November 5, 2014

Bank of Japan

Ensuring Achievement of the Price Stability Target of 2 Percent

Speech at the Kisaragi-kai Meeting in Tokyo

Haruhiko Kuroda

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(English translation based on the Japanese original)

Introduction

It is my great pleasure to have the opportunity today to speak at the Kisaragi-kai meeting.

At the Monetary Policy Meeting held on October 31, the Bank of Japan decided to expand the quantitative and qualitative monetary easing (QQE). Concurrently, in its *Outlook Report for Economic Activity and Prices* (Outlook Report), the Bank published its projections for Japan's economic activity and prices through fiscal 2016. Today, I will explain the background to and the thrust of the decision this time, as well as the Bank's recognition of and prospects for economic activity and prices.

I. Quantitative and Qualitative Monetary Easing and the Significance of Its Expansion

To begin with, let me review the objectives and effects of the QQE.

In April last year, the Bank introduced the QQE to achieve the price stability target of 2 percent at the earliest possible time, with a time horizon of about 2 years. The QQE was designed based on the following basic principles.

First, the Bank will do whatever it can to overcome the deflation that has long undermined Japan's economy. Second, it is making a strong and clear commitment to achieve the price stability target as its responsibility. Third, to underpin the commitment, the Bank is carrying out monetary easing in a new phase both in terms of quantity and quality, which is different from past policies.

During these 15 years of deflation, a view that prices will not rise or that they will decline moderately has been embedded among people. This is referred to as a deflationary mindset, or deflationary expectations. Once such a deflationary mindset is embedded, firms and individuals behave in a manner in line with it, and thus deflation and economic stagnation become protracted in a self-fulfilling manner. In order to escape from such a vicious cycle, it is necessary to drastically convert the deflationary mindset that took root among people by way of monetary easing that is totally different from past policies. The QQE aims to exert such an effect.

One and a half years have passed since the introduction of the QQE, and it has been producing the intended effects so far. Namely, Japan's economy has continued to recover moderately as a trend, although it has been affected by the front-loaded increase and subsequent decline in demand associated with the consumption tax hike. The year-on-year rate of change in the consumer price index (CPI) excluding fresh food, which was minus 0.5 percent in March 2013 immediately before introducing the QQE, has moved to around 1¼ percent excluding the direct effects of the consumption tax hike.

The decline in demand following the consumption tax hike has been somewhat protracted, mainly in durable consumer goods, including automobiles. In addition, crude oil prices have been declining substantially of late. These somewhat weak developments in demand and the decline in crude oil prices have been exerting downward pressure on prices. The year-on-year rate of increase in the CPI excluding fresh food had been in the range of 1.0-1.5 percent since the end of the last year but slowed to 1.0 percent in September. Weakness in demand associated with the consumption tax hike has already started to wane, and the decline in crude oil prices will have positive effects on economic activity from a somewhat longer-term perspective and push up prices. Nevertheless, if the current downward pressure on prices remains, albeit in the short term, there is a risk that conversion of the deflationary mindset, which has been progressing steadily so far, might be delayed. To preempt the manifestation of such risk and maintain the improving momentum of expectation formation, the Bank judged it appropriate to expand the QQE.

In the following, I will explain the economic and price situations on which the Bank's decision was based this time.

II. Economic Activity in Japan

The Outlook for Japan's Economy

To begin with, looking back at Japan's economic activity during the past half year since the release of the April 2014 Outlook Report, relatively weak developments have been observed, particularly on the production side -- effects of the decline in demand following the front-loaded increase prior to the consumption tax hike, particularly in durable consumer goods including automobiles, have been substantial and the weakness in exports has been greater than previously assumed. Therefore, compared with the Bank's projection in the April 2014 Outlook Report, real GDP growth for fiscal 2014 is lower.

Nevertheless, even in such a situation, a virtuous cycle from income to spending has been steadily operating in both the corporate sector and the household sector, as the employment and income situation has continued to improve steadily and corporate profits have remained at a high level. Therefore, the Bank's assessment is that Japan's economy has continued to recover moderately as a trend. Going forward, with the virtuous cycle continuing to operate steadily, domestic demand is expected to maintain firmness and exports are expected to head for a moderate increase, and Japan's economy is likely to continue growing at a pace above its potential as a trend. In the October 2014 Outlook Report, projections for real GDP growth rates were 0.5 percent for fiscal 2014, 1.5 percent for fiscal 2015, and 1.2 percent for fiscal 2016 (Chart 1).

In the following, I will explain somewhat in detail how the virtuous cycle has been operating in the household and the corporate sectors, respectively.

Household Sector

I will start with the household sector. As for the effects of the consumption tax hike on private consumption, since the size of front-loaded purchases was large, the size of the subsequent decline in demand was substantial and effects of this decline have been prolonged. With regard to durable consumer goods, such as automobiles and household electrical appliances, and construction goods related to housing investment, the magnitude of the subsequent decline in demand was larger than previously assumed by firms, causing inventory adjustments and thereby leading to somewhat weak developments in production. In contrast, sales at department stores and supermarkets have been picking up, and the effects of the subsequent decline in demand have been waning gradually. Adverse effects of irregular weather through the past summer seem to have been waning as well. As evidenced by these developments, private consumption has remained resilient as a trend, and the effects of the decline in demand following the front-loaded increase have been waning on the whole, albeit unevenly across items.

The background to this is a steady improvement in the employment and income situation. Labor market conditions have been improving amid continued economic recovery led by domestic demand, which tends to have large stimulative effects on employment (Chart 2). Firms have maintained their positive hiring stance, and the unemployment rate has declined to around the level of the structural unemployment rate, which is deemed to be around 3.5 percent. In this situation, wages clearly have been increasing since spring, registering a year-on-year rate of increase of around 1 percent recently. The year-on-year rate of change in scheduled cash earnings has been positive, reflecting the revival of an increase in base pay at many firms, which had been lost for many years, and special cash earnings have increased solidly, due mainly to the increase in summer bonuses. On the back of the rises in wages and the number of employees, employee income has been increasing at a pace above that of the rise in wages (Chart 3).

Since the inflation rate has accelerated due to the consumption tax hike, some are of the view that real wages that take into account inflation might have been declining. On this point, it is necessary to distinguish between an increase in the inflation rate resulting from the consumption tax hike and from other factors. An increase in tax revenue brought about by the consumption tax hike will be utilized to enrich and stably run the social security system in the future, and thus eventually will be returned to the people. In addition, the push-up in inflation due to the consumption tax hike is a temporary one. Accompanied by the consumption tax hike in April this year, it is estimated that the year-on-year rate of increase in the CPI excluding fresh food has been pushed up by about 2 percentage points, but this will disappear next fiscal year. As I mentioned earlier, with labor market conditions continuing to tighten, the year-on-year rate of increase in wages has been at around 1 percent, and the year-on-year rate of increase in employee income has exceeded that in wages. The year-on-year rate of increase in the CPI (excluding fresh food), excluding the direct effects of the consumption tax hike, has been around 1¼ percent recently; therefore, it could be judged that wages and prices have generally been increasing mostly in line with each other.

As for the outlook, with the employment and income situation continuing to improve steadily, temporary downward pressure, including that of the decline in demand following the consumption tax hike, is expected to wane. As a result of such developments, private consumption is likely to see a clear pick-up gradually and maintain a moderate uptrend.

Corporate Sector

Next, let me move on to the corporate sector. Production has been showing some weakness recently due to a lack of momentum in exports and to inventory adjustments reflecting the decline in demand following the front-loaded increase prior to the consumption tax hike. Nevertheless, corporate profits have continued to improve, and the ratio of current profits to sales of major firms has exceeded the level seen prior to the global financial crisis (Chart 4). While the fact that the expansion of firms' overseas production has progressed during the past yen appreciation phase has been serving as a restraining factor for exports, it has been enhancing firms' profitability on a global basis. An increase in profitability in overseas business has been underpinning business sentiment even when effects of the decline in demand following the front-loaded increase prior to the consumption tax hike have been seen. Business conditions in the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) have remained at a favorable level as a whole (Chart 4). With corporate profits continuing to improve and business sentiment remaining at a favorable level, firms seem to be regarding the decline in economic activity since April as temporary. In the latest *Tankan*, firms' projections for sales and profits have been revised upward, and firms continue to plan to increase their investment steadily (Chart 5).

Business fixed investment is expected to follow a moderate uptrend, with corporate profits continuing their improving trend, supported partly by accommodative financial conditions. In addition, the following factors create an environment in which business fixed investment is likely to increase. First, capital stock has become considerably outdated as investment has been restrained amid the prolonged deflation. There are cases where smooth production has been hampered, and there is increasing demand for investment in maintenance and replacement. Second, wages have risen due to the labor shortage while firms' funding costs have been at low levels with the average bank lending rate being at a historical low level. Therefore, it would be more advantageous for firms to make labor-saving investment than to ensure additional labor forces. Third, as almost two years have passed since the start of the correction of the excessive yen appreciation, some firms plan to once again increase their share of domestic investment to reestablish bases for research and development sites or mother factories (Chart 6).

In this environment, in the corporate sector, the virtuous cycle from income to spending -- that is, from corporate profits to business fixed investment -- has continued to operate steadily.

III. Price Developments in Japan

Let me next explain price developments in Japan. As I mentioned before, the year-on-year rate of change in the CPI excluding fresh food, which was minus 0.5 percent in March last year, turned positive thereafter and has reached around 1¼ percent, excluding the direct effects of the consumption tax hike (Chart 7). Although monthly figures of prices fluctuate depending on various factors, underlying developments of prices are determined by the output gap of the economy as a whole and by inflation expectations. Improvements in price developments since the introduction of the QQE reflect an improvement in the output gap and a rise in inflation expectations.

Let me first explain the output gap. The output gap is an indicator that shows the utilization of production factors such as labor force and capital, and the past long-term average of the utilization is defined as zero. The output gap has been improving steadily, particularly on the labor front -- as employment has continued to improve reflecting firm domestic demand, which has large stimulus effects on labor -- and has recently been around zero, which is the past long-term average (Chart 8). Looking ahead, with Japan's economy continuing to grow at a pace above its potential as a trend, the output gap is expected to expand within positive territory as the tightening of the labor market is likely to continue and capacity utilization rates are expected to become higher. In this situation, upward pressure from the output gap developments on wages and prices is likely to steadily increase.

Let me next turn to inflation expectations. Inflation expectations have been rising on the whole so far. It can be assessed that various indicators such as market data and survey results have risen from a somewhat longer-term perspective, albeit with some fluctuations

(Chart 9). Moreover, this rise in inflation expectations is considered to have induced changes in various economic activities, such as wage negotiations between management and labor, firms' price-setting behavior, and household consumption behavior (Chart 10). In the annual wage negotiations between management and labor, many firms this spring revived the practice of a rise in base pay, which had not been made for many years under deflation. There have been moves among firms to shift their price-setting strategy from a low-price strategy to one of raising sales prices while increasing value-added. Households' attitude toward searching for lower prices has started to become less pronounced, and a tendency to select geographical convenience and high valued-added products seems to have become more pronounced. These changes in economic activity seem to suggest that firms' and households' views concerning future prices have changed and that inflation expectations have been rising gradually. What is critical is whether such changes will continue. As I will talk about in more detail later, somewhat weak developments in demand following the consumption tax hike and a substantial decline in crude oil prices have been exerting downward pressure on prices recently, and if such downward pressure remains, there is a risk that an improvement in inflation expectations might be delayed. The expansion of the QQE decided on October 31 aims to preempt the manifestation of such risk. The Bank believes that, with the QQE, including the measures decided on October 31, continuing to produce its intended effects, inflation expectations are expected to follow an uptrend and gradually converge to around 2 percent -- the price stability target.

On the back of developments in the output gap and inflation expectations, the Bank considers that the year-on-year rate of increase in the CPI (excluding fresh food and the direct effects of the consumption tax hikes) is likely to be at around the current level for the time being, and subsequently accelerate gradually and reach around 2 percent -- the price stability target -- in or around fiscal 2015. Thereafter, the year-on-year rate of increase in the CPI is likely to edge up as medium- to long-term inflation expectations will converge to around 2 percent and the output gap is expected to continue expanding in positive territory. In the October 2014 Outlook Report, projections for year-on-year rates of increase in the CPI were 1.2 percent in fiscal 2014, 1.7 percent in fiscal 2015, and 2.1 percent in fiscal 2016 (Chart 1).

IV. Upside and Downside Risks to Economic Activity and Prices

I have explained the baseline scenario of the Bank's outlook for economic activity and prices. However, this outlook is associated with some factors that could put upward or downward pressure on economic activity and prices, respectively. Since I do not have enough time to explain all such factors, I will talk about two important ones that relate to both economic activity and prices.

The first factor is the effects of the consumption tax hike and whether they might lead to changes in firms' price-setting behavior. As I mentioned earlier, the effects of the decline in demand following the front-loaded increase and of the decline in real income remain, and this warrants continued attention. In addition, there is uncertainty over how developments in consumption following the consumption tax hike will influence firms' price-setting behavior going forward. On this point, firms seem to be regarding the recent decline in economic activity as a temporary one, and it is likely that firms' shift from a low-price strategy to one of raising sales prices while increasing value-added continues. That being said, attention should be paid to whether moves toward a shift to a low-price strategy again will spread in response to the decline in consumption following the tax hike.

The second factor concerns cautious views on the recent global economy and a substantial decline in prices of international commodities including crude oil. Since this factor is important to gaining an understanding of the expansion of the QQE, let me talk about it in more detail.

The baseline scenario for the global economy is that it is expected to moderately increase its growth rate, mainly in advanced economies. However, cautious views on the outlook for the global economy have been increasing, particularly in the financial markets. Looking at this by country and region, in Europe, upward momentum has been waning somewhat, particularly for manufacturers, and it is a matter of concern that business sentiment might become even more cautious. On the price front, the disinflationary trend might become prolonged and there is a recognized risk of a fall into deflation. The Chinese economy is likely to continue growing stably on the whole as authorities carry out policy measures to support economic activity while progressing with structural reforms. However, there is an alarming risk that adjustments in the real estate market might become protracted and have adverse effects on the economy and finance.

In this situation, prices of crude oil and other international commodities have been declining substantially since around this summer. This seems to reflect both supply and demand factors. Specifically, on the supply side, it can be pointed out that, in addition to an increasing trend in supply, such as a production increase in shale oil, some oil-producing countries have started to increase their supply recently as a sense of vigilance against geopolitical risks has receded. On the demand side, it can be considered that, with a downside risk of the global economy being recognized, the projections of demand for crude oil and other commodities have become cautious. These developments, coupled with responses in the international commodity markets, have led to a substantial decline in international commodity prices.

So, what will be the effects of these developments on Japan's economy and price formation? Since Japan is a commodity-importing country, the decline in international commodity prices basically will have positive effects on economic activity and thereby push up prices from a longer-term perspective. In particular, this is more evident if the decline in international commodity prices is attributable to a supply-side factor and responsiveness of the market. On the other hand, if the decline in international commodity prices is suggesting weak global demand in the future, even though this decline itself might be a positive factor, concern over future weakness in the global economy should be taken into account at the same time. At this stage, the jury is still out and it is necessary to pay close attention to developments in the global economy.

On the price formation front, while the decline in crude oil prices will push up prices from a longer-term perspective, we should consider the implication of the decline inducing a decrease in the CPI for the time being. As I mentioned at the outset, the QQE is a policy that aims to dispel people's deflationary mindset and raise inflation expectations through the Bank's strong commitment to achieving the 2 percent CPI inflation in a stable manner and an unprecedented large-scale monetary easing to underpin the commitment. This mechanism has been producing its intended effects so far, and inflation expectations have been rising on the whole. What becomes an issue here is whether the improving momentum of inflation expectations, which is the core of this mechanism, will lose steam due to a lack of momentum in the CPI inflation rate's increase for the time being.

On this point, the basic idea is that medium- to long-term inflation expectations should not be affected that much even if the actual inflation rate has fluctuated as a result of temporary factors such as crude oil prices. For example, in the United States, despite the decline in crude oil prices, there has been little change in indicators of medium- to long-term inflation expectations (Chart 11). It should be noted that, while in the United States inflation expectations have long been anchored around the target set by the central bank, in Japan we have been in the middle of efforts to drastically change the deflationary mindset through the QQE. Compared to countries like the United States, in Japan changes in the actual inflation rate seem to affect the formation of inflation expectations to a considerable degree. In the United States, wages and prices are considered to be set based on the assumption that 2 percent annual inflation on average will be achieved through the central banks' monetary policy management. In countries like the United States, medium- to long-term inflation expectations do not move considerably since people expect that the inflation rate will revert to 2 percent sooner or later even if prices rise or fall temporarily. By contrast, in Japan, after the protracted deflation, the rise in inflation has finally been taken into account this spring in the annual wage negotiations between management and labor, and rises in base pay were revived at many firms. Firms' price-setting behavior has been in the process of changing as well. Based on this situation, as a risk factor, if the current downward pressure on prices remains, there is a possibility that conversion of the deflationary mindset, which has been progressing steadily so far, might be delayed. This is a risk concerning the core mechanism of the QQE. The expansion of the QQE will be carried out to preempt the manifestation of such risk and to maintain the improving momentum of expectation formation.

V. The Bank's Monetary Policy Management

Decisions on October 31, 2014

Specific measures of the decision this time are of a large scale in terms of both quantity and quality (Chart 12).

First, the Bank will accelerate the pace of increase in the monetary base -- its operating target for money market operations -- by about 10-20 trillion yen, from "an annual pace of about 60-70 trillion yen" to "an annual pace of about 80 trillion yen."

Second, the Bank will increase its asset purchases. As for Japanese government bonds (JGBs), the amount outstanding of the Bank's holdings will be increased by about 30 trillion yen from "an annual pace of about 50 trillion yen" to "an annual pace of about 80 trillion yen." The average remaining maturity of the Bank's JGB purchases will be extended by about 3 years at maximum from "about 7 years" to "about 7-10 years." Looking at the shape of yield curves of late, there has been a substantial decline in yields in the short- to medium-term zone, as seen by 5-year bond yields declining to close to 0.1 percent, while yields in the somewhat longer-term zone have remained at relatively high levels. The decision this time aims at putting further downward pressure across the entire yield curve.

As for exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs), the increases in the amount outstanding of the Bank's holdings will be tripled from "an annual pace of about 1 trillion yen" to "an annual pace of 3 trillion yen," and from "an annual pace of about 30 billion yen" to "an annual pace of about 90 billion yen," respectively. The Bank will make ETFs that track the JPX-Nikkei Index 400 eligible for purchase.

These measures will influence mainly real interest rates and asset prices and induce an increase in private demand and an improvement in the output gap. In addition, taking this opportunity, the Bank would like to emphasize again its commitment to achieving the price stability target of 2 percent at the earliest possible time. A large-scale action underpins this commitment. With these measures, the improving momentum of inflation expectations will be maintained and the mechanism of the QQE will continue to work steadily.

As for monetary policy management going forward, as before, the Bank will continue with the QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will examine both upside and downside risks to economic activity and prices, and if it is judged necessary for achieving the price stability target, the Bank will make adjustments without hesitation. This policy stance is unchanged even after the recent action.

Significance of Achieving the Price Stability Target of 2 Percent

Since the outset of the introduction of the QQE, the Bank has committed itself to achieving the price stability target of 2 percent at the earliest possible time. If downside risk to prices becomes substantial, it is a natural and logical move to take additional measures. In this sense, the measures decided this time represent nothing less than a true display of the Bank's unwavering commitment.

Counter to this principle of the Bank, there are views such as "it might not be desirable to have only price increases in the absence of a rise in growth rates" or "it might not be necessary to adhere to the 2 percent target." The fact that people are more strongly aware of price increases due to the consumption tax hike is likely to have been supporting these views.

We at the Bank do not think that simply achieving inflation is a single and ultimate goal. However, achieving moderate inflation is a necessary condition to escape from bad deflationary equilibrium. Under deflation, with firms and households becoming hesitant to take risks, a vicious cycle is perpetuated of a decline in prices, a fall in sales and profits, restraints in wages, weak consumption, and then a return to a decline in prices. In order to escape from such deflationary equilibrium, it is necessary to change people's expectations and create a situation in which economic entities take actions based on the assumption that prices will moderately increase. If such a situation is achieved, the exact opposite cycle to the vicious cycle under deflation will operate. Namely, originating from a moderate increase in prices, a virtuous cycle of the economy in the form of an increase in sales and profits, a rise in wages, a boost in consumption, and a moderate increase in prices will be achieved. The significance of meeting the price stability target of 2 percent is the escape from a shrinking equilibrium -- in other words, deflationary equilibrium -- and achieving conversion to an expanding equilibrium in which prices moderately increase as people enjoy growing prosperity.

A transition from a bad and shrinking equilibrium to a good and expanding equilibrium brings significant changes to Japan's economic and social systems. For that reason, it is to some extent unavoidable that, in the transition process, merits and demerits will surface by taking different forms according to types of business, size of firms, regions, or income conditions. Nevertheless, if conversion to a good and expanding equilibrium is achieved, the merits of this will spread widely to the Japanese people. In order to also achieve growing prosperity of people from a longer-term perspective, we need to get through this critical moment.

We sometimes hear a view that there is no need to adhere to 2 percent inflation, and that about 1 percent will suffice. As evident from overseas examples, we should understand that inflation moves up and down to some extent in accordance with economic fluctuations. Inflation of about 1 percent at a certain point in time does not mean that it will be sustained at that level into the future. Aiming at 2 percent inflation has become a global standard, and this can be viewed as the result of knowledge gained from experience that prevents falling into deflation, taking into account that inflation changes in accordance with economic fluctuations. As explained today, conversion of the deflationary mindset has been steadily progressing under the QQE. Such progress should not be stopped now. In order to completely overcome the chronic disease of deflation, medicine should be taken until the end. A half-baked medical treatment will only worsen the symptoms.

There is also a view that, even if it is aiming at 2 percent, the Bank should not adhere to the period of about 2 years. On this point, in April last year, the Bank declared that it will achieve the price stability target at the earliest possible time, with a time horizon of about 2 years, and it introduced the QQE. In the Outlook Report published in the same month, the Bank provided the median of the board members' projection of CPI inflation for fiscal 2015, of 1.9 percent. While the projection in the latest Outlook Report was slightly lower, CPI inflation is still projected as likely to reach around 2 percent in or around fiscal 2015. The Bank's principle of achieving the price stability target of 2 percent at the earliest possible time, with a time horizon of about 2 years, has not changed.

As you can see from the decline in crude oil prices this time, actual CPI figures will be influenced by various factors in addition to basic factors such as the output gap and inflation expectations. There is no central bank in the world that can achieve 2.0 percent inflation in exactly 2 years. Having said that, if a central bank says it will achieve 2 percent eventually without mentioning a timeframe, that would not prompt firms and households, which have been mired in a deflationary mindset, to take actions from now on based on the assumption of 2 percent inflation. To dispel the deflationary mindset and establish 2 percent inflation firmly in people's minds, it is necessary to have a certain level of velocity and momentum. This is why the Bank adheres to its timing for achieving 2 percent inflation. At the same time, this is also the reason why the Bank puts emphasis on maintaining the momentum of expectation formation in its latest action.

In conclusion, let me repeat what I said in April last year. The Bank will do whatever it can to achieve the price stability target at the earliest possible time.

Thank you for your attention.

Ensuring Achievement of the Price Stability Target of 2 Percent

Speech at the Kisaragi-kai Meeting in Tokyo

November 5, 2014

Haruhiko Kuroda
Governor of the Bank of Japan

Chart 1

Outlook for Economic Activity and Prices (as of October 2014)

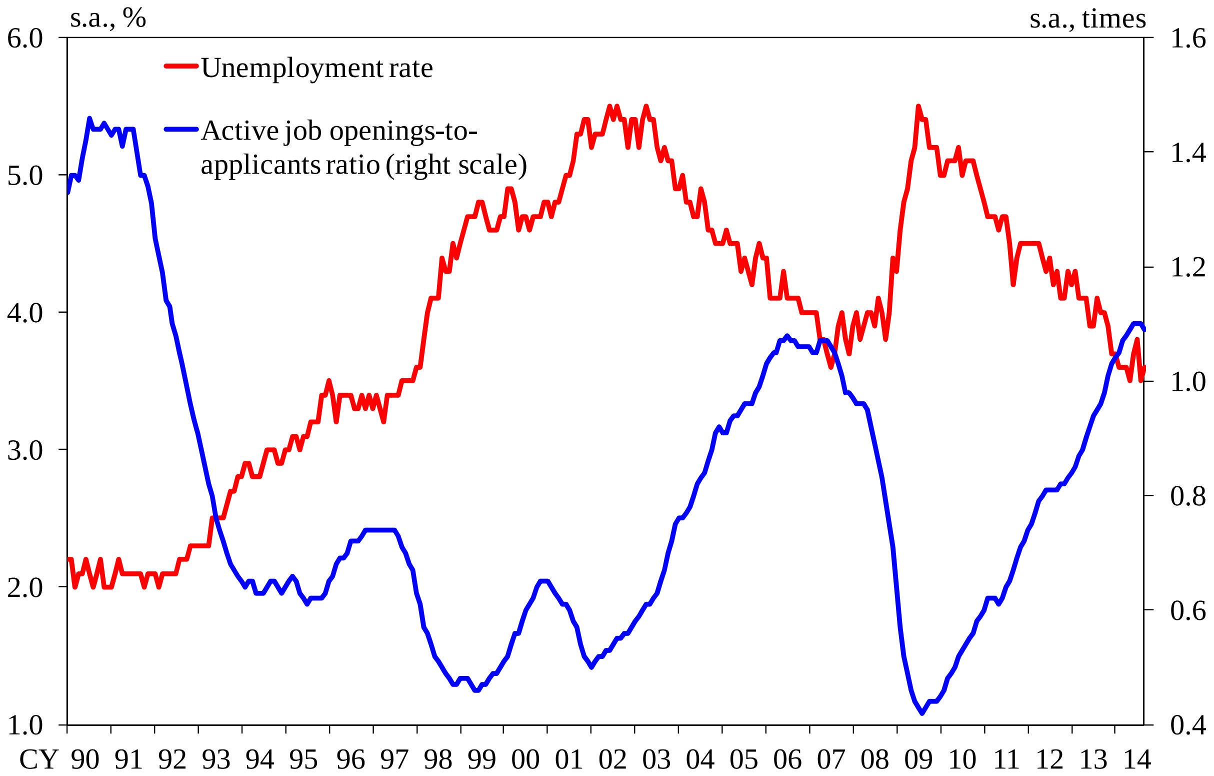
y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2014	+0.5	+3.2	+1.2
Forecasts made in July 2014	+1.0	+3.3	+1.3
Fiscal 2015	+1.5	+2.4	+1.7
Forecasts made in July 2014	+1.5	+2.6	+1.9
Fiscal 2016	+1.2	+2.8	+2.1
Forecasts made in July 2014	+1.3	+2.8	+2.1

Note: Figures indicate the median of the Policy Board members' forecasts (point estimates).
Source: Bank of Japan.

Chart 2

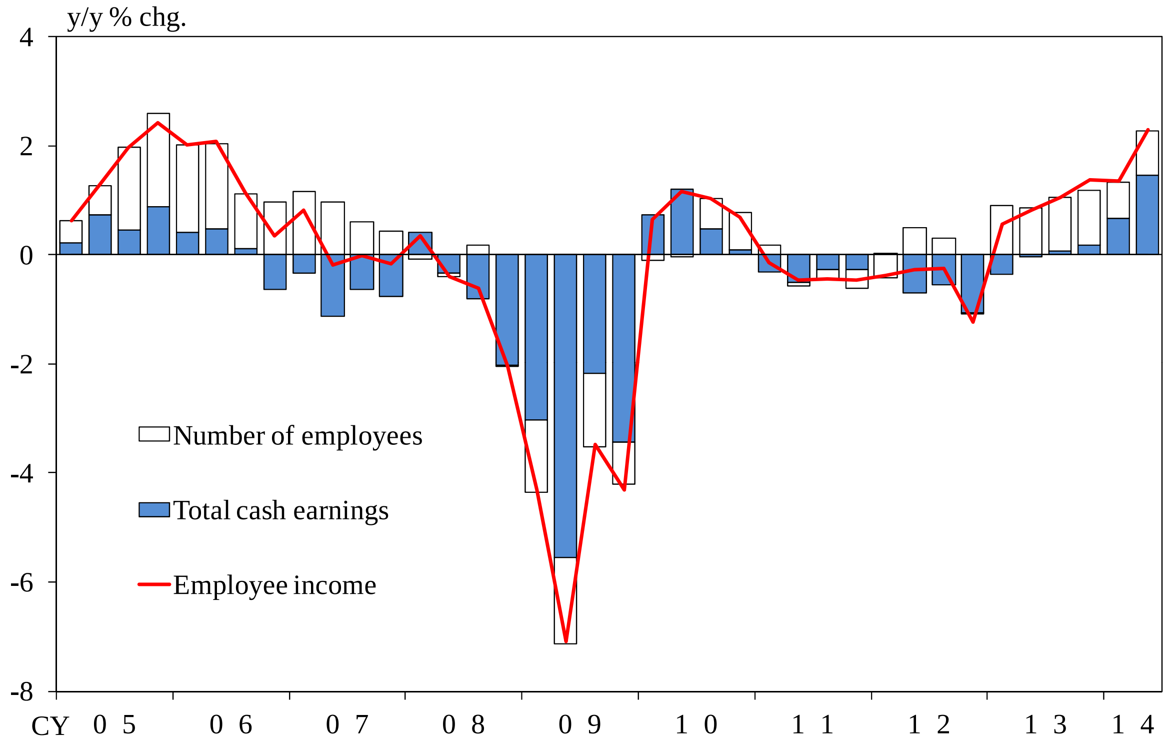
Labor Supply and Demand



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

Chart 3

Employee Income

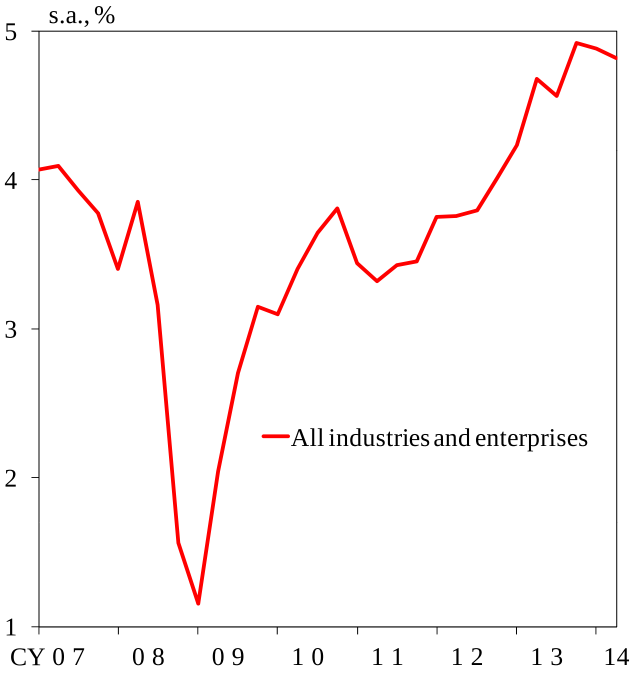


Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Figures for "employee income" are calculated as the "number of employees" (Labour Force Survey) times "total cash earnings" (Monthly Labour Survey).

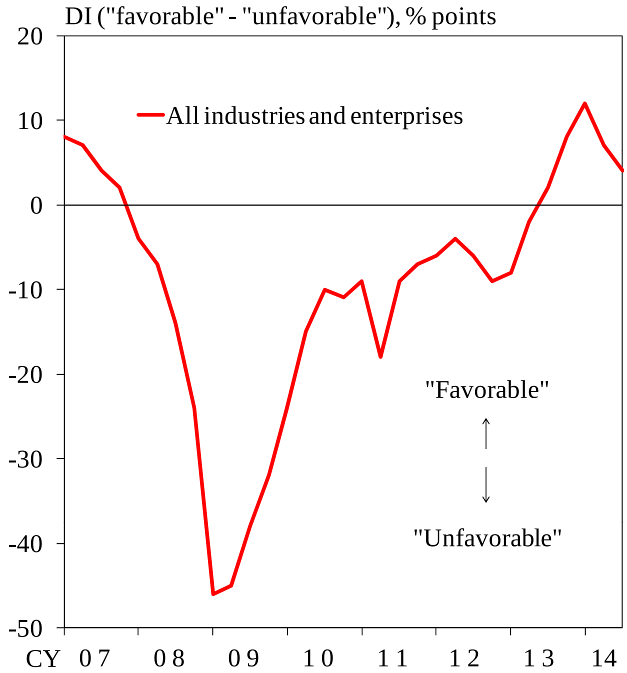
Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

Corporate Profits and Business Sentiment

Ratio of Current Profits to Sales



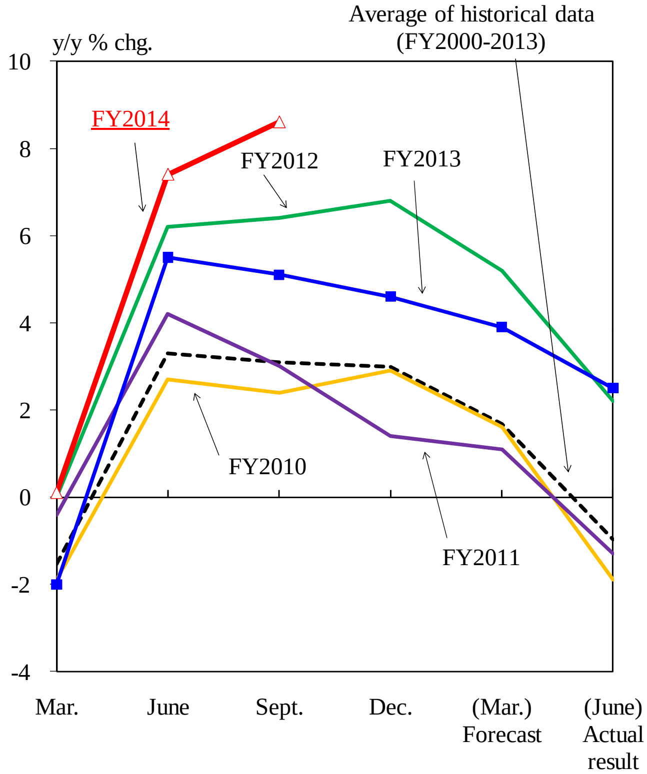
Tankan: Business Conditions DI



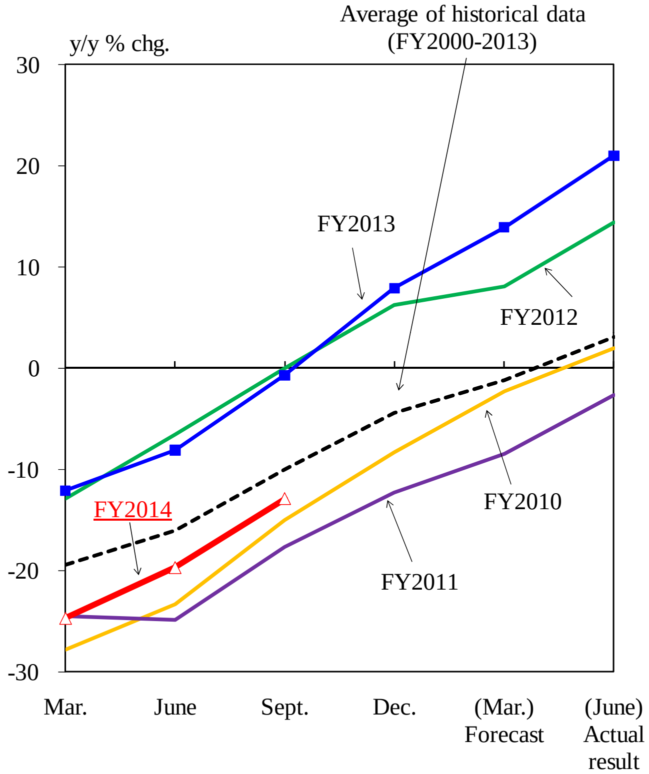
Sources: Ministry of Finance; Bank of Japan.

Tankan: Business Fixed Investment Plans

Large Enterprises



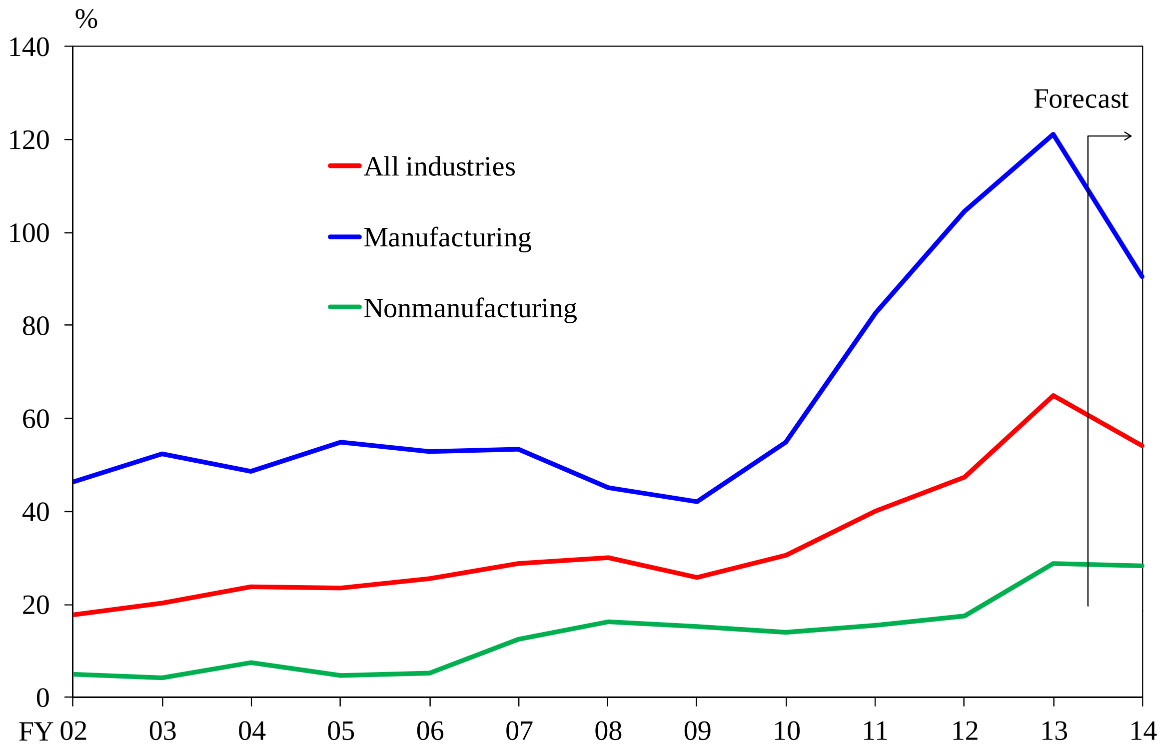
Small Enterprises



Note: Figures include land purchasing expenses but exclude software investment.
Source: Bank of Japan.

Chart 6

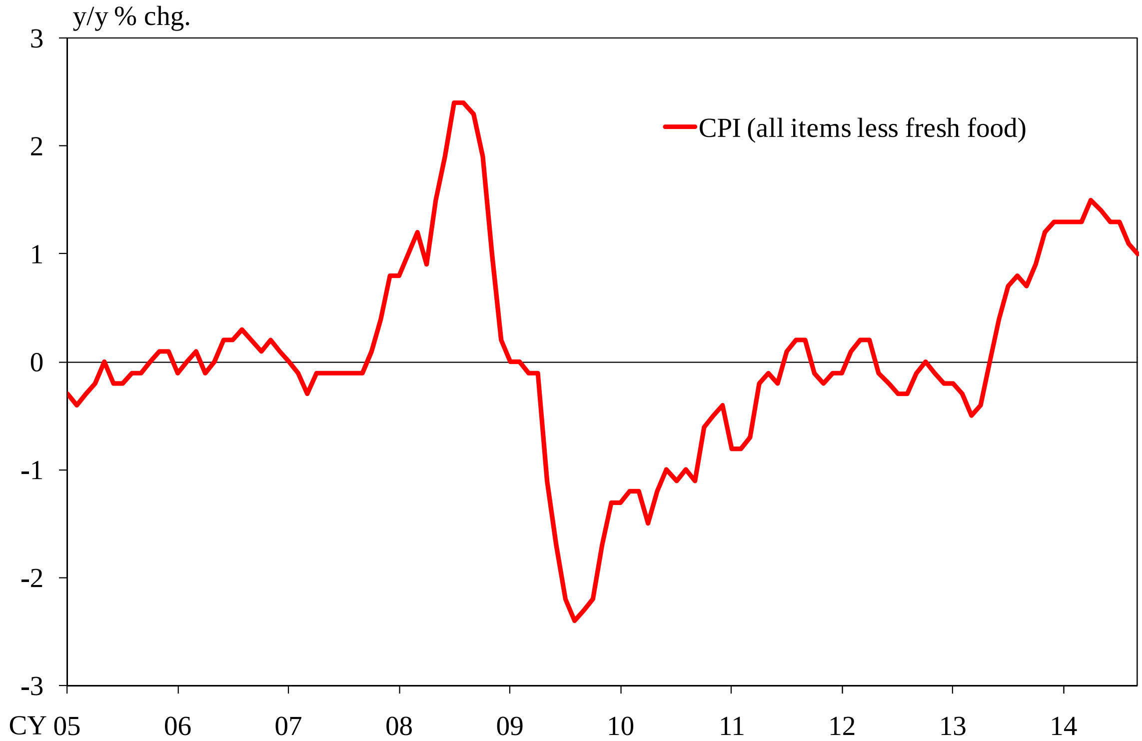
Overseas/Domestic Ratio of Business Fixed Investment



Note: Figures are the ratio of overseas business fixed investment on a consolidated basis to domestic business fixed investment on a non-consolidated base.
Source: Development Bank of Japan.

Chart 7

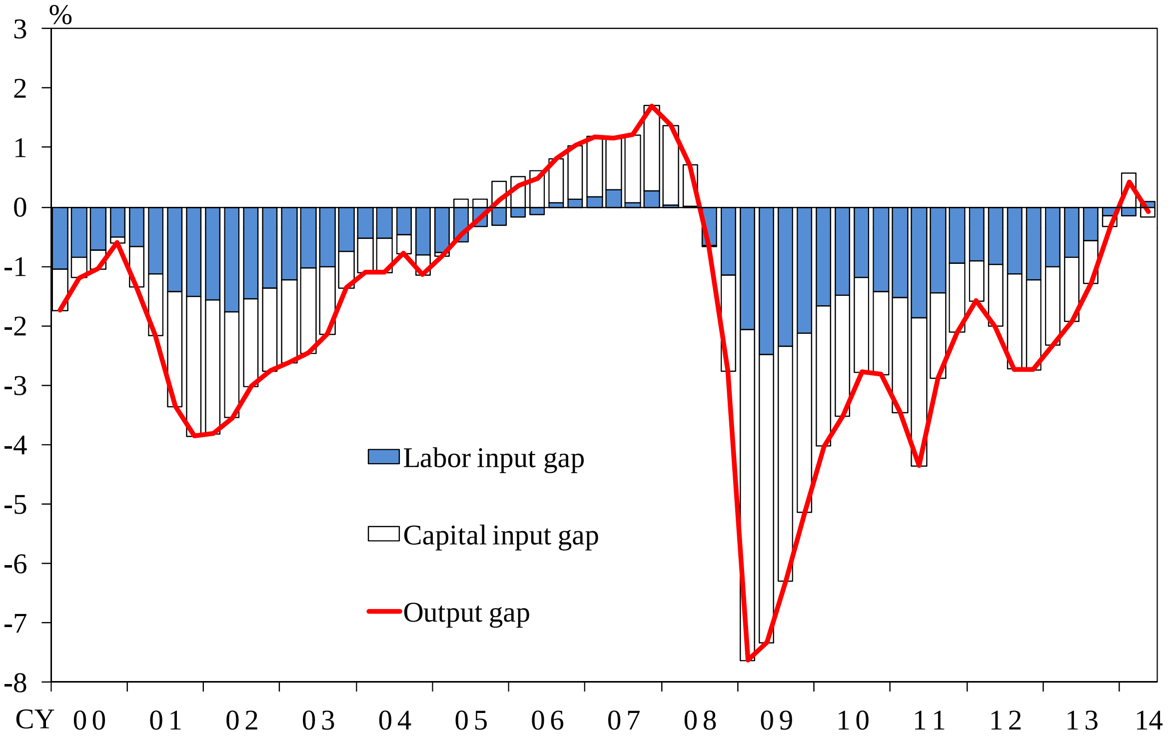
Consumer Prices



Note: Figures from April 2014 onward are calculated to adjust the direct effects of the consumption tax hike.
Source: Ministry of Internal Affairs and Communications.

Chart 8

Output Gap

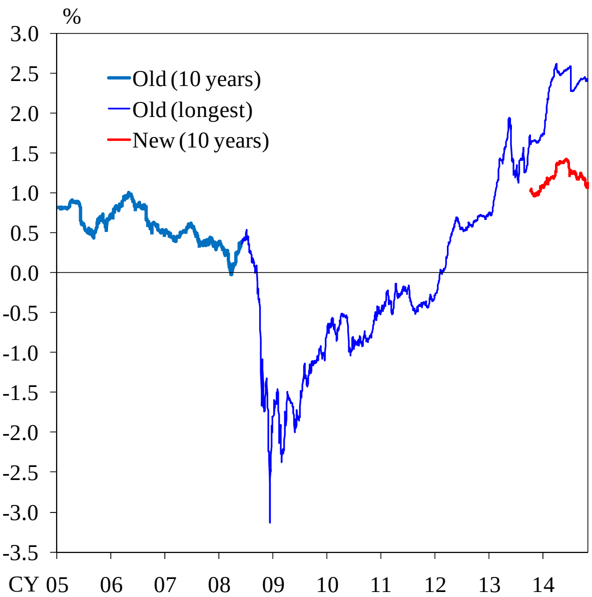


Note: The output gap is estimated by the Research and Statistics Department, Bank of Japan. For the estimation procedures, see "The New Estimates of Output Gap and Potential Growth Rate," Bank of Japan Review Series, 2006-E-3.
Sources: Cabinet Office; Bank of Japan, etc.

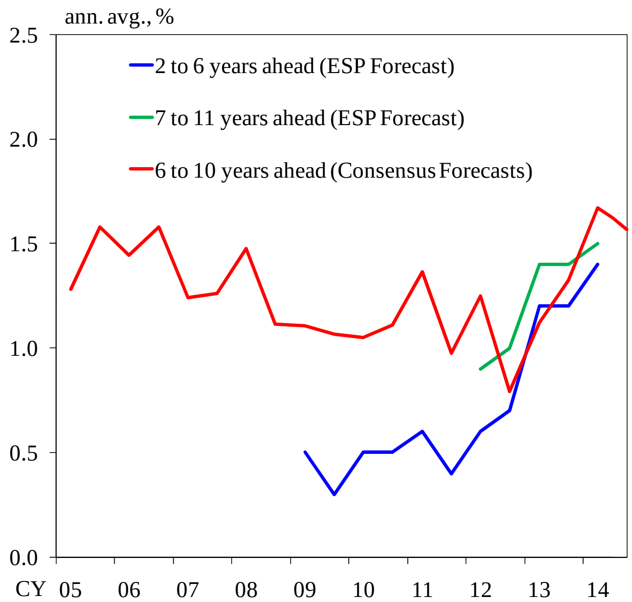
Chart 9

Inflation Expectations

Market Participants (BEI for Inflation-Indexed JGBs)



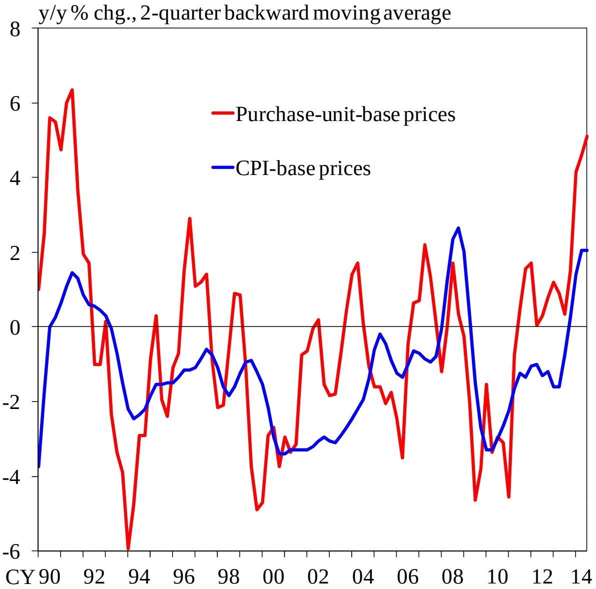
Economists



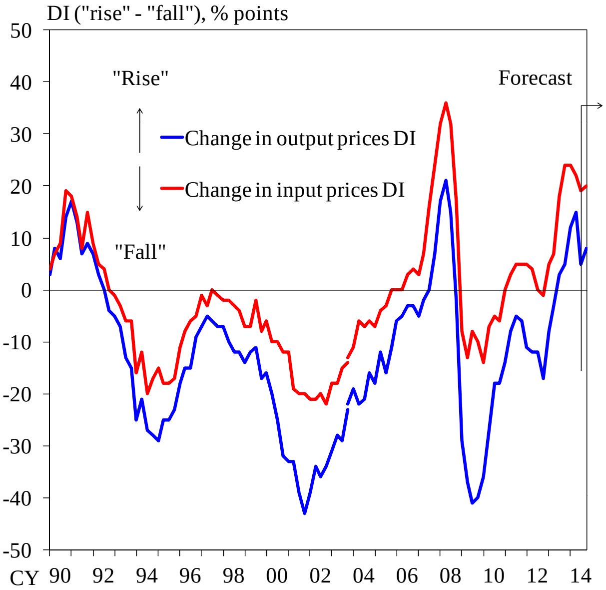
Notes: 1. BEI (break-even inflation) rates are yield spreads between fixed-rate coupon-bearing JGBs and inflation-indexed JGBs. Inflation-indexed JGBs issued since October 2013 are designated as "new," while the rest are designated as "old." Figures for "old (longest)" are calculated using yield data for issue No.16 of the inflation-indexed JGBs, which matures in June 2018.
2. Figures for the Consensus Forecasts are compiled every January, April, July, and October. Those up through April 2014 are compiled every April and October.
3. Figures for the ESP Forecast are compiled every June and December, and exclude the effects of the consumption tax hikes.
Sources: Bloomberg; Consensus Economics Inc.; JCER.

Household Consumption and Firms' Price-Setting Behavior

CPI and Purchase-Unit-Base Prices (Family Income and Expenditure Survey)



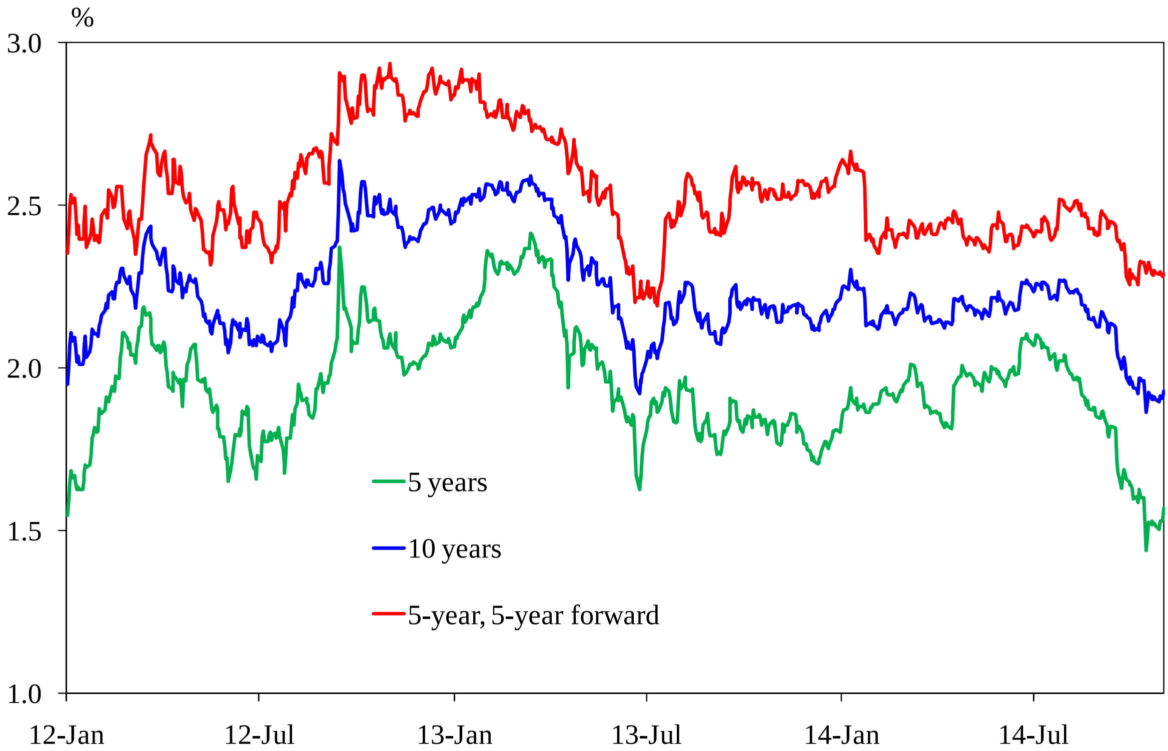
Tankan: Changes in Output and Input Prices DI in the Retail Sector (Large Enterprises)



Notes: 1. Items continuously available in both the CPI and the "Family Income and Expenditure Survey" are selected. The selected items are goods excluding fresh food, petroleum products and electricity, manufactured & piped gas & water charges. Hence they mainly consist of food products, agricultural, aquatic & livestock products (less fresh food), clothes, and durable goods.
2. Figures for the purchase-unit-base prices and CPI-base prices are adjusted to exclude the estimated effect of changes in the consumption tax rate. Figures for 2014/Q3 are July-August averages.

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

Inflation Expectations in the United States (BEI)



Source: Bloomberg.

Expansion of
the Quantitative and Qualitative Monetary Easing

Accelerating the annual pace of increase in the monetary base from about 60-70 trillion yen to **" 80 trillion yen "**

Increasing the Bank's JGB holdings at an annual pace of about **80 trillion yen**: **" + 30 trillion yen "**

Extending the average remaining maturity of JGB purchases to **about 7-10 years**: **" + 3 years "**

Accelerating the pace of purchases of ETFs and J-REITs: **" Tripled "**

- Pre-empt manifestation of a risk that conversion of deflationary mindset, which has so far been progressing steadily, might be delayed
- Maintain the improving **momentum of expectation formation**