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Bank of Japan

Japan's Economy and Monetary Policy

Speech at a Meeting with Business Leaders in Nagasaki

Kikuo Iwata

Deputy Governor of the Bank of Japan

(English translation based on the Japanese original)

Introduction

It is my pleasure to have the opportunity today to exchange views with administrative, financial, and business leaders in Nagasaki Prefecture. I would also like to take this opportunity to express my sincere gratitude for your cooperation with the activities of the Bank of Japan's Nagasaki Branch.

Today, I would like to have your views on the actual situation of the local economy, as well as your candid opinions about the Bank's policies and activities.

Before exchanging views with you, I will briefly explain the recent economic developments at home and abroad, and then touch on some points regarding monetary policy.

I. The Current Situation of Economic Activity and Its Outlook

To begin with, Japan's economy is likely to expand moderately, with a virtuous cycle from income to spending being maintained in both the corporate and household sectors, on the back of highly accommodative financial conditions and the effects of the government's large-scale stimulus measures, as well as the recovery in overseas economies (Chart 1). Real GDP is likely to continue growing at a pace above the potential growth rate through the projection period -- that is, through fiscal 2018 -- at around 1 percent. With regard to the outlook for prices, the year-on-year rate of change in the consumer price index (CPI) for all items less fresh food is likely to be slightly negative or about 0 percent for the time being mainly due to the effects of the decline in energy prices. As the output gap improves -- as will likely be seen in a further decline in the unemployment rate -- and medium- to long-term inflation expectations rise thereafter, the rate of change is expected to increase toward 2 percent in the second half of the projection period. In what follows, I would like to explain the background to this outlook and the issues that warrant attention going forward.

A. Developments in Exports and Overseas Economies

Overseas economies have continued to grow at a moderate pace, particularly in advanced economies such as the United States, but the pace of growth in emerging economies has decelerated somewhat. In terms of the outlook, overseas economies are expected to see a gradual increase in their growth rates, as it is likely that advanced economies will continue

to realize steady growth and emerging economies will be positively influenced by the developments in advanced economies and emerging economies' policy effects (Chart 2). In this situation, exports are projected to remain more or less flat for the time being, due to downward pressure exerted by the slowdown in overseas economies and the past appreciation of the yen, but to moderately increase from the turn of fiscal 2017 as the effects of the slowdown in overseas economies and the appreciation of the yen are expected to gradually wane.

With regard to the economic policies to be implemented under the new administration in the United States, market participants seem to view that the U.S. economy will be boosted by proactive fiscal management. The U.S. economic measures exert great influence not only within the economy but also on the global economy and global financial markets; therefore, the new administration's policy directions and their influence warrant close attention. In assessing overseas economic developments, it is necessary to closely monitor developments in emerging and commodity-exporting economies, particularly China, as well as the consequences stemming from the United Kingdom's vote to leave the European Union (EU) and their effects.

B. Developments in the Corporate Sector

Profits for all industries and company sizes have been at a level close to the record high, although those of large manufacturing firms have been negatively affected by the slowdown in overseas economies and the yen's appreciation (Chart 3). In this situation, business sentiment has generally been favorable, and business fixed investment has been on a moderate increasing trend. According to the September 2016 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), firmness has continued to be seen in business fixed investment plans for fiscal 2016 as a whole, including those of large manufacturers, for which profit projections have deteriorated as the expected exchange rate has shifted toward appreciation of the yen. As the background to these developments, we can point to anticipation of firms undertaking fixed investment from a relatively longer perspective, such as that (1) for growth areas, in view of the 2020 Tokyo Olympics, and (2) in labor-saving machinery and equipment in order to deal with labor shortages.

C. Developments in the Household Sector

Next, I would like to turn to developments in the household sector. Supply-demand conditions in the labor market have improved steadily and employee income has increased moderately (Chart 4). A perception of labor shortage suggested by the diffusion index for employment conditions in the September *Tankan* has heightened, showing a tightening at almost the same levels seen around 1991-1992. The unemployment rate has been about 3 percent, which is close to virtually "full employment." Wages have been rising moderately, albeit with fluctuations, on the back of the tightening of labor market conditions. The year-on-year rate of change in hourly cash earnings of part-time employees, which are responsive to labor market conditions, has seen a relatively high increase, being in the range of around 1.5-2.0 percent. Summer bonuses of full-time employees also have increased clearly, mainly in nonmanufacturing firms.

Private consumption has been more or less flat recently, despite being affected by bad weather conditions such as typhoons (Chart 5). Confidence indicators related to private consumption have been picking up, and such consumption is expected to increase moderately on the back of the continued steady improvement in the employment and income situation.

D. Price Developments

Next, I would like to touch on price developments. The year-on-year rate of change in the CPI for all items less fresh food has been slightly negative due to the effects of the decline in energy prices. This is largely attributable to the decline in energy prices, as that for all items less fresh food and energy has remained positive for three years (Chart 6).

However, the rate of increase in the CPI for all items less fresh food and energy has slowed recently. This is mainly because firms have become cautious about raising prices compared to 2015, reflecting the effects of the yen's appreciation since the middle of 2015 and weakness in private consumption in the first half of 2016.

The year-on-year rate of change in the CPI for all items less fresh food is likely to be slightly negative or about 0 percent for the time being, and gradually increase toward 2

percent. The following three points can be highlighted as the background to this outlook. The first point is that the negative contribution of the decline in energy prices to the annual CPI inflation rate for all items less fresh food is expected to dissipate and almost no effects of this are projected to be seen in early 2017. The second point is that firms' price-setting stance is expected to revert to raising prices as private consumption heads toward a moderate recovery. The third point is that upward pressure on wages is expected to rise further as labor market conditions tighten. Inflation expectations are likely to increase again if the observed inflation rates rise with these factors.

That being said, a wage increase is extremely important with a view to realizing an environment in which prices follow a rising trend. The Bank -- in pursuing monetary easing to achieve its price stability target of 2 percent -- aims to realize a virtuous cycle in which prices rise moderately accompanied by increases in corporate profits, employment, and wages. In fact, when we take a look at the relationship between prices and nominal wages, there is a stable relationship between the CPI and hourly cash earnings, in that they generally move in parallel from a longer-term perspective. In the United States and Europe, it is often the case that negotiated wages apply for several years, and central banks' price stability targets are thereby the crucial factor that determines wages. In Japan, on the other hand, base pay increase is determined considering the actual price developments, particularly the observed CPI in the previous year (Chart 7). In order to achieve the price stability target of 2 percent in a stable manner, it is important that people share the view that annual inflation will be around 2 percent, and that the price-setting and the annual labor-management wage negotiations are conducted based on such view.

II. Thinking behind the Conduct of Monetary Policy

Let me now turn to the Bank's conduct of monetary policy. Since the introduction of quantitative and qualitative monetary easing (QQE) in April 2013, Japan's economic activity and prices have improved significantly, and the economy is no longer in deflation. There is no room for doubt that this policy was effective in overcoming deflation. However, it is true that the price stability target of 2 percent has not been achieved yet, unfortunately, despite the unprecedented large-scale monetary easing.

Based on such recognition, the Bank, at the September Monetary Policy Meeting (MPM), conducted a comprehensive assessment of developments in economic activity and prices as well as policy effects over the three years since the introduction of QQE, and, based on its findings, decided to introduce "QQE with Yield Curve Control," which is a new framework for strengthening monetary easing. In what follows, I will elaborate on this point.

A. Comprehensive Assessment

Although the content of the Bank's "Comprehensive Assessment" is wide-ranging, I will now touch on three points that I consider to be particularly important.

The first point is the effects of QQE. In more than three years since its introduction, Japan's economic activity and prices have improved significantly, and the economy is no longer in deflation, which is generally defined as a sustained decline in prices. Corporate profits have been at record high levels, and the labor market is in a state that is close to virtually "full employment," as evidenced by the fact that the unemployment rate has declined to 3 percent. Against the backdrop of such tightening of labor market conditions, wages have been increasing moderately. Base pay increases, which had not taken place for many years under deflation, were achieved for three consecutive years. In the financial markets, excessive yen appreciation was corrected and stock prices have risen significantly. It is certain that the Bank's monetary easing has played a large role in economic recovery.

In order to achieve the price stability target of 2 percent in a stable manner, it is necessary to drastically change people's deflationary mindset and raise their inflation expectations -- that is, people's perception of future price developments -- to 2 percent. On this point, QQE has been effective in raising such expectations. As mentioned in the Bank's "Comprehensive Assessment," inflation expectations rose significantly through summer 2014, after the introduction of QQE in April 2013. Furthermore, the expansion of QQE in October 2014 played a role in supporting inflation expectations (Chart 8). These facts indicate that, under QQE, the expansion of the monetary base in combination with the commitment to achieving the price stability target have affected people's perception of prices by bringing about a regime change in monetary policy, and have contributed to raising inflation expectations.

Second, the main reason for not being able to achieve the price stability target of 2 percent despite such a positive turnaround in economic and price developments is that inflation expectations, which had increased significantly due to a regime change in monetary policy, weakened again. After the introduction of QQE, the year-on-year rate of change in the CPI reached 1.5 percent in April 2014 and inflation expectations increased steadily. Thereafter, however, mainly reflecting weak aggregate demand following the consumption tax hike, a decline in crude oil prices, and the global economic slowdown as well as turmoil in global financial markets, inflation expectations started to decline after having been flat for a while, with the observed inflation rate decreasing. The mechanism of formation of inflation expectations in Japan has tended to be largely adaptive after the prolonged deflation, in that such expectations are influenced by the course of the past inflation rate. Going forward, in order to achieve the price stability target of 2 percent, inflation expectations need to be raised once again by adopting more powerful measures.

Third, it was made clear that, with a combination of large-scale purchases of Japanese government bonds (JGBs) and a negative interest rate, central banks can exert strong downward pressure on the entire yield curve. What used to be regarded as the most effective monetary policy measure after the short-term policy interest rate facing the zero lower bound was the central banks' large-scale purchases of government bonds that directly influence long-term interest rates. Based on this recognition, the Bank has been conducting JGB purchases as the main easing measure under QQE. Thereafter, the European Central Bank (ECB) introduced the negative interest rate policy in 2014, and other central banks such as those in Switzerland and Sweden followed suit. This policy seeks the possibility of monetary policy that can lead to overcoming the zero lower bound. After analyzing the experiences of these European economies, the Bank introduced "QQE with a Negative Interest Rate" in January 2016. The experience since then proves that the combination of a negative interest rate and purchases of government bonds is effective in influencing the entire yield curve.

Meanwhile, declines in long- and short-term interest rates to unprecedented levels revealed related side effects. One is the effects on the profits of financial institutions. A decline in lending rates accompanying monetary easing has been brought about by reducing financial

institutions' lending margins. The other is that an excessive decline in interest rates -- especially at the long and super-long end -- will likely lower the rates of return on pension and insurance products, leading to uncertainty regarding the sustainability of financial functioning in a broader sense, thereby exerting a negative impact on economic activity and inflation expectations through a deterioration in people's sentiment. Against this background, with a view to pursuing monetary easing, it is necessary for the Bank to facilitate the formation of a yield curve, which is deemed most appropriate for achieving the price stability target of 2 percent, taking account of developments in economic activity and prices as well as financial conditions.

B. QQE with Yield Curve Control

In light of these findings of the comprehensive assessment, the Bank introduced "QQE with Yield Curve Control." This new policy framework consists of two components.

The first is an "inflation-overshooting commitment." As I mentioned earlier, inflation expectations increased significantly after the introduction of QQE but have remained in a weakening phase since last summer amid the headwinds of various developments in domestic and overseas economies. In order to achieve the price stability target of 2 percent, inflation expectations need to be raised through more powerful means. As described earlier, the comprehensive assessment suggested that the combination of an expansion of the monetary base and a strong commitment is effective in raising inflation expectations. In light of this finding, the Bank decided to introduce a more powerful commitment that it will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI exceeds 2 percent and stays above that level in a stable manner.

Achieving the price stability target of 2 percent means attaining a situation in which the observed CPI is 2 percent on average over the business cycle. Thus, it naturally is assumed from the outset that there will be phases when the observed CPI overshoots 2 percent. However, given that there is a time lag before monetary policy takes effect, it is an exceptional and very strong commitment by a central bank to continue with monetary easing until the observed inflation rate exceeds 2 percent and stays above that level in a

stable manner. The Bank believes that such a clear commitment to expanding the monetary base going forward can work on people's perception of prices to a more powerful degree.

The second component is yield curve control. The Bank will facilitate the formation of a yield curve, which is deemed most appropriate for achieving the price stability target of 2 percent. Specifically, in the guideline for market operations, which is decided at every MPM, the Bank sets the short-term policy interest rate and the target level of the 10-year JGB yields. At present, the former is at minus 0.1 percent and the latter is around 0 percent. The Bank conducts JGB purchases, aiming to achieve the target level of the long-term interest rate specified by the guideline, while providing the approximate annual pace of increase in the amount outstanding of its JGB holdings. Currently, the approximate amount is about 80 trillion yen.

On this point, I would like to emphasize that the Bank will continue expanding the monetary base in the future under the new policy framework. The control of long-term interest rates under yield curve control is achieved through large-scale JGB purchases by the Bank. Moreover, with the inflation-overshooting commitment, the Bank commits itself to continuing to expand the monetary base until the year-on-year rate of increase in the observed CPI exceeds 2 percent and stays above that level in a stable manner. Some argue that the Bank's policy focus has shifted from quantity to interest rates under the new policy framework, but such an understanding is inappropriate. Since the introduction of QQE, the Bank has been consistently pursuing powerful monetary easing both in terms of quantity and interest rates, and there is no change in its stance.

The Bank will continue with powerful monetary easing under "QQE with Yield Curve Control," aiming to achieve the price stability target of 2 percent at the earliest possible time. Taking account of developments in economic activity and prices as well as financial conditions, it will take additional easing measures without hesitation if judged necessary to maintain the momentum toward achieving the 2 percent target.

Concluding Remarks

In conclusion, let me touch on the economy of Nagasaki Prefecture. Tracing its history, the prefecture has functioned for a long time as a foothold for cultural interaction between many countries, as evidenced by the history of Dejima, and thus represents a variegated history and culture. The prefecture takes advantage of the tradition of manufacturing, particularly of heavy industry including shipbuilding, and distinguished skill and technique. It also is endowed with tourist attractions including islands, hot springs, and fresh agricultural and fishery products, as well as a fascinating food culture.

The shipbuilding industry, which is the key industry of the prefecture, is facing a severe environment surrounding orders, brought about by chronic excess of vessels globally and by sluggishness in the shipping market. There seems to be no influence on business operations for the time being as there is a backlog of orders for the upcoming three years or so, but I have heard that the local companies, including those engaged in shipbuilding, have started to take actions so as to change their business operations. In terms of tourism, the effects of the Kumamoto Earthquake have waned from summer, and I have heard that the number of visitors to major tourist facilities have picked up. Moreover, efforts have been made steadily toward future developments of the prefecture, such as the proposal of "Churches and Christian Sites in Nagasaki" for inscription on the UNESCO World Heritage List, Nagasaki City being chosen as a "tourism nation showcase" by the Japan Tourism Agency, and initiatives to establish Destination Management/Marketing Organizations for sightseeing. On the financial front, changes in the business environment -- such as consideration on integrating regional financial institutions -- have emerged under the idea to contribute to stimulating the region and vitalizing the local economy amid the situation of a declining and aging population.

As for economic and financial communities of Nagasaki Prefecture, I believe that forthcoming changes must be addressed appropriately and strategically while gaining a strong footing. The Bank anticipates that determined efforts will be made in the prefecture, and would like to provide as much support as possible going forward as the central bank.

Thank you.

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Outlook for Economic Activity and Prices (as of October 2016)

y/y % chg.

	Real GDP	CPI (all items less fresh food)
Fiscal 2016	+1.0	-0.1
Forecasts made in July 2016	+1.0	+0.1
Fiscal 2017	+1.3	+1.5
Forecasts made in July 2016	+1.3	+1.7
Fiscal 2018	+0.9	+1.7
Forecasts made in July 2016	+0.9	+1.9

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

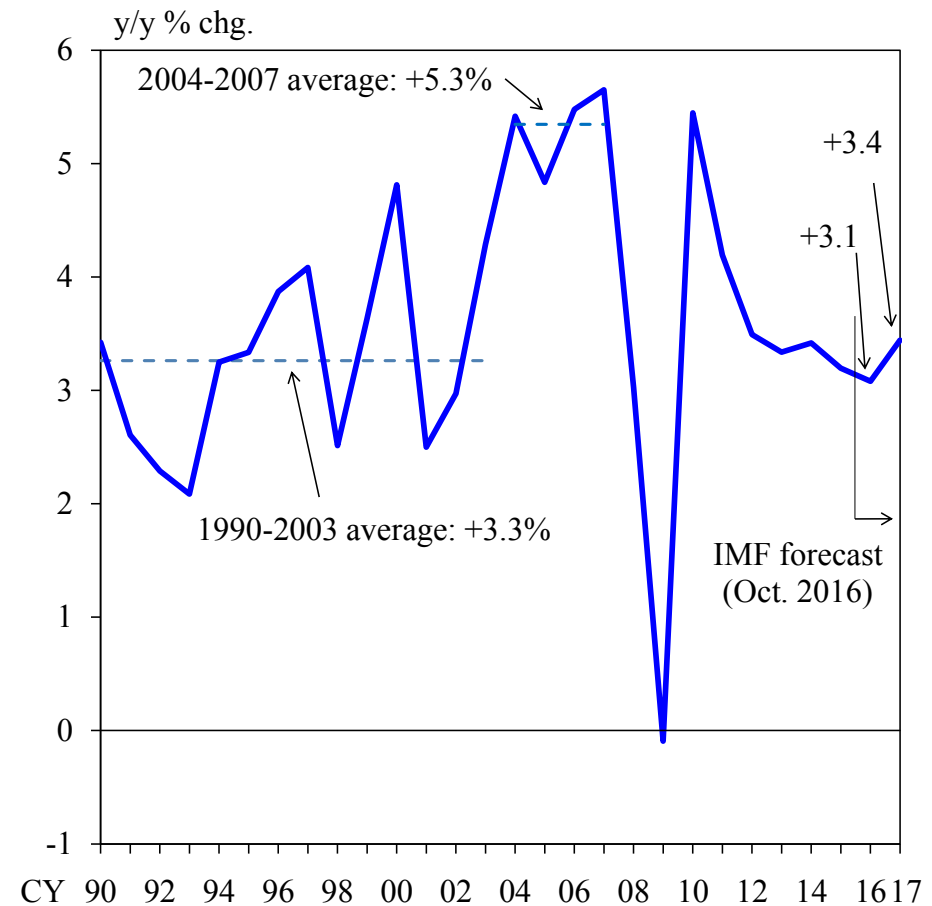
Source: Bank of Japan.

World Economic Outlook Released by the IMF

Projections for Major Economies (as of October 2016)

	y/y % chg.			
	2014	2015	Projections	
			2016	2017
World	3.4	3.2	3.1 (0.0)	3.4 (0.0)
Advanced Economies	1.9	2.1	1.6 (-0.2)	1.8 (0.0)
United States	2.4	2.6	1.6 (-0.6)	2.2 (-0.3)
Euro Area	1.1	2.0	1.7 (0.1)	1.5 (0.1)
Japan	0.0	0.5	0.5 (0.2)	0.6 (0.5)
Emerging Market and Developing Economies	4.6	4.0	4.2 (0.1)	4.6 (0.0)
China	7.3	6.9	6.6 (0.0)	6.2 (0.0)
ASEAN5	4.6	4.8	4.8 (0.0)	5.1 (0.0)

Real GDP Growth Rate

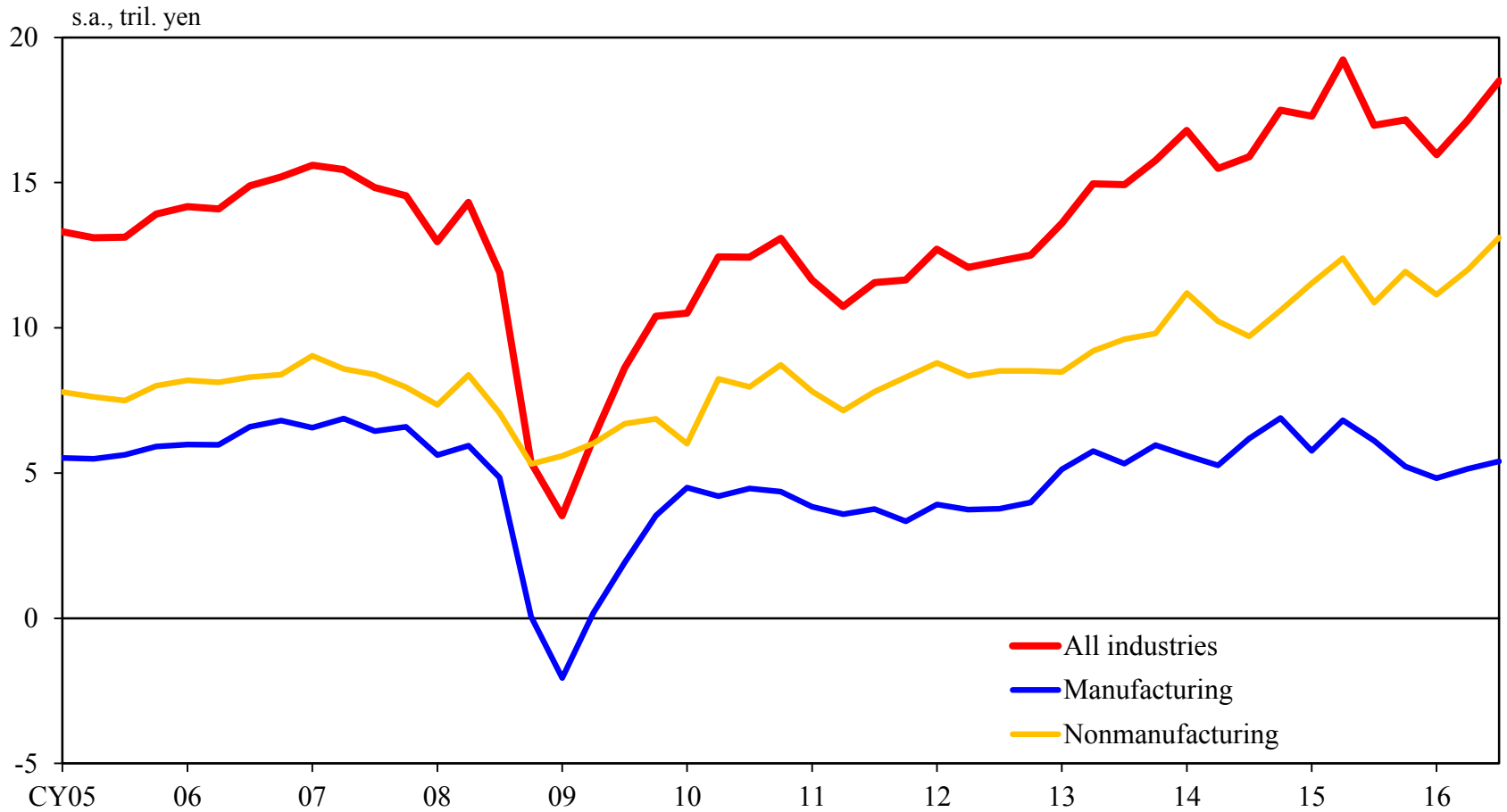


Notes: 1. ASEAN5 are Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam.

2. Figures in parentheses are the differences from the July 2016 WEO projections.

Source: IMF.

Current Profits

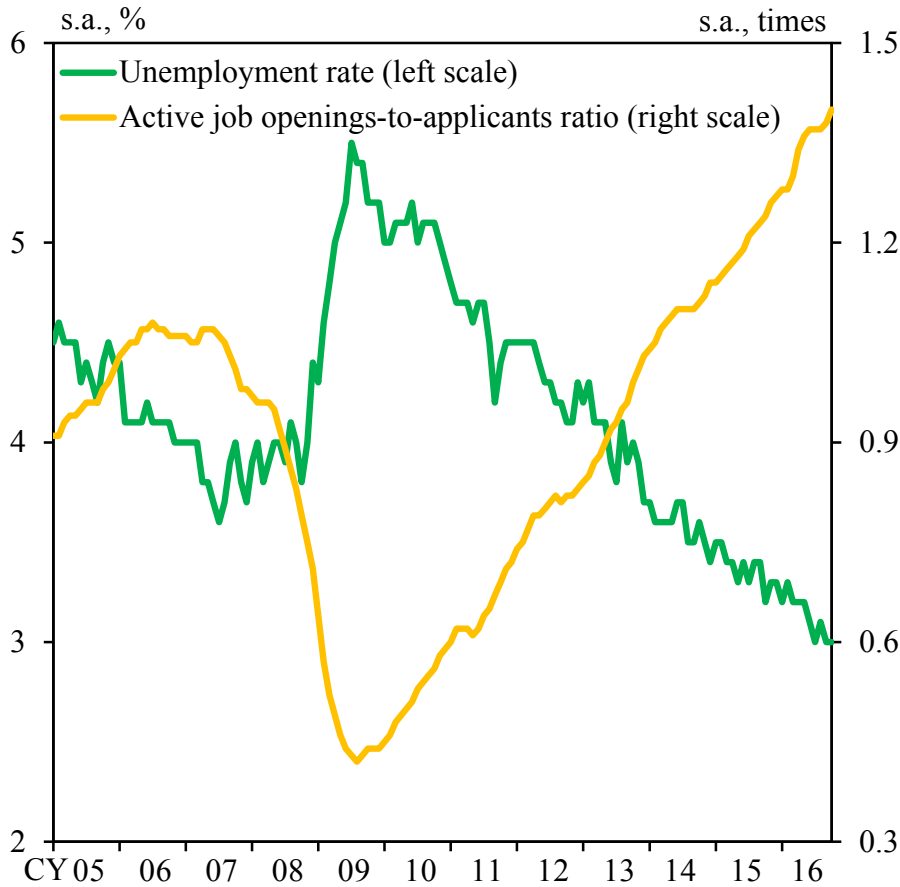


Note: Figures for current profits exclude "Finance and Insurance."

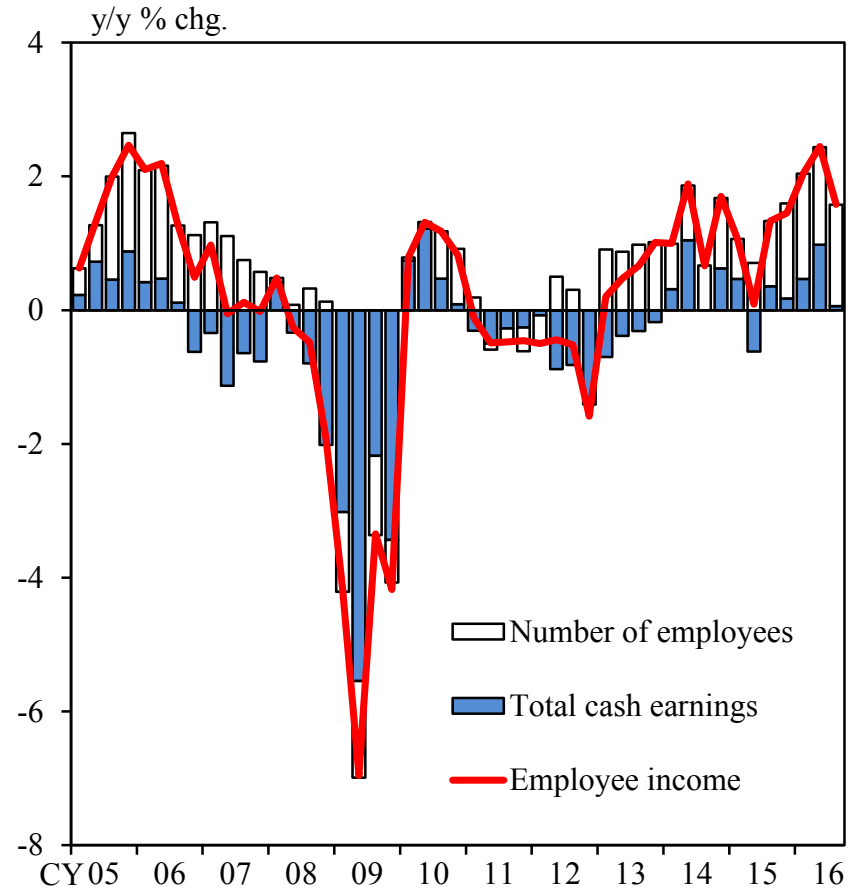
Source: Ministry of Finance.

Employment and Income Situation

Unemployment Rate and Job Openings-to-Applicants Ratio



Employee Income



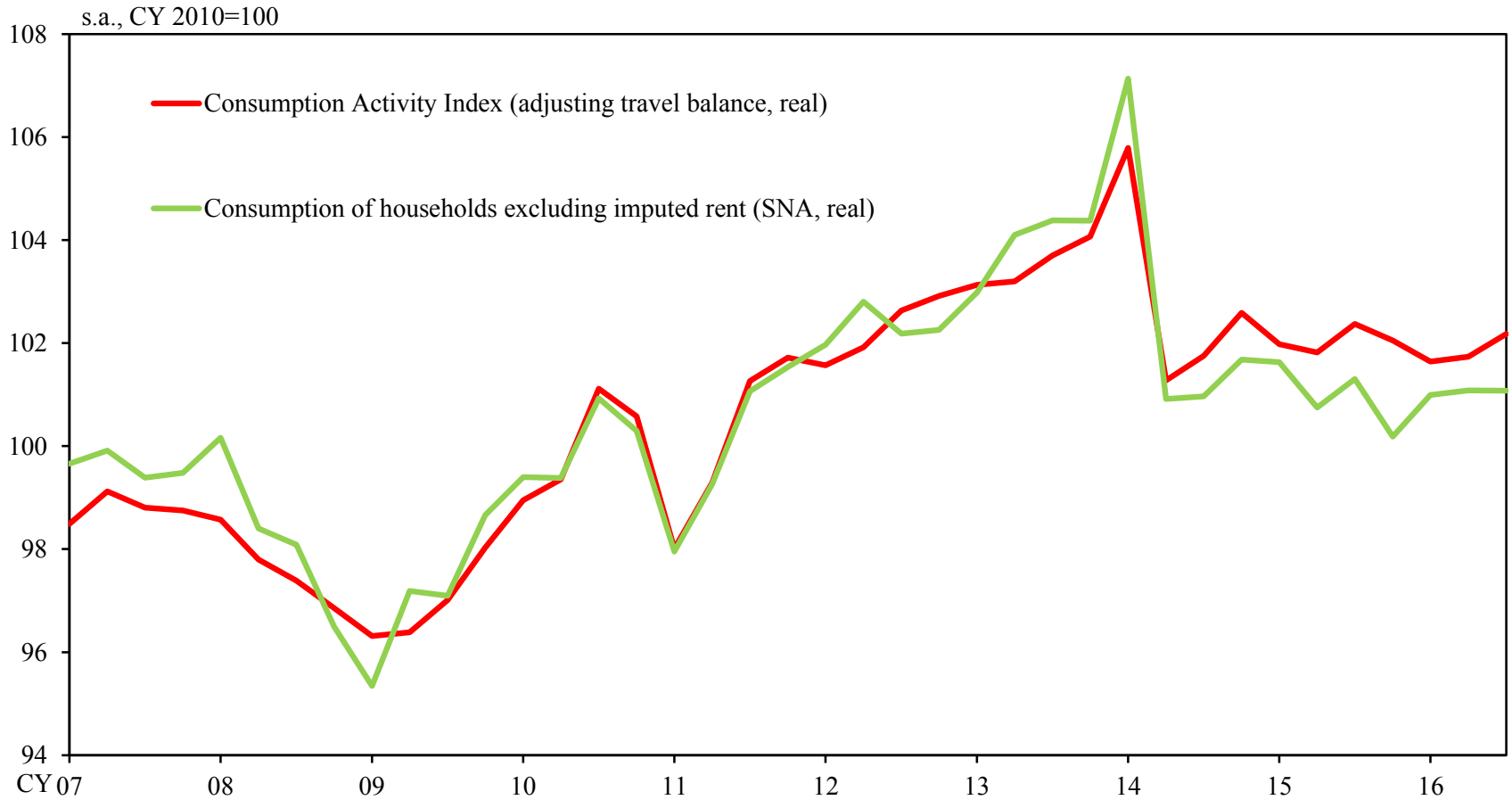
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.

Figures for 2016/Q3 are September-October averages.

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

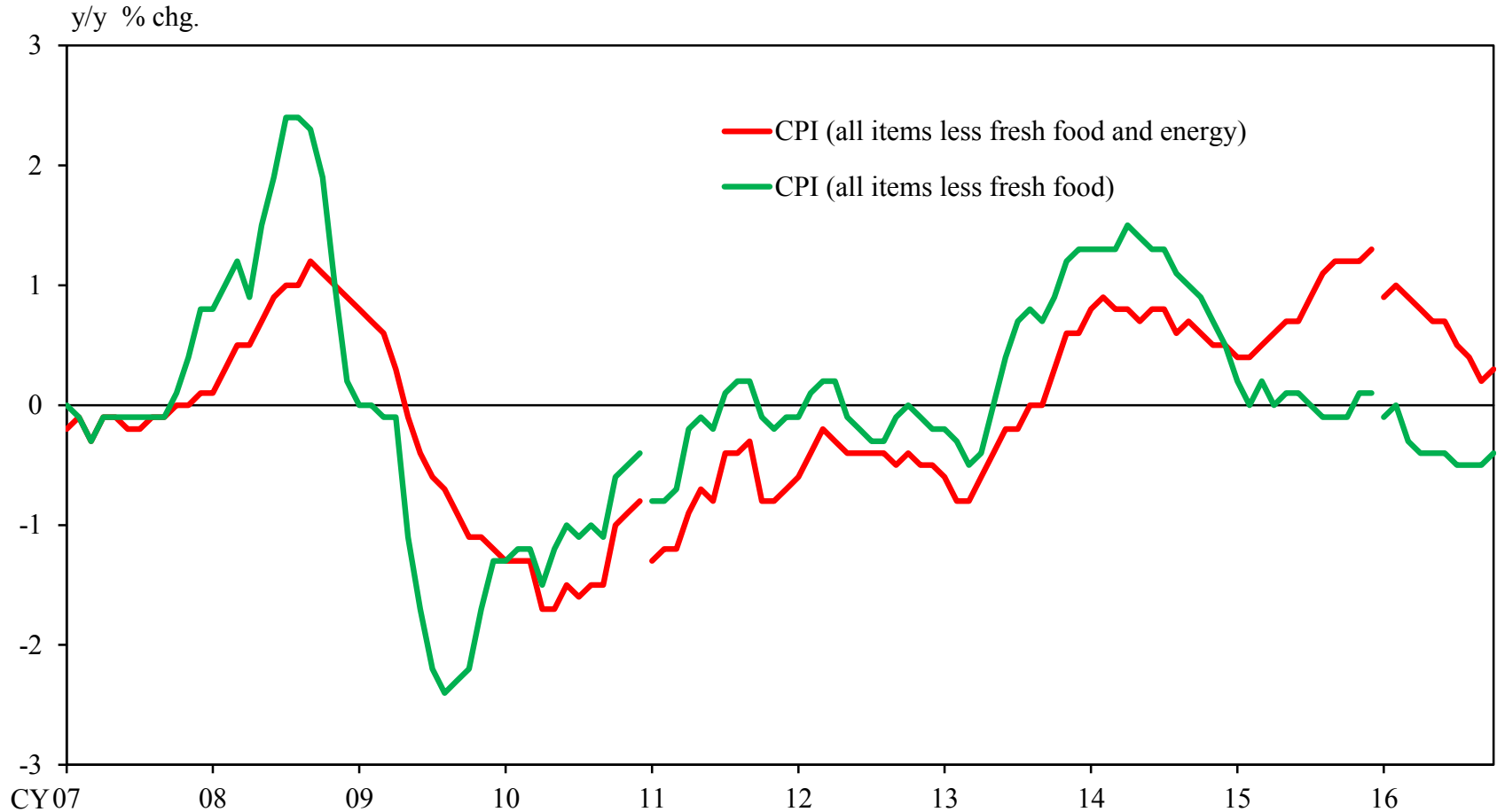
Private Consumption



Note: Figures for the Consumption Activity Index exclude inbound tourism consumption and include outbound tourism consumption.

Sources: Cabinet Office; Bank of Japan; Ministry of Economy, Trade and Industry; Ministry of Internal Affairs and Communications, etc.

Consumer Prices



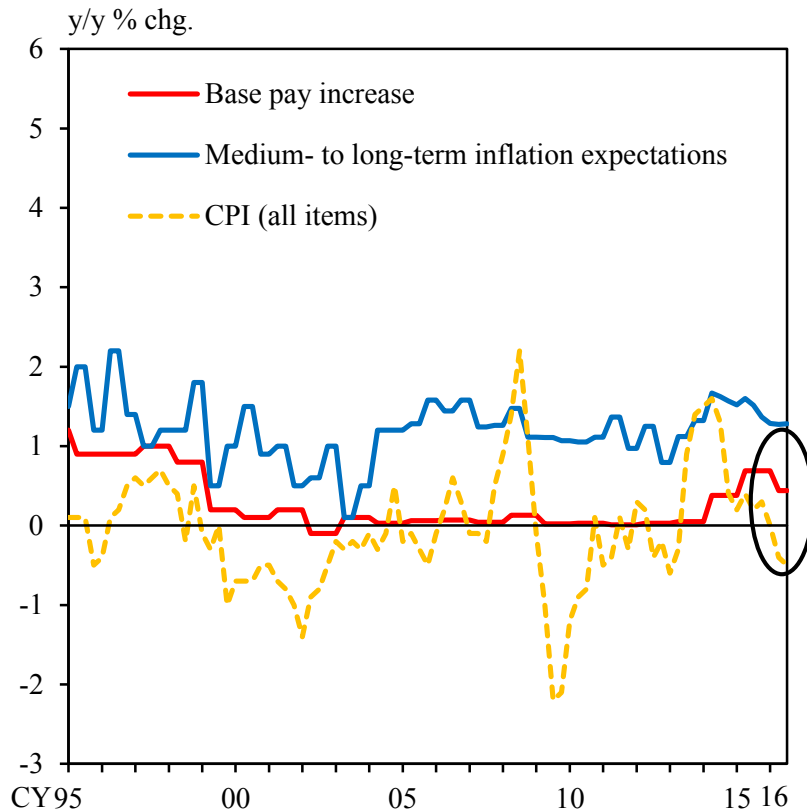
Note: Figures for the CPI (all items less fresh food and energy) are calculated by the Research and Statistics Department, Bank of Japan.

Figures for the CPI are adjusted to exclude the estimated effects of changes in the consumption tax rate.

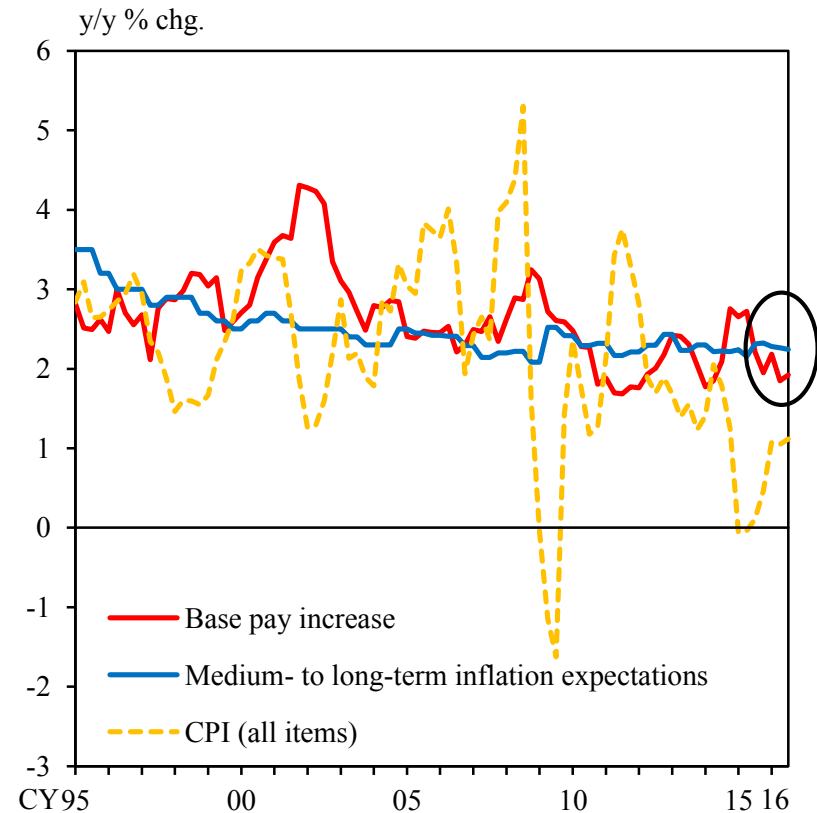
Source: Ministry of Internal Affairs and Communications.

Inflation Expectations and Wages

Japan



United States



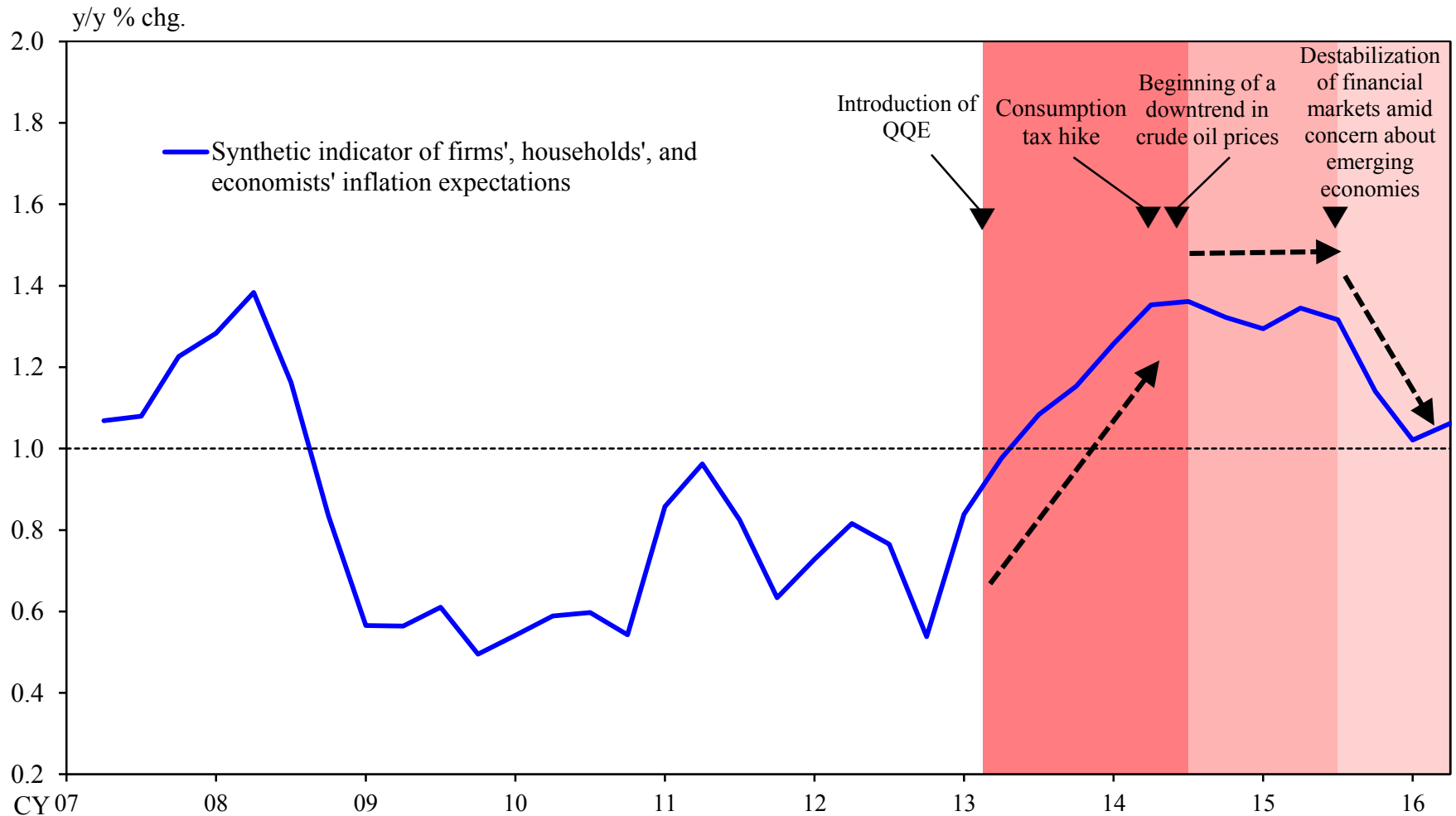
Notes: 1. Figures for the CPI in Japan are adjusted to exclude the estimated effects of changes in the consumption tax rate.

2. Figures for the medium- to long-term inflation expectations are the expectations for the CPI 6 to 10 years ahead and are based on the "Consensus Forecasts."

Sources: Central Labour Relations Commission; Japanese Trade Union Confederation (*Rengo*);

Ministry of Internal Affairs and Communications; BLS; Consensus Economics Inc., "Consensus Forecasts."

Inflation Expectations after the Introduction of QQE



- Notes: 1. Inflation expectations of firms, households, and economists are represented by the *Tankan*, the "Opinion Survey," and the "Consensus Forecasts," respectively.
2. Semiannual data from the "Consensus Forecasts" up through 2014/Q2 are linearly interpolated. "Opinion Survey" figures exclude inflation expectations by respondents whose annual inflation expectations were +5% percent or greater and -5% percent or smaller. The output prices DI in the *Tankan* represents the difference between the share of firms that raised prices in the preceding three months and the share of firms that lowered prices.

Sources: Consensus Economics Inc., "Consensus Forecasts"; Bank of Japan.