognized as a key issue, and its necessity has been acknowledged more strongly of late, reflecting recent discussion that the economy might face supply-side constraints as the supply and demand balance continues to improve steadily.

In order to raise the growth potential of the economy, it is necessary for firms to make technological innovations, as well as active fixed investment, so that such innovations lead to increased productivity. It is important that the government, for its part, make efforts to take measures, for example, to increase labor supply and proceed with regulatory reforms that will lead to tapping of potential demand and increasing value-added. In addition, in order to encourage firms to make active fixed investment in Japan and increase the economy's growth potential through accumulation of capital stock, it is necessary to take measures to increase firms' medium- to long-term expectations for the growth rate of domestic demand. From such a viewpoint, it is also important to address structural issues such as (1) population decline, which can hinder expansion of domestic demand in the medium to long term; and (2) massive government debt. Efforts toward achieving fiscal consolidation are extremely important not only in terms of increasing firms' medium- to long-term expectations for the growth rate of domestic demand, but also in terms of improving the environment in which the effects of QQE will be maximized and of enabling smooth normalization of QQE in the future.

Basically, such improvements on the supply side of the economy are to be made through efforts by the government and firms. On the other hand, monetary policy -- for which the intrinsic function is to work on the demand side of the economy -- can provide indirect support for such efforts by providing a benign financial environment. In this regard, in a situation where supply-side constraints are likely to become increasingly binding as a trend, I consider it also necessary to carefully monitor, from the viewpoint of maintaining the stability of the economy, whether there will be concern over overheating. In light of the Bank's principle that monetary policy shall be "aimed at achieving price stability, thereby contributing to the sound development of the national economy," I think that achieving prolonged economic recovery, albeit moderate, while at the same time increasing the labor productivity growth rate and the potential growth rate, will lead to an increase in real income and improvement in the quality of people's lives.

Meanwhile, it should be noted that, in the course of proceeding with structural reforms, the growth potential of the economy will increase and the general price level that is stable and consistent with the growth potential will rise in the medium term. In the short term, however, prices might face downward pressure, for example, when those in certain industries decline due to deregulation. Bearing this in mind, I think that the conduct of monetary policy with a price stability target has to be very flexible.

D. Price Stability Target and Two Perspectives

Under QQE, the Bank purchases assets on an unprecedented scale. Therefore, it is necessary to be particularly vigilant against various potential risks; for example, the possibility of such purchases leading to a buildup of financial imbalances.

In this regard, the Bank conducts monetary policy, based on the framework of assessing economic activity and prices from two perspectives, in the context of the price stability target. The first perspective is examining, as regards economic activity and prices over the next two years or so, whether the outlook deemed most likely by the Bank follows a path of sustainable growth under price stability. The second perspective is examining, in a longer term, various risks that are most relevant to the conduct of monetary policy aimed at achieving sustainable economic growth under price stability. In particular, financial imbalances will be examined as a risk that will significantly impact economic activity and prices when they materialize, although the probability of their emergence is not necessarily high.

It is fair to say that this framework was formulated in light of the lessons learned regarding the monetary policy conduct during the bubble period of the latter half of the 1980s. That was when policy action to address the accumulation of financial imbalances had been delayed in a situation where attention was focused on stable general prices at the time, and policy measures to achieve economic stability in the medium to long term were not sufficiently implemented. I think that the assessment of economic activity and prices based on this framework has become increasingly important as the Bank pursues QQE.

E. Communication with the Markets

Monetary policy produces positive effects through changes in market developments and in financial institutions' behavior. Accordingly, in order to enhance the effectiveness of monetary policy, communication with the markets is very important. In particular, as many central banks in advanced economies are currently conducting unconventional policy, better communication with the markets has become the common challenge facing each economy.

In relation to this, a notable example has recently been observed in the United States, where the process of normalizing monetary policy has already been initiated, and in the United Kingdom, where normalization is starting to be considered. Specifically, the central banks in both countries were forced in a short period of time to make modifications in their forward guidance that seemed to aim at avoiding a large increase in the long-term interest rate, as such an increase could cause instability in the economy and the financial system. In the United Kingdom, the unemployment threshold for future policy interest rate hikes was maintained, but its significance was reduced substantially. In the United States, the unemployment threshold was abandoned. What is common in both countries is that monetary policy has shifted toward referring to many economic indicators. This can be interpreted as meaning that the intrinsic feature of the forward guidance of "strongly influencing expectations" has weakened, and that there has been a move to return to the conventional policy measure of "comprehensive assessment" that emphasizes the degree of freedom and flexibility in the conduct of policy.

As illustrated, central banks in advanced economies that conduct unconventional policy are still finding a way to achieve better communication with the markets. The Bank, for its part, needs to continue to facilitate effective communication while paying close attention to the experiences of the other economies.

F. Combined Use of Two Policy Tools

It is my understanding that an unconventional policy such as the asset purchase policy implemented under QQE is effective as a temporary tool to generate upward momentum in economic activity and prices and affect the direction of such momentum under the zero lower bound on nominal interest rates. On the other hand, a conventional interest rate policy can be regarded as a usual, fine-tuning tool that is used when it is time to encourage economic activity and prices to reach desirable levels.

In a situation where the unconventional policy has already been effective to a reasonable extent, accommodative financial conditions are starting to further strengthen as policy effects generated by maintained zero interest rates are gradually added to the effects of QQE.

On the other hand, precisely because the unconventional policy is a new policy measure with a short history, its side effects in general could have many unknown parts. Moreover, it would probably take considerable time for monetary policy to be normalized with the unwinding of the unconventional policy -- the main component of which is the asset purchase policy. Thus, a forward-looking policy stance is required to achieve the smooth normalization of monetary policy while maintaining financial market stability.

Taking these factors into account, if developments in economic activity and prices continue to steadily follow an improving trend, I think that it will be necessary in the future to examine the option of gradually starting to shift the focus of monetary policy conduct from the asset purchase policy to the zero interest rate policy, in view of the role of the two policy tools as well as the balance of their positive effects and side effects.