December 6, 2023

Bank of Japan

Japan's Economy and Monetary Policy

Speech at a Meeting with Local Leaders in Oita

HIMINO Ryozo

Deputy Governor of the Bank of Japan

(English translation based on the Japanese original)

Introduction

Good morning, everyone. Thank you for joining me today. I am pleased to be here in Oita, the home prefecture of the great thinker and educator of the Meiji era, Fukuzawa Yukichi, whom I admire a lot.

The 10,000 yen Bank of Japan note has featured Fukuzawa's portrait since 1984. The Bank plans to issue a new series of banknotes around the first half of July 2024, but the current series will remain valid, and we will continue to see Fukuzawa notes in circulation.

The 40 years we have spent with Fukuzawa notes have been a turbulent age. We witnessed an asset price boom in the late 1980s, its collapse in the early 1990s, and the banking crisis and the start of deflation in the late 1990s. We suffered from the Global Financial Crisis in 2008 and the Great East Japan Earthquake in 2011. We struggled to exit from deflation in the 2010s, and the 2020s began with COVID-19. We are now in the process of recovering from the economic shock caused by the pandemic.

After the start of deflation in the late 1990s, the Bank implemented various forms of nontraditional monetary policy. It is reviewing their positive and side effects from a broad perspective. We are keen to have your input and hear your views on how the Bank's policy worked in different phases of the past quarter century. Fukuzawa is known to have placed value on active debates conducted with the spirit of freedom. The Bank would particularly welcome critical views on its analysis and suggestions on what it should learn from the past.

I. Economic Activity and Prices

Developments since the Pandemic in Japan, the United States, and the Euro Area

The COVID-19 pandemic had an enormous impact on the Japanese economy. It exerted an equally severe impact on the U.S. economy and an even bigger one in the euro area. Subsequently, while the U.S. and euro area economies have seen a rapid recovery, Japan's recovery has been more moderate (Chart 1).

In the United States and the euro area, the combination of the rapid economic recovery and the global commodity price hike resulted in a significant acceleration of inflation, with the

year-on-year rate of increase in consumer prices at one point exceeding 10 percent in the euro area and reaching 9 percent in the United States. By contrast, the inflation rate in Japan peaked at around 4 percent.

While the Federal Reserve and the ECB rapidly raised policy rates to contain the inflation, the Bank of Japan has maintained monetary easing and continued to support the economy. Recently, the recovery in the euro area economy has slowed moderately. The U.S. growth surprised many by staying firm despite the rate hikes. Japan's recovery has remained moderate.

What We Have Heard from Japanese Firms on Their Pricing Practices

A key issue for Japan now is if the current higher-than-the-target inflation will abate. Chart 2 shows recent and forecasted inflation rates, one excluding the effects of fresh food price changes and the other excluding fresh food and energy. The former, which is closer to the actual makeup of household budgets, was at around 3 percent in fiscal year 2022 and is projected to stay around the level for fiscal years 2023 and 2024, exceeding the price stability target of 2 percent. The prices of food and other frequently purchased daily necessities are rising at even higher rates, making many households feel burdened by even more than the 3 percent rate may imply. This is a serious issue.

On the other hand, until recently, it had been a prevailing norm that neither wages nor prices could rise. Japan had worked for many years to break free from this, and simply returning to such a frozen state after the current high inflation comes down would not be a desirable outcome either.

The Bank aims to achieve the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases. Such an outcome would require walking a fine line in which inflation decreases, but not too far. The Japanese monetary policy faces multiple needs: addressing the current inflation, supporting the moderate economic recovery, facilitating a favorable environment for wage increases, and preventing the economy from reverting to a deflationary state. The Bank is struggling to find a solution and this is by no means an easy task.

In exploring a solution, we must examine various factors at home and abroad. Today, let me focus on the question of how firms set prices and wages. Changes in firms' wage- and price-setting behavior in recent years are a highly complex matter, but, at the risk of oversimplification, let me try to break them down into four stages (Chart 3).

Stage 1 is where firms reflect higher import prices in their selling prices. Stage 2 is where they reflect the increase in general price levels in wages they pay. Stage 3 is where they reflect higher labor costs in their selling prices. Stage 4 is where firms' pricing policies become more diverse, facilitating firms' exploration of strategies of selling more attractive products and services at commensurate prices in addition to those of selling good products and services at low prices. This stage may provide firms with broader options for attaining higher productivity.

Some might argue that firms have always endeavored to develop products and services that are attractive to customers and to set prices at levels commensurate with the value, and that this has been the case regardless of whether firms have entered stages 1 to 3. While I believe this to be true, let me examine if there could be a development which could facilitate and encourage a broader range of firms to make further efforts.

In recent months, the import price index has declined more than 10 percent compared to a year ago, and thus if the firms just stop at stage 1 -- a pass-through of higher import prices -- the Japanese economy may revert to the former deflationary state. On the other hand, if a virtuous cycle begins in which both stage 2 -- wage hikes -- and stage 3 -- a pass-through of higher labor costs to selling prices -- progress, moderate inflation may be sustainable.

However, if wages increase just as much as prices rise, this will not make people better off in real terms. Living standards would rise if the wage-price cycle ushers in stage 4 -- firms diversifying pricing strategies and pursuing broader options in adding higher value to their products and services as well as in enhancing productivity -- and if the gains from the enhanced productivity are shared with stakeholders.

Stage 1 corresponds to imported inflation, or what we call "the first force," and stages 2 and 3 correspond to homemade inflation, or what we call "the second force."[1] Stage 4 does not necessarily correspond to inflation if firms' pricing is commensurate with the increased value added to their products.

Judging from what we have heard from firms, progress seems to be mixed in each of the four stages at present.

Regarding stage 1, a survey of small and medium-sized firms showed that many firms could pass on only a portion of higher import prices. There was similar feedback from a large Japanese firm in the basic materials industry with a worldwide operation. According to the firm, distinctive features of the Japanese market in the past were that (1) nearly all firms had a policy of demanding that suppliers find ways to avoid passing on cost increases, and (2) they did not accept the norm that the balance of supply and demand determines the prices of materials. The firm further argued that only with the recent hike in the prices of imported materials could it start price negotiations with its clients. Even for a firm whose product line includes many competitive items that command high shares in the world market, it seems that barriers to making a stage 1 pass-through in the Japanese market are quite high.

A major chain restaurant reported to the effect that it had entered stage 2 but not stage 3; it had significantly raised hourly wages for its part-time employees and had absorbed this wage hike with the cost cuts made during the pandemic period.

The same chain restaurant reported that it had been passing on higher raw material costs, but rather than simply raising prices, it was expanding the price range on its menu by introducing items with higher value-added. A Japanese confectionery maker, which suffered from higher red bean prices, reported that it had packaged its products so that they could be used as romantic gifts and then sold them in the Ginza shopping district. Despite much higher prices, the products sold out. These episodes may be interpreted as the emergence of

[1] Regarding the first and second forces, see Ueda, K., "Japan's Economy and Monetary Policy," speech at a meeting with business leaders in Nagoya, November 6, 2023.

a strategy that combines stages 1 and 4, making it possible to pass on higher import prices with an increase in the value of products.

A major firm in the food production industry reported that it had raised prices while increasing the value of its products, taking account of not only past rises in production costs but also projected rises in labor and transportation costs, and that demand had been firm even after the price hikes. The Bank organizes periodic gatherings of its branch general managers, and a participant in the October meeting observed that, in the hotel industry in their district, firms that shifted to focusing on high-quality services for tourists travelling on their own had succeeded in raising prices without losing customers and in securing manpower, while those that continued to provide standard services for those travelling in large groups had not been able to pass on the cost increases to their customers and were having a difficult time in hiring enough employees. These reports can be interpreted as showing a polarization between those who combine stages 2, 3, and 4 -- wage hikes, the pass-through of higher labor costs, and the shift to higher-value products and services -- and those who keep the past strategies.

Oita Prefecture is renowned for its hot springs and ranked first in a survey on tourist satisfaction for fiscal year 2022. I am curious to hear what was the key to enhancing tourist satisfaction.

I asked some branch managers at the meeting how widespread such strategies of increasing the value of products and services, raising wages, and securing human resources were. They responded that, while some firms had started to report that they have taken such approaches, many seemed to be determined to weather labor shortages without raising their break-even point so that they could survive the next wave.

Branch managers also argued that, as the competition remained fierce, many firms were making pricing decisions mainly with an eye on other competitors. Therefore, the possibility cannot be ruled out that, after stage 1 -- the pass-through of higher import prices, which triggered price rises -- subsides, stages 2, 3, and 4 might also fade away. On the other hand, it also might be that once a firm reaches stage 4, reverting to the former state of

affairs may become less likely, at least for the firm in question. Future developments in demand -- in other words, how consumption, investment, and exports will develop -- will also have a major impact on the outlook.

What Statistics Tell Us on the Relationship between Firms' Price-Setting Behavior and Inflation

So far, I have focused on what we have heard from specific firms. I believe that firm-by-firm stories are essential in grasping what is happening, particularly at the turning point of a structural development. Individual stories, however, cannot capture the overall trends. Fukuzawa once argued that one should not speculate on the nationwide trends by just looking at specific cases, and he emphasized the importance of statistics. Let us now turn to statistical data.

To tell you my conclusion first, solid progress is observed in the transformation of firms' wage- and price-setting behavior.

An analysis by the Bank's staff shows that the effect of higher prices feeding into wages, or the stage 2 effect, using my term, was statistically significant in the first half of the 1990s, then became much less clear in the 2010s, but has become significant again in the recent period (Chart 4). The effect of higher wages feeding into prices, or the stage 3 effect, was also statistically significant in the first half of the 1990s and much less clear in the 2010s. The stage 3 effect has not turned statistically significant yet, but the estimated level of effect has risen in the recent period.

I think that these results are signs in the right direction, if not definitive. As I said earlier, without a virtuous cycle between wages and prices, Japan will most likely revert to the deflationary state in the past.

The analysis I just presented considers developments in prices and wages in general. Let us now look more closely at the details. Price tags on some items purchased by households, such as gasoline, change frequently, whereas those of other items are much more stable; some snacks continued to be priced at 10 yen each for 42 years. Chart 5 shows the

proportion of items for which prices have changed more than 0.5 percent year on year. A value of 50 percent means that the prices of half of the items have been almost flat year on year, while a value of 90 percent means that the prices of most items have changed.

Developments in this proportion show that prices of individual items became increasingly static amid a prolonged period of zero inflation or deflation. For 1994 and 2007, the average inflation rates were roughly the same, at around zero, but the proportion of items for which prices changed year on year fell from slightly above 80 percent to slightly below 60 percent.[2]

Meanwhile, it appears that prices of most items change every year during periods of inflation over 2 percent. Currently, the way prices change has returned to how it was before the start of deflation.

A recent paper by the Bank's staff finds a nonlinear pass-through of changes in producer prices, exchange rates, and wages to consumer prices.[3] When the rate of increase in (1) producer prices, which could be considered as a proxy for domestic input prices, (2) foreign exchange rates, which affect imported input prices, or (3) wages, which correspond to labor costs, exceeds a certain threshold, there is a spike in the degree to which it is reflected in the rate of increase in the CPI.

This may imply a pattern of corporate behavior in which, as long as the rates of cost increases stay below that threshold, firms try to swallow their impact without revising selling prices, but they revise them if the rates reach a level at which either they or their suppliers can no longer endure.

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[2] Although some argued that the decline in the pricing power of firms helped to keep inflation low in the United States in the late 1990s, John Taylor argued that the low inflation itself may have contributed to that decline. See Taylor, J. B., "Low Inflation, Pass-Through, and the Pricing Power of Firms," *European Economic Review* 44 (2000): pp. 1389-1408.

[3] Sasaki, T., Yamamoto, H., and Nakajima, J., "Nonlinear Input Cost Pass-Through to Consumer Prices: A Threshold Approach," *Bank of Japan Working Paper Series*, no. 23-E-9 (May 2023).

Firms intending to revise prices after years of keeping them flat have to start collecting and analyzing data in order to determine the timing and degree of price changes. They also need to coordinate internally and negotiate with business partners. In addition to such costs, firms face the risk that customers or competitors will react in unexpected ways.

Some firms may also have asymmetric internal incentive structures. For instance, individuals are held accountable when they fail at something they initiate, but if a failure occurs due to inaction, where the blame lies may remain unclear. Likewise, if employees embark on something new and succeed, they are not rewarded much, but if they launch something and fail, they are severely reprimanded.

Given the costs and risks associated with price setting and the asymmetry in the incentive structure, a strategy of maintaining selling prices while working to cut costs or asking business partners to lower costs is appealing. By contrast, taking initiatives such as adopting new pricing strategies or making inroads into high value-added segments requires determination and courage.

However, if the cycle between wages and prices begins to operate throughout the economy, the barriers to taking action will come down and the risks from inaction will rise. It may be that at some point the relationship between the cost and risk of action and those of inaction will become inverted, giving rise to nonlinear change.

The pass-through paper I referred to estimates the threshold levels at which such nonlinear change occurs (Chart 6). Although the estimated levels should not be taken as definitive, I am tempted to argue that, once entering a state above the threshold, it becomes easier to break free from the barriers arising from the costs and risks of pricing changes and asymmetrical incentives. A state with zero percent inflation may be quite far from the state above the threshold, but a state with 2 percent inflation may have affinity with it. In short, it may be that a state of zero percent inflation is not one in which prices do not change, but one in which firms cannot change prices.

Around spring this year, a management consultant told me that, in the past, the clients of their firm mostly requested advice on cutting costs, but recently advice on pricing strategies has started to be sought. I suppose that Japanese firms have always paid close attention to pricing policies, but given the difficulty of raising prices, perhaps they had no choice but to make cost-cutting as their main strategy.

Of course, cost-cutting, pricing, shifting to higher value-added segments, and competing through use of the appeal of low-cost products are all valuable strategies. If the pricing rigidities create undue biases toward cost-cutting and make firms' product portfolios move toward low-cost products, however, this may not necessarily be conducive to enhancement of the country's industrial structure.

On the other hand, if the prevailing norm that prices cannot be raised starts to dissipate, firms may find it easier to explore a variety of pricing strategies, new initiatives, and ways to develop higher-end products and services and enhance productivity. Stage 4, which I mentioned earlier, may gain momentum.

II. Monetary Policy

Patiently Continuing with Monetary Easing

Let me turn to the topic of how the Bank should conduct monetary policy if it aims to achieve this outcome. It has patiently continued with large-scale monetary easing, aiming to support the economic activity and thereby facilitate a favorable environment for wage increases. In the current monetary policy framework, yield curve control -- in which the Bank sets the short-term policy interest rate at minus 0.1 percent and the target level of 10-year Japanese government bond (JGB) yields at around zero percent -- plays a central role.

In December last year, and in July and October this year, the Bank increased the flexibility in controlling 10-year JGB yields to some extent. These decisions were made because, although strictly capping long-term interest rates will have strong positive effects, it also could entail large side effects. Currently, the Bank regards the upper bound of 1.0 percent for 10-year JGB yields as a reference in its market operations (Chart 7). While taking

measures to balance the positive and side effects, the Bank will patiently continue with monetary easing until sustainable and stable achievement of the price stability target, accompanied by wage increases, comes in sight.

What Would Happen If an Exit from the Large-Scale Monetary Easing Starts in the Future?

What then would happen if the virtuous cycle between wages and prices were to finally take hold, and, as a result, sustainable and stable achievement of the price stability target were to come in sight? A question that is often posed is whether this new phase would trigger a variety of additional problems.

Some argue as follows. Realizing such economic conditions has been a long-standing goal of the country and should be considered as a positive development in itself, but, if this happens, the Bank will likely gradually revise the large-scale monetary easing it has implemented to date. Modification of monetary policy will naturally have some effects on consumption and investment, but would that be the only impact? Given that very strong monetary easing has been continued for an extended period of time, could an exit from it go without exerting novel stresses on the household sector, the corporate sector, or financial institutions?

These are complex questions that need to be considered from various perspectives. In addition, the outcome of an exit would significantly depend on the specific condition at the time and on the way monetary policy is modified. Thus, there would be no easy or simple way to predict the outcome. Today, I would like to offer one perspective by looking at what happened to net interest income for relevant sectors in the past transition from a state with positive interest rates to a state without them. Interest rates may not necessarily return to past levels in the first place, and of course, the opposite would not necessarily happen in the reverse process. This perspective therefore would fall short of providing an answer but may shed some light on the questions.

The government's *Annual Report on the Japanese Economy and Public Finance* this year includes an analysis of how changes in interest rates thus far have affected interest receipts,

interest payments, and net interest income for various economic agents (Chart 8). Net interest income is the difference between each entity's financial assets multiplied by the rate for interest received and the balance of borrowings and other financial liabilities multiplied by the rate for interest paid.

Looking at households, while interest rates on deposits and other assets they held declined first, interest rates on mortgages and other borrowings followed suit. However, since households overall have a larger amount of deposits than mortgage liabilities, net interest income has deteriorated on a scale of trillions of yen compared to the time of positive interest rates. Conversely, if positive interest rates were to return, it may be expected that the household sector, which holds more financial assets than liabilities, will see improvement in net interest income on the whole. However, the interest rates on deposits and mortgages may rise at different speeds and the difference can affect the impact on the household sector. The impact will also vary across individual households.

Next, looking at the corporate sector, it has reduced its debt, has accumulated funds on hand, and has come to register a net interest income surplus. Therefore, the impact of rising interest rates on the net interest income of the overall corporate sector may be more limited than would have been the case when the sector had more debt and less funds. Of course, as some firms carry high debt while others have a significant amount of financial assets, the impact would vary across individual firms.

Lastly, looking at financial institutions, their profit margins have continued to deteriorate during the phase of declining interest rates, with net interest income falling to less than half of its peak. It cannot be guaranteed that, during a phase of rising interest rates, the opposite would simply happen and profit margins would increase accordingly. Moreover, this phase would raise some concerns, including whether the financial institutions would face unrealized losses on the long-term bonds they hold, and whether some borrowers, facing the need to pay higher interest, would default on their loans.

However, this phase would also pave the way for financial institutions to raise their investment yields by replacing the bonds they hold with new ones. In addition, if the

corporate sector makes active investments along with economic improvement during the exit phase, this will likely increase loan demand and make it easier for the financial institutions to secure profit margins between deposits and lending. In other words, while there may be a certain degree of stress in the shorter term, it would be much easier for banks to find ways to be profitable compared to when they were in an environment of continued low interest rates. Appropriate risk management will be needed to weather the stress in the transition phase, but, in our view, the financial system on the whole has the necessary resilience to withstand such stress.[4]

The presentation above focused on nominal interest rates alone. In the environment where the exit occurs, inflation expectations may be higher than today, and the increase in real interest rates could be smaller than that in nominal rates. The impact on households and firms could thus differ from the impact described above.

In any case, relevant economic agents would need to carefully navigate and manage the exit phase. In particular, the Bank of Japan should carefully monitor the evolution of wages and prices, judge the timing of the exit, and design its process. If this is done properly, there would be a sufficient possibility of achieving a positive outcome from the exit, since a wide range of households and firms would benefit from the virtuous cycle between wages and prices.

Conclusion

Fukuzawa was born in Japan's Edo period, when the country was isolated from Western civilization, and lived into the era after the Meiji Restoration, when Japan suddenly opened itself up to the West. He described this experience as living two lives with a single self. He argued that Japanese scholars of his day had a big advantage, since, although they had a fairly limited knowledge of Western civilization, they gained a unique perspective that Western scholars, who remained within a single civilization, could not have.

The experience of those of you in my generation and older may also be compared to living two lives with a single self. We experienced a period in which Japanese industries gained

[4] Bank of Japan, *Financial System Report*, October 2023, Section C of Chapter IV.

dominance in global markets one after another, and most of the world's 10 largest banks, as well as the world's largest and third-largest stock exchanges, were located in Japan. At one point, the scale of the Japanese economy surpassed 70 percent of the size of the U.S. economy. This was followed by the deflationary period, which saw continued declines in Japan's world rankings in a number of areas. If the matters that I have described today unfold in a positive direction, however, we may experience a new third phase in which the Japanese economy will make a comeback.

As I mentioned at the beginning, the Bank is conducting its review of monetary policy over the past 25 years from a broad perspective (Chart 9). The Bank reviews how monetary policy to date has influenced Japan's economic activity, prices, and financial sector, and what lessons it should draw on for the future. The Bank is analyzing a wide range of issues, including those related to the points I have raised today, and is keen to gain input and feedback from you.

In the following sessions, I would appreciate hearing your views on a number of issues, including the situation in Oita Prefecture. Thank you.

Japan's Economy and Monetary Policy

Speech at a Meeting with Local Leaders in Oita

December 6, 2023

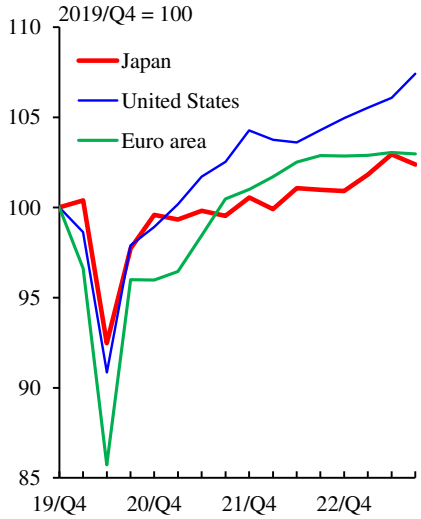
HIMINO Ryozo

Deputy Governor of the Bank of Japan

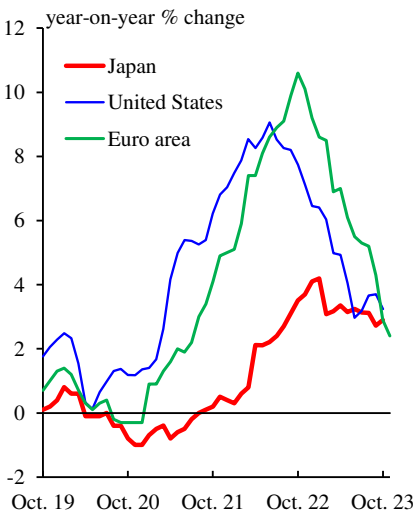
Chart 1

Recent Developments in Japan, the United States, and the Euro Area

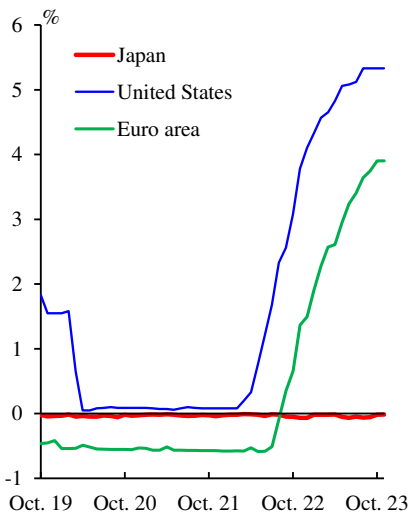
Real GDP



Consumer Prices



Short-Term Interest Rates

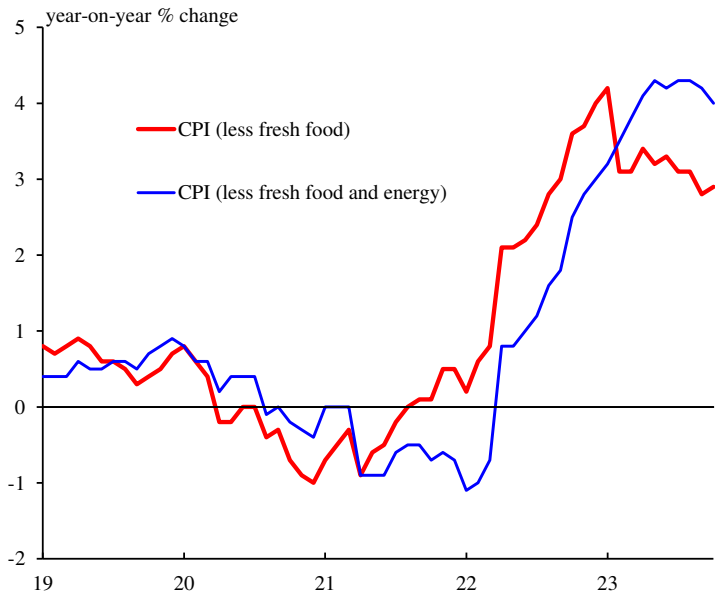


Notes: 1. In the middle chart, figures for Japan are the CPI for all items less fresh food, excluding the effects of the consumption tax hike, while those for the United States and the euro area are the CPI for all items.
2. In the right-hand chart, figures for each economy are as follows: for Japan, the uncollateralized overnight call rate; for the United States, the effective federal funds rate; for the euro area, EONIA before 2020 and €STR thereafter.
Sources: Cabinet Office; Ministry of Internal Affairs and Communications; Bank of Japan; ECB; BEA; BLS; Bloomberg.

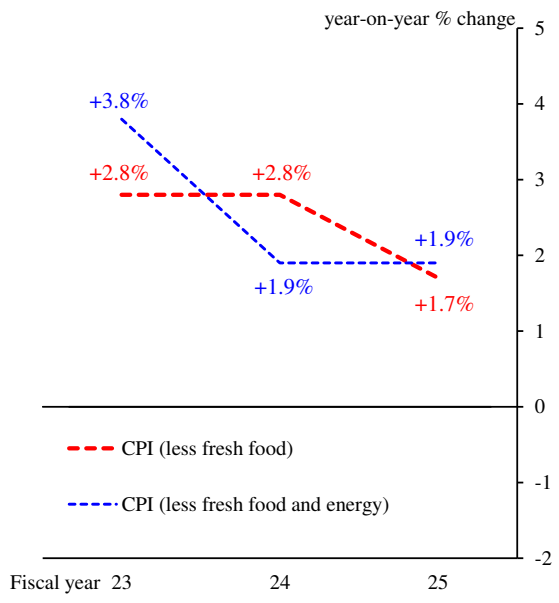
Chart 2

Recent and Forecasted Inflation Rates of Japan

Recent Developments



Forecasts by the Bank of Japan
Outlook Report, October 2023



Note: In the right-hand chart, figures are the medians of the Policy Board members' forecasts.
Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

Chart 3

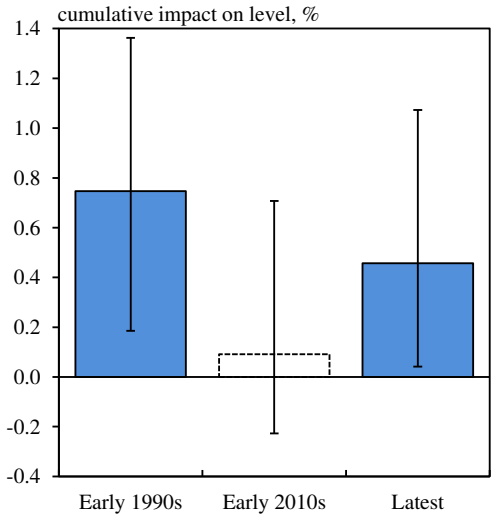
Changes in Firms' Wage- and Price-Setting Behavior

Stage 1	Firms reflect higher import prices in selling prices.
Stage 2	Firms reflect higher general price levels in wages.
Stage 3	Firms reflect higher labor costs in selling prices.
Stage 4	Firms' pricing policies become more diverse, facilitating firms to explore strategies of selling more attractive products and services at commensurate prices, not just good products and services at low prices.

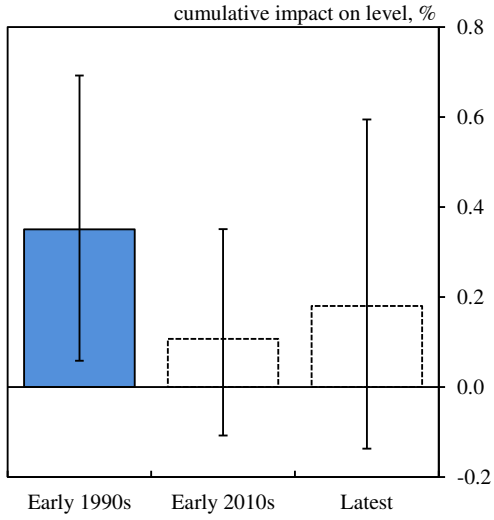
Chart 4

Feedback between Wages and Prices

Response of Wages
to a 1% Increase in Prices



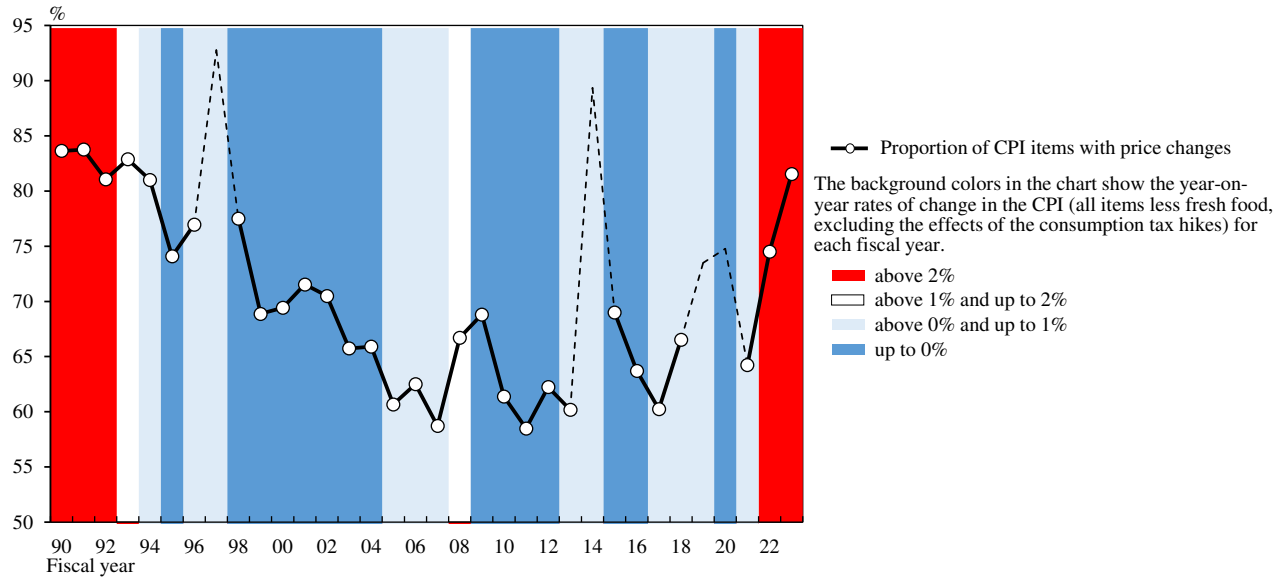
Response of Prices
to a 1% Increase in Wages



Notes: 1. Figures show the estimation results of a time-varying parameter VAR model consisting of the output gap, nominal wages, and the CPI (less fresh food). Import prices are added as an exogenous control variable. The CPI figures are staff estimates and exclude temporary factors.
2. Figures are 4-quarter cumulative impulse responses. The bands indicate the 75 percent confidence intervals, while the broken lines indicate that the results are not statistically significant.
3. Figures for the early 1990s are as of 1991/Q2, those for the early 2010s are as of 2012/Q2, and the latest figures are as of 2023/Q2.
Sources: Ministry of Internal Affairs and Communications; Cabinet Office; Ministry of Health, Labour and Welfare; Bank of Japan.

Chart 5

Proportion of CPI Items with Prices Changes



Notes: 1. Figures are the proportion of the weight of CPI items for which the year-on-year rates of increase or decrease were over 0.5 percent.
2. Figures are calculated using the CPI for all items less fresh food and imputed rent.
3. The broken lines show the periods that were affected by the consumption tax hikes (fiscal 1997, fiscal 2014, and from October 2019 to September 2020).
4. The figure for fiscal 2023 is the April-October average.
Source: Ministry of Internal Affairs and Communications.

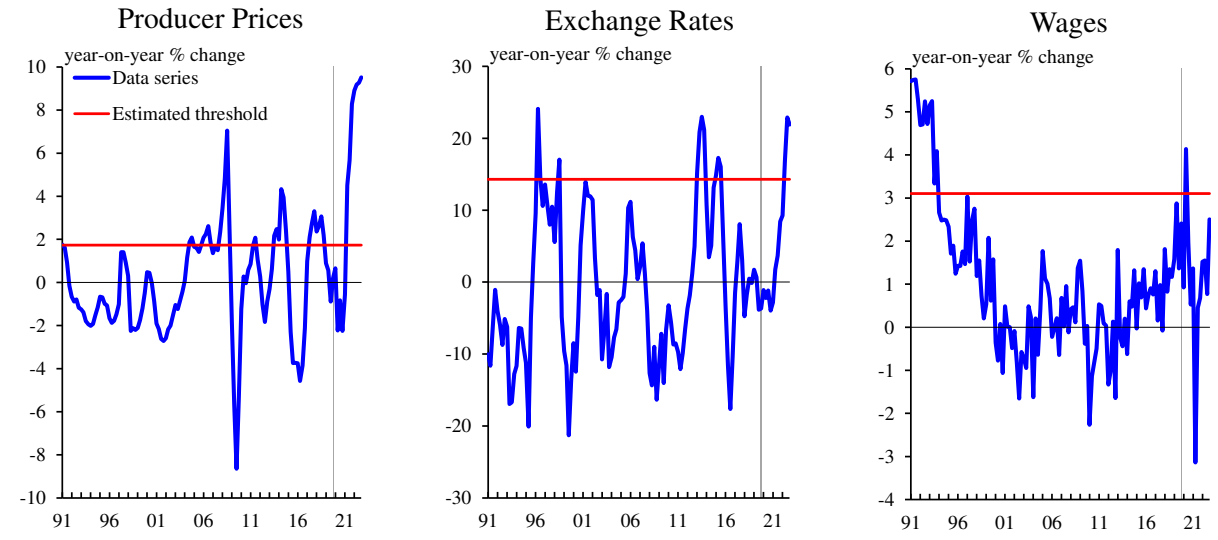
Chart 6

Nonlinear Input Cost Pass-Through to Consumer Prices: A Threshold Approach

Sasaki, T., Yamamoto, H., and Nakajima, J., *Bank of Japan Working Paper Series* (May 2023)

- There is a statistically significant nonlinearity in that the pass-through to CPI inflation of increases in producer prices, exchange rates, and wages rises once the increase in each of these variables exceeds a certain threshold.

Estimated Thresholds



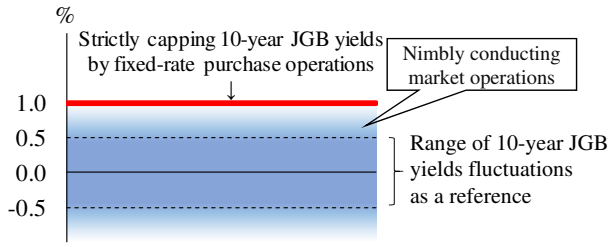
Note: The estimated thresholds are for CPI inflation (less fresh food and energy). The estimation period is from 1991 to 2019. The gray lines in the figures show the end of the estimation period.
Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Bank of Japan; FRED.

Chart 7

Further Increasing the Flexibility in the Conduct of Yield Curve Control (YCC)
(Decided at the October 2023 Monetary Policy Meeting)

- The Bank will patiently continue with monetary easing under Yield Curve Control (the short-term policy interest rate: -0.1%, the long-term interest rate: around 0%), aiming to support Japan's economic activity and thereby facilitate a favorable environment for wage increases.
  - Toward the end of the projection period, the Bank expects that underlying CPI inflation will increase gradually toward achieving the price stability target of 2 percent, while this increase needs to be accompanied by an intensified virtuous cycle between wages and prices.
- With extremely high uncertainties surrounding economies and financial markets at home and abroad, the Bank judges that it is appropriate to increase the flexibility in the conduct of yield curve control, so that long-term interest rates will be formed smoothly in financial markets in response to future developments.

<Previous Conduct of YCC>



<Conduct of YCC after Further Increasing the Flexibility>

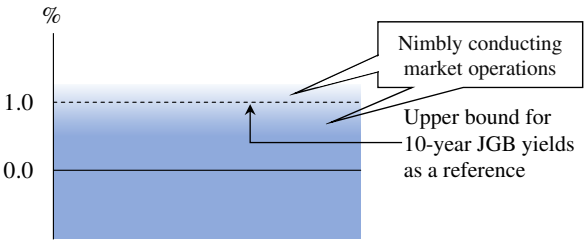
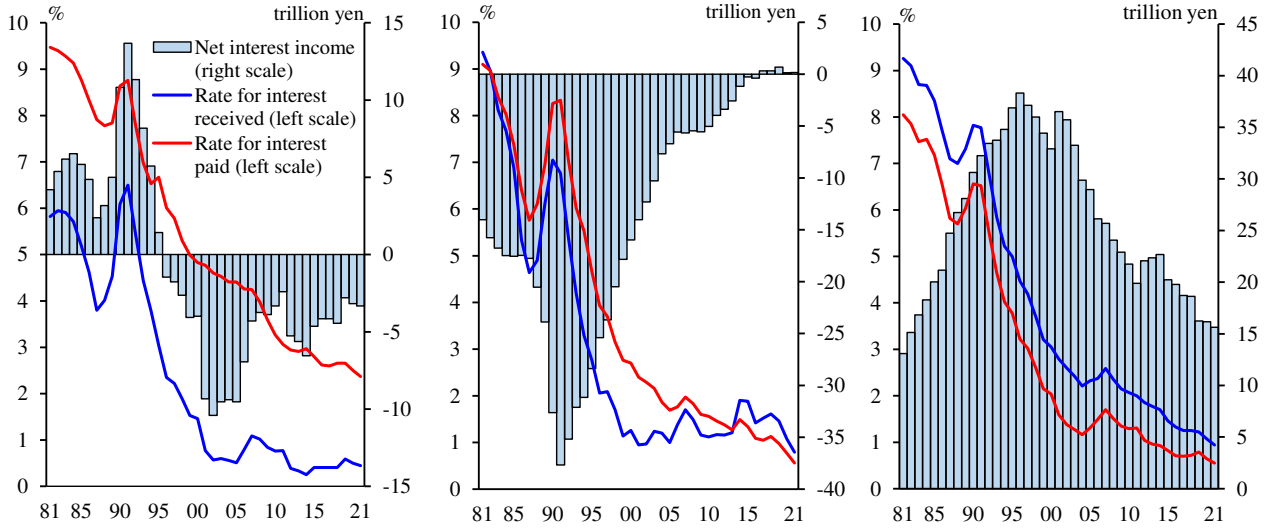


Chart 8

Impact of the Past Interest Rate Changes on Net Interest Income

Household Sector | Corporate Sector | Financial Institutions



Source: Cabinet Office, "Annual Report on the Japanese Economy and Public Finance 2023."

Monetary Policy Review from a Broad Perspective

1. Approach to Analyses

- The Bank will assess the effects of various unconventional monetary policy measures that have been implemented over the past 25 years in the context of interactions with developments in economic activity and prices at each point in time. In addition, it will analyze the impact of these measures on financial markets and the financial system, including their side effects.
  - Deepen understanding on (1) how various changes in the economic environment -- e.g., globalization and the declining and aging population -- have affected factors such as corporate and household behavior and the formation mechanisms of wages and prices and (2) the implications that the effects of these changes have had for monetary policy
  - Flexibly consider specific themes of the analyses during the course of the review

2. Approach to Exchanging Views and Other Initiatives

- The Bank will incorporate diverse expertise and take various initiatives with a view to enhancing the review's objectivity and transparency. Such initiatives include not only internal analyses but also those listed below.
  - ➢ Make use of existing series of materials, such as reports and surveys, and invite public comment
  - ➢ Exchange views on occasions such as meetings with local and business leaders
  - ➢ Hold discussions, such as at workshops (one held on December 4, 2023 and another scheduled for around May 2024)
  - ➢ Exchange views with foreign experts