The New York Economic Club
440th Meeting
107th Year

The Honorable Haruhiko Kuroda, Governor
Bank of Japan

October 8, 2014

Questioners: Mervyn King, Lord King of Lothbury
and the former Governor of the Bank of England

John Lipsky, Senior Fellow of Johns Hopkins University
and the former Acting Managing Director of the IMF

Introduction

William Dudley: Good evening everybody, I am Bill Dudley, Chairman of the Economic Club of New York and also the CEO of the Federal Reserve Bank of New York. Welcome to the 440th meeting of the Club in our 107th year. The Economic Club is the nations leading nonpartisan forum for economic policy speeches. More than one thousand guest speakers have appeared before the club and that has established a very strong tradition of excellence. I would like to recognize the 218 members of the Centennial Society. You have contributed to insure a sound future for the club. We are honored today to hear from Haruhiko Kuroda, Governor of the Bank of Japan since March of 2013. Prior to this appointment Governor Kuroda served for eight years as President of the Asian Development Bank. He served since 1967 at the Ministry of Finance in Japan where his responsibilities encompassed fields ranging from international finance and national and international tax as well as duties in the Finance Minister's office. He represented the ministry at a number of international conferences including the IMF World Bank meetings, meetings of the Central Bank Governors, plus bilateral meetings between Japan and other countries. He was a special advisor to the cabinet of Prime Minister Koizumi and also was Professor at the Graduate School of Economics at Hitotsubashi University in Tokyo. I have enjoyed working very closely with him for the last couple of years. Mr. Governor, the floor is yours.

Haruhiko Kuroda, Governor Bank of Japan

Thank you very much, indeed, for your very kind introduction. I am really honored to have the

opportunity to speak at the Economic Club of New York today.

In April last year, the Bank of Japan introduced quantitative and qualitative monetary easing, or QQE. One and a half years have passed since then, and QQE has been producing its intended effects. The year-on-year rate of change in the consumer price index, or the CPI, excluding fresh food, which was minus 0.4% in April last year, has recently become around 1¼% excluding the direct effects of the consumption tax hike. Japan's economy has been on a path suggesting the 2% price stability target will be achieved as expected.

Meanwhile, cautious views concerning Japan's economy seem to be spreading, with the consecutive release of somewhat weak economic indicators after the consumption tax hike in April. That being said, the Bank's assessment is that with the mechanism of economic recovery operating steadily, Japan's economy is expected to continue its recovery, weathering the temporary slowdown in economic growth due to the consumption tax hike. Today, I will talk about the current situation of Japan's economy under QQE and further challenges.

Let me start by discussing briefly the mechanism of QQE. QQE consists of two pillars. One is a strong and clear commitment to achieve the price stability target of 2% at the earliest possible time and the other is a large-scale monetary easing to underpin the commitment. Specifically, inflation expectations will be raised through a strong and clear commitment to achieve the price stability target and at the same time, downward pressure will be put on the entire yield curve

through massive purchases of government bonds. As a result, real interest rates will decline, thereby stimulating private demand such as business fixed investment, private consumption, and housing investment. There will be upward pressure on prices if private demand increases and the output gap–in other words the slack of the economy as a whole–narrows. If actual inflation rates accelerate, expected inflation rates will also rise and the aforementioned series of processes will be reinforced.

The mechanism of QQE has so far been operating as anticipated. 10-year government bond yields have been in the range of 0.5-0.6% in recent months. An average commercial bank lending rate on new loans has declined to a historic low level of around 0.8%. At the same time, medium to long-term inflation expectations gauged from the Consensus Forecasts have climbed to 1.6%. Thus real interest rates have clearly been negative up to long-term ones.

In a nutshell, with QQE producing its intended effects, a virtuous cycle from income to spending has been operating steadily as a high level of confidence is maintained in both the household and corporate sectors.

In contrast to the view that I have just mentioned, there has recently been concern that Japan's economic recovery might have been losing momentum, reflecting the recent weak economic indicators due partly to the effects of the consumption tax hike.

In particular, the GDP statistics released last month showed that real GDP in the April-June quarter fell substantially at a rate of 7.1% on an annualized quarter-on-quarter basis, garnering people's attention.

The substantial decline in the April-June quarter followed the front-loaded demand in the January-March quarter, in which real GDP have grown significantly at a rate of 6.0%, and thus was expected in advance. Excluding such fluctuations of the front-loaded increase and the subsequent decline in demand prior to and after the consumption tax hike, the annualized growth rate of real GDP in the January-June period this year over the July-December period last year is 1.0%. It is not necessarily a high growth rate, but exceeds Japan's potential growth rate, which is estimated to be around 0.5%. As I will discuss in the following, since the virtuous cycle of economic recovery has been operating steadily, the growth rate of real GDP in the July-September quarter is expected to return to the clearly positive one.

Next, let me explain the mechanism of economic recovery in both the household and corporate sectors.

In the household sector, with QQE producing its intended effect, the output gap has improved substantially, and the economic slack has almost been absorbed. The labor market has been tight, and the unemployment rate was 3.5%, declining to roughly the same level as the structural unemployment rate. If I borrow the terminology used by the Federal Reserve Board and the Bank

of England, in Japan, there is almost no slack in the labor market and spare capacity in firms and the labor market is zero. Those developments have also been putting upward pressure on wages. On wages' front, the practice of increasing base wage annually, which had been lost during the period of deflation, was revived for the first time in more than a decade in wage negotiations between management and labor this spring. An increase in nominal wages has been evident since this spring, and along with a steady increase in the number of employees, employee income has increased above 2% year on year. The recent decline in private consumption is due to the temporary decline in demand following the consumption tax hike, and as the results of such decline wane, private consumption is likely to remain resilient with the employment and income situation improving steadily. In fact, the latest economic indicators show that the effects of the decline following the consumption tax hike have been waning, except for durable goods including automobiles.

Some people view a statistical negative growth in real wages as a problem, but it is due to a one-time increase in the inflation rate resulting from the consumption tax hike. The consumption tax hike was scheduled in advance, and it is not an additional factor putting downward pressure on economic activity and prices.

While the year-on-year rate of increase in the CPI has been around 1¼% excluding the direct effects of the consumption tax hike, that in nominal wages has been in the range of 1-2% and that in employee income has been above 2% recently. The recent developments in nominal

wages have been mostly consistent with those suggested by the wage Phillips curve, which shows the historical relationship between the wage growth rate and the unemployment rate. Unlike in the United States, we don't see a phenomenon in Japan that the wage increase falls short of what has been suggested by the level of the unemployment rate. With those in mind, there is no reason to believe that developments in wages will adversely affect Japan's economic activity.

Let me move on to the corporate sector. Corporate profits have continued to improve, with the ratio of current profits to sales for major firms exceeding the level prior to the global financial crisis. In the current economic recovery, some people point to the sluggishness in exports. It is affected partly by the structural changes including relocation of production sites overseas. Corporate profits on a global basis have been favorable. As shown in the September Tankan survey released last week, business sentiment as a whole has maintained its favorable level, despite being affected by the decline in demand following the consumption tax hike. It suggests that many firms basically regard the decline in demand following the consumption tax hike as a temporary one. Reflecting the favorable corporate performance, stock prices have remained resilient.

In that situation, firms have been taking a positive stance in their business fixed investment plans, and it has remained unchanged in the latest Tankan survey. The increase in business fixed investment might be attributable to several factors. Corporate profits have been favorable and

financial conditions have been accommodative. As a result of restrained investment for some years, capital stock has become outdated, prompting increasing demand for renewal investment. There is also increased demand for investment in labor-saving machinery and equipment due to the labor shortage I mentioned before. Therefore, Japan's economy is expected to continue growing at a pace above its potential as a trend since the virtuous cycle from income to spending has been operating steadily in both the household and corporate sectors.

Next, I will talk about the price developments in Japan. Trend inflation is considered to be determined by the output gap of the economy as a whole and inflation expectations. As for the output gap, with the labor market tightening as I mentioned before, the slack has been almost absorbed. Looking at the developments since the introduction of QQE, inflation expectations have been rising on the whole, albeit with monthly fluctuations. Against such a backdrop, the year-on-year rate of change in the CPI, excluding fresh food, which was, as I said, to minus 0.4% in April last year; has recently become 1.1% excluding the direct effects of the consumption tax hike.

The CPI inflation has more or less leveled off in a narrow range of around 1¼% for eight months since the beginning of this year. Looking at such leveling-off inflation rates, some view that increasing momentum for the CPI inflation has been lost after accelerating strongly last year.

The leveling-off CPI inflation is due to the dissipating base effect. The effects of yen

depreciation and the energy price increase that exerted upward pressure on consumer prices in the previous year have been falling off, compared with a year earlier. By contrast, trend inflation rates have continued to increase steadily. In fact, the developments in the inflation rates so far have been mostly in line with the Bank's projection. The fact that the inflation rate has not declined too much but remained resilient despite the dissipating base effect suggests that the improvement in the output gap and the rise in inflation expectations have been working as trend inflationary pressure.

Looking ahead, the output gap and inflation expectations are expected to continue improving. Since the dissipating base effect is expected to run its course, the year-on-year rate of increase in the CPI is expected to follow an uptrend again from the second half of this fiscal year and reach about 2%, that is, the price stability target, in or around fiscal 2015.

In this way, Japan's economy has been on a path suggesting that the 2% inflation or price stability target will be achieved as expected. Yet, we need to raise inflation rates and inflation expectations further toward 2% and thus we are only halfway there. The Bank will continue with QQE, aiming to achieve the price stability target of 2%, as long as it is necessary for maintaining that target in a stable manner. If the outlook changes due to the manifestation of some risk factors and it is judged necessary for achieving the price stability target, the Bank would make adjustment without hesitation.

Let me emphasize that our commitment is result-oriented. It means that the Bank will continue with QQE to achieve the target, and the Bank will make adjustments if necessary so that the target will be achieved.

In closing, let me talk about Japan's growth potential. As I said earlier, Japan's potential growth rate is estimated to be around 0.5%.

Japan's potential growth rate in the late 1990s that is estimated to be around 2% has thereafter been declining gradually due to such factors as aging, the declining population, and the slowdown in capital stock accumulation during the period of protracted deflation. Those facts are well recognized, and both government and private sector are making efforts to raise the potential growth rate. As a growth strategy to stimulate positive investment, the government formulated the Japan Revitalization Strategy and revised it in June. The Bank strongly expects that the measure will be steadily carried on, and thereby firms will aggressively undertake initiatives.

Raising medium to long-term economic growth potential is basically an issue of the supply side of the economy and thus monetary policy does not play a main role in that regard, but it can make important contributions. That is, by dispelling the deflationary mind-set. When the deflationary mind-set is widespread, cash hoarding and maintaining the status quo are considered rational. Proactive behaviors by taking risks do not result in rewarding a sufficient return. In fact, under the period of protracted deflation, firms have become reluctant to take risks, such as

investing in capital stock and in research and development, resulting in a considerable decline in the potential growth rate.

Dispelling the deflationary mind-set and creating an economy, in which private entities can act based on an assumption of 2% inflation, will lead to reviving the animal spirits of firms that were lost in the prolonged deflationary period and thereby enhancing growth potential. That is evident if you recall that positive developments have become widespread among firms since last year as prices started to rise. The Bank will firmly support such positive developments through achieving the price stability target of 2% at the earliest possible time.

While some question whether it will be desirable to increase prices when the potential growth rate is low, my answer will be a clear "yes." Overcoming deflation and raising growth potential is not an issue of which comes first. Overcoming deflation is an important prerequisite for raising growth potential. The Bank will achieve the price stability target of 2%. In that situation, I am convinced that Japan's economy will achieve a higher potential growth rate.

Thank you.

Question and Answer Session

WILLIAM DUDLEY: Thank you Governor Kuroda for those insightful remarks. As is our

custom, two of our members have been selected to question Governor Kuroda. Mervyn King, Lord King of Lothbury and the former Governor of the Bank of England, who is here in New York for the fall semester at NYU. And John Lipsky, Senior Fellow of Johns Hopkins University and the former Acting Managing Director of the IMF. If you have questions, you may email them to our President Jan Hopkins at questions@econclubny.org. That is questions@econclubny.org. John you will be the first questioner.

JOHN LIPSKY: First of all I want to congratulate you on your active part in the historic effort to improve Japan's economic performance and success and I want to wish you and your colleagues all success in achieving your goals. Secondly, I want thank you for joining us here in New York this evening in your very busy schedule. Well, the latest data, as you acknowledged in your remarks, have been less favorable than virtually all forecasters had anticipated. You have given your explanations here to us, thank you for explaining it clearly, why you think that performance is going to improve after the disappointing recent data. We wish you success. You have also indicated that if the performance were to disappoint going forward, that the Bank would respond. What measures would you have in mind that the Bank could utilize if more stimulus support was needed by the Japanese economy?

THE HONORABLE HARUHIKO KURODA: Of course this is a very important question, although it is also difficult to answer. From Central Bank point of view, because if as I said, the economy shows some significant sign of derailing from the past 2% inflation, we will make

additional monetary easing so as to achieve the 2% price stability target, as we have strongly committed. What kind of measures are available and what kind of monetary easing measures are the most appropriate? I think that will very much depend on the circumstance when the economy and the prices behave. At this stage I can only say that we have a lot of options because in Japan there are so many financial assets to be purchased by the Central Bank. We have been purchasing long-term government bonds as well as some commercial papers, corporate bond, ETF, JGB and so on and so forth. As you know, the JGB market is huge. We have substantially increased our JGB holdings but still it is about 20% of the total JGB's outstanding. I understand the Bank of England has purchased roughly 40% of government bonds in the UK. (Laughter) Our purchase of CB, corporate bond, ETF, JGB have been quite small compared with the market size. So anyway, there are many options available and if necessary we will not hesitate to make any necessary and appropriate monetary easing in order to achieve the 2% price stability target.

MERVYN KING: Good evening everyone and Haruhiko welcome to New York. After 20 years, at last I get to ask the questions. (Laughter) We have all found that monetary policy has not found it easy to generate a sustainable world recovery. Do you think that if this continues that it poses a risk to the public and political support for Central Banking dependents which came out of the experience of high inflation in the 1970's? After all, the strong card of Central Banks is to take measures to lower inflation expectation, not to raise them.

THE HONORABLE HARUHIKO KURODA: Again a very important but at the same time

difficult question to answer—particularly a question raised by the former Bank of England Governor—but let me try. In general I think containing inflation to explore controlling inflation is probably much easier for any Central Bank than raising inflation rates, particularly from negative range. Japan has experienced 15 year deflation from 1998 to 2013, last year—such a long deflation—long and yet fairly mild deflation. On average deflation, negative inflation rate was about -0.5 or something. But very prolonged deflation created deflation of the mind-set which has been so difficult to eradicate through monetary policy. The Bank of Japan tried many times to eradicate this kind of prolonged deflation but unfortunately deflation continued until 2013. Now, the Bank is trying very hard to eradicate this kind of mind-set and as I said, we are halfway and that means that we have been successful but we have not yet achieved the 2% price stability target. So that means that raising inflation rate particularly from the negative range to a positive range is extremely challenging. But I am not so pessimistic as to think it is impossible; it is so difficult, I don't think so. We can make deflation eradicated and we can achieve the 2% inflation target. So I don't think our monetary policy credibility would be lost and at the same time I don't think Central Bank independence would be undermined through these efforts. As Mervyn knows much better than I, Central Bank independence has been gained, acquired through a very long effort by many central banks in particular the Bank of England in controlling inflation and achieving appropriate inflation target. So far, despite the very difficult economic situation prevailed after the "Lehman shock" in all countries, I mean, not only in the US and the UK but also the euro zone, Japan, so many emerging market economies, but all central banks in the world have been making their bets and so forth, and as I understand, the Bank of England and

the Federal Reserve would be the first to normalize or exit from the somewhat unconventional monetary policies. In relation to this issue, I may say just a few words about nature of the unconventional monetary policies. I mean people say that unconventional monetary policies are so different from conventional monetary policies and so difficult and so on and so forth, but I really think the difference between conventional monetary policy and the unconventional monetary policy, the difference has been too much exaggerated. I think always conventional or unconventional monetary policy is not so easy, particularly in controlling inflation and forward guidance or expectation management they are also important, not only in the unconventional monetary policy but also in conventional monetary policy. I studied economics in Oxford, 40 years ago, more than 40 years ago, and at that time John Hicks, Sir John Hicks, was already, of course emeritus professor but providing seminar on monetary economics every week. One day, he said that, "why the Bank of England can effect for instance inflation, can reduce the inflation rate just by raising the bank rate by only half a percentage point", because by doing so, the Bank of England shows the determination to further raise the bank rate to whatever level in order to control inflation. That expectation is taken into account by every economic entity, so that only 0.5% bank rate rise could affect the economy and could affect the inflation rate. So more than 40 years ago, already John Hicks very much emphasized the importance of expectation, commitment related to monetary policy. Now of course many market economists argue that forward guidance, ___ management is so important for unconventional monetary policy but I think they are also important even for conventional monetary policies.

JOHN LIPSKY: In case the audience is wondering, near as I can tell, this is not a Japanese microphone. (Laughter) Are there any lessons that can be drawn from last April's consumption tax increase that could help reduce the potential negative impact on demand of the additional rate hike that is scheduled for October 2015? Moreover, Prime Minister Abe has pledged to implement corporate tax changes. Do you expect that this corporate tax reform will be introduced soon and if so, would you expect that there would be any near term economic impact that could challenge monetary policy beyond that of the consumption tax hike already scheduled?

THE HONORABLE HARUHIKO KURODA: Of course, fiscal policy is something to be decided, determined by the government and supported by the Diet. What I am going to say is just outside of the view, a personal view. I think when the consumption tax rate is further raised by 2% in October of next year; the government will probably provide some fiscal stimulus in order to ameliorate the negative impact of consumption tax hike, as they did when the 3% tax increase was made this April. I think that would help avoid excessive fractionation of growth rate. At the same time, corporate tax reduction, the government is now contemplating, may also help the economy because the so called Tax Council, otherwise already the committee for the Prime Minister, issued a short report on upcoming public acts reform in which the council said or argued that any corporation tax reduction should be financed by some measures to increase revenue, but at the same time the report said that such things should not be simultaneous. I mean monitor year through financing should be made. So in the first year corporate tax reduction may

be bigger than some revenue increase. But in monitor year period, the corporate tax reduction must be fully financed by revenue increase or something like that. Of course that is the view expressed by the Tax Council, the advisory committee for Prime Minister but I think if that kind of thing is actually implemented then again that would be help the economy to avoid any excessive downturn in the event of Consumption Tax Act. But all of these are, I think, still going to be discussed by the government and approved by the Diet. This is only my personal opinion.

WILLIAM DUDLEY: Mervyn, last question please.

MERVYN KING: Now Haruhiko you are about to leave New York and go to Washington for a relaxing weekend in the windowless rooms of Washington. What in the view of the Bank of Japan is the role of the IMF today?

THE HONORABLE HARUHIKO KURODA: This is my view, and I think the IMF will continue to play the central role in the international finance. IMF is quite unique because it is the only global institution which backs up a backup of the world economies through its crisis rendering capacity as well as global surveillance. So I still think that IMF is so vital, so important. As I said, the Bank of England and Federal Reserve have already started normalization process since the economy has been recovering very robustly, in a strong way. These two major central banks have been very careful in communicating their policy intentions to the world so as to avoid any abrupt impact on the world global financial markets, as well as, in

particular effect on emerging economies. But at the same time, we have to be always mindful that financial markets are markets and no one can really predict the future behavior. And particularly their impact on emerging economies should be always taken into account. Then, the IMF is the key player to stabilize the financial market in the world and particularly through possible assistance to emerging economies. I understand that years ago just after the "Lehman shock", major countries through G20 Summit meetings agreed to double the IMF quotas and also improve IMF governance structure. I understand almost all countries ratified but unfortunately the governance reform and quote increase, they are not yet implemented. I hope these reforms will be implemented as quickly as possible to provide a kind of safety net. I clearly don't, at this stage expect turbulence and extreme impact on emerging economies. I don't expect, but still, market is market and some emerging economies in the future might be affected. Then the most important financial safety net is IMF. So IMF resources be strengthened and at the same time of course various regional financial safety nets like Chiang Mai Initiative or ESM, so on and so forth, have already been established and they may further be strengthened but still, IMF is unique and IMF I think should better be further strengthened.

WILLIAM DUDLEY: Thank you Mervyn, thank you John and especially thank you Governor Kuroda. Next Tuesday evening we will be having another event for the Economic Club of New York. We will be honoring Pete Peterson with a special achievement award at a dinner that we will be having at the Hilton. Speakers include Alan Greenspan and Paul Volcker. Have a great evening.