Mizuho Economic Outlook & Analysis

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Issues left unresolved in the BOJ's "Comprehensive Assessment"

Monetary policy has limits in overcoming the malfunction of the monetary transmission mechanism

< Summary >

◆ The Bank of Japan's comprehensive assessment stressed "three external factors" as factors which hampered achievement of the 2% price stability target. However, the Bank of Japan (BOJ) may have failed to reckon the malfunctioning of the "transmission mechanism of monetary easing" itself.

◆ The largest reason for not achieving the 2% inflation target is the fact that the rise of wages did not keep pace with the rise in prices along with the depreciation of the yen. Raising wages requires the utilization of all available policy measures, including monetary, fiscal and structural reforms.

◆ Fiscal measures should be revised to lift the economic growth potential through such means as reversing the declining birthrate. In the area of structural reform, there is still significant room for improvement of the labor market. Furthermore, education and social security reforms to supplement the foregoing are also indispensable.

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1. The "external factors" cited in the BOJ's comprehensive assessment are not the only factors which hampered the achievement of the 2% price stability target

(1) The comprehensive assessment referred to three "external factors" which hampered the achievement of the 2% inflation target

In the BOJ's "comprehensive assessment" released on September 21, the BOJ attributed the failure to achieve the 2% inflation target, despite the passage of more than three years since implementation of quantitative and qualitative monetary easing ("QQE"), to three "external factors" as follows : (1) the decline in crude oil prices, (2) weak demand after the consumption tax hike in April 2014, and (3) the slowdown in the emerging economies and subsequent volatility in the global financial markets (**Chart 1**). These three factors, which are beyond the control of the BOJ, and which lowered the observed inflation rate and weakened the inflation expectations under the "adaptive expectations formation," are the reasons given by the BOJ for the failure to achieve the 2% inflation rate. In other words, as BOJ Governor Haruhiko Kuroda explained at the regular press conference, the 2% inflation target would have been achieved if these three "external factors" had not occurred (**Chart 2**).

Chart 1: Factors that hampered achievement of the 2% inflation target in the comprehensive assessment

Factors	Details
(1) External factors	i. Decline in crude oil prices
	ii. Weak demand after the consumption tax hike
	iii. Slowdown in emerging economies and volatile global financial market
(2) Adaptive expectations formation	Amid i to iii, inflation expectations -- after having been largely flat -- weakened, reflecting the fact that expectations formation in Japan is largely adaptive, that is, backward-looking.

Source: Made by MHRI based on the BOJ.

Chart 2: Statement by BOJ Governor Kuroda at the regular press conference

Statement of Governor Kuroda at the regular press conference
I think the 2% price stability target would have been achieved if they (*external factors) had not occurred.
I believe the expected inflation rate would have grown steadily if the observed inflation rate had not declined due to these external factors, because the inflation rate actually rose to 1.5% in 2014 after implementing the "quantitative and qualitative monetary easing" measures. I cannot deny the fact that "adaptive expectations formation" played a significant role in the process of failing to achieve the inflation rate due to the drop in crude oil prices and other factors.

Source: Made by MHRI based on the BOJ.

Nonetheless, the BOJ's view underestimates the persistence of low inflation in Japan. This is because the price rise in 2014 was mainly due to the cost increase of food items and energy, brought about by a temporary factor of the yen depreciation (**Chart 3**). If the BOJ had taken a more open-minded stance in observing the reality that inflation had failed to reach 2%, in spite of the implementation of "extraordinary" monetary easing that created maximum favorable conditions with a steep yen depreciation exceeding 20% compared with the previous year, it would have recognized the difficulty of achieving a sustainable inflation rate of 2% even without the "external factors."

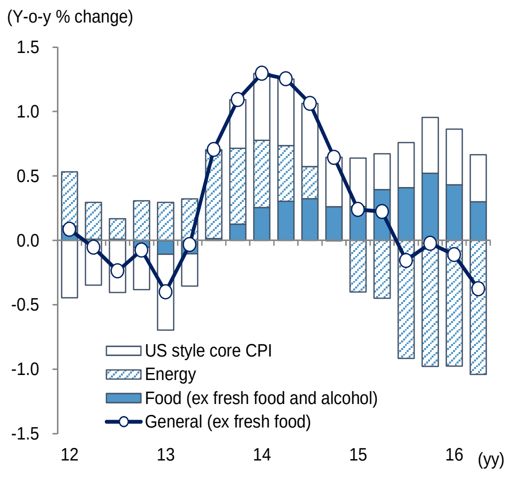
(2) Three misjudgments on the "transmission mechanism of monetary easing" were overlooked in the comprehensive assessment

We believe the factors behind the failure to achieve the 2% inflation target, despite the implementation of "QQE," are not confined to the "external factors" outlined in the comprehensive assessment. The factors should also include the malfunction of the "mechanism to transmit the monetary easing effect to the real economy".

a. Misjudgment that the export volume would grow with the yen depreciation

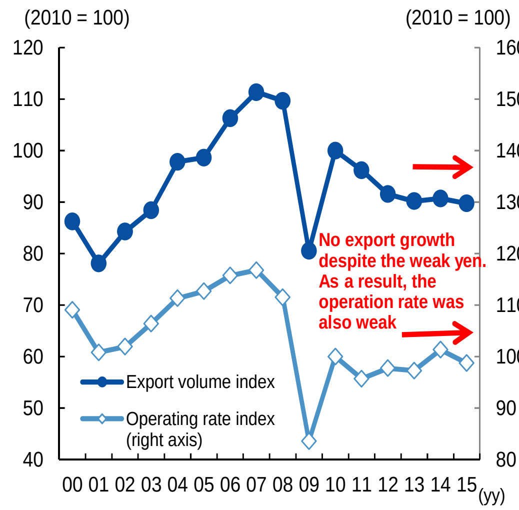
Firstly, the lower-than-expected export volume growth, despite the depreciation of the yen accompanying monetary easing, was due to a malfunction of the monetary transmission mechanism overlooked by the BOJ (**Chart 4**). The *Outlook for Economic Activity and Prices* report released in April 2013 stated that the yen's depreciation in the foreign exchange market was likely to support an increase in Japan's exports, which clearly suggests that the BOJ at that time was expecting the export volume to increase driven by a weaker yen. If the weaker yen had sufficiently pushed up Japan's export volume, it is highly likely that price trends would have improved even more through the transmission effect of capital investment.

Chart 3: Factor analysis of the inflation rate



Source: Made by MHRI based on the Ministry of Internal Affairs and Communications, *Consumer Price Index*.

Chart 4: Export volume and operation rate



Source: Made by MHRI based on the BOJ.

It should be noted that the reasons for lower-than-expected export volume growth, despite the yen's decline, include the long-term trends of (1) Japan's diminishing share in the global export market due to higher competitiveness of companies in the emerging economies, (2) the increase in overseas production by Japanese companies thanks to infrastructure and supply chain improvements in the emerging economies, and most likely (3) the arrival of the timing to execute large-scale overseas investment projects planned at the time of the stronger yen subsequent to the Global Financial Crisis.

b. Misjudgment that capital investment would increase with the decline in the real interest rate

Although "QQE" brought down the real interest rate, it is difficult to say that it was enough to fuel capital investment growth. The background to this includes (1) repercussions from the slower-than-expected growth of Japan's export volume, (2) the situation where a decline in the real interest rate could not be directly translated into capital investment growth due to the corporate sector holding excessive cash (**Chart 5**), and (3) difficulty in carrying out capital investment projects that might lower investment profitability or be loss-making in the short term and require a longer recovery period amid an operating environment where a higher ROE is required following "aggressive" corporate governance reform (**Chart 6**).

c. Misjudgment that the wage increase would keep pace with the rise in prices

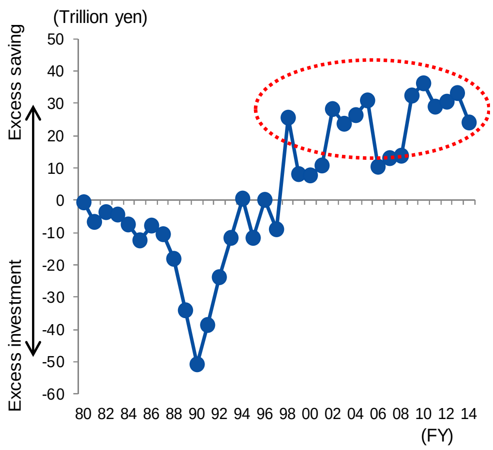
The most important miscalculation concerning the transmission mechanism may be the fact that wages did not increase in line with the rise in prices following the weakening of the yen.[1] As mentioned earlier, food and energy (electricity, gasoline, etc.) prices climbed higher due to the increase in import costs following the yen depreciation. Since these items are necessities for living, the level of prices actually felt by households rose higher than the observed inflation rate (**Charts 7** and **8**).

On the other hand, although the rate of wage increase grew higher than during the period before "QQE" was launched, the extent of the increase was more gradual than the price increase actually felt by households. While the movement of wages strengthened in some parts of the economy, such as in the construction industry, which suffers from a serious labor shortage, and among large companies, which were directly requested by the government to lift wages, the increase in wages did not spread among all companies, especially small and medium-sized enterprises. The lower-than-expected wage increase relative to the increase in prices is believed to be a major factor behind the slowdown in

[1] In the "Comprehensive Assessment" compiled by the BOJ, the problem of wage determination in Japan (wages in Japan are negotiated between workers and management in the spring – the annual *shunto*) is described in Appendix 4 as background to strong "adaptive expectations formation." But such a factor is treated as a supplementary explanation only, and not as one of the main factors for the failure to achieve the 2% inflation target.

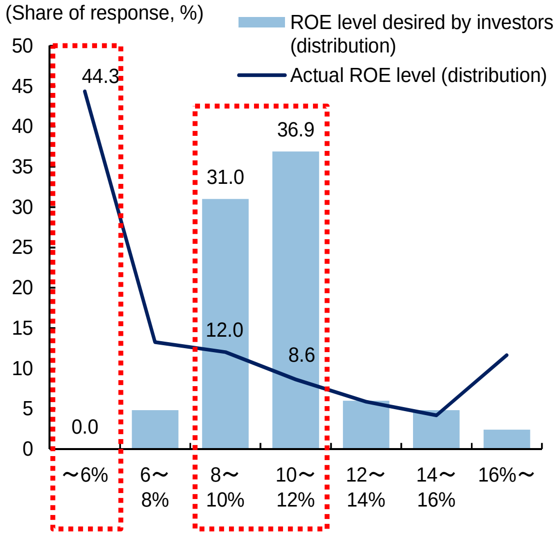
consumer spending and the reluctance of companies to raise prices.

Chart 5: Savings-investment balance in the corporate sector



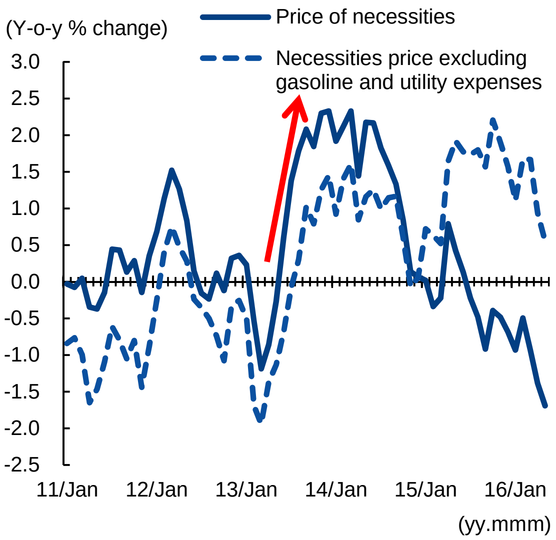
Source: Made by MHRI based on the Cabinet Office, *National Accounts*.

Chart 6: Ideal and actual level of ROE desired by investors in the medium- to long term



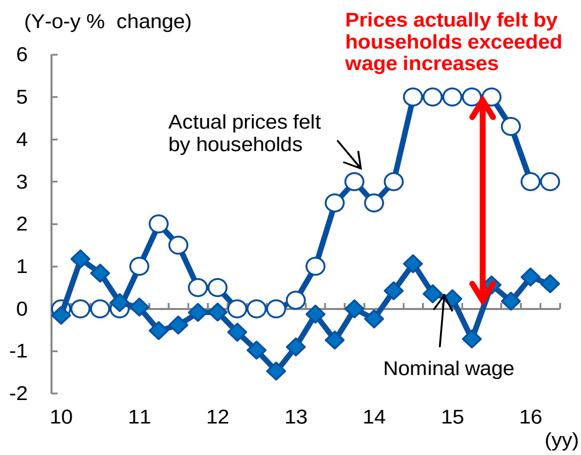
Source: Made by MHRI based on the Life Insurance Association of Japan, *Initiatives to Raise the Value of Stocks*.

Chart 7: Prices of essential items



Note: The above figures exclude the impact of the consumption tax hike in April 2014.
Source: Made by MHRI based on the Ministry of Internal Affairs and Communications, *Consumer Price Index*.

Chart 8: Gap between prices actually felt by households and the rate of wage increase



Note: Prices actually felt by households are the mean value of answers to the question of "By what % do you think prices have changed compared with one year ago?"
Source: Made by MHRI based on the BOJ, *Opinion Survey of the General Public's Views and Behavior,* and the Ministry of Health, Labour and Welfare, *Monthly Labor Survey*.

(3) Lower growth potential of Japan's economy is the background to the BOJ's misjudgments over the "transmission mechanism"

We hold that the reason why the "mechanism to transmit the QQE effect to the real economy" did not function as expected is the decline in the growth potential of Japan's economy. As I mentioned in the previous section, the loss of Japan's share in the export market due to enhanced competitiveness of the emerging economies was one reason for slower-than-expected export volume growth, despite the yen depreciation, and this phenomenon provides clear evidence of the lower growth potential of Japan's economy. In addition, the excess cash position of the corporate sector, which underpins the reason behind weak capital investment, despite the decline in the real interest rate, and certain problems arising from "aggressive" corporate governance reform, are both concerns stemming from the lack of attractive investment opportunities due to Japan's lower expected growth rate. The tepid wage increase can also be explained by the difficulty company managers face in implementing drastic wage increases, given that they cannot project sustainable business growth in the future.

2. The malfunction of the "transmission mechanism" cannot be solved through monetary policy alone. Measures to reverse the low birthrate and acceleration of structural reform are indispensable.

(1) The "new policy framework" ensures the sustainability of an easy monetary policy, but it is difficult to deal with the essential issue concerning the malfunction of the "transmission mechanism"

The "comprehensive assessment" points to the possibility that the price stability target of 2% may take longer than expected to achieve. The new monetary policy framework takes into account this possibility, and has been modified to maintain monetary easing on a sustainable basis. Up until then, expansion of "quantity" in the name of monetary base constituted the main pillar of monetary easing, and the unavoidable contraction of the BOJ's JGB purchases in the future may have been interpreted as a tightening of the monetary policy. In contrast, under the new policy framework, since the core of the monetary easing measure has shifted from "quantity to interest rate," a reduction in JGB purchases would not have to be explained as a tightening of monetary policy. Furthermore, by introducing the idea of controlling the long-term interest rate to back up the side-effects of the financial intermediation function, we understand that the BOJ has secured room to further lower the negative interest rate in the future.

On the other hand, the essential problem concerning the malfunction of the “mechanism to transmit the QQE effect to the real economy” cannot be solved by the new policy framework alone. But we believe the BOJ is not the one to blame, for this issue goes beyond monetary policy. As mentioned earlier, the fundamental problem hindering the working of the “mechanism to transmit the QQE effect to the real economy” is the decline in Japan’s potential growth rate, and this kind of problem should not be dealt with through monetary policy but through fiscal policy and structural reform.

(2) Calls for a commitment to continuous fiscal expansion can be heard, but this move carries great risk at the moment

More people have begun to realize the limit of the current monetary policy, and some are stressing the need for fiscal stimulus. Nonetheless, since an ordinary fiscal stimulus package (that is executed from the supplementary budget of economic measures) has only the effect of a one-time expansion of demand, its effect on achieving the price stability target of 2% seems limited. To take advantage of fiscal measures that can contribute to the 2% price increase, it seems necessary to make a commitment to sustainable fiscal expansion to form the expectations for long-term economic growth and inflation. In fact, one leading economist, Christopher A. Sims, proposed in his address at the economic symposium held this year in Jackson Hole that an increase in the consumption tax rate should be postponed until the 2% price target has been achieved[2] (Sims (2016)).

But commitment to continuous fiscal expansion may heighten the risk of financial collapse if the inflation target cannot be achieved as expected; and while this may be a promising option during an economic crisis sometime in the future, commitment to continuous fiscal expansion at present is hardly a realistic policy choice because its cost (risk of financial collapse) exceeds the benefit. Also, under circumstances in which the reality of this policy is in doubt, the government would not be able to gain the confidence of the private sector, even if it vowed to make such a commitment, and therefore the policy would not be able to lift the expectations for long-term economic growth and inflation as intended.

(3) Labor market reform has significant room for improvement

In light of the above argument, fiscal measures should not focus on an expansion of size, but also consider a shift in content focused on contributing to economic growth.

[2] According to Sims (2016), “In Japan, this might be achieved by explicitly linking planned future increases in the consumption tax to hitting and maintaining the inflation target.”

From the perspective of long-term economic growth, it is important to stop the decline in Japan's population, and to that end, public spending should be directed to the areas of child care and education. With Japan's social security system centered particularly on the redistribution of funds from working households to elderly households through the provision of medical insurance and public pensions, the nation's relatively small outlays on child care and education, compared with other countries, is considered a problem.[3] Although public spending on medical insurance and pensions is expected to grow going forward due to further aging of Japanese society, the government should redirect a portion of such spending for use in the areas of child-rearing and education in order to reshape the spending structure.

Structural reform also plays a crucial role in enhancing growth expectations. One sector with still room for improvement is the labor market. By clarifying dismissal regulations,[4] including the "monetary resolution of employment dismissals,"[5] and by proceeding with education reform (enhancing vocational training) and social security system reform (improving the safety net and portability of pension plans), we can expect to see a shift of employment to growth sectors as well as higher capital investment and increasing wages. From the viewpoint of stimulating innovation, we can expect the activation of innovation through the fusion of knowledge as it becomes easier to invite human resources with diverse backgrounds in areas of research and development.[6]

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[3] According to the OECD (2016), Japan's public spending on education (share to GDP) is the second lowest among OECD countries.

[4] Other leading countries (the UK, Germany and France) also have general provisions on employment dismissal similar to Japan's Employment Dismissal Regulations (Article 16 of the Labor Contract Act: A dismissal shall, if it lacks objectively reasonable grounds and is not considered to be appropriate in general social terms, be treated as an abuse of right and invalid" (Ikezoe (2002), Ikuta (2010), Ministry of Health, Labour and Welfare (2016), among others). The US has no legislation equivalent to Japan's Employment Dismissal Regulations (principles of employment at will) and regulates employment discharge in the employment contract and labor agreement. While Japan's Employment Dismissal Regulations are valid as a general provision, it is necessary to create legislation that includes consideration factors to improve the predictability of interested parties and enable flexible judgment depending on the type of occupation and salary treatment (and unified judgment for similar cases). (The Employment Guideline was created in the National Strategic Special Zones to analyze and categorize judicial decisions but has no legal effect.)

[5] Legislation of "settlement by cash system" concerning illegal employment dismissal is strongly opposed. But there have already been judicial decisions made in the lower court that (1) take into account economic compensation (additional retirement allowance) as one factor to determine the validity of employment dismissal due to restructuring, and (2) recognize compensation for imputed loss of income in the case of illegal employment discharge. Hence we can assume that, in reality, settlement of employment dismissal by cash is already recognized (Ikuta (2010)). It may be beneficial for both workers and employers to clarify the employment dismissal system through legislation because it will improve predictability on the effectiveness of dismissal and help to estimate the fair value of indemnity.

[6] Refer to Fleming (2004), among others, for the importance of fusion of varied knowledge in innovation.

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