June 21, 2023
Bank of Japan

Economic Activity, Prices, and Monetary Policy in Japan

Speech at a Meeting with Local Leaders in Kagoshima

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(English translation based on the Japanese original)

I. Economic Activity and Prices

A. Economic Activity

First, I would like to touch on developments regarding COVID-19. While three years have passed since its outbreak, COVID-19 was downgraded in Japan to a Class V infectious disease under the Infectious Disease Control Law on May 8, 2023, bringing about further normalization of socioeconomic activity. Although a certain degree of vigilance is necessary, leading examples of such normalization overseas suggest that COVID-19 will have much less impact on Japan's economy than previously.

Taking this into account, I will now talk about recent developments in Japan's economic activity. The economy has continued to recover moderately, although the pace of recovery has decelerated recently, as evidenced by some slowdown in certain indicators of private consumption and in exports. These developments in private consumption are likely due to price rises, and those in exports to a slowdown in the pace of recovery in overseas economies.

Let us look at private consumption in more detail. Consumption of durable goods such as automobiles has recovered on the back of a waning of the effects of supply-side constraints. Services consumption has also recovered, partly because demand that was suppressed during the pandemic has materialized as the economy reopens. Therefore, private consumption overall has increased (Chart 1). That said, the effects of price rises have been observed. For instance, regarding consumption of items such as daily necessities, demand seems to have shifted to lower-priced goods and affordable private brand products.

Next, I will turn to exports. While exports to advanced economies have remained on an uptrend on the back of the waning of the effects of supply-side constraints, those to the NIEs, the ASEAN economies, and some other Asian economies have decreased due to weakness in global demand for IT-related goods, as seen in a drop in exports of electronic parts, such as semiconductors mainly for smartphones and personal computers. Those to China have also been somewhat weak, particularly for capital goods. In terms of total exports, they have been more or less flat recently (Chart 2).

Meanwhile, business fixed investment has been generally firm. This is attributable to firmness in (1) IT-related investment aimed at digital transformation (DX) and labor saving, and (2) construction investment in urban redevelopment projects and in logistics facilities resulting from expanding e-commerce. In addition, firms have become more positive about making investment aimed at strengthening supply chains, partly owing to government support. Under these circumstances, business fixed investment plans for fiscal 2023 suggest firmness in such investment (Chart 3).

Since the collapse of the bubble economy, Japanese firms have in some respects been risk averse in making investment, in that they have restrained fixed investment and preferred to secure ample on-hand liquidity, given the widespread prospects for prolonged low growth and the experience of negative external shocks. However, Japanese firms lately appear to be starting to change positively in a way not seen since the 1990s. This is suggested, for example, by the *Annual Survey of Corporate Behavior* released by the Cabinet Office in March 2023, which shows that, based on firms' responses, the expected real economic growth rate for the next five years has increased (Chart 4). To encourage such positive moves among Japanese firms, it is important for the Bank of Japan to provide steady support for the economy when conducting monetary policy, which I will explain later.

B. Price Developments in Japan

1. Price situation

I will now talk about recent price developments and then their outlook.

Starting with recent price developments, the year-on-year rate of increase in the consumer price index (CPI) for April 2023 was 3.4 percent for all items less fresh food (core CPI) and 4.1 percent for all items less fresh food and energy (core-core CPI) (Chart 5). As for the core CPI, the rate of increase is slower than the latest peak of 4.2 percent in January, mainly due to the effects of pushing down energy prices from the government's economic measures. On the other hand, the rate of increase in the core-core CPI has accelerated, reflecting, for example, a pass-through to selling prices of increases in costs such as of raw materials led by the past rise in import prices. My impression is that prices are currently rising faster than I had so far expected.

Meanwhile, inflation expectations have stayed almost flat after rising moderately, although this differs depending on economic entity (Chart 6). Specifically, households appear to expect that prices will continue rising. This is evidenced, for example, by the 93rd *Opinion Survey on the General Public's Views and Behavior* (March 2023 Survey) released by the Bank in April, which shows that 85.7 percent of the respondents expected that prices "will go up" over the year ahead.[1] As for the perception of the present price levels compared with one year ago, 94.5 percent answered that prices "have gone up," suggesting that the respondents expected inflation momentum to level off slightly (Chart 7).[2]

The price situation in Japan that I have just described can be regarded as a move toward overcoming deflation, which Japan has experienced for a long period. On the other hand, if the pace of inflation is too fast, this could have the effect of pushing down the economy, such as downward pressure on real income. In the conduct of monetary policy -- I will return to this topic later -- the Bank will thoroughly assess economic and price developments including various factors brought about by changes in the price situation.

2. Outlook for prices

I would like to move on to future price developments.

I mentioned earlier that prices are currently rising faster than I had so far expected. The Bank's baseline scenario for the price outlook is that the year-on-year rate of increase in the CPI will decelerate temporarily and thereafter accelerate again toward the Bank's price stability target. This scenario is subject to considerable uncertainty, however, and both the upside and downside risks are likely to be high. In what follows, I would like to talk about what informs my thinking in this area.

Before elaborating on the upside and downside risks to prices, I would like to touch on a perspective that I think is a useful starting point when considering price fluctuations.

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[1] The figure comprises the proportions of respondents who chose "will go up significantly" and "will go up slightly," which accounted for 33.1 percent and 52.6 percent, respectively.

[2] The figure comprises the proportions of those who chose "have gone up significantly" and "have gone up slightly," which accounted for 62.8 percent and 31.7 percent, respectively.

While there are various methods for analyzing consumer prices, I think it is helpful to focus on the frequency of price changes in each item by separating the two categories of "sticky" and "flexible" consumer prices. Sticky consumer prices are those for items whose prices change relatively infrequently, and in Japan's CPI these are mainly services prices. On the other hand, flexible consumer prices are those for items whose prices change relatively frequently, and these are mainly goods prices (Chart 8).

Sticky consumer prices are thought to be affected by medium- to long-term inflation expectations, wages, and firms' medium- to long-term growth expectations (or demand forecasts) that are likely to affect wages. Wage growth in this year's annual spring labor-management wage negotiations is projected to exceed the past average and the previous forecast by a wide margin. This could feed into further price rises. In terms of future price developments, however, a crucial point will be whether this wage growth is for the current fiscal year alone or will continue into the next fiscal year and beyond. On this point, it is possible that firms will continue raising wages to secure their workforces given a further tightening of labor market conditions, amid the dim outlook for additional labor force participation by women and seniors, which has so far underpinned the labor supply.

It is likely that sticky consumer prices elevated the CPI considerably from the mid-1980s through the first half of the 1990s, before Japan fell into deflation. In the current situation, however, sticky consumer prices, which are mainly composed of services prices, have not yet made a significant contribution to a rise in the CPI, though they could potentially make a greater contribution in response to the results of this year's annual spring labor-management wage negotiations. The key here, as previously mentioned, will be a sustained increase in wages. I am paying attention to the extent of the spillover effects that wage hikes by firms will have on services prices, which have so far seen only a marginal increase (Chart 9).

Next, flexible consumer prices are susceptible to the business cycle and the output gap, and to raw material prices that mainly reflect commodity market conditions. Due in part to this last factor, flexible consumer prices in the past tended to track movements in import prices with a time lag. Looking at the corporate goods price index (CGPI) released by the Bank, after reaching a peak in September 2022, the import price index has continued to decline, due to such factors as a fall in raw material prices. According to the past trends I referred to earlier, this decline in import prices is likely to dampen the rise in flexible consumer prices with a time lag. In fact, developments in producer prices show that the decrease in import prices is beginning to spread by demand stage from upstream to downstream (Chart 10). As for the outlook, the drop in producer prices is basically projected to spill over into the CPI eventually.

Given what I have just outlined, let me interpret the Bank's baseline scenario for the price outlook mentioned earlier using the framework of "sticky" and "flexible" consumer prices. It can be said that sticky consumer prices are expected to rise gradually along with wage growth; however, as the spillover of a fall in import prices to a decline in flexible consumer prices fully takes hold, the rate of increase in overall prices is projected to be pushed down for the time being.

3. Upside risks to prices

Next, I will discuss risks to the outlook for prices. In my view, upside risks require attention for the time being, but thereafter, more attention should be paid to downside risks.

I will first focus on the upside risks to prices. It is assumed that sticky consumer prices will continue to rise, but also that, in contrast to the baseline scenario, there is a risk that the rate of increase in flexible consumer prices will not cool down.

Earlier, I said that flexible consumer prices tend to track movements in import prices with a time lag. However, this is simply an observation based on the fact that such a relationship existed in the past. As I mentioned earlier when talking about price developments in Japan, the latest *Opinion Survey on the General Public's Views and Behavior*, along with other reports, points out the possibility that households' perception of inflation that prices will not rise, which has been deeply entrenched, may be on the verge of changing. From the standpoint of firms, they may consider that the time has come to rethink the price-setting behavior that took root during the past period of deflation. In other words, in setting product prices, firms may think along this line: "When prices of raw materials eventually come down, sales may not contract even if we do not lower product prices." If an increasing number of firms adopt such price-setting behavior, they will not reduce selling prices even if import prices decline.

As a result, the rate of increase in flexible consumer prices may not cool down as much as expected. Meanwhile, if firms continue to raise wages by tapping into higher margins, the rate of increase in sticky consumer prices could also rise.

In relation to upside risks to prices in Japan, I would now like to touch on the points I am focusing on in terms of the price change distribution by item in the CPI. Let us take as an example the United States, which has already experienced an upswing in prices. While it should be noted that underlying conditions differ from those in Japan, before the COVID-19 pandemic, the price change distribution by item in the U.S. CPI was mountain-shaped, with its peak in the 2 percent vicinity. This changed after the outbreak, however, with the peak above the 2 percent level expanding and then plummeting (so the graph is trapezoid-shaped). In Japan, the price change distribution by CPI item is still unchanged, with the peak around 0 percent (Chart 11). I would like to monitor whether a change in the distribution, if any, will lead to an upswing in prices.

4. Downside risks to prices

I would now like to explain the downside risks to prices. Specifically, the rate of increase in flexible consumer prices, which is projected to decelerate temporarily, may not accelerate again as expected. It is likely that this risk arises from overseas factors rather than domestic factors.

The current global economy is marked by a range of uncertainties. Depending on the course of the situation in Ukraine, the downward pressure on European economies could heighten, particularly for those in the euro area. In China, there are concerns over adjustment pressure in the real estate market and over the risk of economic stagnation amid the elevated youth unemployment rate. Having said that, I believe uncertainties surrounding the U.S. economy warrant particular attention.

In the United States, with inflation having peaked in the second half of 2022 and now gradually settling down, there seems to be a growing consensus in the market that the policy interest rate hike cycle is nearing its end phase and interest rates will begin to decline accordingly, so that a major economic downturn can be avoided. However, one still cannot dismiss the view that the inverted yield curve in the United States, in which short-term interest rates exceed long-term rates, is a signal of future economic downturn. In addition, since developments in employment tend to lag behind economic activity, if the U.S. economy decelerates faster than expected, the unemployment rate could rise by more than expected, following in the wake of such an economic slowdown.

In terms of uncertainties surrounding the U.S. economy, I would like to add the risk that financial conditions will also lead to an economic downturn. The United States has experienced many cases where financial stress exacerbated a recession, such as after the savings and loan (S&L) crisis intensified in the late 1980s and after the Global Financial Crisis in 2008. That said, even if financial stress arises, it is not easy to accurately predict its impact on the real economy.

Monetary tightening is intended to curb overheating of the economy and return it to a "Goldilocks" situation. However, if financial stress increases before the economy returns to a proper level of economic growth, it will become difficult to provide an outlook for economic activity and prices, and policymakers will face a hard decision: whether to continue monetary tightening, to halt it, or to shift to monetary easing. For example, if the shift to monetary easing is premature, there is concern that an insufficient curbing of an overheated economy may lead to the entrenchment of high inflation. On the other hand, if the shift to monetary easing is put off and financial stress intensifies significantly, the adverse impact on the economy could increase.

Although the United States has experienced multiple bank failures since March 2023, the financial market seems to have regained stability, owing to swift responses by the U.S. authorities. A review by U.S. supervisory bodies and other analyses have pointed out that bankruptcies were attributable to the peculiar structure of the financial institutions' balance sheets and the poor level of risk management, such that these institutions were unable to adhere to basic practices for managing interest rate and liquidity risks. It seems to be widely recognized therefore that these bankruptcies were basically caused by factors at the level of individual institutions.

The downside risks to the U.S. economy that I explained, if they were to materialize, could have a significant impact on Japan's economy. It is therefore imperative that the Bank carefully monitor the course of developments, including financial conditions.

II. Conduct of Monetary Policy

Basic Idea

I would like to present my views regarding the Bank's conduct of monetary policy, based on the current economic and price developments and the future scenario I have explained so far (Chart 12).

Since 2022, particularly in the face of rising prices, some have suggested that the time has come for the Bank to revise its monetary policy. Indeed, with observed inflation rates increasing at a fast pace and expected rates showing a moderate rise, I consider that a change has started to take hold in the deflationary mindset or people's perception of inflation that prices will not rise. In that sense, we are coming closer to achieving the price stability target. However, a revision of monetary policy is still premature because there is considerable uncertainty about the baseline scenario regarding the price outlook that I described earlier.

Let me reiterate the Bank's baseline scenario: the year-on-year rate of increase in the CPI is likely to decelerate temporarily and thereafter accelerate again toward the Bank's price stability target. In deciding whether or not monetary policy should be revised, it is important to judge, under the baseline scenario, whether the CPI will move toward a sustainable and stable rise when it starts to increase again following the temporary deceleration. It should also be noted that, as I have described so far, there are both upside and downside risks to the outlook for prices due to considerable uncertainty. From the long-term perspective, I think that risks are more skewed to the downside. It is necessary to take into careful account the risks mentioned when deciding whether monetary policy should be revised.

As I mentioned earlier, there is uncertainty over recent developments in the global economy, especially the U.S. economy. Attention should thus be paid to downside risks to Japan's price developments under the risk scenario of the global economy. If downside risks to the U.S. economy materialize, the negative output gap in Japan could widen, causing a downswing in economic activity and prices. If the U.S. dollar comes under downward pressure due, for example, to a decline in U.S. interest rates, this could exert downward pressure on Japan's import prices and in turn consumer prices.

Due attention should also be paid to the scenario of an upswing in prices in Japan. As I mentioned earlier, there is the possibility that flexible consumer prices will not decline.

Having said that, it is important at this point for the Bank to carefully assess developments in achieving the 2 percent price stability target in a sustainable and stable manner based on the recognition that uncertainty is high regarding the price outlook.

At the Monetary Policy Meeting held in April 2023, the Bank confirmed that it will patiently continue with monetary easing while nimbly responding to developments in economic activity and prices as well as financial conditions. It also decided to conduct a broad-perspective review of the monetary policy it has been implementing for the past 25 years. Achieving price stability has been a challenge facing Japan's economy for a long period since it fell into deflation in the late 1990s. To address the challenge, the Bank has devised various monetary policy measures. These measures have interacted with and influenced wide areas of Japan's economic activity, prices, and financial sector. Through the review, the Bank aims to deepen its understanding of the interaction between monetary policy, economic activity, and various other factors, and make use of the insights gained for future policy conduct. To this end, the Bank will spend a sufficient amount of time, around a year to 18 months, drawing on the knowledge it has gained from its experience to date, the research that has accumulated in the academic community in Japan and abroad, and the opinions received at meetings with local leaders and on other occasions.

Yield Curve Control

For the last topic of monetary policy conduct, I will focus briefly on yield curve control.

Yield curve control is a framework in which the Bank applies a negative interest rate of minus 0.1 percent as the short-term policy interest rate and purchases a necessary amount of

Japanese government bonds (JGBs) so that long-term interest rates, specifically 10-year JGB yields, remain at around 0 percent.

Let us look back at the introduction of yield curve control. Following the introduction of negative interest rates in January 2016, the Bank introduced yield curve control in September that year to strengthen the policy framework thus far implemented, aiming to achieve the 2 percent price stability target at the earliest possible time. The Bank assessed at that time that a weakening of inflation expectations was a major factor in delaying achievement of the target. Although inflation expectations have risen recently, I believe that the framework of yield curve control is necessary given the Bank's baseline scenario regarding the price outlook and downside risks to prices, as I discussed earlier.

Since the introduction of yield curve control, the Bank has devised various measures to enhance the sustainability of monetary easing under this framework. Here are some examples of controlling long-term interest rates under yield curve control. In 2022, the functioning of bond markets deteriorated, particularly in terms of relative relationships among interest rates of bonds with different maturities and arbitrage relationships between spot and futures markets. Specifically, interest rates of bonds with 8-9 years of maturity were higher than those of bonds with 10-year maturity, and a price gap was observed between spot and futures markets. A gap was also observed between the yields for on-the-run issues of 10-year JGBs, which are eligible for the Bank's fixed-rate purchase operations, and those for issues of 20-year JGBs with a residual maturity of 10 years. This is likely because a gap was created between the Bank's yield target and yields based on market participants' predictions, as volatility in overseas financial and capital markets increased from early spring 2022. Yields on JGBs are reference rates for corporate bond yields, bank lending rates, and other funding rates. The Bank judged that if these market conditions persisted, this could have had a negative impact on financial conditions such as issuance conditions for corporate bonds.

In response, the Bank decided to modify the conduct of yield curve control in order to improve market functioning and encourage a smooth formation of the yield curve. Specifically, it decided to expand the range of 10-year JGB yield fluctuations from the target level while increasing the amount of JGB purchases. Owing to this modification, along with a decline in overseas interest rates, the shape of the JGB yield curve is generally smoother at present, and market functioning has shown signs of improvement (Chart 13). All of this has convinced me that it is appropriate for the Bank to continue with monetary easing under the framework of yield curve control.

Thank you.

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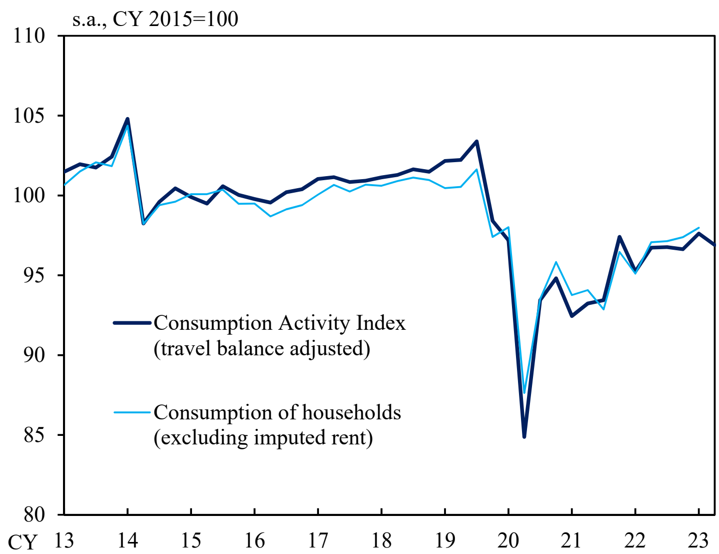
Chart 1

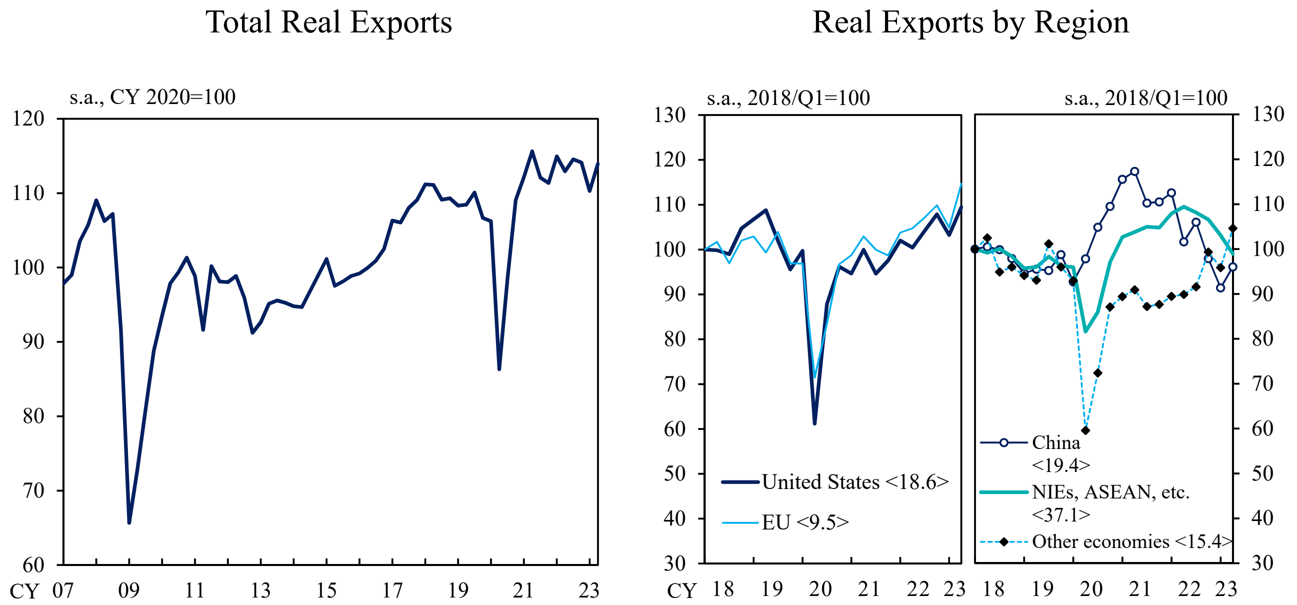
Private Consumption



Note: Figures for the Consumption Activity Index (CAI) are based on Bank staff calculations. The CAI figures (travel balance adjusted) exclude inbound tourism consumption and include outbound tourism consumption. The figure for 2023/Q2 is that for April.
Sources: Cabinet Office; Bank of Japan, etc.

Chart 2

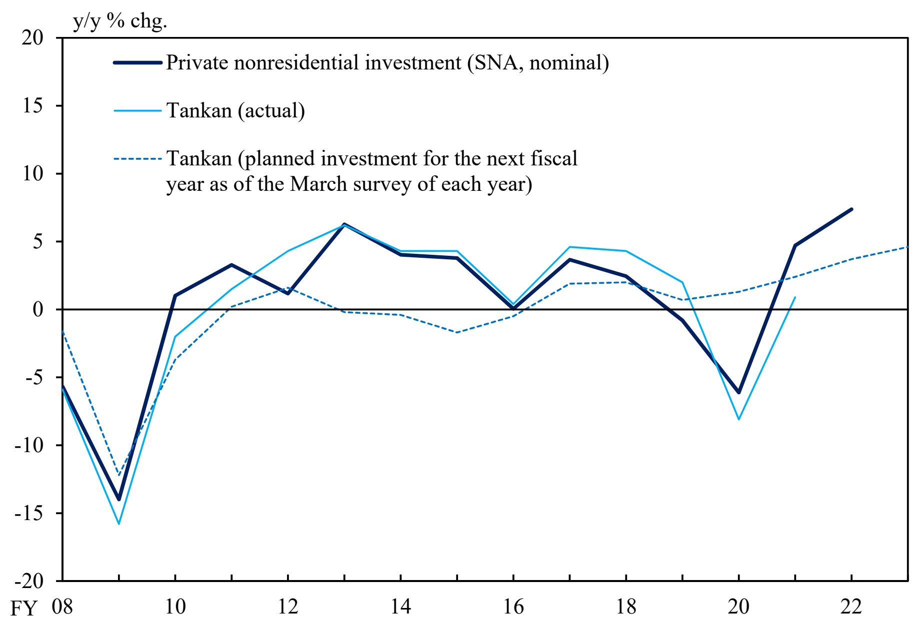
Exports



Note: Figures are based on Bank staff calculations. Figures for 2023/Q2 are those for April. In the right panel, figures in angle brackets show the share of each country or region in Japan's total exports in 2022. Figures for the EU exclude those for the United Kingdom for the entire period.
Sources: Ministry of Finance; Bank of Japan.

Chart 3

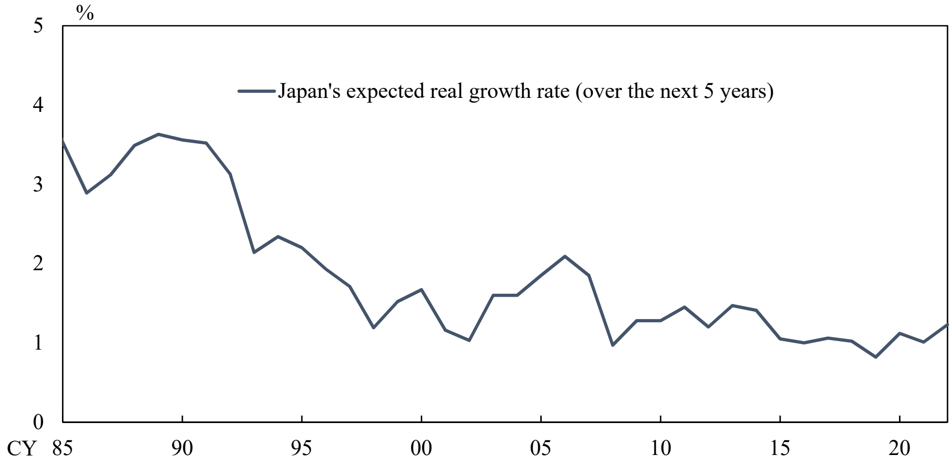
Business Fixed Investment



Note: Figures based on the *Tankan* include software and R&D investments but exclude land purchasing expenses. R&D investment is not covered as a survey item before the March 2017 survey. The figures are for all industries including financial institutions.
Sources: Cabinet Office; Bank of Japan.

Chart 4

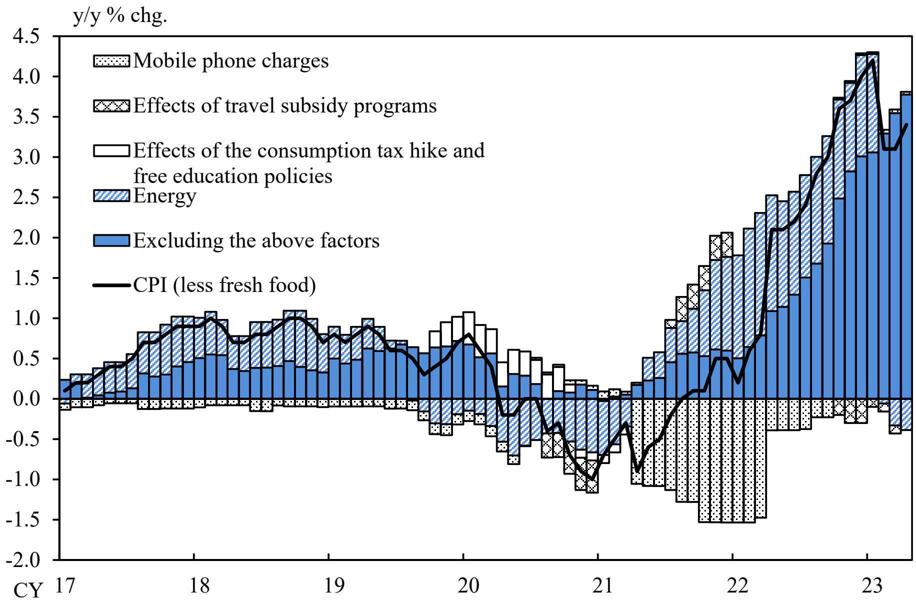
Expected Growth Rate



Note: Based on the *Annual Survey of Corporate Behavior*. Figures show the results for listed firms in a particular survey year for the next five years.
Source: Cabinet Office.

Chart 5

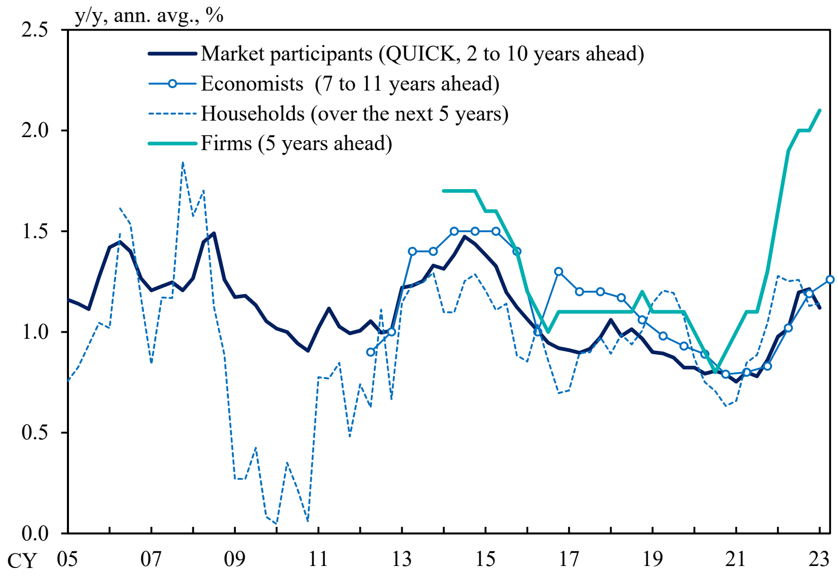
CPI for All Items Less Fresh Food



Notes: 1. Figures for "energy" consist of those for petroleum products, electricity, as well as manufactured and piped gas charges.
2. Figures for the "effects of the consumption tax hike and free education policies" from April 2020 onward are Bank staff estimates and include the effects of measures such as free higher education introduced in April 2020.
Source: Ministry of Internal Affairs and Communications.

Chart 6

Inflation Expectations

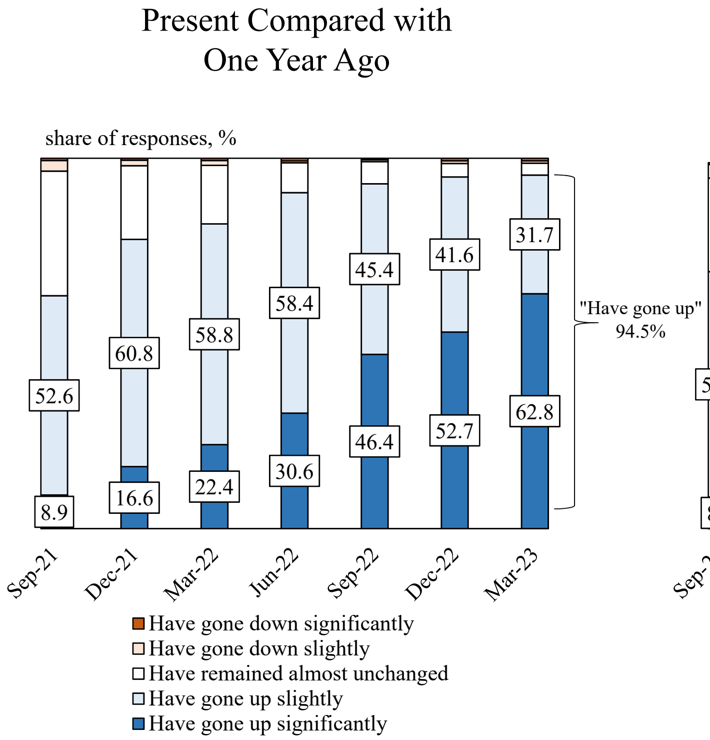


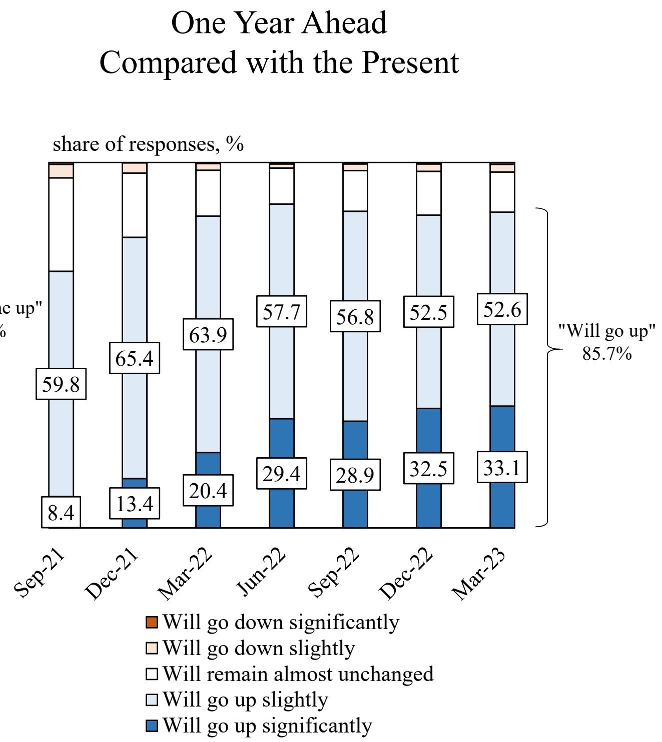
Notes: 1. Figures for economists are the forecasts of forecasters surveyed for the *ESP Forecast*.
2. Figures for households are from the *Opinion Survey on the General Public's Views and Behavior*, estimated using the modified Carlson-Parkin method for a 5-choice question.
3. Figures for firms show the inflation outlook of enterprises for general prices (all industries and enterprises, average) in the *Tankan*.

Sources: Japan Center for Economic Research (JCER), "ESP Forecast"; QUICK, "QUICK Monthly Market Survey <Bonds>"; Bank of Japan.

Chart 7

Households' Current and Future Perception of Price Levels



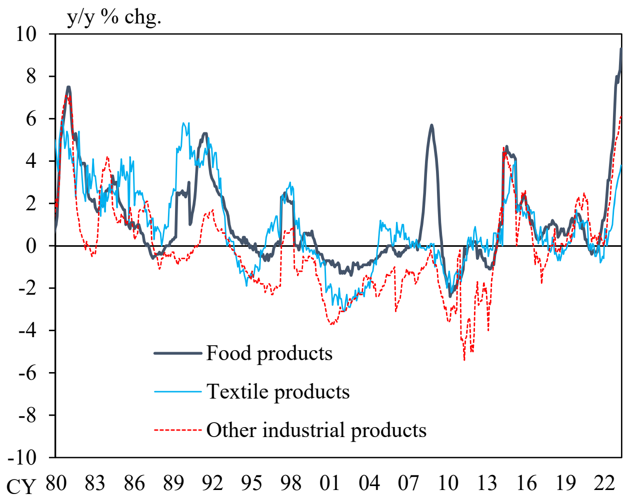


Note: "Have gone up" comprises "have gone up significantly" and "have gone up slightly." "Will go up" comprises "will go up significantly" and "will go up slightly."
Source: Bank of Japan.

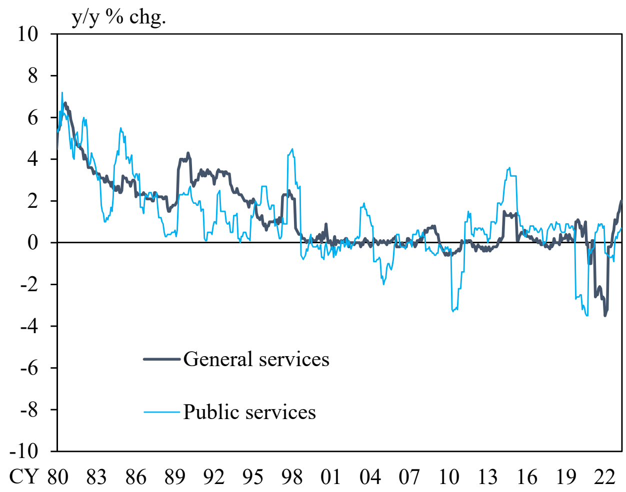
Chart 8

CPI for Goods and Services

Goods



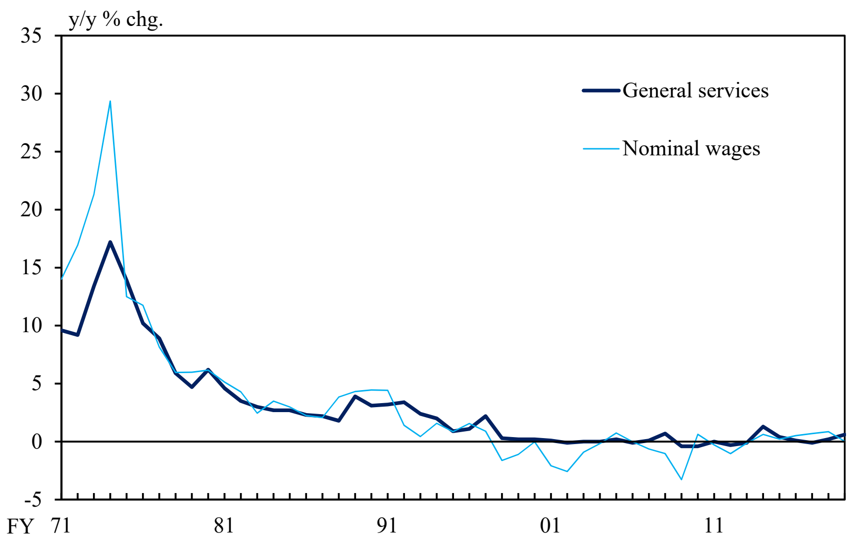
Services



Source: Ministry of Internal Affairs and Communications.

Chart 9

Wages and Services Prices

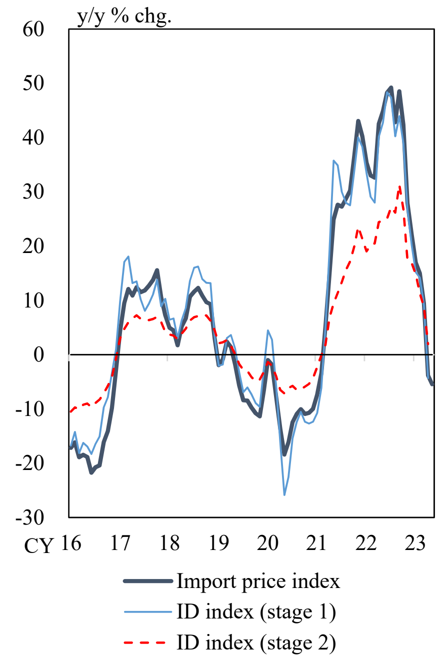


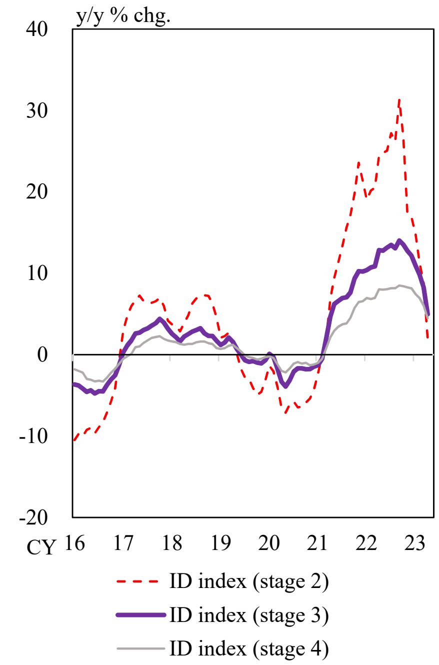
Note: Figures for nominal wages are for establishments with 30 or more employees up through fiscal 1990, and with 5 or more employees from fiscal 1991 onward.

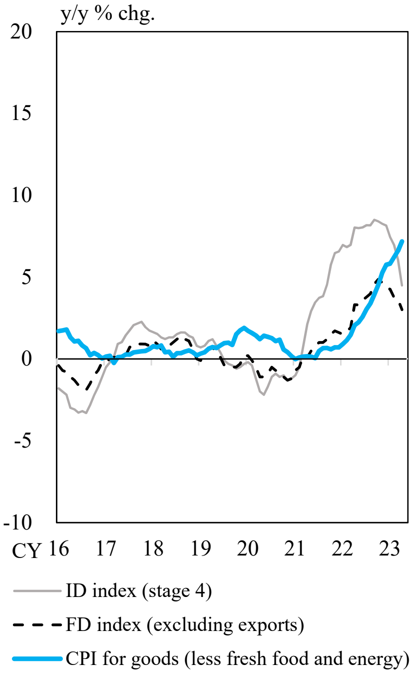
Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

Chart 10

Spillover Effects of Import Prices on the CPI for Goods



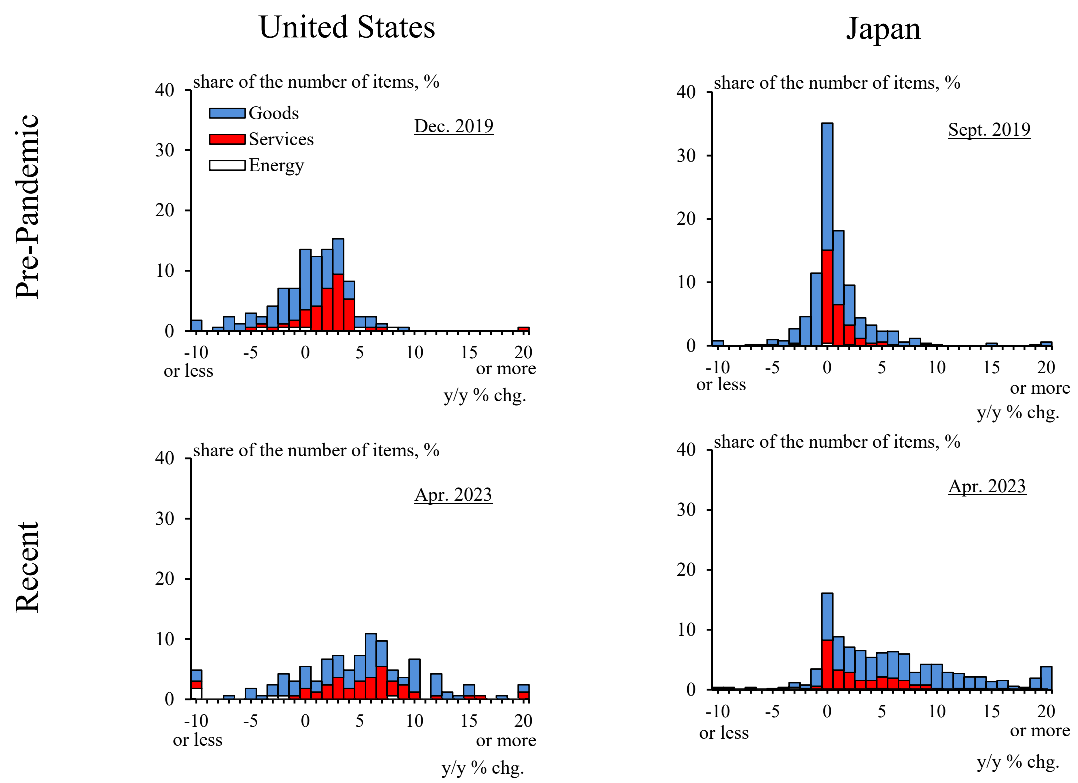




Note: The import price index is on a yen basis. The FD-ID price indexes divide demand into the final demand (FD) stage and four stages of intermediate demand (ID) based on the Input-Output Tables for Japan. Goods and services prices are then aggregated according to the stage to which they belong to compile the FD index and the ID indexes for stages 1 to 4, ranging from the upstream to downstream stages of the production process.
Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

Chart 11

Price Change Distributions



Note: Figures for the United States are for the CPI for all items, while those for Japan are for the CPI for all items excluding fresh food. The pre-pandemic distribution for Japan is based on data for September 2019, which was before the CPI developments were affected by the consumption tax hike.
Sources: Ministry of Internal Affairs and Communications; U.S. Bureau of Labor Statistics (BLS).

Chart 12

Conduct of Monetary Policy

Guideline for market operations under yield curve control

The short-term policy interest rate: Apply a negative interest rate of minus 0.1 percent to the Policy-Rate Balances in current accounts held by financial institutions at the Bank.

The long-term interest rate: Purchase a necessary amount of JGBs without setting an upper limit so that 10-year JGB yields will remain at around 0 percent.

The Bank will continue to allow 10-year JGB yields to fluctuate in the range of around plus and minus 0.5 percentage points from the target level, and will offer to purchase 10-year JGBs at 0.5 percent every business day through fixed-rate purchase operations, unless it is highly likely that no bids will be submitted. It will make nimble responses for each maturity by increasing the amount of JGB purchases and conducting fixed-rate purchase operations.

Asset purchases (other than JGBs)

Purchase as necessary with following upper limits on annual paces of increase in their amounts outstanding

ETFs: About 12 trillion yen

J-REITs: About 180 billion yen

CP: Maintain the amount outstanding at about 2 trillion yen

Corporate bonds: Purchase at about the same pace as prior to the COVID-19 pandemic, so that their amount outstanding will gradually return to the pre-pandemic level of about 3 trillion yen.

Stance on future conduct of monetary policy

Basic stance

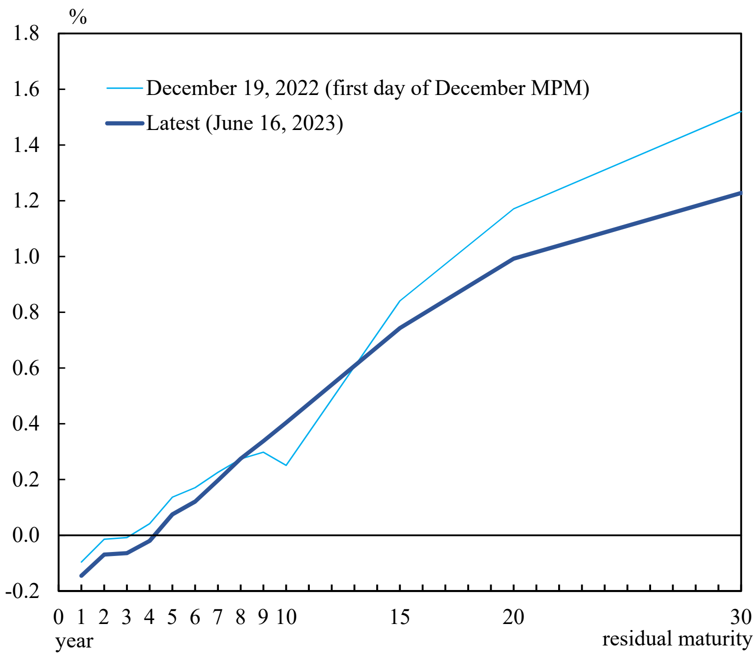
With extremely high uncertainties surrounding economies and financial markets at home and abroad, the Bank will patiently continue with monetary easing while nimbly responding to developments in economic activity and prices as well as financial conditions. By doing so, it will aim to achieve the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases.

Future conduct of monetary policy

The Bank will continue with QQE with Yield Curve Control, aiming to achieve the price stability target, as long as it is necessary for maintaining that target in a stable manner. It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner. The Bank will continue to maintain stability of financing, mainly of firms, and financial markets, and will not hesitate to take additional easing measures if necessary.

Chart 13

Yield Curve



Source: Bloomberg.