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Bank of Japan

Recent Developments in Economic Activity, Prices, and Monetary Policy

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I. Economic Developments

A. Overseas Economies

I would like to start my speech with a look at overseas economies. Overseas economies -- mainly advanced economies -- are starting to recover, although the performance remains lackluster in some parts and they are expected to recover moderately. Looking at the projections of global economic growth recently released by the International Monetary Fund (IMF), the growth for 2014 is projected to be at around 3.7 percent, mainly due to rises in growth rates of advanced economies.

Looking at respective major countries and regions, the U.S. economy has continued to recover moderately. A downtrend was observed in some economic indicators around the turn of the year, but this likely is largely attributable to temporary factors such as winter snowstorms. As for the outlook, the pace of economic recovery is expected to gradually rise, led by domestic demand in particular, mainly as the fiscal drag continues to fade and because accommodative financial conditions are projected to be maintained.

The European economy has been picking up after it emerged from a recession in 2013. Private consumption has been picking up moderately, with consumer sentiment continuing to improve, although the employment and income situation has remained severe. Business fixed investment has bottomed out. Although attention still needs to be paid to the point that there are various adjustment pressures, including the European debt problem, the economy is likely to continue picking up, mainly due to a pick-up in domestic demand that reflects improvement in business and household sentiment.

Meanwhile, the Chinese economy has continued to see stable but somewhat lower growth than before. As for the outlook, although structural reforms by the Chinese government such as those to respond to the problem of excess production capacity may exert downward pressure on domestic demand, the economy is expected to maintain stable growth as the government will likely continue to pay consideration to economic activity as well as the employment situation, and as the environment surrounding exports will improve. On the other hand, some of the emerging economies other than China and commodity-exporting economies have continued to lack momentum. In some of these economies facing structural problems, economic activity has been notably weak and financial markets have been showing unstable movements since 2013. In India, the economy remains in a state of deceleration, particularly in domestic demand. Growth momentum in the ASEAN countries remains weak.

Under these circumstances, I am paying attention particularly to developments in emerging and commodity-exporting economies, the prospects for the European debt problem, and the pace of recovery in the U.S. economy as risks to the outlook for overseas economies.

B. Current State of and Outlook for Japan's Economic Activity and Prices

Japan's economy has continued to recover moderately. According to the second preliminary estimate of the real GDP growth rate in the October-December quarter of 2013 released on March 10, 2014, which registered 0.2 percent on a quarter-on-quarter basis and 0.7 percent on an annualized quarter-on-quarter basis, the economy continued to increase at a pace considered to be above its potential for four consecutive quarters. Looking at each component, exports -- which registered a small increase of 0.4 percent on a quarter-on-quarter basis -- are likely to have leveled off more or less recently, considering developments in real exports in January 2014. Business fixed investment has increased for three consecutive quarters on a quarter-on-quarter basis, and the pick-up has become evident as corporate profits have improved. While a front-loaded increase in demand prior to the consumption tax hike in April 2014 has recently been observed, private consumption has remained resilient as a trend with improvement in the employment and income situation.

With regard to the outlook, Japan's economy is expected to continue its moderate recovery as a trend, albeit with some fluctuations caused by the consumption tax hike. Exports are expected to increase moderately, mainly against the background of the recovery in overseas economies. Public investment is expected to trend upward for the time being and then become more or less flat at a high level. Business fixed investment is projected to follow a moderate increasing trend. Private consumption and housing investment, albeit with some fluctuations caused by the consumption tax hike, are expected to remain resilient as a trend, supported mainly by improvement in the employment and income situation.

Meanwhile, prices have risen markedly in the past year. The year-on-year rate of increase in the consumer price index (CPI, for all items less fresh food, and the same hereafter) has been around 1¼ percent for three consecutive months through January 2014 -- the first time since November 2008 that it has exceeded 1.0 percent. On a basis excluding food and energy, it has also registered high growth of 0.7 percent -- the highest level since August 1998 -- for two consecutive months through January 2014. Regarding the outlook, the year-on-year rate of increase in the CPI, excluding the direct effects of the consumption tax hike, is likely to be around 1¼ percent for some time.

According to the Bank of Japan's interim assessment released in January 2014 of the October 2013 *Outlook for Economic Activity and Price*s (hereafter the Outlook Report), the median of the Policy Board members' forecasts for the real GDP growth rate was 2.7 percent for fiscal 2013, 1.4 percent for fiscal 2014, and 1.5 percent for fiscal 2015. The median of their forecasts for the year-on-year rate of increase in the CPI, excluding the direct effects of the consumption tax hikes, was 0.7 percent for fiscal 2013, 1.3 percent for fiscal 2014, and 1.9 percent for fiscal 2015.

II. Risks to the Outlook for Economic Activity and Prices

Although there are both upside and downside risks to the Bank's aforementioned baseline scenario regarding economic activity and prices in Japan, I personally pay closer attention to downside risks. The consumption tax hikes are unlikely to affect the ongoing moderate recovery trend, although they may temporarily cause greater fluctuations in economic activity. However, I am paying particular attention to developments in exports and consumption as downside risks to the economy. In addition, as revealed in, for example, the minutes of the Monetary Policy Meetings (MPMs), I personally hold a more cautious view of the outlook for prices compared with the forecasts in the baseline scenario. Let me share some of my considerations regarding the outlook with you.

A. Developments in Exports

Exports have continued to slightly lack momentum. This reflects both external demand factors and other factors, and I consider that exports are likely to continue to lack momentum for some time.

Regarding external demand factors, it must be noted that Asian economies that are Japan's major export destinations still lack momentum. For example, looking at developments in the Chinese economy since the beginning of 2014, the Purchasing Managers' Index (PMI) for manufacturing activity for February marked its lowest level since the middle of 2013, and, in parallel with the progress in implementation of measures to cope with structural problems, there are signs of sluggishness in the pace of increase in fixed asset investment. In addition, there is uncertainty regarding the outlook for the issue of shadow banking, and depending on the outcome of this, it could become an additional downside risk to the Chinese economy.

There is also high uncertainty regarding some emerging and commodity-exporting economies facing structural problems. In these economies, a buildup of imbalances has progressed, such as accumulation of private-sector debt, due to excessive fiscal and monetary policy measures following the Lehman shock and to the increase in capital inflows to these economies based on excessive expectations for economic growth. I think these economies are currently undergoing an adjustment process. Therefore, the financial markets in these economies are likely to become unstable when market participants become concerned about the possibility that a reversal in the global flow of funds might occur in the process of normalization of the U.S. monetary policy, and this instability may become an additional downside risk to emerging economies. In addition, attention needs to be paid to developments in Ukraine, although it is difficult to predict the possible effects at present.

On the other hand, in the U.S. economy, adjustments such as those in the housing market and of household debt have progressed. However, prolonged adjustments may have brought about an increase in the number of unemployed who have difficulties finding a new job, and also in the number of people who have problems participating in or returning to the labor force, leading to new structural problems such as persisting economic slack and a decline in the growth rate of labor productivity. Taking account of these possibilities, I am paying particular attention to the pace of recovery in the U.S. economy.

Next, I would like to point out two possible factors contributing to the lack of momentum in Japan's exports, other than the aforementioned external demand factors. The first is that structural factors -- including the shift of Japanese firms' production sites to overseas accompanying increased local procurement of parts by Japanese manufacturers -- may be at work. According to recent research conducted by the Cabinet Office, manufacturers are expected to continue to increase the ratio of overseas production. This suggests that firms are more conscious of the low growth rate of domestic demand relative to that in external demand, rather than changes in foreign exchange rates. The second factor is that Japanese firms may be taking a cautious stance toward lowering foreign currency-denominated contract prices of exported goods. This could suggest that firms currently have a stronger tendency to enjoy a temporary increase in profits stemming from a rise in prices of exported goods denominated in yen, rather than to expand their overseas markets by lowering foreign currency-denominated contract prices. I will continue to pay attention to how these two factors will affect Japan's exports.

B. Developments in Consumption

Private consumption remains resilient and a front-loaded increase in demand prior to the consumption tax hike has also been observed recently. However, there are signs that consumer sentiment might be changing. For example, (1) the consumer confidence index deteriorated in February 2014 to its lowest level in two years and five months and (2) the overall diffusion index for future economic conditions in the *Economy Watchers Survey* dropped in February to its lowest level in two years and ten months, mainly due to a drop in the index of household activity.

In particular, I think it is necessary to carefully monitor whether the momentum in private consumption will eventually weaken if the current declining trend in real wages continues. Let me elaborate on this point. At present, the number of employees is increasing while real wages decrease, and thus real compensation of employees in total is on a moderate increasing trend. However, there is a large gap between the year-on-year growth in real compensation of employees in total and in real private consumption: in the October-December quarter of 2013, the former showed only a moderate increase of 0.6 percent, while the latter increased by 2.3 percent. There seem to have been fairly strong expectations among the public since 2013 that, as the inflation rate rose, the rate of wage increases would eventually reach the same level. However, it must be noted that, if the public increasingly expects that the rate of wage increases will remain below the inflation rate for a protracted period, this could make consumer sentiment cautious, thereby negatively affecting the public's consumption behavior.

In relation to this point, let me now turn to developments in wages. Scheduled wages, or base salaries, remain on a declining trend, but supported by the improvements in corporate profits and in supply and demand conditions in the labor market, they are likely to stop declining at some point after the upcoming spring wage negotiations. However, many firms seem to remain cautious about significantly increasing the levels of monthly salaries -- the so-called base salaries -- due to concerns about future increases in fixed costs, while they are willing to use improved profits to reward their employees with a rise in lump-sum payments. This stance of firms is consistent with the fact that they remain cautious about increasing the number of regular employees. The active job openings-to-applicants ratio, which shows supply and demand conditions in the labor market, has exceeded 1.00, reaching 1.04 in January. However, supply and demand conditions in the labor market for regular employees do not seem to be so tight, and therefore it seems difficult to expect significant increases in their base salaries, which will be the subject of discussion during the wage negotiations.

Considering that (1) most wage increases could be regular annual raises or a rise in lump-sum payments, although base salaries could rise to a certain level, (2) the proportion of non-regular employees -- whose wages are not discussed in the wage negotiations -- to total employment is increasing, and (3) the rates of wage increases in small firms and in the public sector are likely to be relatively low, the rate of overall wage increases could remain only moderate despite the temporary positive effects expected from the termination of the measures that reduced salaries of government employees to secure funds for reconstruction work after the Great East Japan Earthquake. If that turns out to be the case, and if the rate of nominal wage increases consequently falls below the rate of increase in the CPI excluding the effects of the consumption tax hike, consumers might increasingly expect that decreases in real wages will be protracted. Developments in wages therefore require careful monitoring.

C. Outlook for Prices

The Bank's outlook and the private sector's expectations for prices for fiscal 2013 have been converging, but there is still a wide gap between them for fiscal 2014 and 2015. As for the outlook for prices, I take a more cautious view than the forecasts in the Bank's baseline scenario, as evident from the fact that I formulated a proposal to change the expression regarding the outlook for prices in the October 2013 Outlook Report, although it was defeated by a majority vote during the MPM.

Let me explain the background to this view. So far, the Bank's quantitative and qualitative monetary easing (QQE) has produced positive effects on Japan's economy by stimulating domestic demand and supporting the positive developments in economic activity. This has contributed to some degree to price rises through an improvement in the output gap. I personally take the view, however, that rises in the inflation rate to date have been caused mainly by changes in the foreign exchange rates, and that the trend in the pace of the price rises is more moderate if the effects of developments in the foreign exchange rates are eliminated. In addition, the rise in medium- to long-term inflation expectations remains moderate, as will be explained later, and the rate of wage increases may remain moderate for the time being. Therefore, I take a cautious view regarding the outlook for prices.

The rate of inflation has risen markedly within a short period since 2013, but the Bank's price stability target aims at creating a virtuous cycle in which wages and prices increase in a balanced manner with an upturn in economic activity, and at maintaining it stably. For this to happen, it is necessary that prices rise at a pace consistent with the increase in the growth potential of the economy. Given this, I consider that the price stability target of 2 percent is appropriate only when it is regarded as a medium- to long-term target. I will elaborate on this point later when I will explain my proposal regarding the conduct of monetary policy.

Let me add that, as for firms' responses to the consumption tax hike, there will likely be variation among different industries and sales strategies, in terms of such aspects as the degree to which they pass higher costs on to sales prices and the timing of price revisions. The price trend therefore may remain difficult to assess for a while. Bearing this in mind, I would like to monitor developments in prices closely.

III. Conduct of Monetary Policy

The Bank introduced QQE at the MPM held on April 3 and 4, 2013, 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. Under this new framework for monetary policy, the Bank conducts money market operations so that the monetary base increases at an annual pace of about 60-70 trillion yen. In order to realize this, the Bank purchases Japanese government bonds (JGBs) so that their amount outstanding increases at an annual pace of about 50 trillion yen. In addition, with a view to lowering risk premia of asset prices, the Bank purchases exchange-traded funds (ETFs) and Japan real estate investment trust (J-REITs) so that their amounts outstanding increase at an annual pace of about 1 trillion yen and about 30 billion yen, respectively. In aiming to achieve the price stability target 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.

Almost one year has passed since the introduction of QQE. So far, it has exerted positive effects on Japan's economy through a positive influence on the expectations of financial markets and of households and firms. Since the introduction of the policy, however, while supporting the concrete measures of QQE, I have continued to propose changing the expression in the Statement on Monetary Policy regarding the time frame for achieving the 2 percent price stability target and for continuing with QQE, although my proposal has been repeatedly defeated by a majority vote during the MPMs. 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. Issues to Be Considered regarding the Price Stability Target

Prior to the introduction of QQE, the Bank introduced the price stability target of 2 percent at the MPM held in January 2013. First of all, I would like to explain my thinking behind the price stability target from two perspectives.

First, the Bank conducts monetary policy based on the principle that the policy shall be aimed at "achieving price stability, thereby contributing to the sound development of the national economy." In line with this principle, "price stability" is defined as "a state where various economic entities including households and firms may make decisions regarding such economic activities as consumption and investments without being concerned about the fluctuations in the general price level." It could be said that, by realizing such price stability, the Bank is responsible for creating in the medium to long term an environment in which the economy can achieve sustainable growth so that its growth potential will be realized to the maximum extent. In other words, I think that achieving price stability plays a role as an intermediate objective, or a yardstick, to achieve the ultimate goal of contributing to the sound development of the national economy. In my view, therefore, the most important thing in the conduct of monetary policy is not to pay attention solely to monthly movements in price indices, but to give due consideration to a wide range of developments in the overall economy in achieving price stability, and thereby achieve this ultimate goal.

Second, the price stability target of 2 percent aims to maintain the 2 percent inflation rate in a stable manner. This is because price stability consistent with the sustainable growth of the economy must be sustainable over the medium to long term. Therefore, in order to achieve the price stability target of 2 percent, a temporary achievement of 2 percent in the observed inflation rate is not sufficient -- it is necessary that the rate be stabilized at that level. In order to achieve this, households, firms, and financial markets need to act on the assumption that prices will increase by about 2 percent; in other words, that medium- to long-term inflation expectations be about 2 percent.

So far, medium- to long-term inflation expectations have been mostly in positive territory as a trend, while actual prices have long been on a declining trend. Consequently, price stability has not been achieved, and thus the economy has been in an undesirable situation. This is the background to why it became necessary to introduce QQE.

However, 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 and the supply and demand balances in the goods, services, and labor markets. At least for now, I think that the 2 percent target is well above the level that is consistent with the economy's growth potential. For example, although the observed inflation rate has risen markedly, recent various indicators suggest that the rise in medium- to long-term inflation expectations, such as for five to ten years ahead, remains moderate. Therefore, to achieve the price stability target of 2 percent, I think it is necessary that a wide range of economic entities make use of the benign economic and financial environment brought about by QQE and make continuous efforts to strengthen the economy's growth potential. If medium- to long-term inflation expectations rise as a result of such efforts, it could become appropriate to set the target for the level of inflation at 2 percent, although I think that this will require considerable time. Due to the reasons I have explained so far, I have continued to propose at MPMs 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. Moreover, I think there will be room for a future review of the level of the price stability target that is currently set at 2 percent, considering future changes in the growth potential and medium- to long-term inflation expectations.

B. Issues to Be Considered regarding QQE

When the introduction of QQE was decided in April 2013, I supported the concrete measures of QQE because I considered that this 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 return to the conventional interest rate policy in the future, as zero interest rates produce positive effects through an improvement in economic and price conditions.

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. 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.

In this regard, my understanding is that the 2 percent price stability target can be consistent with the fundamentals 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. 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. Monetary Policy and Structural Reforms

QQE itself is a powerful policy, but it will exert maximum effects when combined with various efforts by both the public and private sectors.

Generally speaking, monetary policy can provide indirect support for structural reforms mainly by working on the demand side of the economy, but cannot substitute for such reforms themselves. For example, as I mentioned earlier, various measures on the supply side to strengthen the growth potential of the economy are necessary to increase the potential growth rate and the labor productivity growth rate. In relation to this, the possibilities of a decline in the potential growth rate and of a rise in the natural unemployment rate, for example, have recently become a hot topic of discussion in the United States and other major advanced economies. Due attention should be paid to the risk that excessive monetary easing without an accurate recognition of these structural changes could result in the accumulation of economic and financial imbalances. There is also a concern that, if excessive expectations on monetary policy increase, or if monetary easing is promoted beyond the appropriate scope of monetary policy, this may lead to losing momentum for advancing necessary structural reforms and instead exert negative effects on economic growth from a long-term perspective.

In order to ensure that the effects of monetary easing fully take hold, the government's efforts to secure confidence in fiscal sustainability are also essential. 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 were to weaken or such speculation were to permeate the financial markets -- reflecting overly heightened expectations that stability in the bond market will be ensured by the Bank's JGB purchases -- confidence in fiscal sustainability could be undermined and long-term interest rates could rise. This in turn could worsen fiscal conditions and substantially constrain the effects of monetary easing. 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 QQE and is essential for Japan's economy in overcoming deflation and achieving sustainable growth.

D. Use of a Wide Range of Policy Measures

1. Loan Support Program

In addition to powerful monetary easing through QQE, the Bank has established a fund-provisioning measure called the Loan Support Program to support initiatives to make the best use of accommodative financial conditions within efforts to increase bank lending and strengthen the growth potential of Japan's economy. The program consists of two measures: the fund-provisioning measure to stimulate bank lending (hereafter the Stimulating Bank Lending Facility) and the fund-provisioning measure to support strengthening the foundations for economic growth (hereafter the Growth-Supporting Funding Facility). At the MPM held in February 2014, the Bank decided to increase the scale of the two facilities and extend the deadlines for new applications under these facilities, which were due to expire shortly, by one year. Specifically, under the Stimulating Bank Lending Facility, the maximum amount of the Bank's fund-provisioning to each financial institution will be increased from the amount equivalent to the net increase in its lending to an amount that is twice as much as the net increase in its lending. As for the Growth-Supporting Funding Facility, the maximum amount of the Bank's fund-provisioning under the main rules will be increased from 3.5 trillion yen to 7 trillion yen, and the maximum amount of its fund-provisioning to each financial institution will be increased from the current 150 billion yen to 1 trillion yen. Furthermore, under these facilities, financial institutions will be able to borrow funds at a fixed rate of 0.1 percent per annum for an extended duration; namely, for four years instead of one to three years at present.

With these revisions, the Loan Support Program is expected to further promote efforts to increase bank lending and strengthen the growth potential of Japan's economy, thereby complementing QQE and contributing to an improvement in the economy. I consider it desirable to aim at achieving economic conditions that are preferable from a medium- to long-term perspective by making use of various measures in a parallel manner, as I have explained, instead of relying too much on QQE, which has considerable side effects.

2. Conduct of monetary policy in view of the effects of interest rate policy

An unconventional policy such as the asset purchase policy implemented under QQE can be regarded as an exceptional and somewhat temporary measure 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 measure that is used when it is time to encourage economic activity and prices to reach desirable levels.

My understanding is that, if the momentum of economic activity and prices becomes sufficiently strong as a result of the positive outcome of QQE and the expected rate of return rises, only with zero interest rates being maintained, the effects of monetary easing will be cumulatively increased by the conventional interest rate policy, and consequently stimulative effects on economic activity will take hold. In fact, in calculating Japan's policy interest rate under the Taylor rule,[1] my recent estimates suggest that the rate has been shifting upward, from being in negative territory to 0 percent or almost in positive territory, reflecting the improvement in the output gap and the increase in prices since the introduction of QQE.

Therefore, in my view, if the cumulative effects of monetary easing generated by maintained zero interest rates, in addition to easing effects of QQE, increase further going forward, one option is to gradually 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. Precisely because the unconventional policy is a new policy measure with a short history, its side effects in general could still have many unknown parts. In particular, in the future, in order to achieve the smooth normalization of monetary policy while maintaining financial market stability, I consider that aiming to make such a shift in the focus of monetary policy conduct, together with the government's fiscal consolidation, will become the important requirement.

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[1] The Taylor rule is a monetary policy rule under which the level of a benchmark policy interest rate is calculated based on a particular formula using, for example, the deviation of the observed inflation rate from the targeted inflation rate, and the output gap.