



November 7, 2018

Bank of Japan

**Economic Activity, Prices,
and Monetary Policy in Japan**

Speech at a Meeting with Business Leaders in Kochi

Yukitoshi Funo

Member of the Policy Board

(English translation based on the Japanese original)

I. Recent Economic and Price Developments

A. Overseas Developments

I would like to begin my speech by talking about overseas economies. The business sentiment of manufacturing firms on a global basis has maintained its improving trend, although it recently has deteriorated somewhat, and the world trade volume has continued to recover. In this situation, overseas economies have continued to grow firmly on the whole.

In terms of the outlook, overseas economies are expected to continue growing firmly on the whole. According to the October 2018 *World Economic Outlook* released by the International Monetary Fund (IMF), the global growth rate is projected to be 3.7 percent in both 2018 and 2019.

Looking at developments by major region, the U.S. economy has been expanding. The European economy has continued to recover, although its growth pace has decelerated somewhat. The Chinese economy has continued to see stable growth on the whole. Other emerging economies and commodity-exporting economies have been recovering moderately on the whole, reflecting in particular an increase in exports and the effects of those economies' stimulus measures.

As for the outlook, the U.S. economy is expected to keep expanding and the European economy is projected to continue recovering. The Chinese economy is likely to broadly follow a stable growth path as authorities conduct fiscal and monetary policy in a timely manner. Other emerging economies and commodity-exporting economies are likely to continue their moderate recovery on the whole.

Risk factors to the overseas economic outlook are wide ranging, as exemplified by (1) the U.S. macroeconomic policies and their impact on global financial markets, (2) the consequences of protectionist moves and their effects, (3) developments in emerging and commodity-exporting economies, including the effects of the two factors I just mentioned, (4) negotiations on the United Kingdom's exit from the European Union (EU) and their effects, and (5) geopolitical risks. Uncertainty is particularly high regarding future

developments in trade policies worldwide, and therefore these developments warrant attention. I hold the view that it is important to stay vigilant regarding these risk factors, especially now that overseas economies are continuing to grow firmly on the whole.

B. Japan's Economy and Prices

1. Economic activity

I will now discuss the economic situation in Japan. The economy is expanding moderately, with a virtuous cycle from income to spending operating. The real GDP growth rate registered minus 0.9 percent for the January-March quarter of 2018 on an annualized quarter-on-quarter basis, and thereafter marked 3.0 percent for the April-June quarter, which was above the economy's potential growth rate.¹ While the contribution of net exports on real GDP growth has remained slightly negative, that of domestic demand has turned positive.

With regard to the outlook, Japan's economy is likely to continue its moderate expansion. In fiscal 2018, the economy will probably continue growing at a pace above its potential. Namely, 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, mainly against the background of highly accommodative financial conditions and the underpinnings through government spending. In Kochi Prefecture, given the favorable situation in domestic demand, various measures have been taken such as events to commemorate the 150th anniversary of the Meiji Restoration, and it is expected that these events will increase tourist numbers. In terms of Japan's exports, these are expected to continue their moderate increasing trend, with overseas economies expected to grow firmly on the whole. In fiscal 2019 and 2020, Japan's economy is expected to continue on an expanding trend although the growth pace is projected to decelerate due to a slowdown in domestic demand, reflecting the effects of the scheduled consumption tax hike, cyclical adjustments in capital

¹ Under a specific methodology, Japan's potential growth rate is estimated to be in the range of 0.5-1.0 percent. However, the estimate of the potential growth rate varies depending on the methodologies employed and could be revised as the sample period becomes longer over time. Thus, it should be regarded as being subject to a considerable margin of error.

stock, and Olympic Games-related demand peaking out.² According to the October 2018 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) released by the Bank of Japan, the medians of the Policy Board members' forecasts of the economic growth rate are 1.4 percent for fiscal 2018, and 0.8 percent each for fiscal 2019 and 2020.

2. Prices

Let me now explain price developments. Although the year-on-year rate of change in the consumer price index (CPI) for all items less fresh food is at around 1.0 percent, it has continued to show relatively weak developments compared to the economic expansion and labor market tightening, remaining at around 0.5 percent excluding the effects of energy prices.

With regard to the outlook, medium- to long-term inflation expectations are projected to rise gradually as firms' stance is likely to gradually shift toward further raising wages and prices with the output gap remaining positive. As a consequence, the year-on-year rate of change in the CPI (all items less fresh food) is likely to increase gradually toward 2 percent. 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 October 2018 Outlook Report are 0.9 percent for fiscal 2018, and, excluding the direct effects of the scheduled consumption tax hike, 1.4 percent for fiscal 2019 and 1.5 percent for fiscal 2020.³

² It is assumed that the consumption tax will be raised to 10 percent in October 2019 and that a reduced tax rate will be applied to food and beverages -- excluding alcohol and dining-out -- and newspapers. Policies concerning the provision of free education are also factored into the forecasts, based on information available as of October 2018.

³ Assuming that the rise in the consumption tax will be fully passed on to prices of taxable items, excluding those to which a reduced tax rate will be applied, the effect of the October 2019 consumption tax hike on the year-on-year rate of change in the CPI (all items less fresh food) for October 2019 onward is estimated to be 1.0 percentage point; the effect for fiscal 2019 and 2020 is estimated to be 0.5 percentage point for each year. It also is assumed that the effects of policies concerning the provision of free education will not be reflected in the CPI, as statistical treatment of these effects is not yet decided.

II. Keys to Assessing the Outlook for Economic Activity and Prices

In what follows, I would like to discuss several points that I think deserve particular attention in terms of realizing the outlook for economic activity and prices that I mentioned earlier.

A. Supply-Demand Conditions in the Labor Market and the Income Situation

Let me first talk about supply-demand conditions in the labor market and the income situation. As the economy has continued its moderate expansion, the output gap has widened within positive territory; the figure for the April-June quarter of 2018 -- the most recent data available -- was about 2 percent. Furthermore, supply-demand conditions in the labor market have continued to tighten steadily. The year-on-year rate of increase in the *Labour Force Survey*-based number of employees has been at around 2 percent, and against this backdrop, the active job openings-to-applicants ratio has been at a level that exceeds the peak marked during the bubble period. Moreover, a perception of labor shortage suggested by the employment conditions diffusion index (DI) in the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) has heightened, and the unemployment rate has been around 2.5 percent recently. These indicators of supply-demand conditions in the labor market show that the degree of labor market tightness has been at around the level last seen in the first half of the 1990s or in the first half of the 1970s. In terms of the outlook, as Japan's economy is likely to continue on a growing trend at a pace above its potential, it is expected that the number of employees will keep increasing and that the supply-demand conditions in the labor market will continue to tighten steadily.

Amid such supply-demand conditions in the labor market, the year-on-year rate of increase in hourly scheduled cash earnings of part-time employees, which are responsive to supply-demand conditions in the labor market, has exhibited relatively high growth of around 2.0 percent on average. On the other hand, the year-on-year rate of increase in scheduled cash earnings of full-time employees has remained at around 0.5 percent. As a result, although total cash earnings per employee have been increasing moderately, albeit with fluctuations, the increases have remained relatively weak compared to the labor market tightening, partly due to the high wage elasticity of labor supply in recent years, mainly among women and seniors. With regard to the outlook, overall employees' hourly cash

earnings are projected to increase moderately at almost the same pace as labor productivity growth in nominal terms, and their rate of increase is expected to accelerate thereafter. However, there is a risk that firms will remain cautious with their decisions on wage setting, and in this context, I am paying attention to their stance regarding wages going forward.

B. Prices

Next, I will turn to price developments, taking into account supply-demand conditions in the labor market and the income situation. The year-on-year rate of change in the CPI (all items less fresh food and energy) has remained at around 0.5 percent.

There are likely to be two main factors behind such weak developments. One is that the mindset and behavior based on the assumption that wages and prices will not increase easily have been deeply entrenched among firms and households, due mainly to the experience of prolonged low growth and deflation. The other is that the room to raise productivity and the technological progress have allowed firms to absorb a rise in labor costs by increasing labor-saving investment and streamlining their business process, and thereby constrain price rises.

On the other hand, although the pace of improvement in prices has remained slow, some changes have been seen amid the improvement in the economic and employment conditions. For example, moves to raise sales prices are starting to be observed at a wide range of firms, mainly in the services sector. According to the *Tankan*, the number of enterprises answering that the output prices have risen has been exceeding the number of those answering that such prices have fallen. Also, with the aging of the population, labor market conditions are likely to tighten further and the pace of increase in hourly scheduled cash earnings of part-time employees is expected to accelerate. In addition to such moves, if full-time employees' wages increase with an improvement in productivity, this will lead to an increase in households' tolerance of price rises.

While price developments are affected by various factors, I consider that the factor that determines the underlying trend in prices is the aggregate supply-demand balance. As the output gap remains positive, various factors behind the weak developments in prices will

likely be resolved gradually. If that happens, firms' wage- and price-setting stance and households' tolerance of price rises will improve, and the pace of increase in inflation expectations will accelerate gradually.

III. Conduct of Monetary Policy

Let me now turn to the Bank's monetary policy.

The Bank has set the price stability target at 2 percent in terms of the year-on-year rate of change in the CPI and has been conducting monetary policy to achieve this target at the earliest possible time. To this end, the Bank has been pursuing powerful monetary easing, considering developments in economic activity and prices, as well as financial conditions, under the framework of Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control introduced in September 2016. The Bank, under this framework, has been conducting yield curve control, in which it controls short- and long-term interest rates. Specifically, at present, according to the guideline for market operations, the Bank sets the short-term policy interest rate at minus 0.1 percent and purchases Japanese government bonds (JGBs) so that 10-year JGB yields will remain at around 0 percent. By conducting this operation, short- and long-term interest rates have been stable at low levels, and I consider that the highly accommodative financial conditions, brought about by yield curve control, have contributed to an improvement in the output gap by stimulating firms' and households' spending activities.

Meanwhile, prices have continued to show relatively weak developments compared to the economic expansion and labor market tightening. Following the discussion at the Monetary Policy Meeting (MPM) held on July 30 and 31, 2018, the Bank released its economic projections, which showed that it would take time to achieve the price stability target of 2 percent. It also judged that, while the momentum toward 2 percent inflation had been maintained, it was necessary to persistently continue with powerful monetary easing, thereby maintaining the output gap within positive territory for as long as possible. Based on this judgment, the Bank decided at the MPM to implement measures to strengthen its commitment to achieving the price stability target and to enhance the sustainability of QQE with Yield Curve Control.

This set of measures consists of two major components. The first is the introduction of forward guidance for policy rates. Forward guidance is a measure that guides the future policy path in order to strengthen market confidence and expectations toward monetary policy. The Bank announced in its July policy statement that it "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." In consideration of these uncertainties and the price developments, the Bank will not reduce the degree of this powerful monetary easing for an extended period of time.

The second component is the implementation of several measures to enhance the sustainability of QQE with Yield Curve Control. For example, the Bank, while maintaining the target level of 10-year JGB yields at around 0 percent, made clear that the yields might move upward and downward to some extent mainly depending on developments in economic activity and prices. I believe that allowing the long-term yields to move to some extent will, in a broad sense, lead to maintaining market functioning. Meanwhile, it should be noted that the Bank does not intend to raise the level of yields -- this means that, in the case of a rapid increase in the yields, the Bank will purchase JGBs promptly and appropriately. In addition, as for exchange-traded fund (ETF) purchases, from the same aspect of enhancing the sustainability of the monetary policy framework, 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 at about 6 trillion yen.

The Bank also recognizes the risk that continuing powerful monetary easing will cumulatively affect financial institutions' strength, mainly through a decrease in their lending margins, and thus the functioning of financial intermediation will be stagnant. The Bank intends to continue paying careful attention to the risks considered most relevant to the conduct of monetary policy. With a view to achieving the price stability target of 2 percent, the Bank will continue conducting monetary policy in an appropriate manner, taking account of developments in economic activity and prices as well as financial conditions.

IV. Challenges for Japan's Economy

I would now like to express my thoughts regarding the current situation for Japan's economy from a longer-term perspective.

According to the Bank's estimates, the potential growth rate has been in the range of 0.5-1.0 percent recently. Although the rate has risen compared to around 2010, it can be said that Japan's growth potential has been sluggish. That said, as initiatives toward structural reforms and a growth strategy proceed among a wide range of entities, I consider that the boost in the country's growth potential would be accelerated through the rise in productivity.

Looking at corporate activities, it has been a couple of years since the output gap turned positive. Although it differs by industry, firm size, and other factors, supply-side constraints have been the bottleneck in firms' growth on the whole. In this situation, mainly on the back of improved profits, firms have started to increase fixed investment aimed at expansion in supply capacity of products and services: firms often start to review their business strategy when planning fixed investment and can improve productivity through such efforts. At the same time, firms have been making plans for development of new high value-added products and services by increasing research and development investment.

Moreover, firms have been taking various measures that reflect demographic changes and tight labor market conditions, on which I now would like to elaborate using five examples.

The first is effective use of employees through initiatives including working-style reforms. In Japan, inefficiency borne from the lack of streamlining and the practice of working long hours are common; in my view, there is still considerable room to enhance work efficiency through such initiatives.

The second is women's participation in the economy. In Japan, the labor force participation rate of women in the working-age population has reached 70 percent, which is considered a high level on a global standard. I expect that this trend will encourage firms to assign more women to value-added work and promote them to managerial positions from now on.

The third is employment of seniors. Although their employment has been progressing, there remains considerable room for improvement, as there are gaps between what they can accomplish through their ability and will, and what they actually are assigned to do.

The fourth is employment of foreigners. Although their employment has been increasing gradually, it is still vital to further develop systems to accept them.

Lastly, the fifth example is labor-saving efforts through utilization of information technology including the use of robots. Japan is a leading country in robotics, and I believe that we should expand its application from manufacturing operations to other kinds of work, including administrative work.

As these initiatives toward structural reforms and a growth strategy bring about benefits including improvement in business efficiency, they may exert downward pressure on wage increases in the short term, but in the longer term, they will raise the productivity of the economy as a whole, thereby strengthening its growth potential. I believe that improving productivity would stimulate price rises through increases in wages and private consumption. Nevertheless, even now there are firms that maintain their cautious wage- and price-setting stance, as they are concerned, for example, about a shrinking of the domestic market size and the issue of succession for businesses; they also lack confidence in growth in private consumption. Let me note that raising productivity and growth potential is a time-consuming task. Therefore, while the Bank's conduct of monetary policy stimulates aggregate demand and suitably tight supply-demand conditions are being maintained, a virtuous cycle in which active demand encourages progress in various initiatives should remain intact for a long period of time. I believe that, with a view to achieving its price stability target and realizing sustainable economic growth in a coordinated manner, the Bank should continue with its monetary easing policy and firmly support the various initiatives taken by a wide range of entities.