February 27, 2015

Bank of Japan

Japan's Economy and Monetary Policy

Initial Remarks at the 2015 U.S. Monetary Policy Forum

Held in New York

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Introduction

It is my pleasure to join this panel at the U.S. Monetary Policy Forum together with distinguished panelists. In my initial remarks, I would like to touch upon three issues. First, I would like to briefly talk about Japan's growth potential to provide you with the background to the current policy pursuit. Second, I will discuss ongoing policy efforts and the aims of these efforts, while highlighting the substantial progress made in the labor market. And third, I will offer a few thoughts on an issue that has yet to be addressed, namely the need to anchor inflation expectations.

I. Bleak Near-Term Growth Potential

To start with, let me present you with a figure, Japan's potential growth rate. This is at present estimated to be in a range of 0.0-0.5 percent (Chart 1). A major factor impeding potential growth is the strong headwind posed by demographic trends, particularly the rapid decline in the working-age population, which is expected to continue. Meanwhile, capital accumulation remained weak during Japan's decade and a half of deflation. Finally, while estimates of total factor productivity (TFP) are subject to a considerable margin of error, a ballpark figure is that Japan's TFP is growing at a rate of around one percent a year.

Against this backdrop, the "three-pronged approach" of Abenomics, which relies on the synchronized deployment of QQE (representing monetary expansion on an unprecedented scale), fiscal stimulus, and structural reforms, remains an appropriate strategy. We are fully aware that expansionary fiscal policies cannot replace structural reforms and that committing to fiscal consolidation over the medium term remains critical for sustainable growth.

With these caveats in mind, I would like to emphasize that the concerted effort involving both QQE and well-targeted fiscal policy under the "three-pronged approach" was indispensable to rekindle Japan's economy. In other words, a single-pronged approach relying on either monetary or fiscal policy alone was insufficient to trigger a regime change, that is, to provide sufficient velocity to escape from the deflationary equilibrium which Japan was caught in until late 2012. Currently, with QQE and other policy measures successfully underway, Japan's economy -- despite the temporary setback after the consumption tax hike -- is continuing its moderate recovery trend and is expected to keep growing at a pace well above its potential over the coming few years.

II. Disappearing Slack in the Labor Market

As a result of the recovery, there is now little slack left in Japan's labor market, with the unemployment rate having declined to 3.5 percent in the October-December quarter of 2014 (Chart 2). Admittedly, the improvement in labor market conditions partly owes to the rapid decline in the working-age population. Apart from such supply-side effects, however, there has also been an increase in labor demand, spurred by the effects of QQE and expansionary fiscal policy. At 3.5 percent, the current unemployment rate is roughly equivalent to the structural unemployment rate or so-called NAIRU (non-accelerating inflation rate of unemployment). Simply put, given current labor participation, Japan has full employment.

Under these very tight labor market conditions, wage increases have been gaining some momentum over the past two years since the introduction of Abenomics and QQE. Wages and prices are, however, still hobbling along and are yet to demonstrate an upturn strong enough to reach the 2 percent price stability target. Weak increases in wages so far are observed not only in Japan, but also in the U.S. and elsewhere. A possible explanation is that in the early phase of labor market recovery, many re-entrants tend to take low-paid jobs, thus resulting in slow growth in average wages.

III. (Re-)Anchoring Inflation Expectations: An Issue Yet to Be Addressed

In addition to such composition effects -- which are common to the U.S., Japan, and other countries -- Japan faces the unique challenge to fully dispel the deflationary mindset that has been entrenched in Japan's economy, as well as society more broadly. This deflationary mindset looming over the corporate sector prevented firms from taking more ambitious investment and wage-setting decisions. If inflation expectations were anchored at 2 percent, firms would invest and raise nominal wages more willingly, on the assumption that, in the future, prices will rise by 2 percent every year.

Despite the lingering deflationary concerns, green shoots can increasingly be observed with regard to wage and inflation expectations. By and large, long-term inflation expectations in the U.S. and Europe appear to be well anchored at around 2 percent. Although long-term inflation expectations in Japan long hovered around 0-1 percent, they have recently been gathering momentum (Chart 3). Not only various indicators of inflation expectations but also firms' actual behavior provide clear indications of a regime change. Most importantly, more firms have expressed their willingness to raise wages this year. I think this is a notable manifestation of the improved inflation expectations in the corporate sector. Reflecting the tight labor market conditions, wage increases are expected to accelerate as a result of the annual spring wage negotiations currently underway. These wage negotiations should provide renewed momentum to the virtuous cycle from income to spending operating in the direction of solid economic expansion and stable inflation at 2 percent. Overall, the "payback effect" after the consumption tax hike last April is now judged to be behind us and the economy seems to be back again on a sustained growth path. With the underlying trend of inflation dynamics firmly pointing upward, I think we have a good chance of overcoming the deflation and witnessing a true dawn to Japan's economy.

Conclusion

That said, firmly anchoring inflation expectations at 2 percent, which is the Bank's price stability target, requires continued efforts down the road. Despite all the green shoots, we are still only halfway toward achieving our target. As evidenced by the expansion of QQE last October, the Bank's commitment to achieving the price stability target of 2 percent is unshakable. The Bank will continue with QQE and will make adjustments, if deemed necessary, so that the target will be achieved at the earliest possible time. Let me stop here. Thank you.

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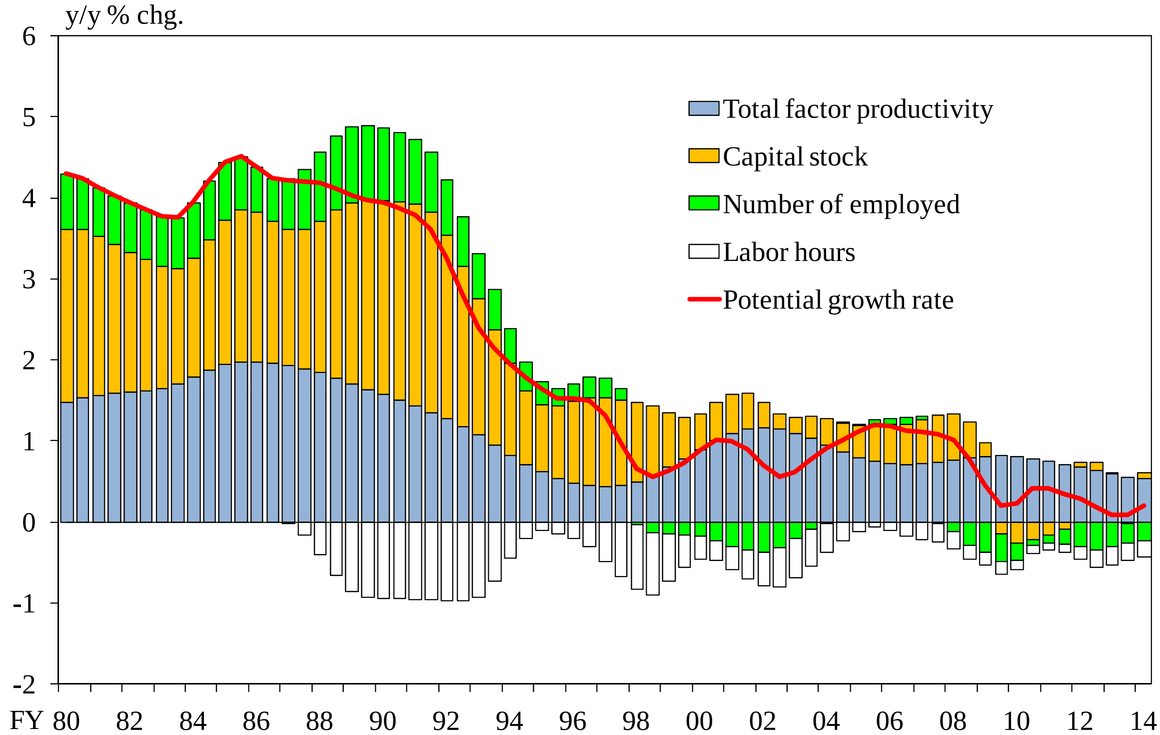
Chart 1

Potential Growth Rate

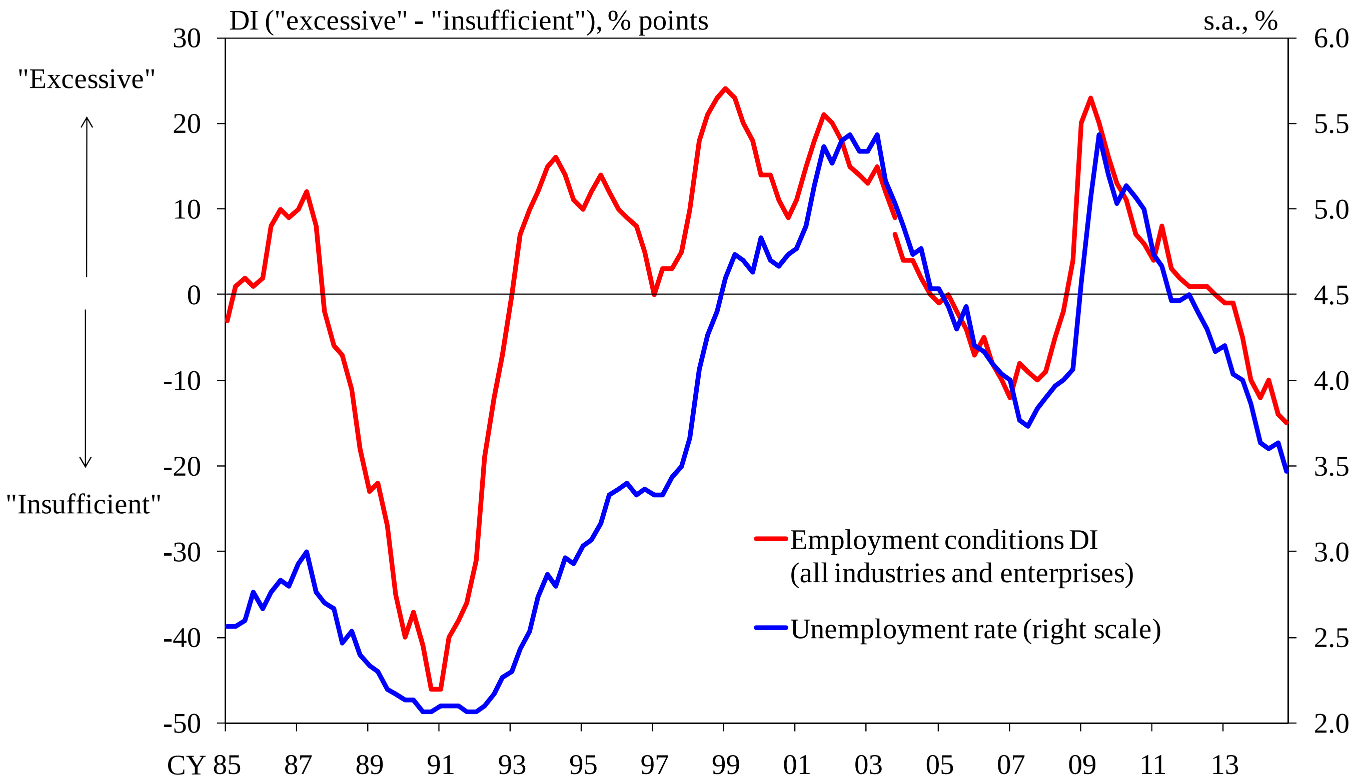


Note: The potential growth rate is estimated by the Research and Statistics Department, Bank of Japan. For the estimation procedures, see "The New Estimates of Output Gap and Potential Growth Rate," Bank of Japan Review Series, 2006-E-3. Figures for the first half of fiscal 2014 are those of 2014/Q2.

Sources: Cabinet Office; Bank of Japan; Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Ministry of Economy, Trade and Industry, etc.

Chart 2

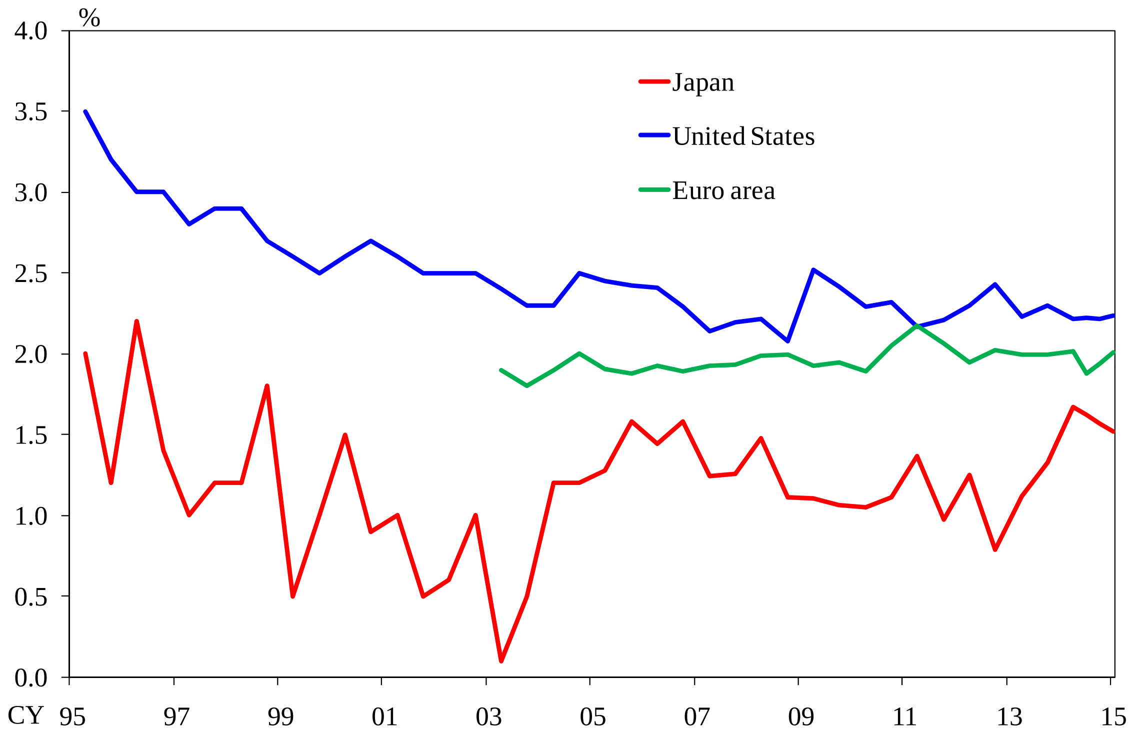
Labor Utilization



Sources: Bank of Japan; Ministry of Internal Affairs and Communications.

Chart 3

Inflation Expectations in Advanced Economies



Notes: 1. Figures are inflation expectations 6 to 10 years ahead, taken from the "Consensus Forecasts."
2. Figures are compiled every January, April, July, and October. Those up through April 2014 are compiled every April and October.
Source: Consensus Economics Inc.