February 8, 2018
Bank of Japan

Economic Activity, Prices, and Monetary Policy in Japan

Speech at a Meeting with Business Leaders in Wakayama

Hitoshi Suzuki
Member of the Policy Board

(English translation based on the Japanese original)

I. Recent Economic and Price Developments

A. Overseas Economies

I would like to begin my speech by talking about overseas economies.

Overseas economies have continued to grow at a moderate pace on the whole in a situation where an improving trend in the business sentiment of manufacturing firms has been strengthening further on a global basis.

The U.S. economy has continued to recover firmly, mainly in household spending, owing to a steady improvement in the employment and income situation. Private consumption and housing investment have been on a moderate increasing trend, partly supported by this favorable employment and income situation. In terms of the outlook, the U.S. economy is expected to continue to see firm growth driven by domestic private demand.

The European economy as a whole also has continued to recover steadily in a situation where private consumption has been on an increasing trend, partly supported by improvements in the labor market and consumer sentiment, and firms' production activity has been solid. As for the outlook, the European economy is expected to continue its moderate recovery, while uncertainty -- for example, over political issues such as those regarding negotiations on the United Kingdom's exit from the European Union (EU) -- is likely to weigh on its activity.

The Chinese economy has continued to see stable growth on the whole, partly due to the effects of authorities' measures to support economic activity, amid an uptrend in exports. As for the outlook, the economy is likely to broadly follow a stable growth path as authorities conduct fiscal and monetary policy in a timely manner.

Emerging economies other than China and commodity-exporting economies as a whole have been recovering moderately, due mainly to the increase in exports and the effects of the economic stimulus measures of these economies. Their growth rates are likely to increase gradually, due mainly to the effects of the economic stimulus measures and the spread of the effects of steady growth in advanced economies.

According to the January 2018 *World Economic Outlook* (WEO) *Update* released by the International Monetary Fund (IMF), global growth is projected to be 3.9 percent in 2018, exceeding the estimate for 2017 of 3.7 percent (Chart 1). Together with high stock prices worldwide, the economy could deviate upward from the baseline scenario depending on the developments in fiscal and monetary policies and structural reforms in each country. However, due attention should be paid to factors that could exert downside risks to economic activity, such as (1) the U.S. economic policies and their impact on global financial markets, (2) developments in emerging and commodity-exporting economies, (3) negotiations on the United Kingdom's exit from the EU and their effects, and (4) geopolitical risks. I consider it important to also focus on the following: the fact that spreads for U.S. high-yield bonds have narrowed in the U.S. economy to a level close to that seen right before the global financial crisis in 2008; the fact that stock prices, which had been on an uptrend, fell sharply in early February by more than the decline seen in a day at times during the global financial crisis in 2008; and how U.S. long-term interest rates and capital flows to emerging and commodity-exporting economies are affected by moves toward normalization of monetary policy in the United States and Europe. Moreover, developments in commodity prices -- including crude oil prices, which have continued to increase -- also could be risks to the outlook (Chart 2). This is because excessive rises in commodity prices could lead to a rise in firms' expenses for materials, while sudden drops may bring about market turmoil.

B. Current Situation and Outlook of Japan's Economy

I will now discuss the economic situation in Japan. Japan's economy is expanding moderately, with a virtuous cycle from income to spending operating. Reflecting developments in firms' exports and business fixed investment, the real GDP growth rate for the July-September quarter of 2017 was 2.5 percent on an annualized quarter-on-quarter basis, representing positive growth for seven consecutive quarters (Chart 3). This is a level above Japan's potential growth rate, which is estimated to be in the range of 0.5-1.0 percent. As the background to these developments, we can point to the fact that real exports have been on an increasing trend on the back of the growth in overseas economies and business fixed investment has continued on an increasing trend with corporate profits and business sentiment improving (Charts 4 and 5). Owing to steady improvement in the employment and income situation, private consumption also has been increasing moderately, albeit with fluctuations. According to the *Regional Economic Report* released by the Bank of Japan in January 2018, out of a total of nine regions across Japan, six regions, including the Kinki region, reported that their economy had been expanding or expanding moderately. In particular, the Kinki region -- of which Wakayama Prefecture is part -- revised up its assessment based on the strengthened momentum in exports and the improvement in private consumption, marking three consecutive quarters of upward revisions since July 2017 (Chart 6).

With Japan's economic expansion, supply-demand conditions in the labor market have tightened steadily. Firms' perception of labor shortage suggested by the diffusion indexes (DIs) for the employment conditions in the December 2017 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) has heightened in a wide range of industries, and the unemployment rate has been in the range of 2.5-3.0 percent. The active job openings-to-applicants ratio is at its highest level since 1974, and the ratio for full-time workers has recorded a historical high (Chart 7). Against this backdrop, labor-saving investment has increased in a wide range of industries with a view toward using artificial intelligence (AI), robotic process automation (RPA), and other means. Some are concerned that, if the use of AI and RPA increases, labor positions would be taken over by robots and machines, thereby easing labor market conditions. Viewed from a long-term perspective, however, given that Japan's population is expected to decline, the labor force, which has continued to increase, may peak out. Moreover, since firms are likely to be in need of new employees to provide new products and services brought about through innovation and to make up for a reduction in work hours under working-style reforms, there is a good chance that labor market conditions could tighten.

With regard to the outlook, Japan's economy is likely to continue its moderate expansion. Through fiscal 2018, domestic demand is likely to follow an uptrend, 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 underpinnings through the government's past stimulus measures. Business fixed investment is likely to continue increasing, supported by firms' heightened growth expectations and increases in Olympic

Games-related investment, as well as in labor-saving investment to address labor shortages. Private consumption is also expected to follow a moderate increasing trend as the employment and income situation continues to improve. Moreover, exports are expected to continue their moderate increasing trend on the back of the growth in overseas economies. In fiscal 2019, although business fixed investment is likely to decelerate -- mainly reflecting cyclical adjustments in capital stock as well as Olympic Games-related demand peaking out -- and household spending is likely to decline in the second half of the fiscal year due to the effects of the scheduled consumption tax hike, Japan's economy is expected to continue expanding, supported in part by the increase in exports led by external demand. According to the Bank's January 2018 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), the medians of the Policy Board members' forecasts of the real GDP growth rate are 1.9 percent for fiscal 2017, 1.4 percent for fiscal 2018, and 0.7 percent for fiscal 2019 (Chart 8).

C. Current Situation and Outlook of Prices

Turning to price developments, the year-on-year rate of change in the consumer price index (CPI) for all items less fresh food is currently 0.9 percent. The rate has been on an improving trend, although gradual, since January 2017, when it started to increase. During the 12 months since then, the rate rose by more than 1 percentage point (Chart 9).

I believe that there are three factors to consider when projecting the outlook for prices. The first is the output gap, which determines future inflation rates. The output gap has widened steadily within positive territory on the back of the steady tightening of labor market conditions and a rise in capital utilization rates (Chart 10). In this situation, firms' moves to raise their employees' wages and prices have started to be seen. Furthermore, upward pressure on prices is heightening steadily. Specifically, labor market conditions have been tightening further in a wide range of industries -- as evidenced by the medical and nursing service industry, for example, where labor shortage has become more severe amid an increase in job openings resulting from large firms entering the market -- and hourly cash earnings of part-time employees in particular have started to increase. Against this backdrop, in the service industry, such as dining-out and transportation, some firms have started to raise prices since the second half of 2017 by passing a rise in labor costs -- arising from labor shortage -- on to prices.

The second factor is medium- to long-term inflation expectations, which are more or less unchanged, after having remained in a weakening phase since summer 2015 (Chart 11). Going forward, with the improvement in the output gap, firms' stance is likely to gradually shift toward raising wages and prices and is expected to push up the observed inflation rate, as I mentioned earlier. In this way, inflation expectations are likely to rise through the adaptive component, in which expectations are formed in a backward-looking manner. In addition, medium- to long-term inflation expectations are likely to be raised in particular by the forward-looking component, which will be in place, as the Bank pursues monetary easing through its strong commitment to achieving the price stability target.

The third factor is import prices. The effect of a pick-up in crude oil prices since spring 2016 is likely to wane moderately, while the yen's depreciation since autumn 2016 is likely to increase upward pressure on prices for the time being.

In this regard, I think it will take some time to achieve the price stability target, although this seems to be on track so far; favorable conditions for prices to rise at a faster pace going forward are beginning to materialize. Therefore, the year-on-year rate of increase in the CPI (all items less fresh food) is projected to continue on an uptrend and will likely reach around 2 percent around fiscal 2019. Specifically, the medians of the Policy Board members' forecasts of the year-on-year rate of change in the CPI (all items less fresh food) presented in the January 2018 Outlook Report are 0.8 percent for fiscal 2017, 1.4 percent for fiscal 2018, and, excluding the direct effects of the scheduled consumption tax hike, 1.8 percent for fiscal 2019 (Chart 8).

Nevertheless, what warrants attention is developments in the CPI for all items less fresh food and energy, which is essential to the year-on-year rate of increase in the CPI for all items less fresh food rising further toward the price stability target going forward. With that being said, since there may be some time lag until the effects of labor shortages and the hike in expenses for materials will be reflected in prices of goods and services provided by firms more widely across industries, I will continue to pay close attention to firms' actions toward raising prices of goods and services.

II. Conduct of Monetary Policy

A. Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control

Let me now turn to the Bank's monetary policy. In April 2013, the Bank introduced QQE to overcome deflation that had lasted for nearly 15 years. In September 2016, from the viewpoint of further strengthening the effects of monetary easing, it introduced a new policy framework of QQE with Yield Curve Control -- consisting of yield curve control, in which the Bank controls short- and long-term interest rates, and an inflation-overshooting commitment.

The new policy framework has two key features. The first is to facilitate the formation of the yield curve that is considered most appropriate for achieving the price stability target of 2 percent. With yield curve control, the Bank seeks a decline in real interest rates by controlling short- and long-term interest rates in a situation where QQE has brought about positive effects on economic activity and prices mainly through the decline in real interest rates. In theory, the new framework aims to lower the observed real interest rates -- which are obtained by subtracting inflation expectations from the nominal interest rates -- to levels below the natural rate of interest, which is the real interest rate at which the economy neither accelerates nor decelerates. The basic mechanism is that, when the observed real interest rates are lower than the natural rate of interest, this stimulates economic activity, leading to acceleration of economic growth; as the output gap improves, upward pressure on prices is generated.

Second, as another means of lowering the observed real interest rates, the inflation-overshooting commitment, under which the Bank works on people's expectations to increase inflation expectations, is also important. The Bank aims to push up inflation expectations and further strengthen the effects of monetary easing by making a strong commitment to 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.

B. Effects of Monetary Easing

Since the introduction of QQE with Yield Curve Control, the year-on-year rate of change in the CPI for all items less fresh food -- which had declined to minus 0.5 percent in September 2016 -- rose nearly 1.5 percentage points to 0.9 percent in November 2017. Short- and long-term interest rates also have thus far been maintained at levels consistent with the Bank's guideline for market operations. In addition, the sustainability of its policy framework has increased, in that the amount of the Bank's JGB purchases varies flexibly according to financial market conditions at the time. With regard to inflation expectations, the results of the 72nd *Opinion Survey on the General Public's Views and Behavior* (December 2017 Survey) released by the Bank in January 2018 suggests that monetary easing has started to influence people's inflation expectations; the proportions of respondents who answered that prices would go up one year from now and over the next five years increased compared to the previous survey conducted in September 2017 (Chart 12).

Although the inflation rate has been rising since the introduction of QQE with Yield Curve Control, there is still some way to go to achieving the price stability target. Let me note, however, that Japan's economy has been expanding firmly. The conditions of a further rise in prices are also beginning to materialize, judging from (1) the rise in prices of goods traded among firms, reflecting increases in commodity prices such as crude oil prices, (2) the tightening of labor market conditions, and (3) the government's various efforts toward improving firms' productivity and increasing wages. Thus, I consider that the momentum toward achieving the price stability target is maintained. Given this situation, I believe that it is important to persistently maintain powerful monetary easing under QQE with Yield Curve Control.

C. Regarding Future Conduct of Monetary Policy

Based on the objectives of monetary policy and its effects that I have outlined so far, let me now discuss two points regarding the future conduct of such policy that warrant attention.

First, while a situation where prices do not rise easily persists, the following achievements are confirmed: the real GDP growth rate registered positive growth for seven consecutive quarters, and the *Financial Statements Statistics of Corporations by Industry* (FSSC) released by the Ministry of Finance showed that current profits reached a record high level and that internal reserves for nonfinancial corporations for fiscal 2016 reached a historical high exceeding 406 trillion yen (Chart 13). Nevertheless, the ratios of investments and personnel expenses to corporate profits have remained low, and I believe that increasing the proportion of firms' on-hand liquidity to be spent for future business fixed investment, research and development, and employees' wages will lead to a rise in wages and prices (Chart 14). The same could be said for individuals. Many people have saved money because of anxiety over issues such as a possible decline in the receipt of pension benefits and an increasing burden of medical expenses in the future. I also hear that, amid the recent stock price hike, gains on stock sales have accumulated as bank deposits. If these funds were used for private consumption, owing to an improvement in the employment and income situation, corporate profits would be pushed up further and an economic virtuous cycle would operate. To address this situation, on December 8, 2017, the Cabinet decided the New Economic Policy Package, which placed "Supply System Innovation" and "Human Resources Development" as major pillars. The government has laid out measures such as providing preferential tax treatment for firms that have raised wages. I consider that these measures by the government, coupled with the Bank's monetary easing, will play an important role in realizing an economy in which the virtuous cycle operates firmly.

Second, as I mentioned earlier, short- and long-term interest rates have been maintained at levels consistent with the Bank's guideline for market operations for more than a year since the introduction of QQE with Yield Curve Control in September 2016. However, looking back at the aftermath of Black Monday in 1987 and the global financial crisis in 2008, during which I worked as a market practitioner, the market is volatile by nature, much like a living creature; therefore, close attention should continue to be paid to the effects of the current large-scale monetary easing on developments in economic activity and prices, as well as financial conditions. In particular, I focus on the effects imposed on (1) yields on securities held by financial institutions and their lending rates, (2) developments in corporate bond rates and flow of funds between firms and investors based on these rates, and (3) investments by insurance companies and pension funds. In a situation where firms find it easier to raise funds under a low interest rate environment, financial institutions have been taking an active lending stance, and the amount outstanding of bank loans has in fact been increasing (Chart 15). Meanwhile, financial institutions' earnings have been reduced, due in part to a further decline in lending rates brought about by intensifying competition among banks and to a decline in yields on securities held by financial institutions. At least for now, I believe that financial institutions in Japan as a whole have robust resilience against stress in terms of both capital and liquidity, and stability in the financial system has been maintained. However, it is necessary to carefully monitor how monetary policy will affect the financial system and the financial intermediation function, including the cumulative effects stemming from sustaining the Bank's large-scale monetary easing. Moreover, in facilitating the formation of an appropriate yield curve, the Bank should take account of economic, price, and financial conditions, as was indicated when QQE with Yield Curve Control was introduced in September 2016.

Thank you very much for your attention.

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Chart 1

Global Economy

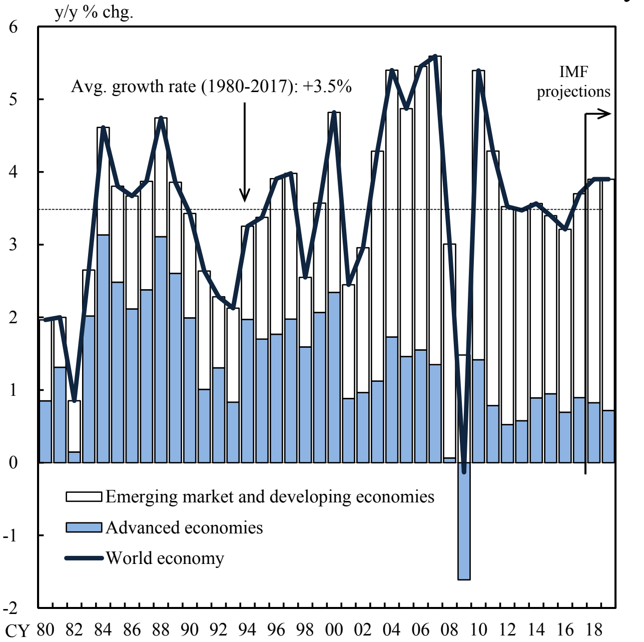
IMF Projections (as of January 2018)

real GDP growth rate, y/y % chg.

CY	2016	2017 estimates	2018 projection	2019 projection
World	3.2	3.7	3.9 (0.2)	3.9 (0.2)
Advanced economies	1.7	2.3	2.3 (0.3)	2.2 (0.4)
United States	1.5	2.3	2.7 (0.4)	2.5 (0.6)
Euro area	1.8	2.4	2.2 (0.3)	2.0 (0.3)
United Kingdom	1.9	1.7	1.5 (0.0)	1.5 (-0.1)
Japan	0.9	1.8	1.2 (0.5)	0.9 (0.1)
Emerging market and developing economies	4.4	4.7	4.9 (0.0)	5.0 (0.0)
Emerging and developing Asia	6.4	6.5	6.5 (0.0)	6.6 (0.1)
China	6.7	6.8	6.6 (0.1)	6.4 (0.1)
ASEAN	4.9	5.3	5.3 (0.1)	5.3 (0.0)
Russia	-0.2	1.8	1.7 (0.1)	1.5 (0.0)
Latin America and the Caribbean	-0.7	1.3	1.9 (0.0)	2.6 (0.2)

Source: International Monetary Fund.
Note: Figures in parentheses are the difference from the October 2017 *World Economic Outlook* projections.

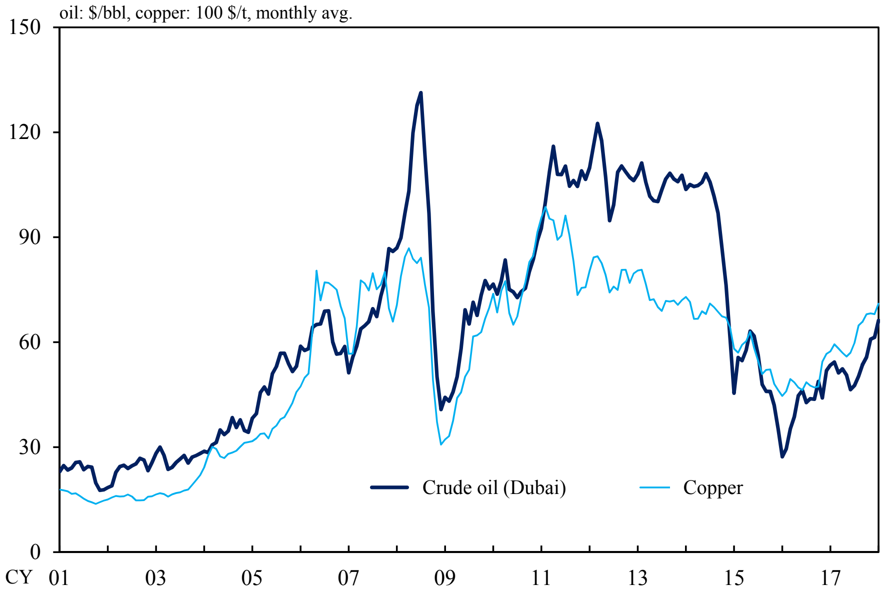
Real GDP Growth Rate of the World Economy



Source: International Monetary Fund.
Note: As of January 2018. Figures are calculated using GDP based on purchasing power parity (PPP) shares of the world total from the International Monetary Fund.

Chart 2

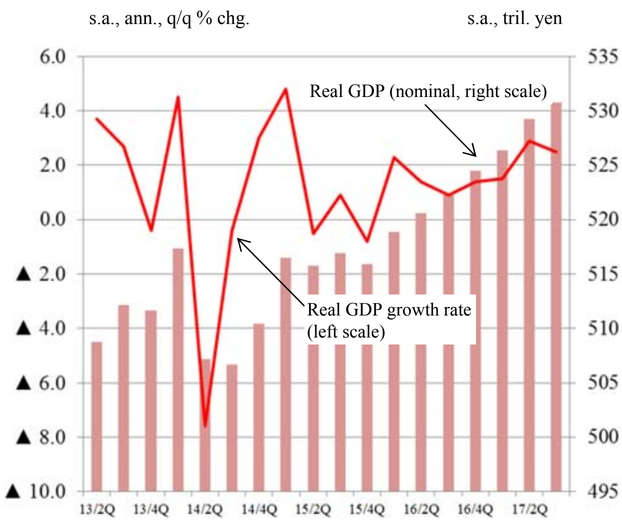
International Commodity Prices



Sources: Nikkei Inc.; Bloomberg.

Chart 3

Japan's Economy: Real GDP



Source: Cabinet Office.

s.a., q/q % chg.

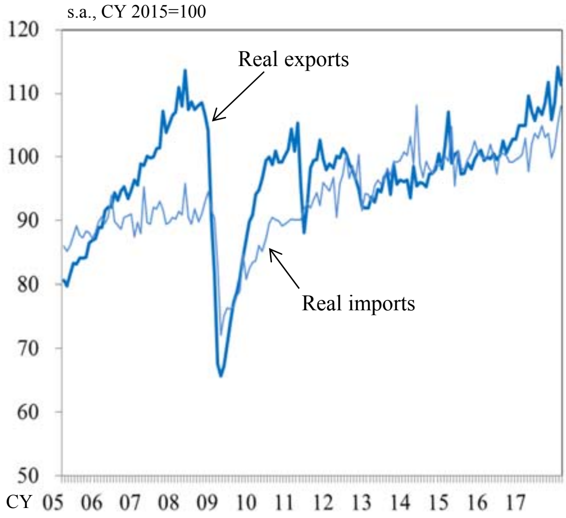
	2016		2017		
	3Q	4Q	1Q	2Q	3Q
Real GDP	0.2	0.3	0.4	0.7	0.6
[ann., q/q]	[0.9]	[1.4]	[1.5]	[2.9]	[2.5]
Private Consumption	0.4	0.1	0.4	0.9	-0.5
Private Non-Resi. Investment	-0.2	1.5	0.2	1.2	1.1
Private Residential Investment	3.0	0.2	0.9	1.3	-1.0
Public Demand	0.4	-0.7	0.2	1.1	-0.5
Exports of Goods & Services	2.1	3.0	1.9	-0.1	1.5

Source: Cabinet Office.

Chart 4

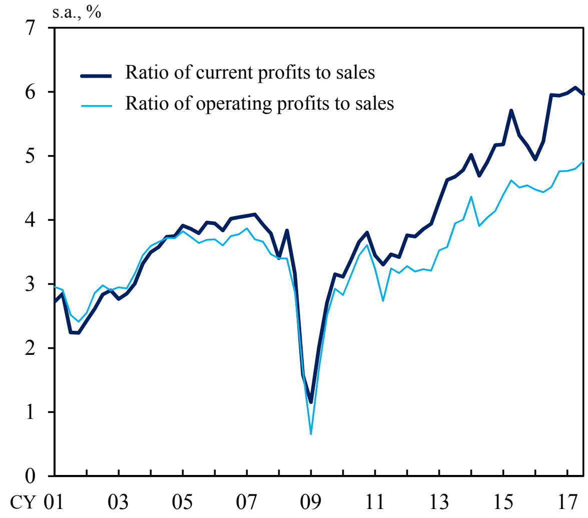
Exports and Corporate Profits

Real Exports and Real Imports



Source: Bank of Japan.

Corporate Profits

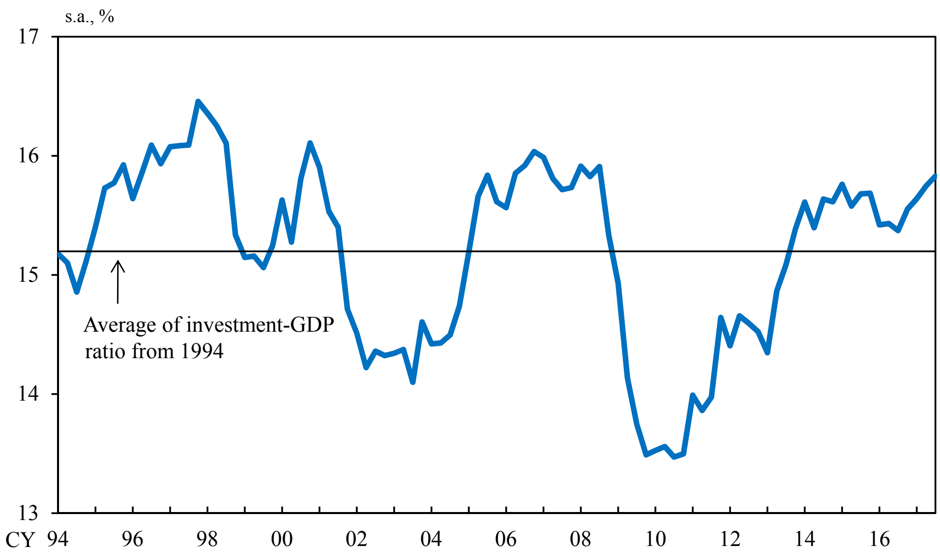


Source: Ministry of Finance.
Note: Based on the "Financial Statements Statistics of Corporations by Industry, Quarterly." Excluding "finance and insurance."

Chart 5

Business Fixed Investment

Investment-GDP Ratio (Nominal)



Source: Cabinet Office.

Chart 6

Regional Economic Assessments

Comparison of Previous and Current Assessments by Region (Regional Economic Report)

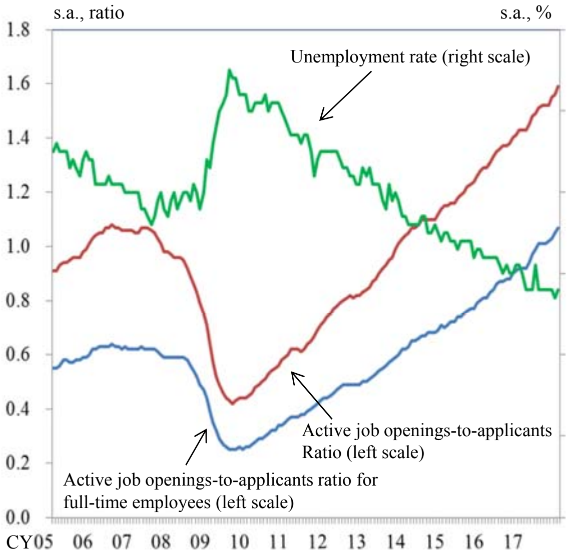
Region	Assessment in October 2017	Changes from the previous assessment	Assessment in January 2018
Hokkaido	The economy has been recovering.	→	The economy has been recovering.
Tohoku	The economy has continued its moderate recovery trend.	↗	The economy has continued to recover moderately.
Hokuriku	The economy has been expanding moderately.	↗	The economy has been expanding.
Kanto-Koshinetsu	The economy has been expanding moderately.	→	The economy has been expanding moderately.
Tokai	The economy has been expanding.	→	The economy has been expanding.
Kinki	The economy has been expanding moderately.	↗	The economy has been expanding moderately, with its growth becoming more solid.
Chugoku	The economy has been expanding moderately.	→	The economy has been expanding moderately.
Shikoku	The economy has continued to recover moderately.	→	The economy has continued to recover moderately.
Kyushu-Okinawa	The economy has been expanding moderately.	→	The economy has been expanding moderately.

Source: Bank of Japan.

Chart 7

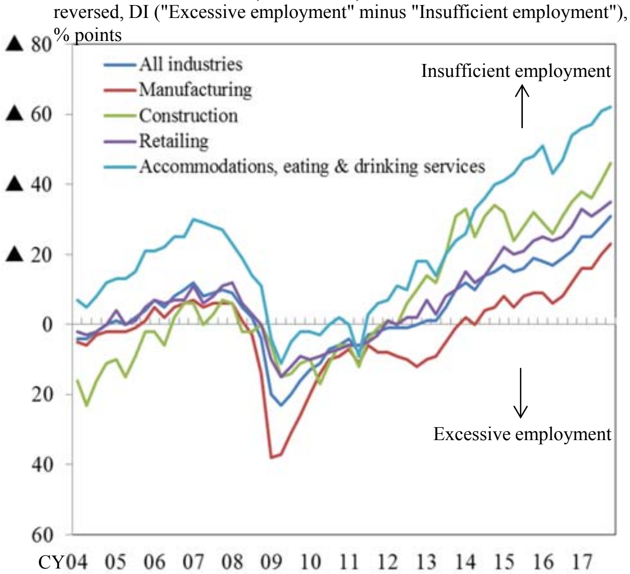
Labor Market Conditions

Unemployment Rate and Active Job Openings-to-Applicants Ratio



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

Diffusion Index of Employment Conditions (*Tankan*)



Source: Bank of Japan.

Chart 8

"Outlook for Economic Activity and Prices"

(January 2018)

Forecasts of the Majority of Policy Board Members

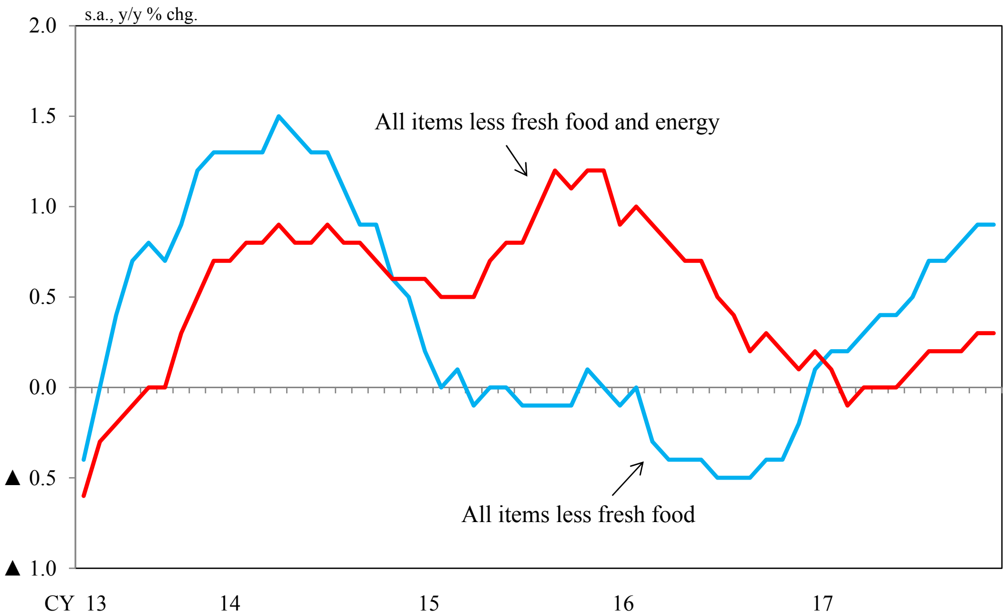
y/y % chg.

	Real GDP	CPI (all items less fresh food)
Fiscal 2017	+1.8 to +2.0 [+1.9]	+0.7 to +1.0 [+0.8]
Forecasts made in October 2017	+1.7 to +2.0 [+1.9]	+0.7 to +1.0 [+0.8]
Fiscal 2018	+1.3 to +1.5 [+1.4]	+1.3 to +1.6 [+1.4]
Forecasts made in October 2017	+1.2 to +1.4 [+1.4]	+1.1 to +1.6 [+1.4]
Fiscal 2019	+0.7 to +0.9 [+0.7]	+1.5 to +2.0 [+1.8]
Forecasts made in October 2017	+0.7 to +0.8 [+0.7]	+1.5 to +2.0 [+1.8]

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

Chart 9

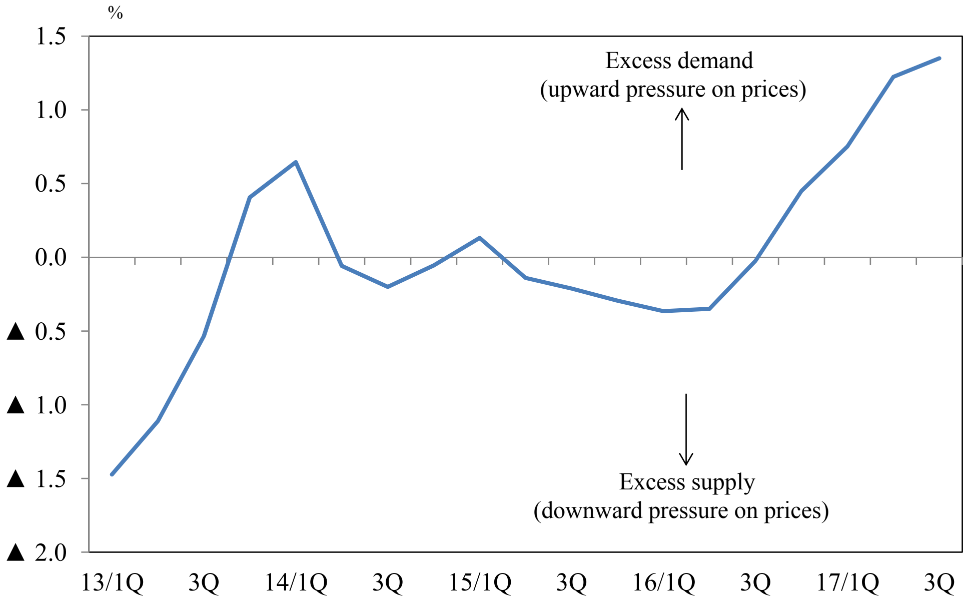
CPI



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

Chart 10

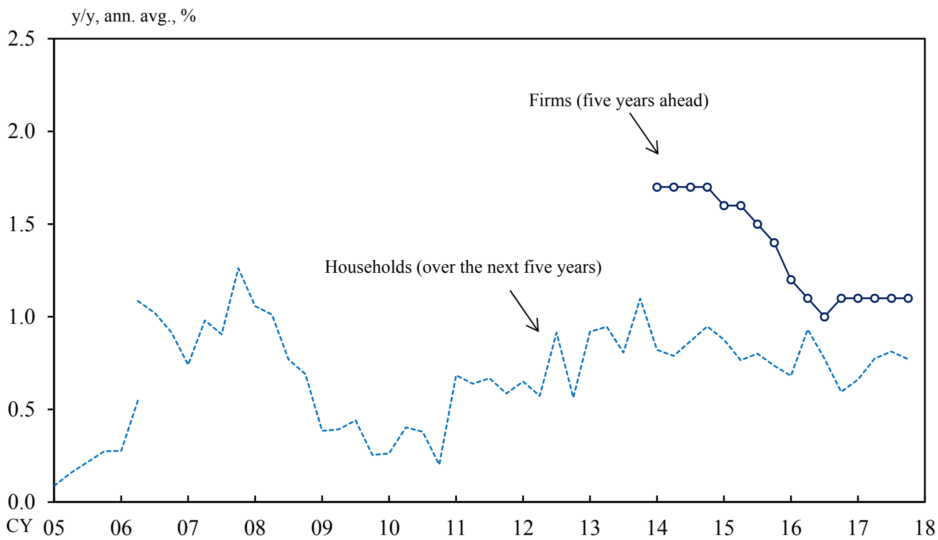
Output Gap



Source: Bank of Japan.
Note: Based on staff estimations.

Chart 11

Inflation Expectations (Survey)

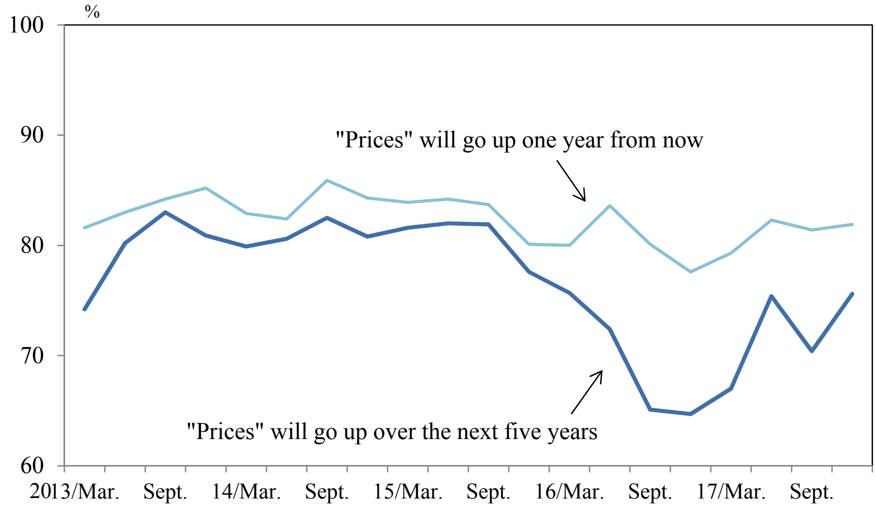


Source: Bank of Japan.
Notes: 1. Figures for households are from the *Opinion Survey on the General Public's Views and Behavior*, estimated using the modified Carlson-Parkin method.
2. Figures for firms are "Outlook for General Prices (*Tankan*, all Industries and enterprises, average)."

Chart 12

Outlook for Price Levels

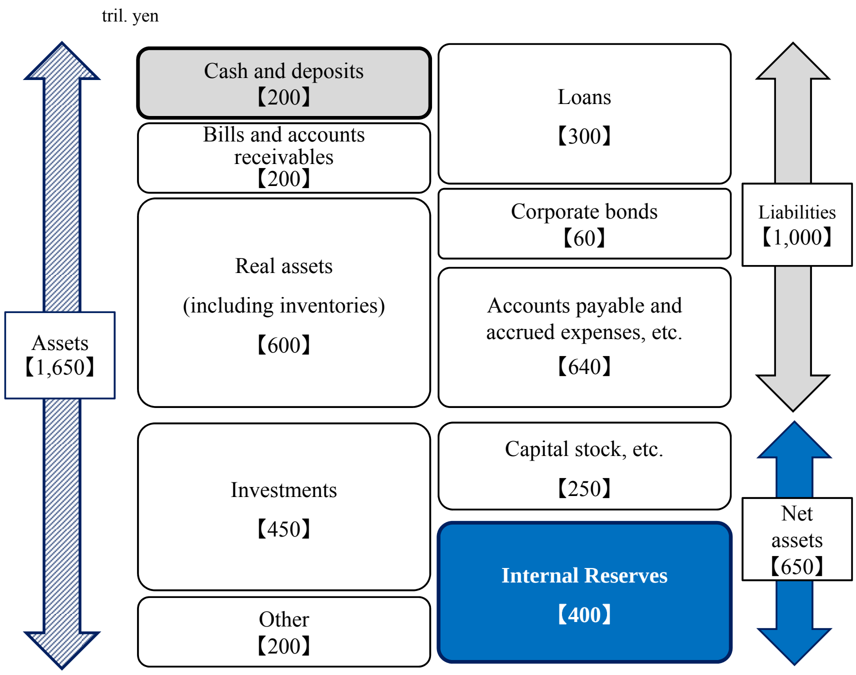
Results of the 72nd *Opinion Survey on the General Public's Views and Behavior* (December 2017 Survey)



Source: Bank of Japan.
Note: Figures for both one year from now and over the next five years comprise the choices "will go up significantly" and "will go up slightly" that are found in the questionnaire.

Chart 13

Balance Sheet of Nonfinancial Corporations

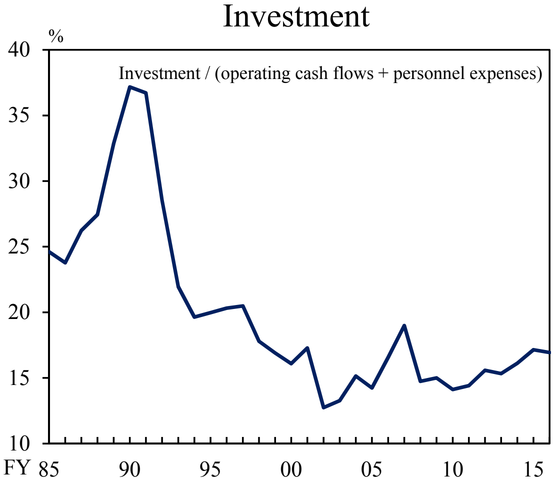


Source: Ministry of Finance; Bank of Japan; Japan Securities Dealers Association.
Note: Figures in brackets are the amount outstanding of each component at the end of fiscal 2016 (approximation).

Chart 14

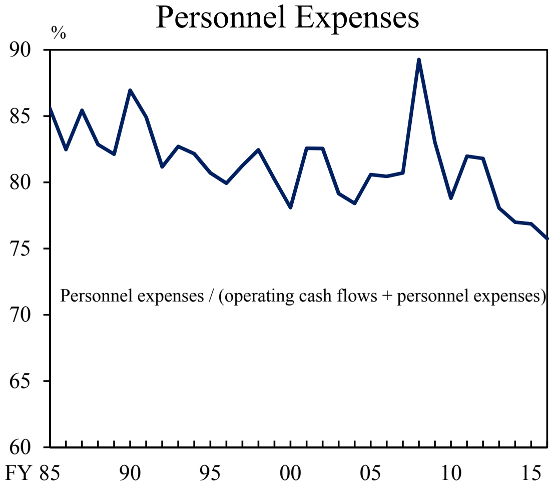
Investment and Personnel Expenses

Investment



Source: Ministry of Finance.
Notes: 1. Figures for "operating cash flows," "personnel expenses," and "investment" are based on the "Financial Statements Statistics of Corporations by Industry, Annually." Excluding "finance and insurance."
2. Operating cash flows are defined as follows:
Operating cash flows = net income – dividends + depreciation expenses + Δprovisions – Δinventories – Δtrade credits – Δnet amount of other current assets.
3. Investment includes land purchasing expenses and excludes software and R&D investment.

Personnel Expenses

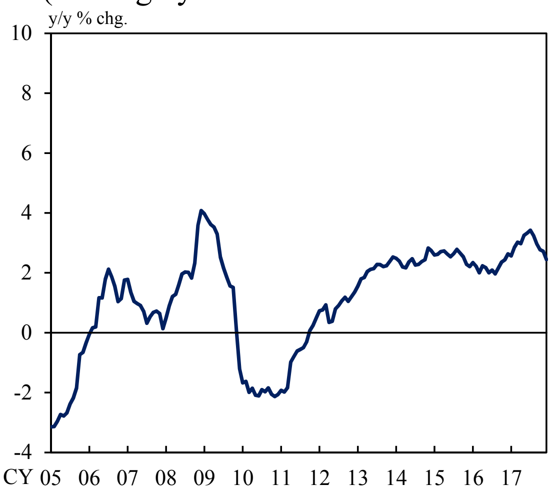


Source: Ministry of Finance.
Notes: 1. Based on the "Financial Statements Statistics of Corporations by Industry, Annually." Excluding "finance and insurance."
2. The definition of operating cash flows is the same as in the left chart.

Chart 15

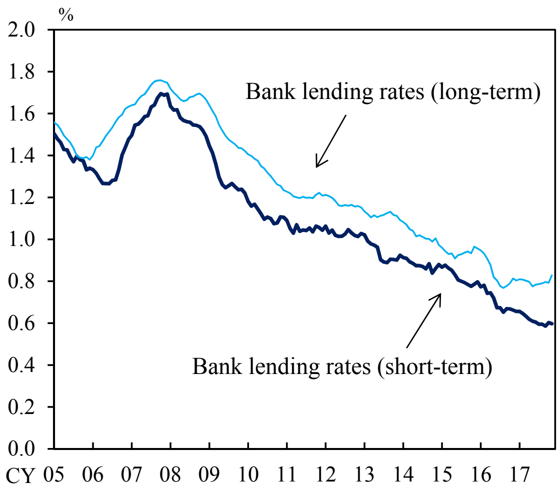
Bank Lending

Amount Outstanding of Bank Loans (lending by domestic commercial banks)



Source: Bank of Japan.
Note: Figures are year-on-year percent changes in the monthly average of the amount outstanding.

Bank Lending Rates



Source: Bank of Japan.
Note: Figures are 6-month backward moving averages.