September 25, 2018

Bank of Japan

Japan's Economy and Monetary Policy

Speech at a Meeting with Business Leaders in Osaka

Haruhiko Kuroda

Governor of the Bank of Japan

(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 Kansai 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 branches in Osaka, Kobe, and Kyoto.

In my speech today, I would like to first talk about the Bank's view on the recent developments in economic activity and prices, and then explain its thinking behind the conduct of monetary policy.

I. Economic Developments

Let me start by talking about economic developments. Japan's economy is expanding moderately, with a virtuous cycle from income to spending being maintained in both the corporate and household sectors. Although the real GDP growth rate for the January-March quarter temporarily marked negative growth, due mainly to irregular weather, after continuing to register positive growth for eight consecutive quarters, the rate for the April-June quarter showed a return to firm growth, representing 3.0 percent on an annualized basis (Chart 1).

The long-lasting recovery of Japan's economy is likely to be mainly attributable to both external and domestic demand increasing in a well-balanced manner. As for external demand, exports have continued on an increasing trend, exceeding the peak before the global financial crisis, led mainly by those of capital goods and IT-related goods, in which Japan has a comparative advantage (Chart 2). Looking at the underlying developments in overseas economies in detail, the U.S. economy has continued to expand firmly, with the growth rate for the April-June quarter registering 4 percent on an annualized basis. Firms' sentiment has continued to improve in both the manufacturing and nonmanufacturing sectors, and there has been positive momentum in private consumption on the back of the favorable employment and income situation. Meanwhile, the European economy has continued to recover on the whole with business fixed investment and private consumption following an uptrend; however, exports recently have decelerated somewhat, due mainly to the effects of the appreciation of the euro. As for emerging economies, the Chinese economy has continued to see stable growth on the whole with private investment and consumption remaining firm, although growth in infrastructure investment has decelerated somewhat. Other emerging economies, mainly Asian economies, have been recovering moderately, reflecting in part an increase in exports and the effects of their economic stimulus measures. Thus, while the momentum of economic recovery differs to some extent across countries and regions, the Bank judges that overseas economies have continued to grow firmly on the whole.

Turning to the domestic situation, in the corporate sector, the profit environment has remained favorable, with the ratio of current profits to sales having been at a record high level (Chart 3). Under these circumstances, according to the Bank's June *Tankan* (Short-Term Economic Survey of Enterprises in Japan), firms' business fixed investment plans for fiscal 2018 showed the highest growth for this time of the year since the survey started. In the manufacturing sector, there has been a notable increase in research and development investment with a view to advancing next-generation technology such as self-driving systems and large-capacity batteries, in addition to investment intended for capacity expansion on the back of firm domestic and external demand. In the nonmanufacturing sector, investment aimed at improving efficiency and saving labor in order to deal with the recent labor shortage has maintained its high growth. Such improvement in the corporate sector has had positive effects on the household sector. In the labor market, the active job openings-to-applicants ratio is currently 1.63, the high level last seen during the period of high economic growth, and the unemployment rate has declined to around 2.5 percent, the level observed during the bubble period (Chart 4). While the number of employees has registered a year-on-year growth rate of around 2 percent, total cash earnings per employee have risen moderately but steadily, led mainly by those of part-time employees. Against the background of such improvement in the employment and income situation, private consumption has been increasing moderately, albeit with fluctuations.

In terms of the contribution to economic growth, the recent increase in demand from foreign visitors cannot be ignored. Sales of duty free goods at department stores in the first half of this year registered an annual increase of close to 50 percent, and the occupancy rates of city hotels have maintained the high level of almost 80 percent for the past few years. On this point, as big events such as the Rugby World Cup and the G-20 summit are scheduled to be held in Osaka next year, I hear that the construction of new hotels and rebuilding of existing facilities have been taking place successively. As for the typhoon at the beginning of September, the Bank will make efforts to firmly grasp the impact of the damage caused, and expects that both the public and private sectors will work together to overcome the disaster and create regions that are even stronger and more attractive.

So far, I have explained that Japan's economy has been improving, led by external and domestic demand in a well-balanced manner. With regard to the outlook, the economy is likely to continue its moderate expansion. However, there are various risks to this baseline scenario, and uncertainties regarding overseas economies in particular warrant attention. For example, it is necessary to thoroughly examine the extent to which recent protectionist moves, such as the trade friction between the United States and China, will affect trade as well as firms' investment activities. There have been active discussions over this issue at international conferences that I have taken part in, including the G-20 and G-7 meetings. In addition, the International Monetary Fund (IMF) recently released a simulation analysis of the effects of protectionist moves on the global economy. According to the simulation, downward pressure on the global economy stemming from stagnation in trade activity itself is likely to be 0.1 percentage point at most in the next five years. However, if such protectionist moves bring about turmoil in global financial markets and deterioration in firms' sentiment, downward pressure on the global economy is expected to be around 0.5 percentage point at most. Global economies have become more interdependent than ever before, with the recent progress in globalization and information technology. In this situation, it is clear that protectionist policies will not benefit any economy, regardless of whether it adopts such policies. Therefore, while a brake is expected to be put on excessive protectionist moves at some point, it is essential to continue global discussion to ensure this and to make sure that protectionist moves will not create instability in financial markets and firms' sentiment.

Moreover, attention also should be paid to the effects that moves toward monetary policy normalization, including the policy rate hikes in the United States, will have on global capital flows and emerging economies. In fact, some emerging economies such as Turkey and Argentina -- where there are vulnerabilities in the economy including twin deficits and high inflation -- are confronted with a significant depreciation of their currencies, as the inflow of dollar-based capital into these economies has turned to an outflow. That said, the fundamentals of many other emerging economies including Asian economies have been firm, and the Federal Reserve seems to be conducting its policy by carefully taking account of developments in global financial markets and the global economy. Thus, it is fairly unlikely at this point that the problems happening in some emerging economies will spread widely. However, as sudden changes could arise in the market, we will continue to carefully examine developments in global financial markets and emerging economies.

II. Price Developments

Now I will move on to price developments. Prices have continued to show relatively weak developments compared to the economic expansion and the labor market tightening, and the year-on-year rate of change in the consumer price index (CPI) excluding fresh food and energy prices has been in the range of 0.0-0.5 percent (Chart 5). After five years, Japan's economy is no longer in deflation, in the sense of a sustained decline in prices, but the Bank's price stability target of 2 percent inflation on an annual basis has not yet been achieved. For this reason, in the *Outlook for Economic Activity and Prices* (Outlook Report) released at the end of July, the Bank focused on examining the reasons for these sluggish price developments and updated the outlook for economic activity and prices. Today, I would like to outline some key points of the report.

The first point is the reason why prices have been sluggish even though the economy has improved steadily. Basically, this is likely to be mainly attributable to the experience of prolonged low growth and deflation. The long and severe adjustment phase since the second half of the 1990s, including the financial crisis, brought about sluggishness in economic activity and asset prices. Under these circumstances, firms' wage- and price-setting stance as well as households' views toward price rises have become cautious. The Bank introduced quantitative and qualitative monetary easing (QQE) in 2013 and has been persistently conducting powerful monetary easing. However, as the mindset and behavior based on the assumption that wages and prices will not increase easily have become embedded in the economy over a long period of time, it has been taking time for the situation to change.

In addition to such basic factors, the large room to raise productivity, mainly in the nonmanufacturing sector, as well as the technological progress such as digitalization in recent years, have allowed firms to maintain their cautious stance toward raising prices despite an increase in labor costs. For instance, many firms in the accommodations as well as eating and drinking services sectors have been compensating for a rise in personnel expenses by introducing online reservation and ordering systems using tablet devices. In addition, a further increase in labor participation by women and seniors in the past few years has eased labor shortage in part, serving as a factor slowing the pace of wage increases. In the long term, such moves are likely to strengthen the economy's growth potential and make firms' and households' spending activities more active, thereby contributing to pushing up prices. At least in the short term, however, these moves will weaken upward pressure on wages and prices due to the reasons I mentioned earlier.

The second point concerning prices in Japan is that the mechanism for a rise in inflation itself is not lost, although its pace is sluggish. Moves to raise sales prices have been observed recently among a wide range of firms, reflecting rises in personnel expenses and prices of raw materials as well as components. Also, according to the *Tankan*, for the first time in about 10 years, the number of enterprises answering that the output prices have risen has been exceeding the number of those answering that such prices have fallen (Chart 6). Going forward, with the heightening perception of labor shortage, as wages of part-time employees continue to increase, its effects are likely to spread to wages of regular employees, mainly among small and medium-sized firms and the younger generations. In fact, at this year's annual spring labor-management wage negotiations, the rise in the rate of increase in base pay was more evident for small and medium-sized firms than for large firms, and summer bonuses increased more significantly than last year. Such moves are expected to ease consumers' cost-saving mentality and price rises by firms are likely to be more easily accepted accordingly.

In this way, as a high level of utilization of labor and capital, or an improved output gap, is sustained, many of the factors that have been delaying inflation -- such as firms' cautious wage- and price-setting stance as well as households' cautiousness toward price rises -- will likely be resolved gradually. When further price rises come to be observed widely as a result of this, people's medium- to long-term inflation expectations are projected to rise gradually. As a consequence, the year-on-year rate of change in the CPI is likely to increase gradually toward the price stability target of 2 percent, although it will take more time than expected. In the July Outlook Report, the Bank projected that the year-on-year rates of change in the CPI (less fresh food) for fiscal 2018 through fiscal 2020 would likely be 1.1 percent, 1.5 percent, and 1.6 percent, respectively. We are in a difficult situation in terms of achieving 2 percent inflation by fiscal 2020. Nevertheless, maintaining a positive output gap -- a driver for a rise in inflation -- for a long time, which will firmly push up actual prices as well as inflation expectations, as I just mentioned, is likely to be the most certain path toward achieving 2 percent inflation.

III. The Bank's Conduct of Monetary Policy

Lastly, I would like to talk about the Bank's thinking behind the conduct of monetary policy.

The Bank has been conducting powerful monetary easing under the framework of "QQE with Yield Curve Control," aiming to achieve the price stability target of 2 percent (Chart 7). In terms of yield curve control, with a view to facilitating the formation of the yield curve that is considered most appropriate for achieving 2 percent inflation, the Bank has purchased Japanese government bonds (JGBs) under the guideline for market operations, in which it sets the short-term policy interest rate at minus 0.1 percent and the target level of 10-year JGB yields at around zero percent. Under the circumstances, not only JGB yields, but also lending rates for firms as well as issuance rates for corporate bonds have remained at extremely low levels, and the amount outstanding of bank lending has been increasing. In addition, the Bank has purchased exchange-traded funds (ETFs) so that their amount outstanding will increase at an annual pace of about 6 trillion yen, with a view to lowering risk premia in the stock market and exerting positive effects on economic activity and prices.

As I mentioned earlier, it is likely to take more time than expected to achieve 2 percent inflation. On the other hand, the mechanism whereby an improvement in the output gap leads to a rise in inflation has continued to operate. Considering such situation, the Bank judged it important to persistently continue with powerful monetary easing and decided at the July 2018 Monetary Policy Meeting (MPM) to strengthen the policy framework as follows (Chart 8).

First, the Bank introduced forward guidance for policy rates. Specifically, it publicly made clear to "maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices including the effects of the consumption tax hike scheduled to take place in October 2019." This is based on the recognition that, in a situation where achieving 2 percent inflation is taking time, simply stating that it will persistently continue with monetary easing cannot sufficiently ensure public confidence regarding its monetary policy. I hope the introduction of forward guidance makes clear the Bank's strong policy stance toward achieving the price stability target.

With regard to this forward guidance, some point out that it is difficult to understand how long "for an extended period of time" means. First of all, as the words imply, it is not based on a specific period of time. The phrase "for an extended period of time" was often used by other central banks, presumably implying a fairly long period of time. Partly because central banks in the United States and Europe are proceeding with monetary policy normalization recently, some market participants speculated that a policy rate hike would take place soon even in Japan. However, the situation regarding the price stability target in Japan differs substantially from that in the United States and Europe. In terms of clarifying this point, it is very important to make clear that the Bank will maintain the current extremely low levels of short- and long-term interest rates for an extended period of time.

Of course, "for an extended period of time" does not mean permanently. Such being the case, some may think that the period for which interest rate levels will be maintained should be linked to a specific period of time or price indicators, in order to ensure the effectiveness of the commitment. However, there are various uncertainties regarding economic activity and prices in Japan, as I mentioned earlier. Therefore, in designing forward guidance, we need to ensure not only the effectiveness of the commitment, but also the flexibility of the future policy conduct, and in a balanced manner. The same applies to forward guidance by other central banks. That is, in the initial stage following its introduction, as is the case in

Japan, it is common to commit to maintaining interest rate levels while presenting qualitative conditions such as the economic situation and risk assessments, focusing rather on the flexibility of the policy conduct.

In addition to the introduction of forward guidance, the Bank decided at the July MPM to enhance the sustainability of "QQE with Yield Curve Control." In persistently continuing with monetary easing, it is necessary to make adjustments to the policy framework so that it can function in a competent manner over the period of the easing's duration. For example, while the current target level of 10-year JGB yields is around zero percent, as I mentioned earlier, the Bank made it clear that, under the target, the long-term yields might move upward and downward to some extent mainly depending on developments in economic activity and prices, thereby conducting market operations in a more flexible manner. Yield curve control is an essential measure in stabilizing interest rates in Japan at low levels. On the other hand, because it is powerful, interest rate formation in the JGB market has been somewhat rigid, and there has been a notable decline in transactions. It is considered that the measures decided at the July MPM will mitigate the side effects accompanying such powerful monetary easing while facilitating the formation of an appropriate yield curve, and as a consequence, lead to enhancing the sustainability of the policy. In addition, as for ETF purchases, from the same aspect of enhancing the sustainability of the policy, the Bank made it clear that it might increase or decrease the amount of purchases depending on market conditions, while maintaining the annual pace of increase in the amount outstanding of about 6 trillion yen.

Almost two months have passed since this policy decision was made. So far, stock prices and foreign exchange rates have been stable on the whole, and the Bank recognizes that its policy intention was accepted by market participants without misunderstanding. Meanwhile, in the JGB market, transactions have become more active and price movements have increased somewhat (Chart 9). According to a survey conducted in August, the proportion of respondents answering that the degree of bond market functioning "has improved" exceeded the proportion of those answering that it "has decreased" for the first time in about three years. As market transactions usually tend to decrease in summer and it is difficult to grasp actual developments, the Bank will continue to thoroughly examine the degree of recovery in market functioning.

I have been given the opportunity to talk to you at this time every year, and this is the sixth occasion for me to do so since taking office as Governor of the Bank of Japan in April 2013. Six years ago, economic recovery had just started and overcoming deflation was not in sight. Under such developments in economic activity and prices, it was necessary to decisively implement a large-scale policy, and thus the policy that should be taken and the Bank's thinking behind it were simple and clear. Over the past five years, Japan's economy has continued its long-lasting recovery, corporate profits have been at record highs, and the employment situation has improved substantially. Wages and prices are no longer seeing a sustained decline and have turned to an uptrend. However, achieving the price stability target of 2 percent is taking more time than expected. In such a situation where economic activity and prices have improved significantly but their developments have been somewhat varied, it is appropriate to conduct monetary policy by taking account of a variety of developments in a comprehensive manner. This means that, in continuing with powerful monetary easing, we now need to consider both its positive effects and side effects in a balanced manner. The latest policy response is indeed in line with this thinking, and the Bank's stance toward aiming at price stability with a view to contributing to the sound development of the national economy has not changed at all. Going forward, it will continue to make its utmost efforts as a central bank, taking account of developments in economic activity and prices as well as financial conditions, and thereby firmly support corporate activities in Japan.

Thank you very much for your attention.

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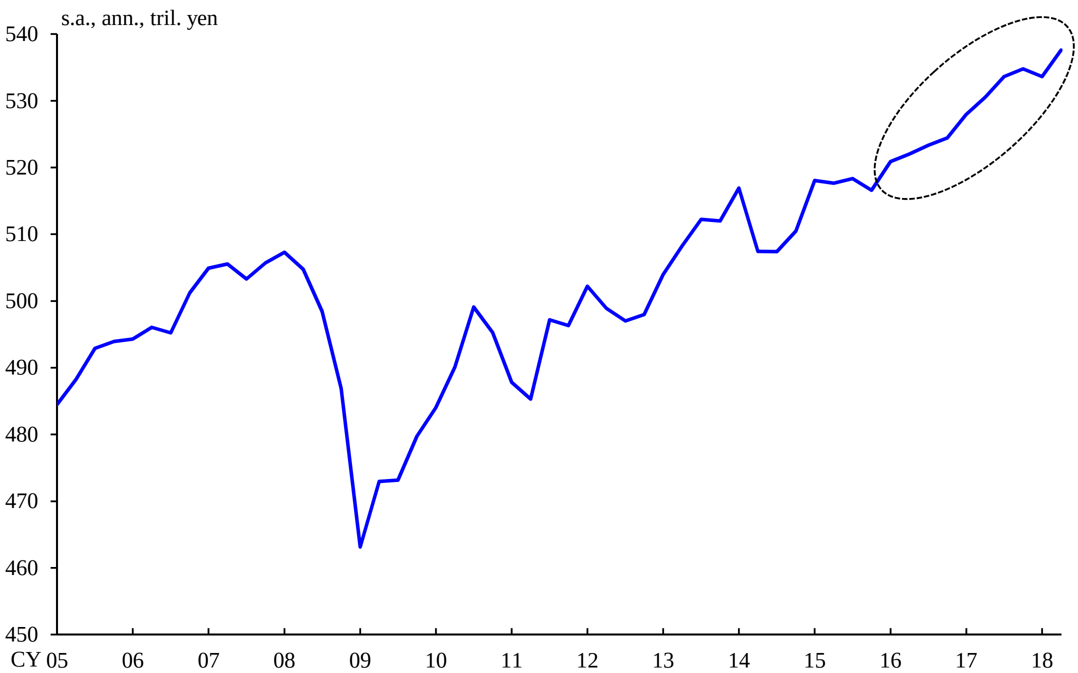
Chart 1

Japan's Economy

Real GDP

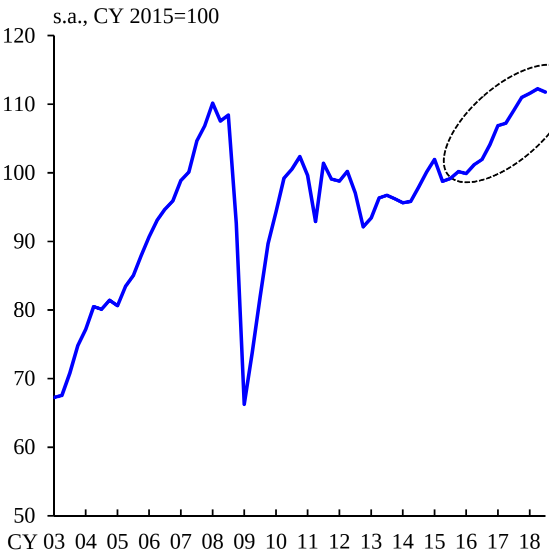


Source: Cabinet Office.

Chart 2

Exports and Overseas Economies

Real Exports



Projections for Major Economies (IMF)

y/y % chg.

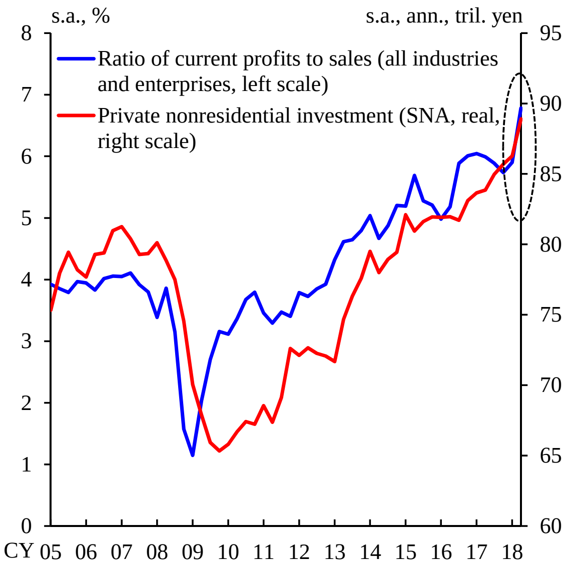
	2016	2017	2018 Projection	2019 Projection
World	3.2	3.7	**3.9**	**3.9**
Advanced economies	1.7	2.4	2.4	2.2
United States	1.5	2.3	2.9	2.7
Euro area	1.8	2.4	2.2	1.9
Japan	1.0	1.7	1.0	0.9
Emerging market and developing economies	4.4	4.7	4.9	5.1
China	6.7	6.9	6.6	6.4
ASEAN-5	4.9	5.3	5.3	5.3

Notes: 1. The figure for real exports for 2018/Q3 is the July-August average.
2. The post-2018 figures in the right table are based on July 2018 WEO projections.
Sources: IMF; Ministry of Finance; Bank of Japan.

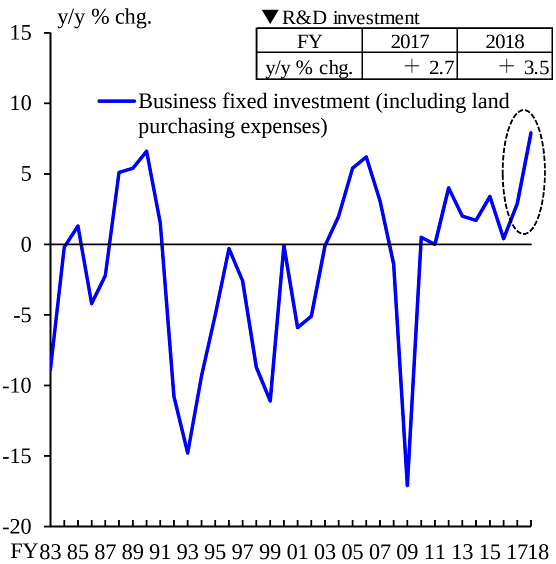
Chart 3

Corporate Profits and Business Fixed Investment

Corporate Profits



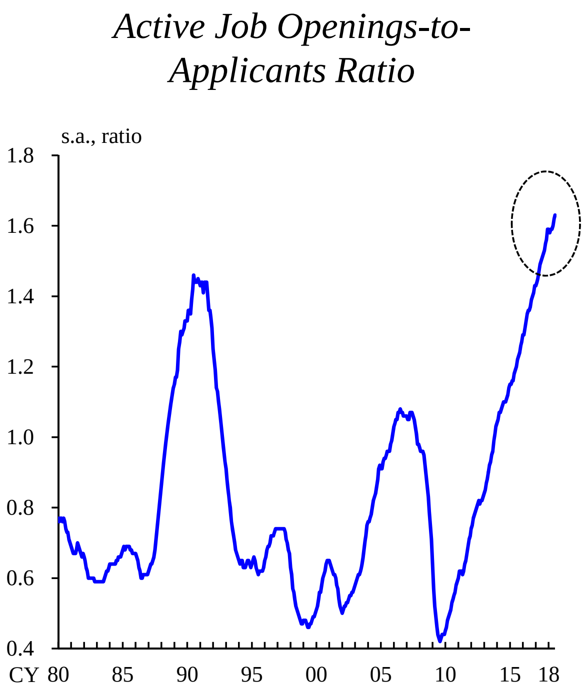
Business Fixed Investment Plans (June Tankan)

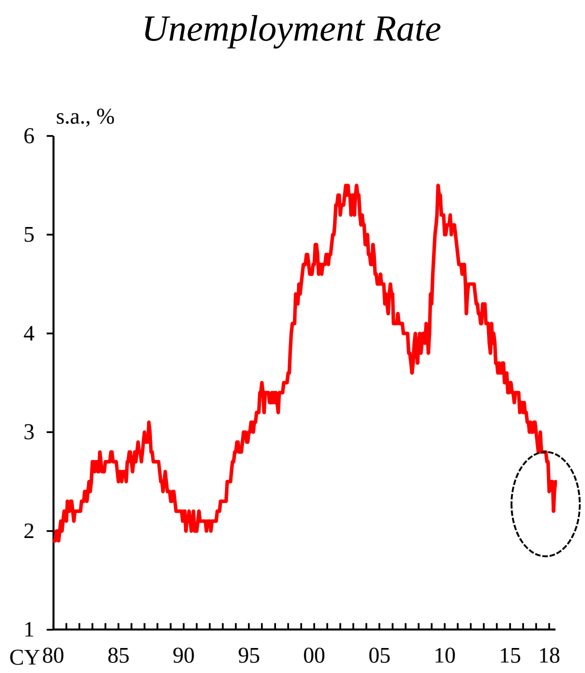


Notes: 1. Figures for ratio of current profits to sales are based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. Excluding "finance and insurance."
2. Figures for business fixed investment (including land purchasing expenses) and R&D investment are based on the plans as of June *Tankan* in each fiscal year (all enterprises).
Sources: Ministry of Finance; Cabinet Office; Bank of Japan.

Chart 4

Employment Situation

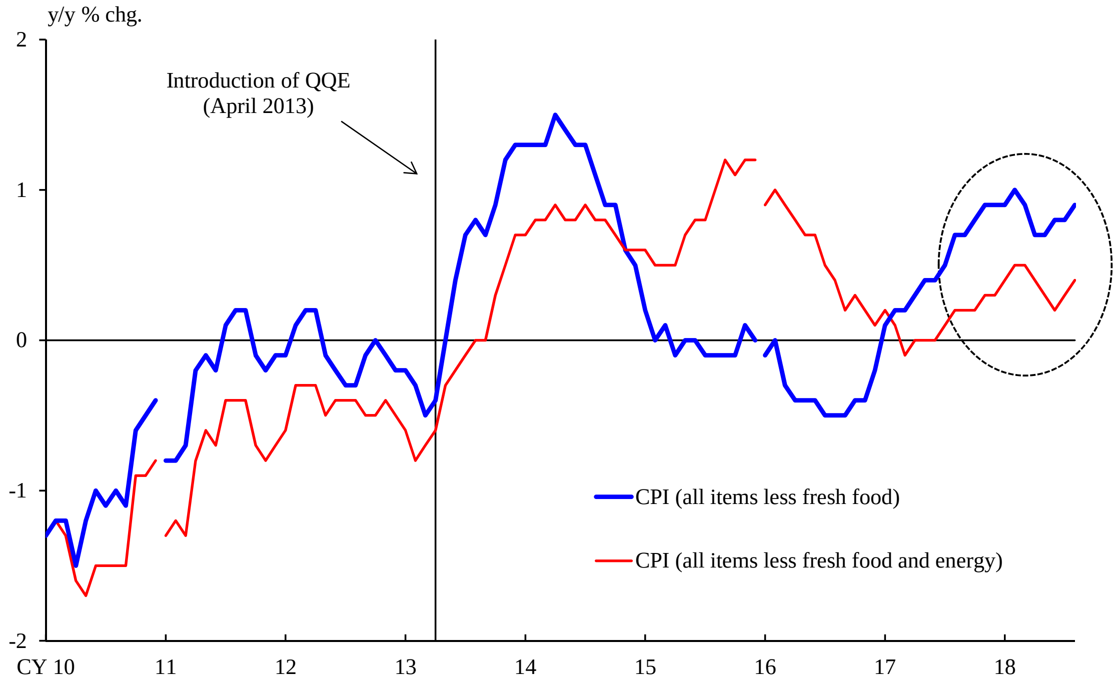




Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

Chart 5

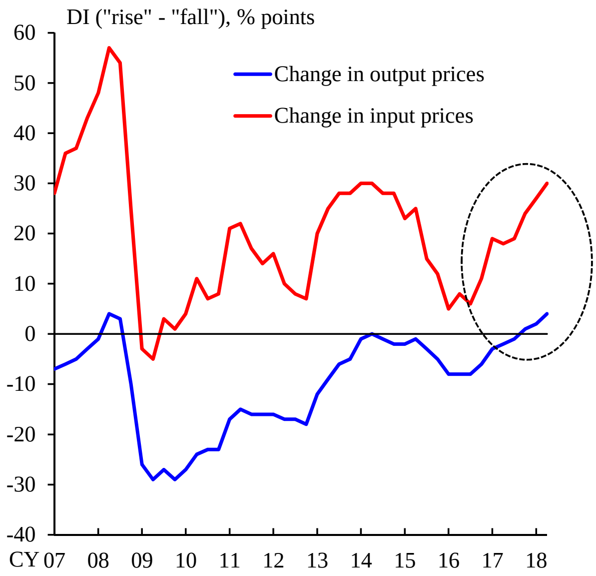
Consumer Prices



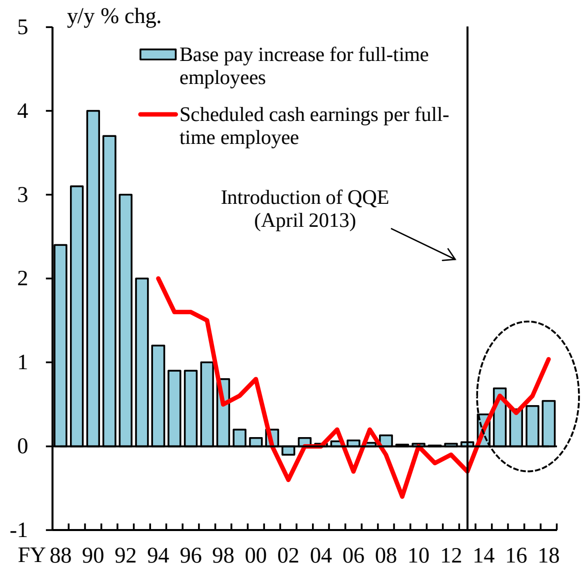
Note: The CPI figures are adjusted for changes in the consumption tax rate.
Source: Ministry of Internal Affairs and Communications.

Environment Surrounding Prices

Changes in Prices (Tankan)



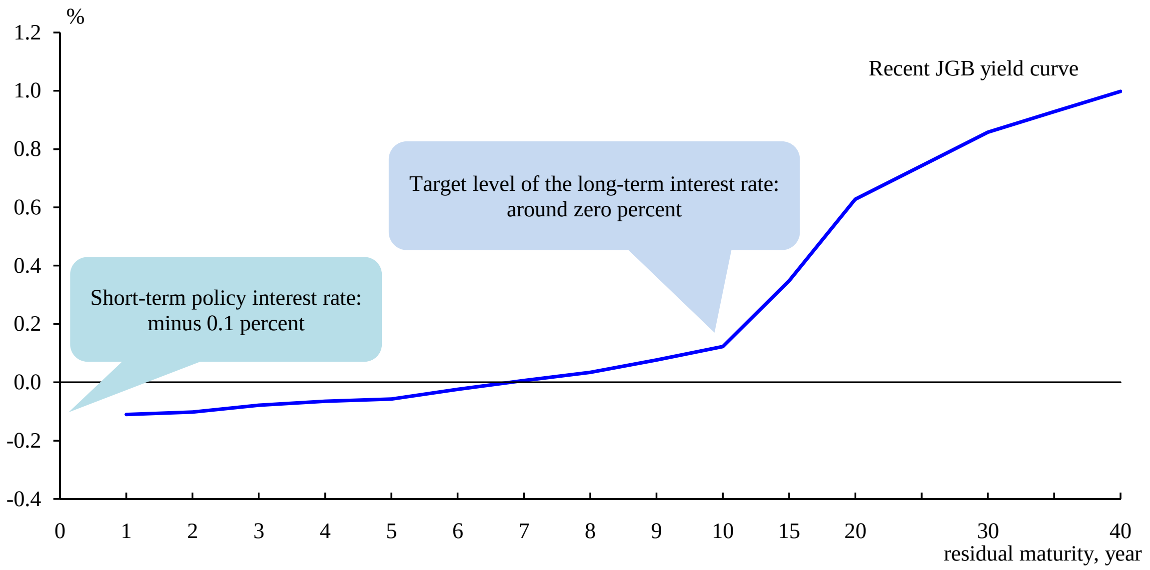
Nominal Wages



Notes: 1. Figures in the left chart are those of all enterprises.
2. In the right chart, the figure for scheduled cash earnings per full-time employee for FY 2018 is the April-July average. That for base pay increase for FY 2018 is as of July 6, 2018.
Sources: Ministry of Health, Labour and Welfare; Central Labour Relations Commission; Japanese Trade Union Confederation (Rengo); Bank of Japan.

Quantitative and Qualitative Monetary Easing with Yield Curve Control

Yield Curve Control



Source: Bloomberg.

Strengthening the Framework for Continuous Powerful Monetary Easing

Taking more time than expected to achieve the price stability target of 2 percent.
Maintaining the output gap as long as possible within positive territory is appropriate.

Persistently Continuing with Powerful Monetary Easing

Forward guidance for policy rates

"The Bank intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices including the effects of the consumption tax hike scheduled to take place in October 2019."

⇒ Strengthening the commitment to achieving the price stability target

Enhancing the sustainability of "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control"

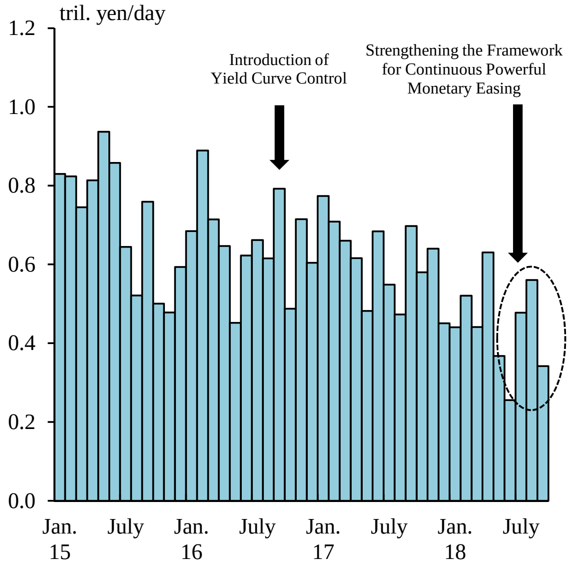
Long-term interest rate: The Bank maintains the target level of around zero percent. While doing so, the yields may move upward and downward to some extent mainly depending on developments in economic activity and prices.

Purchases of ETFs: The Bank maintains the annual pace of increase in the amount outstanding of about 6 trillion yen. While doing so, the Bank may increase or decrease the amount of purchases depending on market conditions. etc.

Achieving the price stability target of 2 percent at the earliest possible time while securing stability in economic and financial conditions.

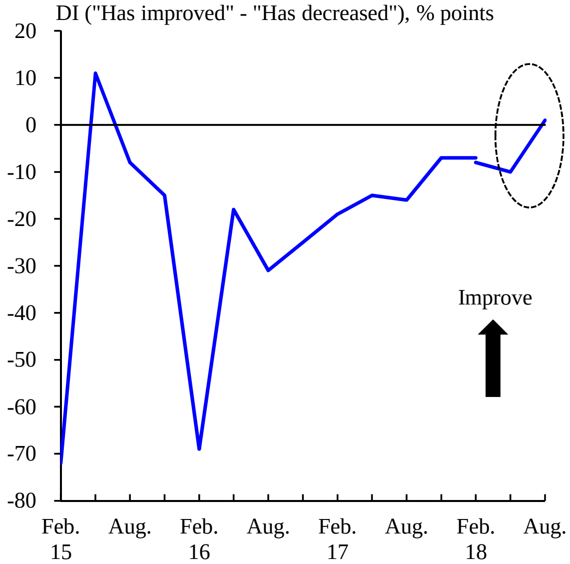
JGB Market

Transaction Volume for JGBs



Bond Market Survey

Degree of Bond Market Functioning (Change from Three Months Ago)



Notes: 1. The left chart shows the trading volume via the Japan Bond Trading. Excluding T-bills, etc. The figure for September 2018 is the September 1-20 average.
2. In the right chart, the survey from February 2018 onward includes responses from major insurance companies, asset management companies, etc., in addition to those from eligible institutions for the Bank's outright purchases and sales of JGBs. The latest survey was conducted from August 8-16, 2018.

Sources: QUICK; Bank of Japan.