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Bank of Japan

Japan's Economy and Monetary Policy

Speech at a Meeting with Business Leaders in Nagoya

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(English translation based on the Japanese original)

Introduction

It is my great pleasure to have the opportunity today to exchange views with a distinguished gathering of business leaders in the Chubu region. I would like to take this opportunity to express my sincerest gratitude for your cooperation with the various activities of the Bank of Japan's Nagoya Branch.

At the Monetary Policy Meeting (MPM) held last week, the Bank updated its projections for Japan's economic activity and prices through fiscal 2019 and released them in the October 2017 *Outlook for Economic Activity and Prices* (Outlook Report). Today, I would like to talk about the Bank's outlook for Japan's economic activity and prices as well as its thinking behind the conduct of monetary policy, while outlining the Outlook Report.

I. The Current Situation of Japan's Economic Activity and Its Outlook

Let me start by talking about economic developments. Japan's economy is expanding moderately, with a virtuous cycle from income to spending operating. The real GDP has continued to improve steadily; the output gap that shows the utilization of capital and labor exceeded the long-term average of 0 percent in the second half of 2016, and has widened further in positive territory recently (Chart 1). In the Bank's September 2017 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the diffusion index (DI) for business conditions marked a high level last seen in 1991.

One of the features of the current economic recovery is the length of the recovery period. According to the government, the current recovery phase, which started in December 2012, is highly likely to have lasted for 58 consecutive months by September this year. This represents the second longest period of economic recovery in the post-war era, longer than the *Izanagi Boom* in the second half of the 1960s. During the course of the recovery, in around 2015, for example, Japan's exports temporarily turned to a decline against the background of a slowdown in emerging economies. For the past year or so, however, the economic recovery has taken hold more firmly. Furthermore, I think that the recovery has become more sustainable for the following three reasons.

The first reason is that the global economy has continued to improve in a well-balanced manner. Both the advanced and emerging economies have continued to improve, supporting Japan's economic expansion. The positive effects of the recovery in the world trade volume are spreading across the world, including to Japan. In the World Economic Outlook (WEO) released by the International Monetary Fund (IMF) last month, growth projections have continued to be revised upward for many countries and regions, and the global economy is expected to continue its firm growth, with the real GDP growth rate rising from 3.2 percent in 2016 to 3.6 percent in 2017 and 3.7 percent in 2018 (Chart 2). Last month, I attended a number of international meetings, including the Group of Twenty (G-20) meeting held in Washington D.C., and it was striking that many participants referred to "synchronous growth" of the global economy.

The second reason is that Japan's economic growth has been led by both external and domestic demand in a well-balanced manner. Japan's exports have increased -- mainly led by automobile-related and IT-related exports -- on the back of the growth in overseas economies. In addition to such strong external demand, domestic demand has been on an increasing trend. Specifically, business fixed investment has been on a moderate increasing trend, while corporate profits have marked record high levels (Chart 3). Private consumption has increased its resilience, supported by steady improvement in the employment and income situation as well as replacement demand for durable goods. Public investment also has been increasing clearly since the turn of the fiscal year. These developments show that the current economic expansion is not relying on a single factor, but rather is supported by multiple factors. Therefore, the Bank views that the expansion is quite sustainable.

The third reason is that the effects of economic expansion have been spreading to a wide range of economic entities. The business conditions DI in the *Tankan* has continued to be positive in recent quarters, even in small firms and nonmanufacturing firms. This is clearly different from the recovery phase in the mid-2000s, in which the DI improved mainly for large firms and manufacturing firms (Chart 4). Looking at developments by region, the DI has been positive for all regions since the December 2013 survey. In addition, in the Bank's October 2017 *Regional Economic Report*, all nine regions across the country showed positive economic assessments, using phrases such as moderate recovery and expansion. Of the nine regions, the Tokai region has been the frontrunner of economic expansion. In the latest *Regional Economic Report*, the Bank's Nagoya Branch revised its economic assessment of the Tokai region upward to one stating that the economy "has been expanding" from the previous one stating that it "has been expanding moderately." The Tokai region is the only region that assesses the economy as having been expanding. As the region is one of the largest manufacturing centers in Japan, it has benefitted from the global economic recovery and stable exchange rates. However, these factors alone cannot explain its recent strong growth. I feel that your various management efforts, including strategic investment for future development, have paid off and led to the strength in this region's economy.

As I have explained so far, in Japan's current economic recovery, both external and domestic demand have been increasing in a well-balanced manner, and the effects of economic expansion have been spreading to a wide range of economic entities, with overseas economies continuing to grow at a moderate pace. Under the circumstances, labor market conditions have tightened further. The active job openings-to-applicants ratio has continued to rise, marking 1.52 for September and reaching a level seen in 1974 (Chart 5). The unemployment rate has declined to the range of 2.5-3.0 percent, which is equivalent to virtually full employment. Against the background of such tightening of labor market conditions, wages have risen moderately, mainly for part-time employees.

Next, I would like to talk about the outlook for Japan's economic activity. The Bank projects that Japan's economy is likely to continue its moderate expansion on the back of highly accommodative financial conditions and the effects of the government's large-scale stimulus measures, with overseas economies continuing to grow at a moderate pace. In the October Outlook Report, the medians of the Policy Board members' forecasts of the real GDP growth rates for fiscal 2017 and 2018 are 1.9 percent and 1.4 percent, respectively (Chart 6). These figures are above Japan's potential growth rate, which is estimated to be in the range of 0.5-1.0 percent. In fiscal 2019, although the growth pace is projected to decelerate, the economy is expected to continue expanding, underpinned by the increase in exports on the back of the growth in overseas economies, and the median of the forecasts of the real GDP growth rate is 0.7 percent.

There are, of course, upside and downside risks to this baseline scenario of the outlook for Japan's economic activity. The biggest risk factor is developments in overseas economies. As I have explained, overseas economies are expected to continue growing at a moderate pace, but the U.S. economic policies and their impact on global financial markets warrant attention. Risks also include those concerning developments in emerging and commodity-exporting economies as well as geopolitical issues. If these risks were to materialize, they could exert downward pressure on economic activity. On the other hand, we also should keep in mind that, given that market participants and economic entities already factor these risks in to a certain extent, the economy could deviate upward from the baseline scenario depending on how they play out. The Bank assesses that upside and downside risks to economic activity are generally balanced, but will examine both risks thoroughly.

II. Price Developments and their Outlook

Now I will move to price developments. The year-on-year rate of change in the consumer price index (CPI) excluding fresh food has risen somewhat, reflecting an increase in energy prices, and has been in the range of 0.5-1.0 percent (Chart 7). The rate of change in the CPI excluding fresh food and energy, however, has remained slightly positive despite the economic expansion and the tightening of labor market conditions. While this is partly attributable to temporary factors, including a reduction in mobile-phone related prices, this also reflects the fact that a wide range of firms have been making efforts to absorb a rise in wage costs by increasing labor-saving investment and streamlining their business process. As just described, price developments have remained relatively weak, but the Bank projects that the year-on-year rate of change in the CPI is likely to continue on an uptrend and increase toward the price stability target of 2 percent.

Specifically, the following mechanism is assumed. First, prices of items such as processed food and daily necessities -- which are responsive to economic activity -- are likely to rise gradually as private consumption improves moderately, and the yen's depreciation as well as the pick-up in crude oil prices to date are expected to push up import prices. Second, as the economy continues to expand moderately and the output gap improves further, firms' stance is likely to gradually shift toward raising wages and prices, and the inflation rate is projected to rise in line with wage increases. Third, with these factors pushing up actual inflation, a virtuous cycle is expected to operate in which people's inflation expectations rise accordingly, leading to a further increase in actual inflation. Bearing this mechanism in mind, the October Outlook Report shows that the medians of the Policy Board members' forecasts of the year-on-year rate of change in the CPI excluding fresh food are 0.8 percent for fiscal 2017, 1.4 percent for fiscal 2018, and on a basis excluding the effects of the consumption tax hike, 1.8 percent for fiscal 2019 (Chart 6).

Firms' price-setting stance going forward is the key to the Bank's outlook for prices. Firms that have faced a rise in labor costs due to tight labor market conditions are likely to consider passing on a rise in wage costs to prices of their products and services. At the same time, they often try to absorb the rise in wage costs and keep their prices unchanged mainly through labor-saving and efficiency-improving investment that makes use of information technology. In fact, software investment plans of small firms for fiscal 2017 have marked a significant increase of more than 20 percent on a year-on-year basis (Chart 8). In addition, many firms lately are trying to absorb the rise in wage costs by streamlining the existing business process. In other words, they are making efforts to reduce services for which labor costs are too high to make profits. These firms' efforts make it possible to restrain an increase in total labor costs even if hourly wages of employees rise, thereby containing the passing on of those costs to product prices. While these efforts are based on individual firms' reasonable business strategy with a view to raising productivity, on the price front, they would reduce the upward pressure on prices at least in the short run.

However, the Bank does not expect that this situation will last for a long time. Rather, it assesses that upward pressure on prices has been increasing gradually. I would like to highlight the following three points as the recent change in the environment surrounding prices.

First, labor market conditions have tightened significantly, with the annual rate of increase in hourly wages of part-time employees reaching around 2.5 percent; as a result, the upward pressure of the rise in firms' costs on prices has been increasing steadily. Under such circumstances, in parallel with the aforementioned efforts to streamline their business process, an increasing number of firms have been working on passing on the increased costs that they cannot absorb to their sales prices (Chart 9). In the transportation industry, where labor shortage is acute, one of the major companies announced this spring that it planned to raise the prices of its home delivery services, and competitors followed suit. This episode suggests that upward pressure on prices stemming from the rise in wage costs has been mounting.

Second, consumers' and customers' perception of price rises has been changing. As the employment and income situation in the household sector has improved, it seems that consumers are gradually accepting price rises. Recently, it is reported more frequently that some firms in the restaurant business, for example, decided to raise prices for the first time in a while. It looks as though firms that had been hesitant to raise prices for many years are encouraged by the increase in consumers' appetite for spending.

Third, it appears that investors have started to consider the recent price rises as positive developments. Among budget chain restaurants listed on the Tokyo Stock Exchange, there have been some cases where the announcement of price rises was received positively and stock prices increased sharply. I feel it was often the case in the past that investors were rather concerned about the declines in the number of customers and sales as a result of price rises. Recently, however, it seems that investors are expecting an increase in profits instead. Amid changes in firms' price-setting stance and in consumers' perception of price rises, it appears that investors are starting to appreciate these developments.

Indeed, the specific timing at which each firm's stance shifts toward raising prices is likely to vary, depending on developments in demand that each firm and industry faces or on the extent of the rise in wage costs. In this regard, there is a risk that a rise in inflation expectations will lag behind if it takes time for firms' stance to shift toward raising prices and price developments remain relatively weak. However, the Tokai region -- the frontrunner of Japan's economic expansion -- has shown a rise in the active job openings-to-applicants ratio to 1.8, indicating that the region's labor market conditions are much tighter than those of the national average. I believe that a favorable environment has been put in place in which wage increases stimulate consumers' appetite for spending, leading to firms' bullish price-setting stance.

III. The Bank's Conduct of Monetary Policy

Next, I will talk about the Bank's conduct of monetary policy. The Bank has been conducting "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control" with the aim of achieving the price stability target of 2 percent. This framework consists of two components (Chart 10).

The first is an inflation-overshooting commitment. This is a strong commitment that the Bank will continue expanding the monetary base until the year-on-year rate of increase in the actual CPI exceeds 2 percent and stays above that level in a stable manner. It is crucial that people actually experience inflation above 2 percent and thereby the perception takes hold among them that prices of goods and services tend to go up every year by around 2 percent. With this in mind, the Bank has committed itself to continuing with large-scale monetary easing until such situation is achieved.

The second component is yield curve control. The Bank continuously conducts purchases of Japanese government bonds (JGBs) to facilitate the formation of the yield curve that is considered most appropriate for achieving the price stability target of 2 percent at the earliest possible time. Under this framework, the yield curve has been formed smoothly in a manner consistent with the current guideline for market operations in which the Bank sets the short-term policy interest rate at minus 0.1 percent and the target level of the 10-year JGB yields at around zero percent.

Under the Bank's yield curve control, JGB yields -- which are the base interest rates in Japan -- have been stable at low levels; as a result, bank lending rates as well as issuance rates for CP and corporate bonds -- to which certain spreads are added in both cases -- also have remained at extremely low levels (Chart 11). The amount outstanding of bank lending, as well as of CP and corporate bonds, has been increasing firmly. These developments suggest that the current highly accommodative financial conditions, brought about by yield curve control, have been strongly supporting Japan's economic activity from the financial side.

As described in the October Outlook Report, the Bank is also aware that prolonged downward pressure on financial institutions' profits under the continued low interest rate environment could create risks of a gradual pullback in financial intermediation. At this point, this risk is judged as not significant, mainly because financial institutions have sufficient capital bases; however, the Bank will keep closely monitoring the effects of the continued low interest rate environment on the functioning of financial intermediation.

As I mentioned today, price developments in Japan have been relatively weak compared with the improvement in economic activity, and there is still a long way to go to achieve the price stability target of 2 percent. Going forward, however, firms' stance is likely to gradually shift toward raising wages and prices with the further improvement in the output gap. People's medium- to long-term inflation expectations are projected to rise steadily as further price rises come to be observed widely. With these positive developments persisting, the Bank will steadily proceed toward achieving the price stability target of 2 percent. Under the current framework of "QQE with Yield Curve Control," the Bank will continue to persistently pursue powerful monetary easing.

Conclusion

Lastly, I would like to once again touch upon the economy of the Tokai region. As I mentioned earlier, the region is the frontrunner of economic expansion in Japan. One of the driving forces of such strong growth is that firms are expected to continue making fixed investment -- such as in next-generation cars and related to maglev trains -- from a long-term perspective. I feel that the mindset of firms in this region is always future-oriented, while also taking the present situation into account. With respect to future development, there are some challenges ahead for the region. These include (1) what will happen and what will become possible when, after a decade, a maglev train links the two major economies -- Tokyo and Nagoya -- in 40 minutes, (2) what the relationship between people and cars will be after two decades, and (3) how to make the most of firms' expertise, where Japan's advantage lies, as global manufacturing shifts toward standardizing production as well as deploying the "Internet of Things (IoT)." As is the case to date, I believe that you will find solutions to these challenges through persistent efforts. Needless to say, the biggest challenge is how individual firms and Japan's economy continue to achieve sustainable growth amid a decline in population. Not much time is left until the baby-boomer generation fully retires. These challenges are not easy to tackle, but we have to solve all of them simultaneously. I would like to close my speech by making a commitment that the Bank will firmly support Japan's economy by persistently pursuing powerful monetary easing, while trusting that the Tokai region will accumulate the wisdom and technology to address these challenges. Thank you for your attention.

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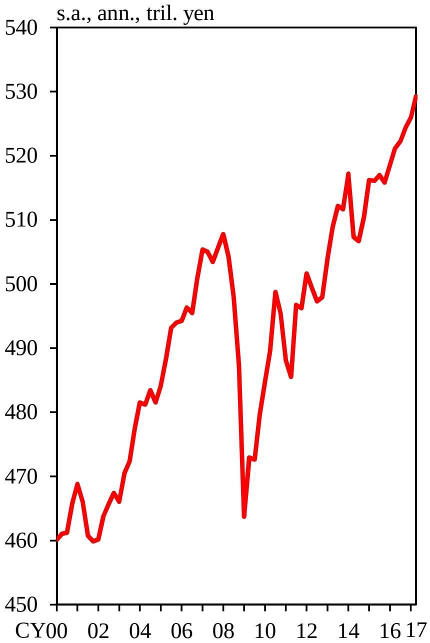
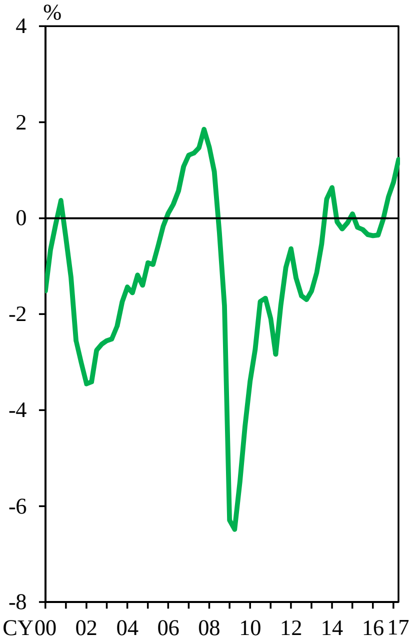
Chart 1

Economic Recovery in Japan

Real GDP



Output Gap



Length of Economic Recovery Period

Rank	Period	Length
1	February 2002-February 2008	73 months
2	November 1965-July 1970 (*Izanagi Boom*)	57 months
3	December 1986-February 1991 (*Bubble Boom*)	51 months
4	November 1993-May 1997	43 months
Current	December 2012-	58 months (as of September 2017)

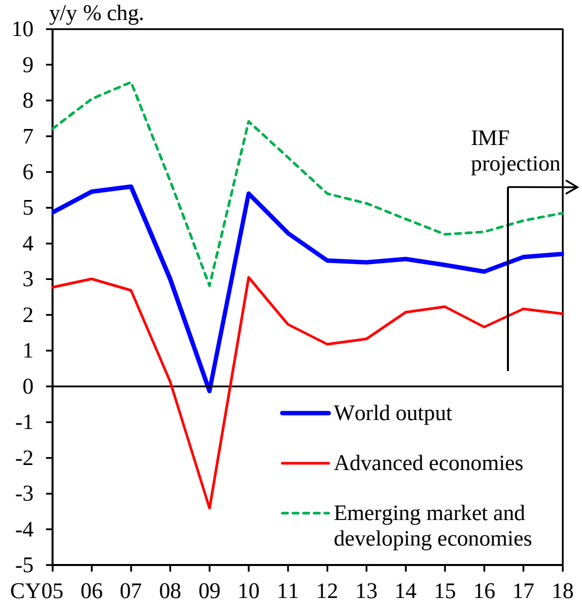
Notes: 1. The output gap is based on BOJ staff estimations.
2. Economic peaks and troughs are judged based on discussions by experts after waiting for data accumulation. The current recovery phase, which started in December 2012, seems to have lasted for 58 consecutive months by September 2017. This represents the second longest period of economic recovery in the post-war era.

Sources: Cabinet Office; Bank of Japan.

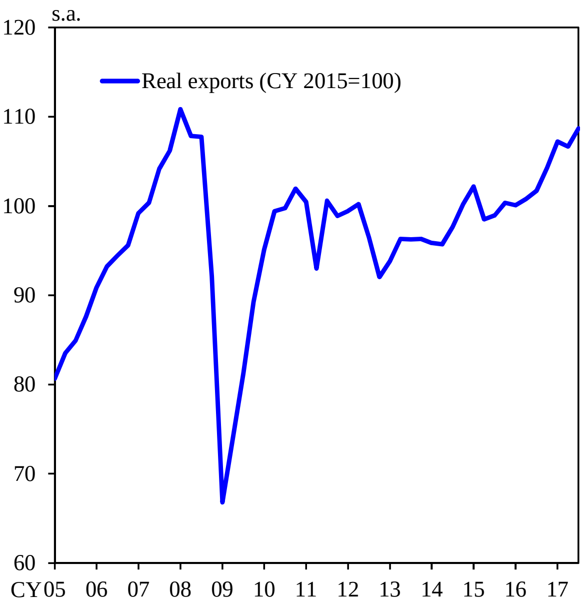
Chart 2

Global Economy and Japan's Exports

Global Real GDP Growth



Japan's Exports

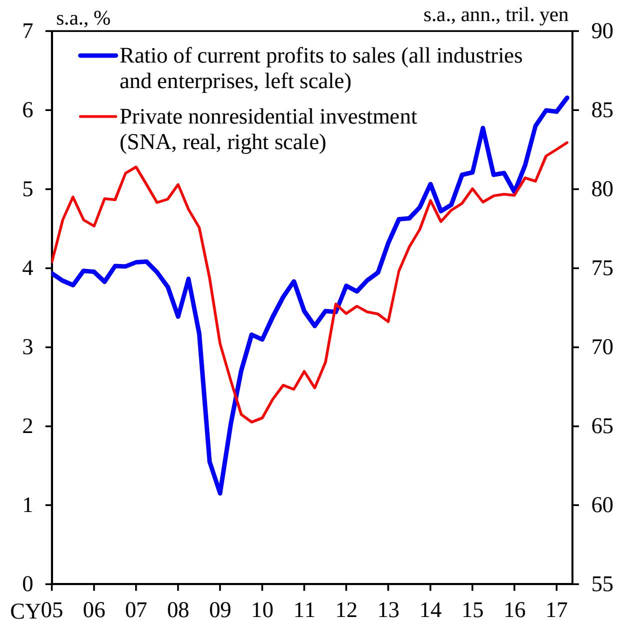


Sources: IMF; Bank of Japan; Ministry of Finance.

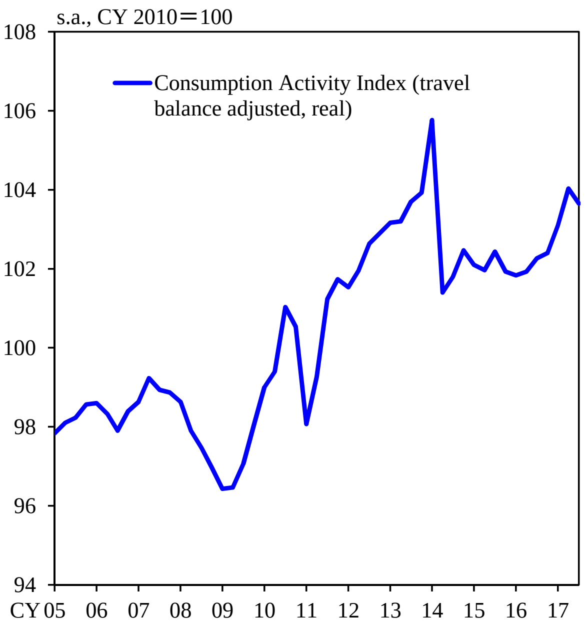
Chart 3

Domestic Demand

Corporate Profits and Business Fixed Investment



Private Consumption



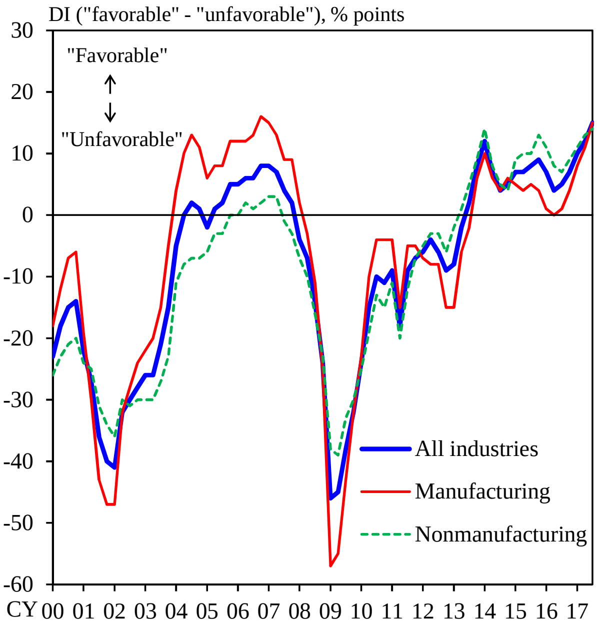
Notes: 1. Figures for corporate profits are based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. Excluding "finance and insurance."
2. Figures for private consumption are based on BOJ staff calculations. Figures exclude inbound tourism consumption and include outbound tourism consumption. The figure for 2017/Q3 is the July-August average.

Sources: Ministry of Finance; Cabinet Office; Bank of Japan.

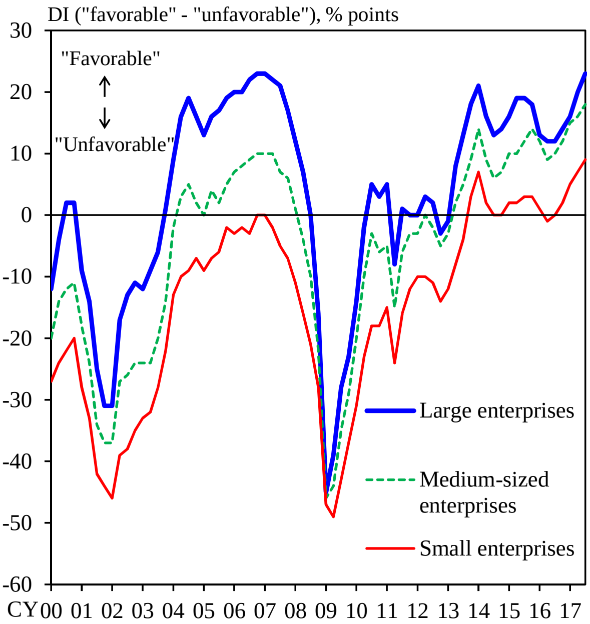
Chart 4

Business Conditions DI (*Tankan*)

By Industry



By Firm Size

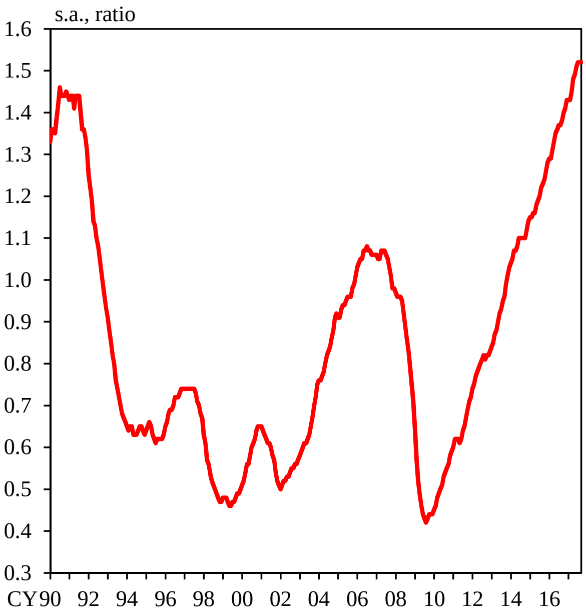


Source: Bank of Japan.

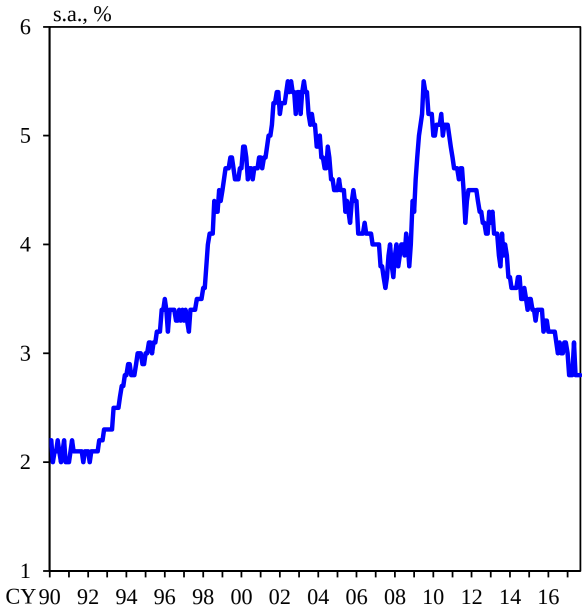
Chart 5

Labor Market Conditions

Active Job Openings-to-Applicants Ratio



Unemployment Rate



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

Chart 6

Outlook for Economic Activity and Prices (as of October 2017)

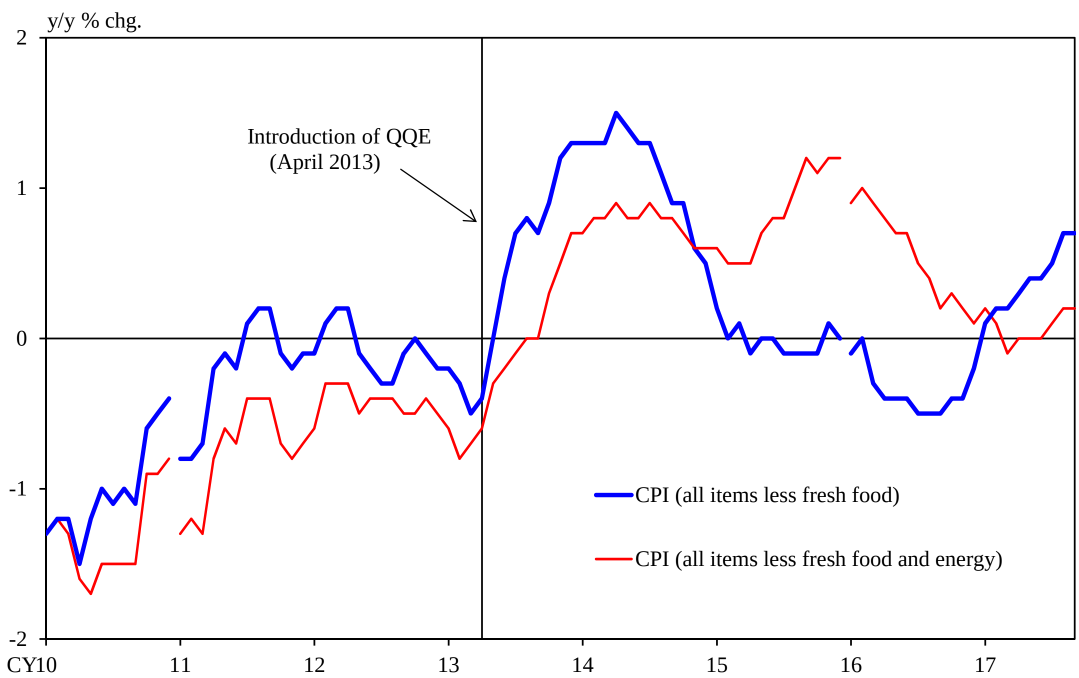
y/y % chg.

	Real GDP	CPI (all items less fresh food)
Fiscal 2017	+1.9	+0.8
Forecasts made in July 2017	+1.8	+1.1
Fiscal 2018	+1.4	+1.4
Forecasts made in July 2017	+1.4	+1.5
Fiscal 2019	+0.7	+1.8
Forecasts made in July 2017	+0.7	+1.8

Note: Figures indicate the medians of the Policy Board members' forecasts (point estimates). Figures for the CPI (all items less fresh food) exclude the effects of the consumption tax hike.
Source: Bank of Japan.

Chart 7

Consumer Prices

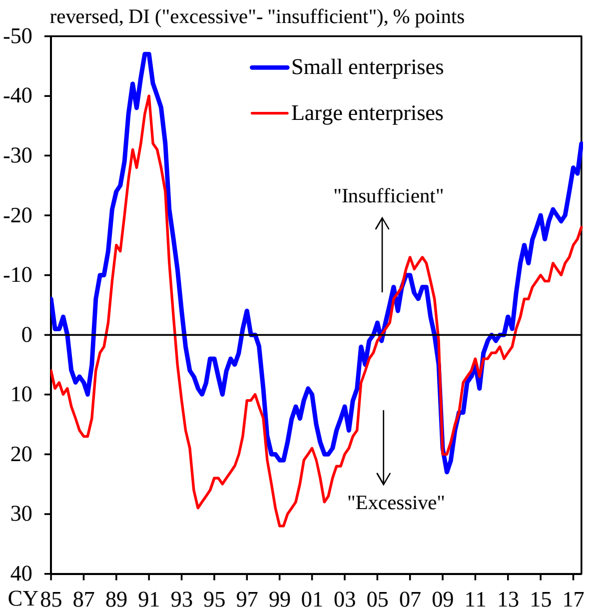


Note: Figures are adjusted for changes in the consumption tax rate.
Source: Ministry of Internal Affairs and Communications.

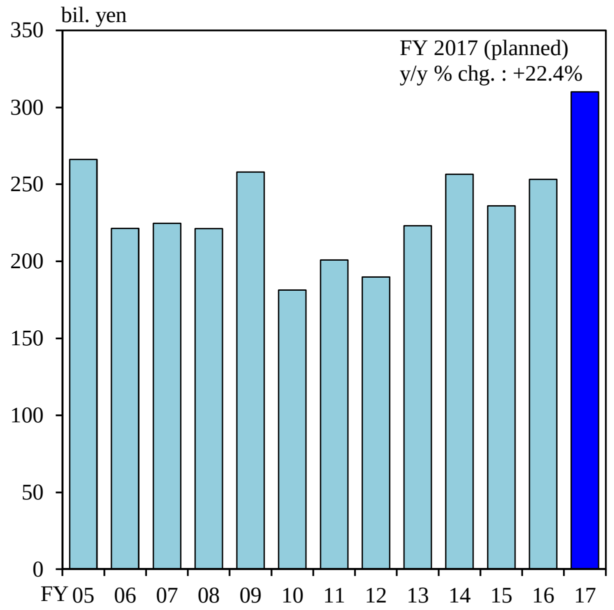
Chart 8

Labor-Saving Investment of Small Enterprises

Employment Conditions DI (Tankan)



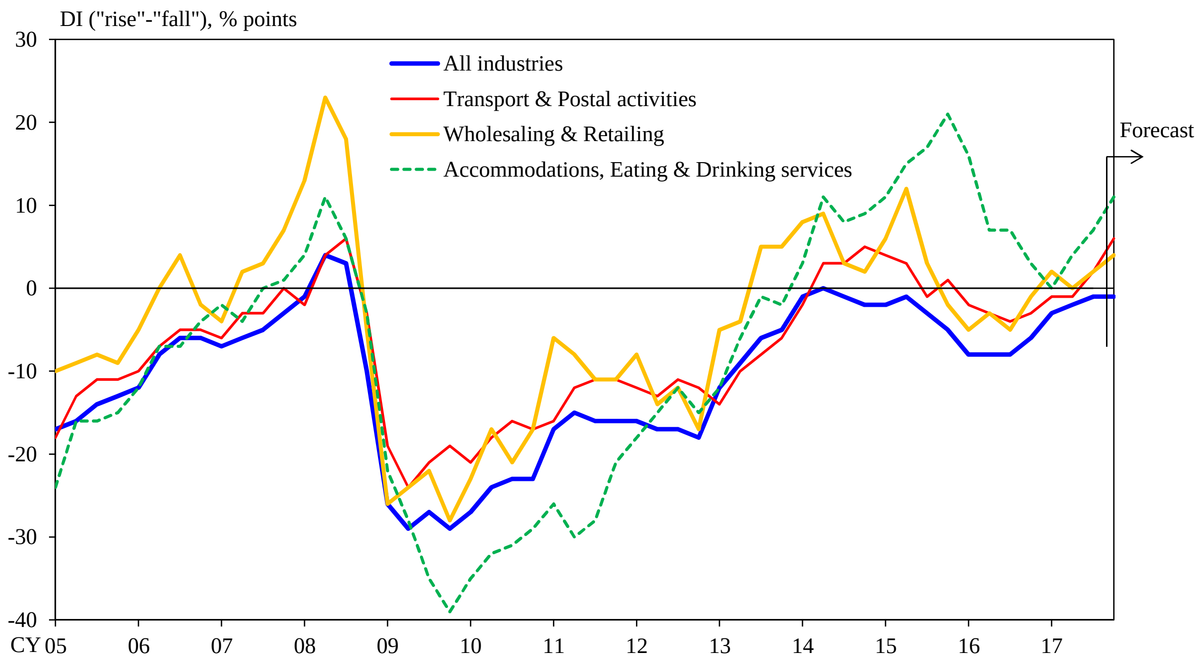
Software Investment of Small Enterprises (Tankan)



Note: The figure for the software investment plans for fiscal 2017 is from the September 2017 *Tankan* survey.
Source: Bank of Japan.

Chart 9

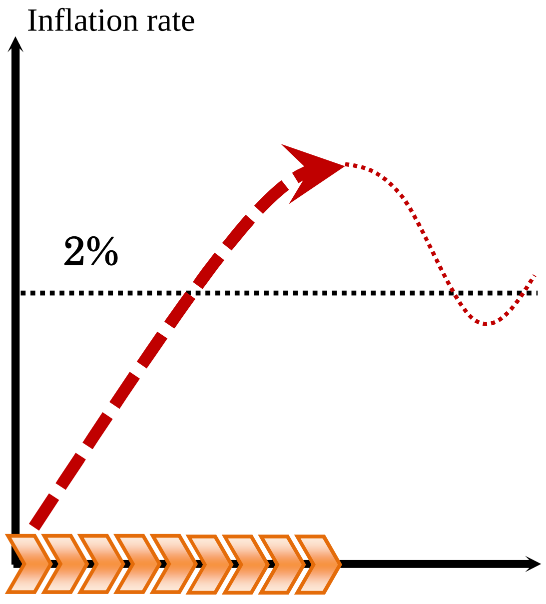
Change in Output Prices DI (*Tankan*)



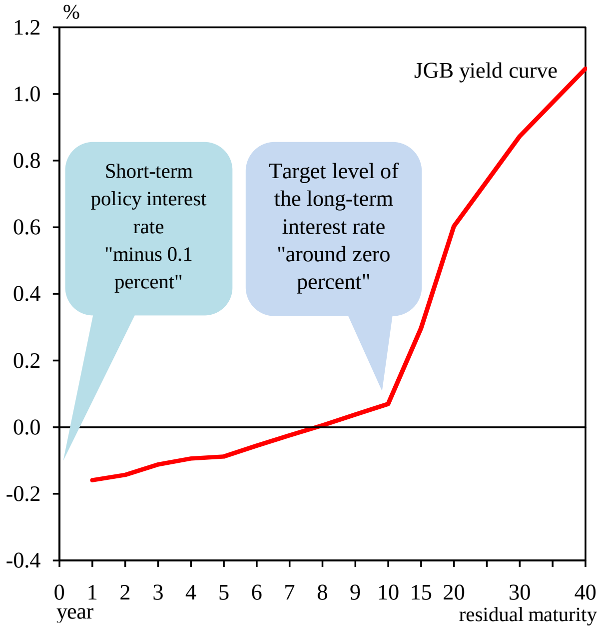
Source: Bank of Japan.

QQE with Yield Curve Control

Inflation-Overshooting Commitment



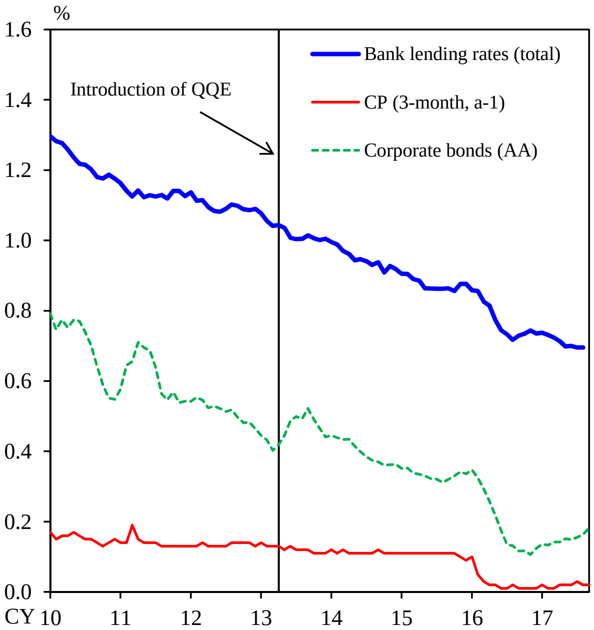
Yield Curve Control



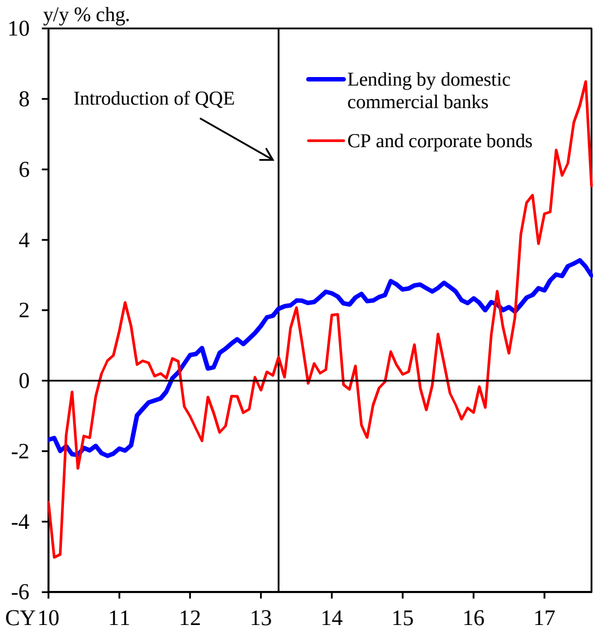
Source: Bloomberg.

Effects of Monetary Policy

Bank Lending Rates and Issuance Yields for CP and Corporate Bonds



Amount Outstanding of Bank Lending, CP, and Corporate Bonds



Notes: 1. Figures for issuance yields for corporate bonds are the averages for domestically issued bonds launched on a particular date. Bonds issued by banks and securities companies, etc., are excluded. Figures for bank lending rates and issuance yields for corporate bonds show 6-month backward moving averages.
2. Figures for lending by domestic commercial banks are monthly averages. Figures for CP and corporate bonds are those at the end of period.

Sources: Bank of Japan; Japan Securities Depository Center; Capital Eye; I-N Information Systems; Bloomberg; Japan Securities Dealers Association.