March 7, 2024
Bank of Japan

Economic Activity, Prices, and Monetary Policy in Japan

Speech at a Meeting with Local Leaders in Shimane

NAKAGAWA Junko
Member of the Policy Board

(English translation based on the Japanese original)

I. Current Situation of Economic Activity and Prices

A. Current Economic Developments Abroad

I would like to begin my speech by talking about the current situation of overseas economies.

The pace of recovery in overseas economies has slowed on the whole. Although business sentiment for the services industry has been above the break-even point between improvement and deterioration, it has become lower as the momentum from the reopening of the economy following the COVID-19 pandemic has dissipated (Chart 1). Business sentiment for the manufacturing industry has been around the break-even point between improvement and deterioration. Despite being affected by the slowdown in the pace of recovery in the global economy, world trade volume has shown signs of bottoming out because of progress in inventory adjustments for intermediate and IT-related goods.

Let me briefly explain developments in major overseas economies. In the United States, while monetary tightening has been affecting the real estate and housing markets, the economy has been firm, mainly led by private consumption and the favorable employment and income situation. Although it has been widely reported that China's GDP growth rate for 2023 surpassed 5 percent, the country's economy has remained on a moderate slowing trend, with weakness being seen in the real estate market and in those sectors involving external demand. European economies have also continued to slow moderately, partly affected by developments in the Chinese economy.

B. Current Economic Developments in Japan

I will now turn to the current situation of Japan's economy. Exports have been more or less flat, in line with the weakness in the global manufacturing sector. Industrial production has been relatively weak recently, partly affected by some automakers having suspended their factories' operations. Despite being affected by the slowdown in the pace of recovery in overseas economies, high levels of corporate profits have supported a moderate increasing trend in business fixed investment and an improving trend in the employment and income situation. Private consumption has been increasing moderately. Even though some indicators of private consumption have been relatively weak recently, there was no significant trend change. In fact, the level of consumer sentiment has been maintained thus far, mainly due to moderate improvement in the employment and income situation, despite the effects of price rises. Next, I would like to give a more detailed explanation of developments in Japan's economy from two aspects: the corporate sector and the household sector.

1. Corporate sector

Let me start with the corporate sector. Corporate profits have been trending upward. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly*, current profits based on all industries and enterprises have reached the highest level since the April-June quarter of 1985, from when comparable data are available. Thus, corporate profits as a whole have been favorable. By firm size, current profits of large firms have been supported by a recovery in economic activity and hikes in selling prices (Chart 2). With the yen depreciating, large firms' current profits have also been pushed up by foreign exchange gains and an increase in dividend income from overseas subsidiaries. While the uptrend in profits has been led, relatively speaking, by large firms, the profit environment of small and medium-sized firms has been on an improving trend as well.

Business sentiment has improved (Chart 2). Although it has been a while since its release, according to the Bank of Japan's December 2023 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the diffusion indexes (DIs) for business conditions have improved from the previous survey, for all firm size categories in both manufacturing and nonmanufacturing. By industry, the DI for manufacturing has improved, particularly for small firms, due to the progress in price revisions and the recovery in automobile production. With regard to nonmanufacturing, the DIs have improved for a wide range of industries, particularly those related to private consumption. This is due to the recovery in economic activity and, as is the case for manufacturing, to the progress in price revisions. The improvement in business sentiment has been supported by inbound tourism demand, with the number of inbound visitors, which decreased sharply during the pandemic, having recovered to the pre-pandemic level.

Business fixed investment has continued on a moderate increasing trend, led by investments aimed at future growth, including those related to digitalization and labor saving (Chart 3). As in fiscal 2022, business fixed investment for fiscal 2023 is expected to show relatively strong growth. Although some firms have been postponing their fixed investment plans due to high material prices, there have been moves to resume investment plans as commodity prices have been stable recently.

Exports have been more or less flat, due in part to the effects of the slowdown in the pace of recovery in overseas economies, and industrial production has been relatively weak recently, partly affected by some automakers having suspended their factories' operations (Chart 4). As for real exports by region, those to the United States and Europe have been at high levels, mainly led by automobile-related goods (Chart 5). On the other hand, although real exports to China and to the NIEs and the ASEAN economies have been at reduced levels, they have bottomed out, with progress in global inventory adjustments for IT-related goods. By goods, exports of automobile-related goods have been on an uptrend, buoyed by a waning of supply-side constraints for semiconductors used in automobiles. Exports of capital goods and IT-related goods -- mainly semiconductor production equipment, semiconductors, and other electronic parts -- have bottomed out, with progress in inventory adjustments for IT-related goods. Exports of intermediate goods, including chemicals, have been at reduced levels, reflecting weakness in the Chinese real estate market.

2. Household sector

I now turn to the household sector, focusing on private consumption and the employment and income situation.

Private consumption has been increasing moderately; however, the effects of higher prices and weather conditions have been seen in part (Chart 6). Specifically, as for goods consumption, a rise in households' thriftiness in response to price rises has led to a lower volume of purchases, mainly for nondurable goods such as beverages, food, and clothes. It appears that the weakness in consumption of nondurable goods has also been affected by a temporary factor of sluggish sales of autumn and winter clothes due to milder winter weather than usual. Meanwhile, the level of consumer sentiment has been maintained, even amid price rises. This is supported by government measures, such as those to address rising prices, a moderate improvement in the employment and income situation, and furthermore, by retail firms' various measures to promote sales. On the other hand, consumption of durable goods has been at a relatively high level. For example, the number of new cars sold has been on an increasing trend, with supply-side constraints gradually dissipating. However, attention is warranted on the possibility that supply-side effects may emerge from the suspension of operations at some automaker factories. The recovery in services consumption following the reclassification of COVID-19 under the Infectious Disease Control Law has continued moderately.

The employment and income situation has continued to improve moderately (Chart 7). The number of employed persons has been on a moderate uptrend. The growth in regular employees is led by the medical, healthcare, and welfare services industry and by the information and communications industry, both of which have faced severe labor shortages, while that in non-regular employees is led by industries such as retail trade and face-to-face services. Nominal wages per employee have shown relatively high growth, although the pace of growth is lagging behind that of inflation. Scheduled cash earnings have also been on the rise. This is because the wages of full-time employees have reflected the results of annual spring labor-management wage negotiations in 2023, which ended up with the highest wage growth rate since 1993, and also because minimum wages for part-time employees have been raised amid tight labor market conditions. Special cash earnings have increased as well, as improvement in corporate earnings has brought about larger bonuses. As a result, total employee income, which is the product of the number of employees and nominal wages per employee, has also continued to rise.

As for employment and wages, I recognize that, even more than last year, corporate executives have been increasingly voicing their concern over labor shortages and their positive views toward wage hikes. In fact, the employment conditions DI in the *Tankan* shows that the level of tightness in labor market conditions has become significantly higher than in the past, mainly in nonmanufacturing, as the economy has continued to recover moderately (Chart 8). It can be said that the practice of annual wage reviews based on the economic and price situation has more or less been restored, mainly at large firms. Furthermore, coordinated support from both the public and private sectors has increasingly accommodated the need of small and medium-sized firms to negotiate price revisions. With corporate profits being on an improving trend as mentioned earlier, labor share -- which shows the share in which firms distribute profits to employees in the form of wages -- has been on a declining trend. Of course, this is only an overall trend, and I understand that firms are faced with different circumstances, but based on these developments, there is a growing possibility that wage revisions for this spring will be at relatively higher levels than in the past.

C. Current Price Developments in Japan

Next, I would like to talk about prices in Japan. Specifically, I will touch upon developments in producer and consumer prices.

1. Producer prices

In terms of producer prices, let me first explain developments in import prices. The year-on-year rate of change in the import price index has remained negative, reflecting the leveling off of the inflation momentum seen in many commodity prices, including crude oil (Chart 9). In this context, the year-on-year rate of increase in the producer price index (PPI), which is based on the price of goods traded within the domestic corporate sector, has continued to decelerate, and has been at around 0 percent recently. On the other hand, the year-on-year rate of increase in the overall services producer price index (SPPI) has remained on an accelerating trend, reflecting higher prices across a wide range of areas, including accommodations, software development, and leasing and rental services, against the backdrop of a recovery in travel demand -- including inbound tourism demand -- and rises in personnel expenses and goods prices.

2. Consumer prices

The pace of increase in consumer prices has also slowed compared with the high rates of increase seen earlier. This is because electricity and gas charges and other energy prices have contributed to the slowdown, with the government's economic measures pushing down such prices. It is also because, as I mentioned, producer prices have leveled off. The year-on-year rate of increase in the consumer price index (CPI) for all items excluding fresh food was 2.0 percent for January 2024 (Chart 10). The rate of increase in the CPI for all items excluding fresh food and energy has also begun to decelerate, but it has continued to show relatively high growth of around 3.5 percent. This is because the effect of previous rises in raw material costs is being reflected in the CPI growth rate over time, with a lag, although food prices are beginning to settle down, after having continued to rise last year at the fastest rate since the oil shock. Thus, the CPI growth rate will likely subside gradually.

II. Outlook for and Risks to Economic Activity and Prices

A. Outlook

Next, I would like to turn to the outlook for Japan's economic activity and prices.

The economy is likely to continue recovering moderately, mainly supported by the materialization of pent-up demand and the government's economic measures, although it is expected to be under downward pressure stemming from a slowdown in the pace of recovery in overseas economies. Thereafter, these temporary boosting effects are projected to gradually wane, but the economy is expected to continue growing at a pace above its potential growth rate as a virtuous cycle from income to spending gradually intensifies in the overall economy. As presented in the *Outlook for Economic Activity and Prices* (Outlook Report) decided by the Bank at the January 2024 Monetary Policy Meeting, the real GDP growth rate is projected to be 1.8 percent for fiscal 2023, 1.2 percent for fiscal 2024, and 1.0 percent for fiscal 2025, in terms of the median of the Policy Board members' forecasts (Chart 11).

Turning to consumer prices, the effects of inflation stemming from the past rise in import prices are expected to continue waning. Meanwhile, inflation expectations are likely to rise gradually toward a level consistent with the price stability target, as the output gap turns positive along with economic recovery and as expectations for wage increases also rise. Given this context, in terms of the median of the Policy Board members' forecasts in the January 2024 Outlook Report, the year-on-year rate of change in the CPI (all items less fresh food) is projected to be 2.8 percent for fiscal 2023, 2.4 percent for fiscal 2024, and 1.8 percent for fiscal 2025 (Chart 11). Likewise, the year-on-year rate of change in the CPI (all items less fresh food and energy), which had continued to climb at relatively high rates until January, is projected to be 3.8 percent for fiscal 2023 and 1.9 percent for both fiscal 2024 and fiscal 2025.

B. Risks

As I have just outlined, I believe that Japan's economy is likely to achieve a virtuous cycle between wages and prices, supported by high levels of corporate profits. Of course, the outlook for economic activity and prices that I mentioned entails a range of uncertainties. In what follows, I will describe three risk factors to this outlook that I am paying particular attention to.

The first is developments in overseas economic activity and prices and in global financial and capital markets. Inflation rates in the United States and Europe, which were at high levels, have been steadily declining recently. This can be attributed to the rapid policy interest rate hikes implemented by overseas central banks. However, there is a risk of inflation rates staying elevated through wage increases, mainly in advanced economies, and of tightened monetary policy continuing longer than expected. There is also a risk that the policy interest rate hikes by overseas central banks to date will affect their real economies and financial markets over time, and that this will spill over into Japan's economy as well.

Second is geopolitical risks and developments in the price of commodities, including grain. The price of grain and other commodities has declined on the whole after reaching a peak around the middle of 2022. Nonetheless, the price of grain and other commodities may rise again, as their prices will naturally be affected by global economic developments and climate conditions, and will also depend on geopolitical developments such as those concerning Ukraine and the Middle East. This could pose the risk of putting downward pressure on economic activity in Japan.

The third risk concerns developments in consumer sentiment. I think the key is to avoid the possibility of a deterioration in consumer sentiment and Japan's economy returning to deflation. So far, households have been defensive about spending, mainly because the rate of increase in the price of everyday goods such as food and daily necessities has been relatively high, as is the case with dining-out and accommodations. At this point, however, the level of consumer sentiment has been maintained through government measures, such as those to address rising prices, as well as through improvement in the employment and income situation and firms' efforts to promote sales. The Bank's baseline scenario is that consumer sentiment will be supported for the time being by expectations for wage increases. Nevertheless, if real income does not grow but rather turns out to be lower than expected, there is a risk that demand will wane through deterioration in consumer sentiment, thereby exerting downward pressure on economic activity and prices.

III. The Bank's Monetary Policy Conduct

Next, I would like to talk about the Bank's monetary policy, and share my views regarding its conduct.

The Bank is currently pursuing monetary easing with the aim of achieving the price stability target of 2 percent in a sustainable and stable manner. As specific easing measures, the Bank conducts yield curve control, which includes the purchase of long-term Japanese government bonds (JGBs), and also purchases assets including corporate bonds, CP, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs). The Bank introduced and has subsequently revised these policy tools to enable sustainable monetary easing, while taking into account their impact on financial markets.

Under the current framework of yield curve control, the short-term policy interest rate is set at a negative interest rate of minus 0.1 percent, and the target level of 10-year JGB yields is around 0 percent, with the upper bound of 1.0 percent for the yields regarded as a reference. In December 2022, the Bank expanded the range of 10-year JGB yield fluctuations from the target level, from between around plus and minus 0.25 percentage points to between around plus and minus 0.5 percentage points. In July 2023, the Bank decided to continue allowing 10-year JGB yields to fluctuate in the range of around plus and minus 0.5 percentage points from the target level, and at the same time to conduct yield curve control flexibly, regarding the upper and lower bounds of the range as references, or non-rigid limits. Accordingly, it allowed the yields to move beyond the range, depending on market conditions. However, 10-year yields were contained to be below 1.0 percent to ensure the effectiveness of monetary easing. In October 2023, with extremely high uncertainties surrounding economies and financial markets at home and abroad, the Bank considered that strictly capping the upper bound for 10-year JGB yields at 1.0 percent would have strong positive effects, but could also entail large side effects. Given this, it decided to conduct yield curve control mainly through large-scale JGB purchases and nimble market operations. These revisions have reduced distortions on the yield curve, and long-term interest rates have also become more attuned to market conditions (Chart 12). The overall functioning of the bond market, as determined by market participants, has been improving from the low level seen earlier.

The Bank also reviewed its purchase of risky assets, namely ETFs and J-REITs, in March 2021; in light of the objective of such purchases, it decided to purchase such assets only during times of heightened market instability, so as to conduct the purchases more flexibly in a prioritized manner.

In addition to these policy measures, the Bank has reviewed other measures as necessary to ensure the smooth implementation of monetary easing, including revising its standards for eligible collateral submitted by financial institutions for the Bank's provision of credit, as well as relaxing the terms and conditions for the Securities Lending Facility (SLF), the Bank's facility for lending government bonds to eligible financial institutions, which constitute market participants.

In this way, while taking various approaches, the Bank has maintained an accommodative monetary policy. Under these circumstances, I believe that economic activity and prices in Japan are making steady headway toward achieving the 2 percent price stability target, as seen, for example, with the clear signs of change in firms' wage-setting behavior. Of course, in addition to the risks I mentioned earlier, there is always a number of uncertainties for Japan's economy, including the possibility of a natural disaster. To be able to conduct appropriate policy at each point in time, the Bank will continue gathering information, without any preconceptions, before reaching a decision. At some time in the future, when the Bank deems that achievement of the 2 percent price stability target has come in sight and monetary policy revision should be considered, it will revisit the policy measures introduced to date, including yield curve control and the purchase of risky assets, keeping in mind their impact on financial markets as well as their unconventional nature, and then decide whether or not a revision is necessary.

Thank you.

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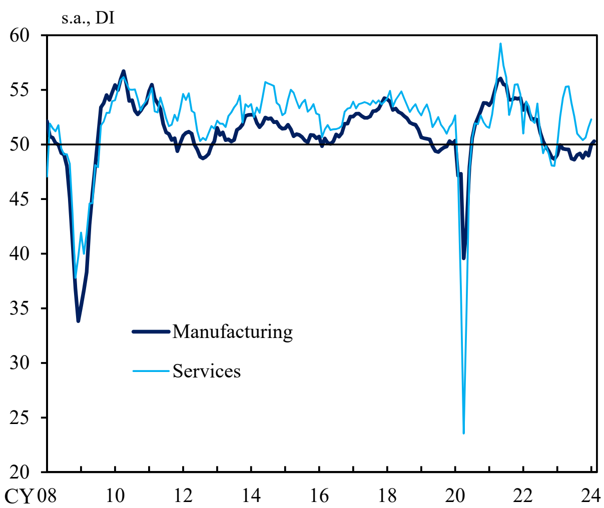
Chart 1

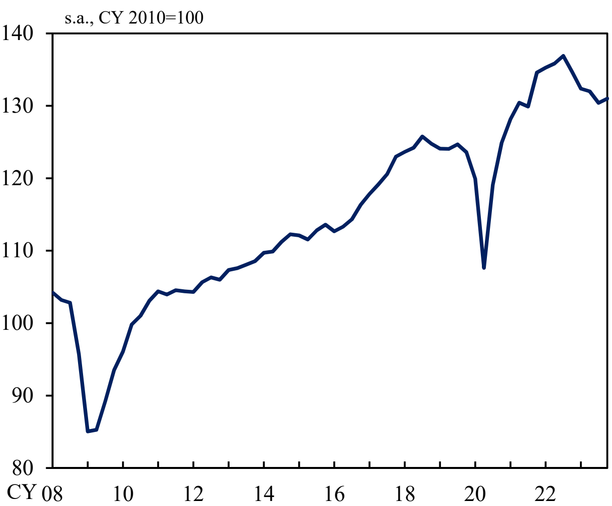
Overseas Economies

Global PMI



Note: Figures for manufacturing are the J.P.Morgan Global Manufacturing PMI. Figures for services are the J.P.Morgan Global Services Business Activity Index.
Source: Copyright © 2024 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.

World Trade Volume

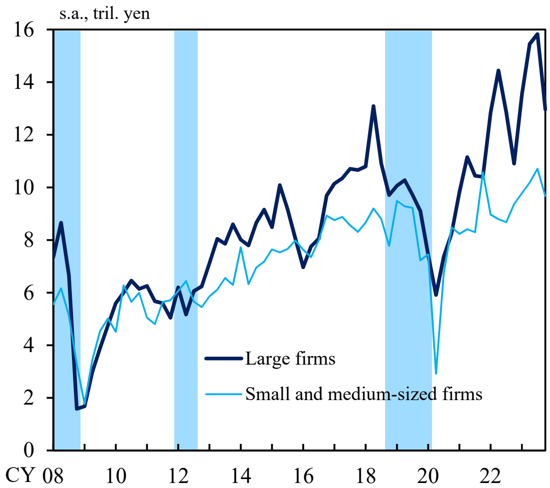


Note: Figures for the world trade volume are those for world real imports.
Source: CPB Netherlands Bureau for Economic Policy Analysis.

Chart 2

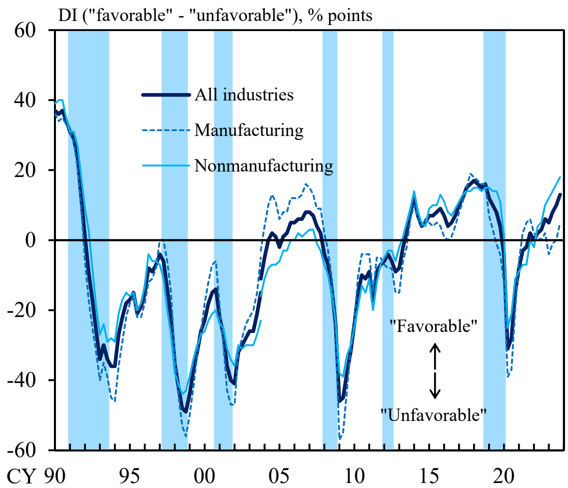
Corporate Sector in Japan

Current Profits



Notes: 1. Based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. Excluding "finance and insurance."
2. Figures from 2009/Q2 onward exclude pure holding companies.
3. Shaded areas denote recession periods.
Source: Ministry of Finance.

Business Conditions

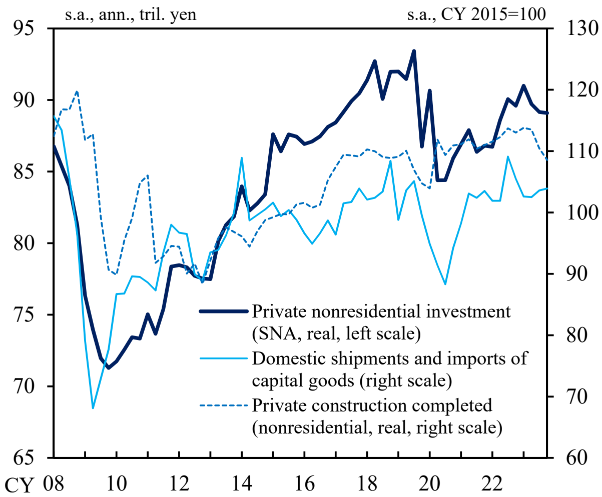


Notes: 1. Based on the *Tankan*. All enterprises. There is a discontinuity in the data for December 2003 due to a change in the survey framework.
2. Shaded areas denote recession periods.
Source: Bank of Japan.

Chart 3

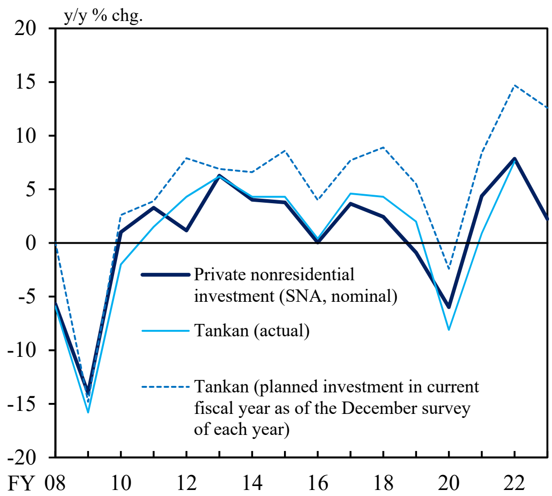
Corporate Sector in Japan

Coincident Indicators of Business Fixed Investment



Note: Figures for real private construction completed are based on Bank staff calculations using the construction cost deflators.
Sources: Cabinet Office; Ministry of Economy, Trade and Industry; Ministry of Land, Infrastructure, Transport and Tourism.

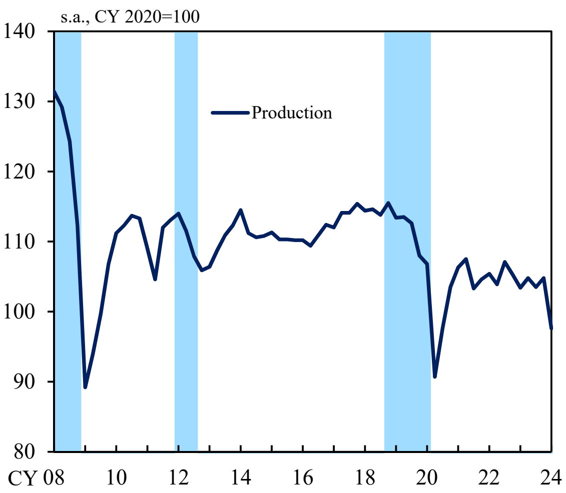
Planned and Actual Business Fixed Investment



Notes: 1. The *Tankan* figures include investments in software and research and development (R&D) but exclude land purchasing expenses. R&D investment is not included before the March 2017 survey. The figures are for all industries including financial institutions.
2. The figure for private nonresidential investment for fiscal 2023 is the 2023/Q2-Q4 average.
Sources: Cabinet Office; Bank of Japan.

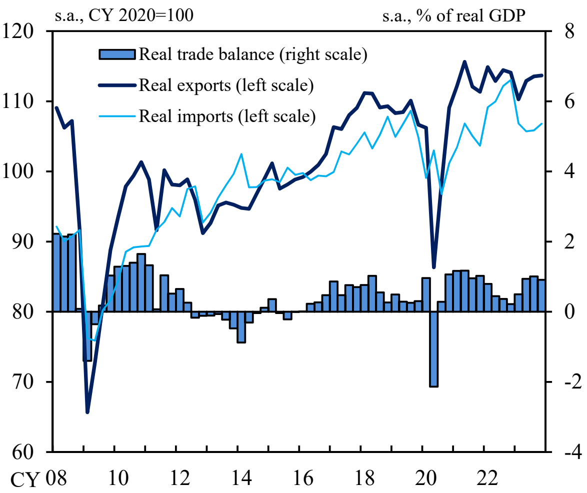
Corporate Sector in Japan

Industrial Production



Notes: 1. Shaded areas denote recession periods.
2. The figure for 2024/Q1 is that for January.
Source: Ministry of Economy, Trade and Industry.

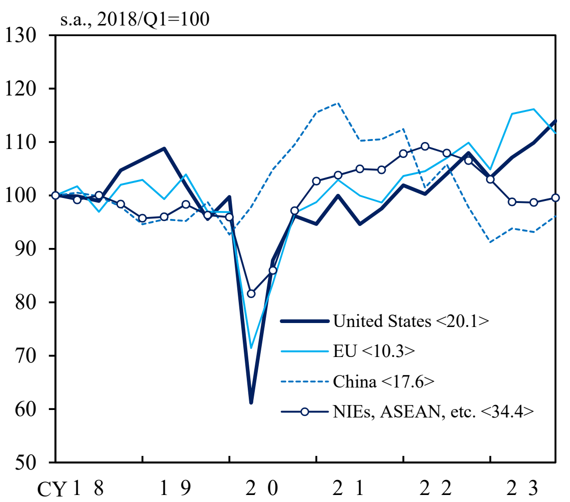
Real Exports and Imports



Note: Based on Bank staff calculations.
Sources: Cabinet Office; Ministry of Finance; Bank of Japan.

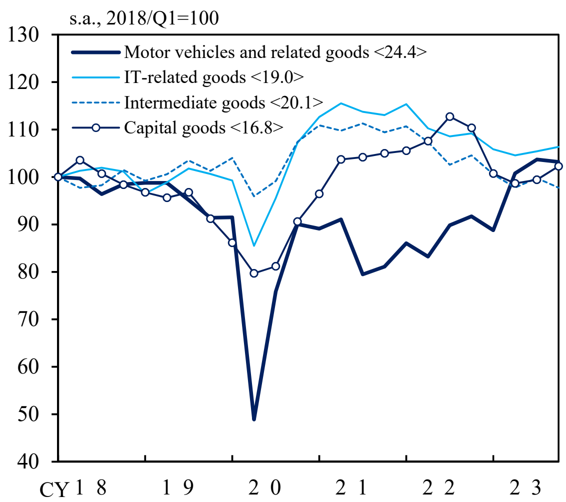
Corporate Sector in Japan

Real Exports by Region



Notes: 1. Based on Bank staff calculations. Figures in angle brackets show the share of each country or region in Japan's total exports in 2023.
2. Figures for the EU exclude those for the United Kingdom for the entire period.
Sources: Ministry of Finance; Bank of Japan.

Real Exports by Type of Goods

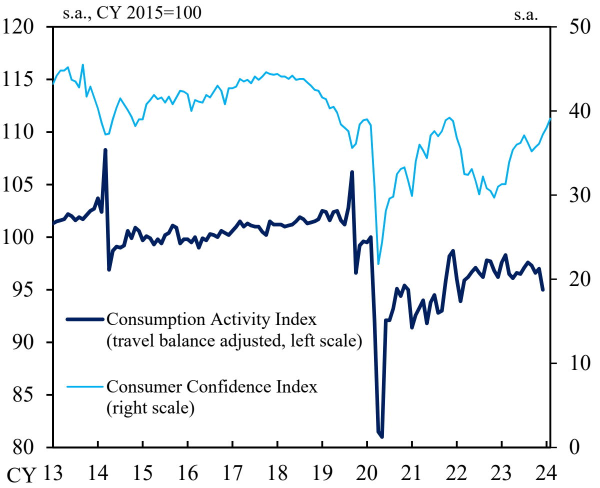


Note: Based on Bank staff calculations. Figures in angle brackets show the share of each type of goods in Japan's total exports in 2023.
Sources: Ministry of Finance; Bank of Japan.

Chart 6

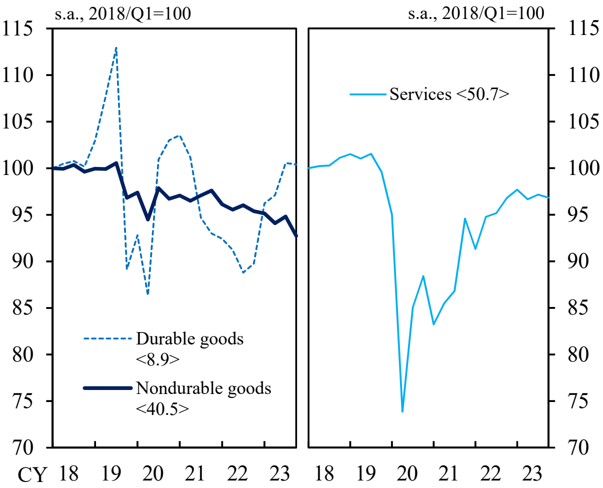
Private Consumption in Japan

Real Private Consumption and Confidence Indicator



Note: Figures for the Consumption Activity Index (CAI) are based on Bank staff calculations. The CAI figures (travel balance adjusted) exclude inbound tourism consumption and include outbound tourism consumption.
Sources: Cabinet Office; Bank of Japan, etc.

Consumption Activity Index (CAI, Real)



Notes: 1. Based on Bank staff calculations. Figures in angle brackets show the weights in the CAI.
2. Nondurable goods include goods classified as semi-durable goods in the SNA.
Sources: Bank of Japan, etc.

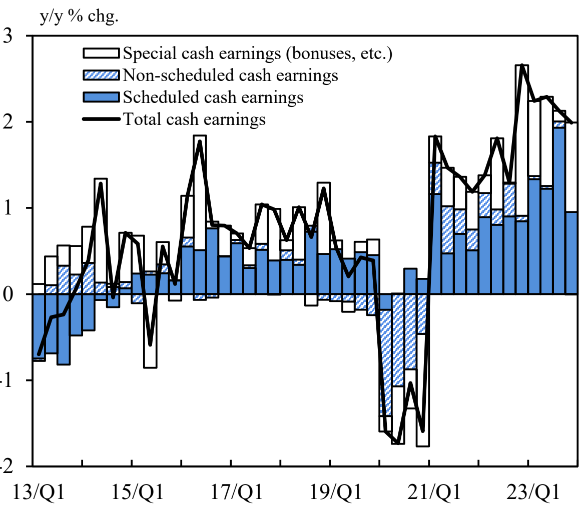
Chart 7

Employment and Income Situation in Japan

Number of Employed Persons

Source: Ministry of Internal Affairs and Communications.

Nominal Wages per Employee

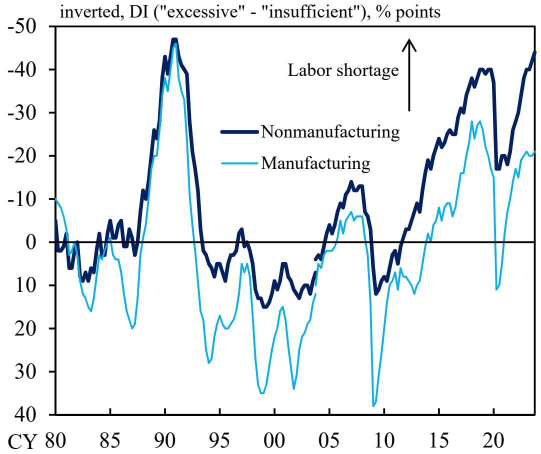


Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. Figures for 2023/Q4 are those for December.
2. Figures from 2016/Q1 onward are based on continuing observations following the sample revisions.
Source: Ministry of Health, Labour and Welfare.

Chart 8

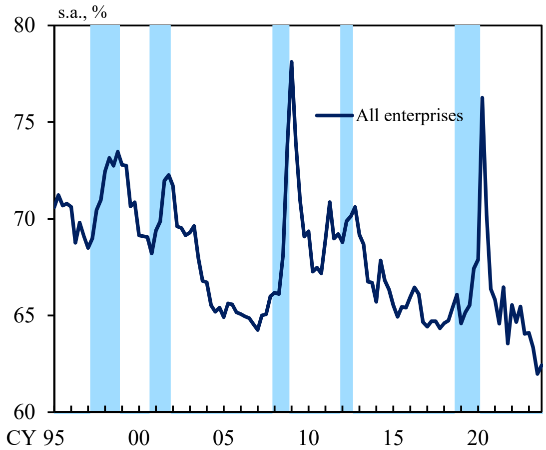
Employment and Income Situation in Japan

Employment Conditions DI



Note: Based on the *Tankan*. All enterprises. There is a discontinuity in the data for December 2003 due to a change in the survey framework.
Source: Bank of Japan.

Labor Share

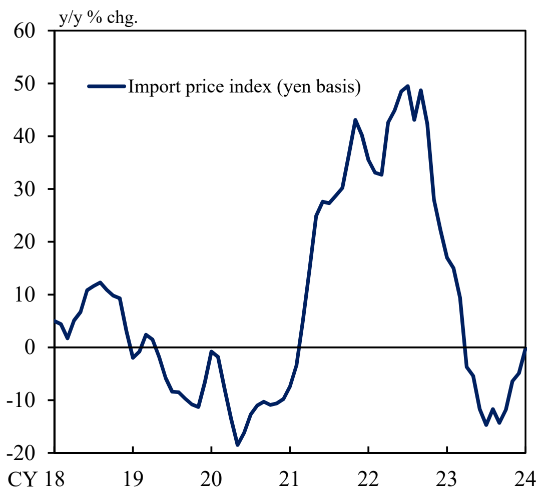


Notes: 1. Based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. Excluding "finance and insurance."
2. Figures from 2009/Q2 onward exclude pure holding companies.
3. Shaded areas denote recession periods.
Source: Ministry of Finance.

Chart 9

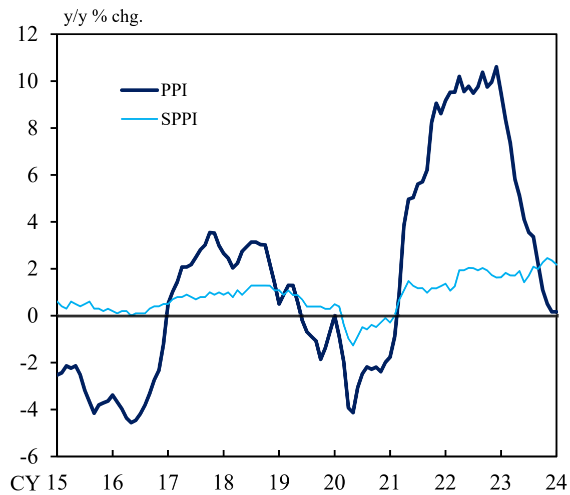
Producer Prices

Import Prices



Source: Bank of Japan.

Goods and Services Prices

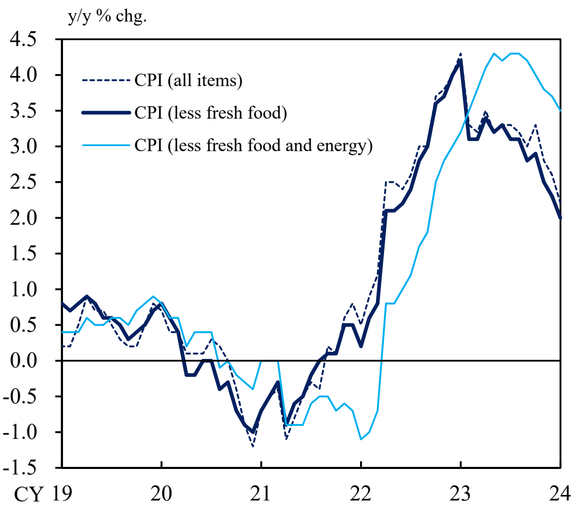


Note: Figures exclude the effects of the consumption tax hike.
Source: Bank of Japan.

Chart 10

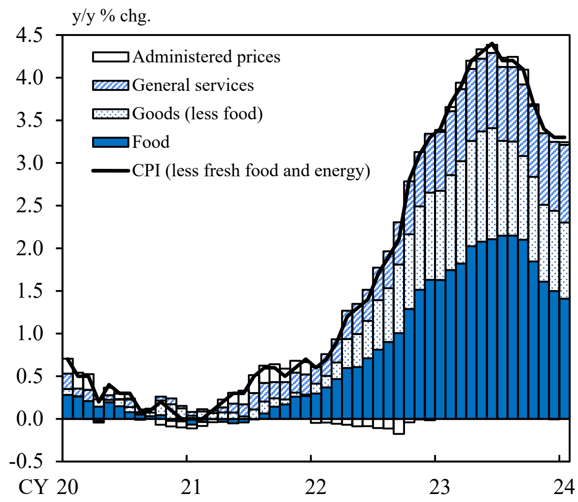
Consumer Prices

CPI for All Items and Core CPI



Source: Ministry of Internal Affairs and Communications.

CPI (Excluding Temporary Factors)



Notes: 1. "Food" excludes fresh food and consists of "agricultural, aquatic, and livestock products" and "food products."
2. "Administered prices" excludes energy prices and consists of public services and water charges.
3. The CPI figures are Bank staff estimates and exclude the effects of the consumption tax hike, free education policies, travel subsidy programs, and mobile phone charges.
Source: Ministry of Internal Affairs and Communications.

Chart 11

Outlook for Economic Activity and Prices
(as of January 2024)

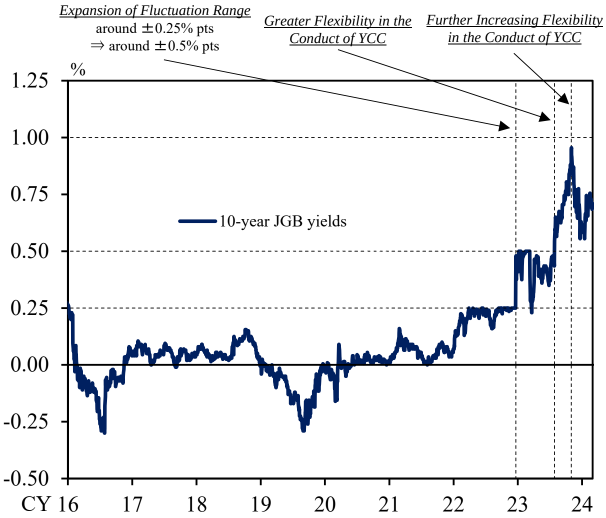
y/y % chg.

	Real GDP	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
Fiscal 2023	**+1.6 to +1.9 [+1.8]**	**+2.8 to +2.9 [+2.8]**	**+3.7 to +3.9 [+3.8]**
Forecasts made in October 2023	+1.8 to +2.0 [+2.0]	+2.7 to +3.0 [+2.8]	+3.5 to +3.9 [+3.8]
Fiscal 2024	**+1.0 to +1.2 [+1.2]**	**+2.2 to +2.5 [+2.4]**	**+1.6 to +2.1 [+1.9]**
Forecasts made in October 2023	+0.9 to +1.4 [+1.0]	+2.7 to +3.1 [+2.8]	+1.6 to +2.1 [+1.9]
Fiscal 2025	**+1.0 to +1.2 [+1.0]**	**+1.6 to +1.9 [+1.8]**	**+1.8 to +2.0 [+1.9]**
Forecasts made in October 2023	+0.8 to +1.2 [+1.0]	+1.6 to +2.0 [+1.7]	+1.8 to +2.2 [+1.9]

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

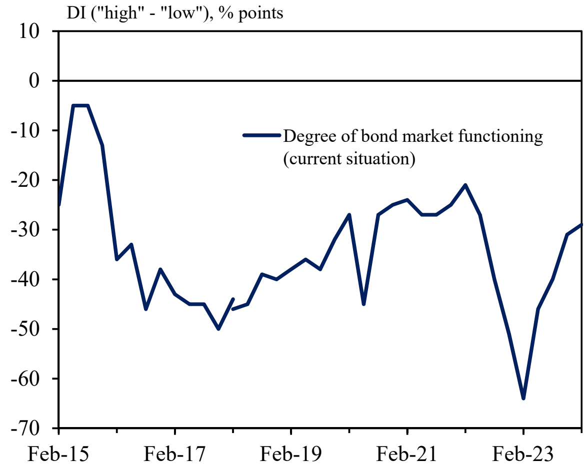
Developments in the Bond Market

JGB Yields



Source: Japan Bond Trading.

Bond Market Survey



Notes: 1. The survey from February 2018 onward includes responses from major insurance companies, asset management companies, etc., in addition to those from institutions eligible for the Bank's outright purchases and sales of JGBs. Regarding the figures for February 2018, the reference data, which are based on responses only from institutions eligible for the Bank's outright purchases and sales of JGBs, are also indicated.
2. The survey is conducted in February, May, August, and November each year.

Source: Bank of Japan.