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Press conference by Governor Kuroda – Significance of inflation

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Introduction:

MPMs in April and in October are regarded as pivotal events in a year, because the members of the policy board review the outlook of economy. Since the monetary policy will be managed according to inflation outlook, as Governor Kuroda insists, these meetings are all the more important this year.
I discuss several points of their revised outlook which seem to disappoint some market participants.

Outlook of economy and inflation

Members of the policy board marginally revised down their outlook of GDP growth rates. For FY2014, new range is +0.8% to +1.3% in comparison with +0.9% to +1.5% in January (as mid-term review). And for FY2015, top of the range is lowered (from +1.8% to +1.5%). According to the comments by Governor Kuroda at the press conference, this is due to 1) carry-over effect of weaker growth in late FY2013 and 2) slower recovery of export demands especially from emerging economies in south eastern Asia.

In contrast, the outlook of inflation (excluding the impacts of consumption tax hike) was virtually unchanged. Median rates for both FY 2014 (+1.3%) and FY 2015 (+1.9%) remained the same as those in January and the bottoms of their ranges became slightly higher (from +0.9% to +1.0% for FY 2014 and from +1.0% to +1.2% for FY 2015). While it may appear strange to revise the outlook in opposite direction, Governor Kuroda insisted that further removal of economic slackness – in labor markets in particular – and higher expectation of inflation are the reasons for upward revision of inflation outlook.

Macro-gap : Revisited

At the press conference today, issue of macro-gap attracted attention again. Readers may like to remember that Governor Kuroda's comments on this issue at the previous conference invited negative reactions from the markets. It was because his comment ("deflationary gap is estimated to be effectively zero") was misunderstood as if the BOJ expects an earlier acceleration of inflation, which would make an additional stimulus unnecessary at all.

As a matter of fact, empirical studies of our history of inflation - an example is sometimes attached to the monthly reports by the BOJ - suggests that inflation rates would not have to become higher even when deflationary gap would be zero. In the context of Philips Curve, inflation rate depends on the Curve's intercept at Y axis. While the BOJ is confident about the gradual improvements of inflation expectation, there is high uncertainties about the shape and position of the Curve.

More fundamentally, accurate estimation of macro-gap is a very tough task. I personally agree that "production function approach" by the BOJ would be more practical for policy decision than "potential growth rate approach" which would be vulnerable to the accuracy and robustness of GDP data. Nevertheless, estimation of utilization of capital and labor on aggregate basis would not be an easy task even for "production function approach" .

With these backgrounds, the BOJ deliberately avoided the term of "deflationary gap" this time to minimize the communication problem, and used the term of "macro-economic imbalances in demands and supply". In any case, disappearance of deflationary gap should be welcome as a cornerstone and should be treated as one of the necessary conditions for exiting from deflation.

Wage inflation

A press reporter raised this important issue today. Specifically, he asked if the BOJ is satisfied with the economic condition with higher rate of inflation and lower rate of wage increase. In fact, experts who are skeptic about QQE seem to shift their targets to this issue from the risk of underperformance of inflation rates, after having observed higher inflation in recent months than they had previously thought.

Governor Kuroda implied that such decrease in real income would be temporary, and tightening labor markets would bring about higher wages in the end. If, however, reduction in real purchasing power would be maintained, it would cause some problematic effects. First of all, households and corporations could revise down inflation expectation due to less demands for consumption. Moreover, smaller wage increases would have weaker impacts on service prices which have dominant weights in consumer price index.

For the moment, we have mixed information and anecdotal comments. On the one hand, a number of large corporations agreed to pay higher base wage in March. This was indeed an unexpectedly positive developments of Abenomics. But on the other hand, wage statistics suggest extremely slow process of wage adjustment, especially for non-manufacturing firms. We anyway need to wait for hard data with regard to proliferation of wage increase.

Early discussion on exit strategy

Although I do not think that the BOJ's exit strategy has become an imminent policy agenda, there was an interesting discussion at today's conference.

Several press reporters asked if approximately 2% inflation in two consecutive years would provide the opportunity for the BOJ to exit from QQE. Readers may like to note that the outlook by the member of the policy board has started to cover FY 2016 this time, and in terms of inflation, their forecast is +1.3% to +2.3% (with +2.1% as median). Readers may also like to note that the BOJ commits itself to maintain QQE, until 2% inflation would be stably maintained. In fact, these press reporters inquired if the revised outlook today implies that the commitment would be satisfied in FY 2016.

Governor Kuroda replied that the BOJ would review other conditions including inflation expectation and economic outlook in the future. If, however, inflation expectation would be dependent on historical inflation, large part of determinants would be back-ward in nature. This line of argument simply implies that the markets would keep speculating about the exit strategy, as far as the BOJ reinforces confidence further.

Communication policy by the BOJ appears to be more important and require sophisticated skills as in the US, because too early speculation about exit strategy would be harmful for the markets and the economy.

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