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Bank of Japan

Economic Activity, Prices, and Monetary Policy in Japan

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(English translation based on the Japanese original)

I. Economic Activity at Home and Abroad: Recent Developments and the Outlook

A. Overseas Economies

Let me start my speech by talking about developments in overseas economies.

The global economy had been on a gradual decelerating trend for the past few years, recording 3.2 percent growth in 2015 on a year-on-year basis from 4.2 percent in 2011. During this period, advanced economies maintained growth of around 1 to 2 percent, whereas emerging economies slowed to a fair extent, from 6.3 percent in 2011 to 4.0 percent in 2015. This suggests that the global economic deceleration was largely attributable to the slowdown in emerging economies. Amid the heightening uncertainty over emerging economies, global financial markets have shown volatile movements since summer 2015, with the depreciation of currencies and the decline in stock prices mainly being seen in emerging economies.

Recently, this decelerating trend in the global economy has been staved off. Among advanced economies, the U.S. economy has maintained its stable growth, led mainly by solid consumption. The employment situation -- which underpins consumption -- has been steadily improving, with the unemployment rate declining to around 5 percent, the level close to full employment. While the entering administration's policy management and the Federal Reserve's monetary policy conduct have been attracting much attention, I expect the economy to continue to grow for the time being at a rate of around 1.5 to 2.0 percent on a year-on-year basis -- which is close to its potential growth rate -- in a situation where accommodative financial conditions will be maintained.

The European economy has continued to recover moderately, mainly in the household sector. As for the outlook, it is highly likely that this moderate growth will continue under accommodative financial conditions, although uncertainty -- mainly associated with the United Kingdom's vote to leave the European Union (EU) -- is still a drag on the economy.

Among emerging economies, the Chinese economy is likely to broadly follow a stable growth path as the government proactively implements both fiscal and monetary policy measures to underpin economic activity, although the pace of growth has somewhat slowed, mainly in manufacturing, during the process of structural reform. So far, commodity-exporting economies have experienced downward pressure from the decline in commodity prices, but they are likely to gradually pick up going forward as commodity prices hit the bottom. Other emerging economies are also expected to gain momentum for growth as the effects of their governments' economic stimulus measures, as well as those of economic recovery in advanced economies, permeate them.

According to the October 2016 *World Economic Outlook* (WEO) released by the International Monetary Fund (IMF), emerging economies are projected to register relatively high growth of 4.2 percent for 2016 and 4.6 percent for 2017 and continue to moderately increase their pace of growth thereafter. Reflecting such recovery in emerging economies, the global economy is projected to grow at 3.1 percent for 2016, 3.4 percent for 2017, and gradually accelerate its pace thereafter.

That said, it is difficult to dispel uncertainties currently surrounding the global economy in a short period of time. Regarding the entering U.S. administration, expectations for expansionary fiscal policies and unwinding of financial regulations seem to be heightening in the markets. However, details of the policy measures are still unclear, and therefore their effects should be carefully monitored. Regarding the United Kingdom's vote to leave the EU, due attention should continue to be paid to developments in the negotiations between the United Kingdom and the EU as well as any influences spreading to other EU member states. Other new global concerns include uncertainty in the banking sector in Europe and the increasing protectionist movements across the globe. It is unlikely that geopolitical risks will diminish anytime soon. Although the global economy has been gradually entering a recovery process, considering the high uncertainty at present, the recovery path is not rock solid.

B. Japan's Economy

Next, I will touch on economic activity in Japan.

The economy has continued its moderate recovery trend, although exports and production have been sluggish, due mainly to the effects of the slowdown in overseas economies. The real GDP growth rate, which was 0.6 percent on average during the period from 2013 through 2015, marked 2.1 percent, 0.7 percent, and 2.2 percent, respectively, for the first through the third quarter of 2016 on an annualized quarter-on-quarter basis, registering positive growth for three consecutive quarters for the first time since 2013. These rates may not seem so high compared to those of other countries, but Japan's economy has continued to grow at a pace above its potential, which is estimated to be in the range of 0.0-0.5 percent. As for the outlook, the relatively high growth is expected to continue given the pick-up in overseas economies and the government's large-scale stimulus measures.

Let us look at growth components by expenditure item. Net exports have remained more or less at the same level amid the continuing slowdown in overseas economies. Going forward, the growth momentum in net exports is likely to gradually accelerate as overseas economies -- mainly emerging economies -- start to pick up.

Growth in private consumption has been slow after the consumption tax hike to 8 percent in 2014 when people in Japan substantially front-loaded purchases, particularly of durable goods, bearing in mind the subsequent raise to 10 percent that had been scheduled in October 2015. Even before then, demand in durable goods had been brought forward by a tax reduction for environmentally friendly cars and the eco-point system for energy-efficient household electrical appliances. Reflecting these factors, the slowdown in demand following the front-loaded consumption seems to be somewhat prolonged. Since summer 2015, amid highly volatile global market movements, private consumption has been pushed down by the weakening of consumer sentiment and the negative wealth effects brought about by the decline in stock prices. As for the outlook, I expect that private consumption will gradually become robust as such negative external factors gradually dissipate, and as the employment and income situation continues to improve, mainly on the back of the government's large-scale stimulus measures.

Business fixed investment has continued to increase, albeit moderately, as corporate profits have been at high levels. It is likely to maintain its increasing trend, supported by accommodative financial conditions and heightening of Olympic Games-related demand.

Public investment is projected to expand, due mainly to the government's large-scale stimulus measures, and thereafter remain at a relatively high level as Olympic Games-related demand heightens. The stimulative effects of the fiscal measures are expected to be maximized with financial conditions remaining accommodative. The Cabinet Office estimates that the fiscal measures can push up real GDP by about 1.3 percentage points.

In the Bank's October 2016 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), the real GDP growth rate is projected to continue growing at a pace above its potential, with the medians of the Policy Board members' forecasts at 1.0 percent for fiscal 2016, 1.3 percent for fiscal 2017, and 0.9 percent for fiscal 2018, although there are differing views on this among the members.

C. Prices

The year-on-year rate of change in the consumer price index (CPI) for all items less fresh food has declined to a level slightly below 0 percent. The effects of the decline in energy prices have continued to make a relatively large negative contribution, and prices for durable goods, such as household electrical appliances, have turned to a decline, reflecting the yen's appreciation since the middle of 2015. The sluggish private consumption has led firms' price-setting behavior to become cautious. Going forward, the effects of the decline in energy prices are likely to dissipate through the beginning of 2017 and those of the yen's appreciation are also expected to gradually wane. If private consumption starts to recover as the economy continues to grow at a pace above its potential and as the employment and income situation improves further, firms are expected to take a more aggressive stance on setting prices. In this situation, the year-on-year rate of change in the CPI is likely to gradually start picking up. According to the medians of the Policy Board members' forecasts in the October 2016 Outlook Report, the CPI for all items less fresh food is projected to see a steady acceleration in its rate of increase from minus 0.1 percent for fiscal 2016 to 1.5 percent for fiscal 2017, and 1.7 percent for fiscal 2018.

In the longer run, prices tend to move almost in parallel with nominal wages: firms try to pass on rises in cost, which are due to wage increases, to sales prices and households try to maintain real purchasing power by demanding wage increases in line with price increases. With the growing expectations that wages will be raised continuously amid continued improvement in the employment situation, the underlying rate of increase in the CPI will likely accelerate gradually with such interactive effects between rises in wages and prices. In this sense, I am paying particularly close attention to the labor-management wage negotiations in spring 2017 in forecasting future price developments.

II. Monetary Policy: Comprehensive Assessment and New Monetary Policy Framework

At the Monetary Policy Meeting held on September 20 and 21, 2016, the Bank decided to introduce Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control as a new framework for strengthening monetary easing. At the meeting, it conducted a comprehensive assessment of the effects of past policy measures and factors that have hampered the achievement of the price stability target.

Next, I would like to give an outline of the Comprehensive Assessment and then explain the new policy framework with my own view.

A. Comprehensive Assessment

The Bank introduced QQE in April 2013. Since then, the employment situation has significantly improved with the unemployment rate having declined to 3 percent, and corporate profits have reached a record-high level with stock prices having risen. As for prices, the year-on-year rate of change in the CPI for all items less fresh food and energy -- for which prices tend to fluctuate widely -- turned positive in autumn 2013 and has remained in positive territory for three years. Japan's economy is no longer in deflation, which is commonly defined as a sustained decline in prices. Thus, QQE has served to improve economic activity and price developments.

However, the price stability target of 2 percent has not yet been achieved. When the Bank introduced QQE, it had envisioned a main transmission mechanism of the policy effects through which QQE would lower real interest rates by raising inflation expectations and pushing down nominal interest rates. The main factors behind the delay are as follows. First, since the second half of 2014, the observed inflation rate has stalled due to exogenous developments including the decline in crude oil prices, weakness in demand following the consumption tax hike in April 2014, and volatility in financial markets. Second, amid this situation, inflation expectations weakened, reflecting the fact that they have a strong tendency to move in line with the observed inflation rate in Japan.

Meanwhile, the Bank's large-scale purchases of Japanese government bonds (JGBs) under QQE, in combination with the negative interest rate policy introduced in January 2016, have been significantly effective in pushing down nominal interest rates across the entire yield curve. Given this experience, the Bank judged that it was possible to control short- and long-term interest rates under the new policy framework. At the same time, there was concern, such as over the possibility that deterioration in the business environment for financial institutions might negatively affect the financial intermediation going forward. This was because, since the introduction of the negative interest rate policy, the declines in banks' lending rates had been significant compared to those in deposit interest rates, which already had little room to fall, and because long- and super-long-term interest rates also had declined significantly. The Bank considered it necessary to take these points into account when introducing the yield curve control.

B. New Monetary Policy Framework

Based on the Comprehensive Assessment, the Bank decided to introduce QQE with Yield Curve Control as a new framework for strengthening monetary easing. The framework consists of the two components of yield curve control and an inflation-overshooting commitment.

Under yield curve control, the Bank controls short- and long-term interest rates through open market operations, such as purchases of JGBs. It sets the short-term policy interest rate applied to part of financial institutions' current accounts at the Bank (the Policy-Rate Balances) and the target level for 10-year JGB yields. In the past, many central banks have conducted monetary policy by controlling short-term interest rates. Controlling the long-term interest rate is a new challenge, but it seems to be functioning smoothly so far. By adding long-term interest rate control to the tools of monetary policy, I think that it has become possible for the Bank to implement monetary easing measures more flexibly, taking account, for example, of the effects on the financial intermediation, and that the sustainability of these measures has been enhanced.

Under the inflation-overshooting commitment, the Bank commits itself to continuing to expand the monetary base until the year-on-year rate of increase in the observed CPI for all items less fresh food exceeds the price stability target of 2 percent and stays above the target in a stable manner. In general, central banks have conducted monetary policy in a forward-looking manner, given that the effects of monetary policy spread to the economy with a certain time lag. In this regard, the Bank's new framework, which is linked to the observed CPI, is an extremely strong commitment. Through this commitment, the Bank aims to enhance the credibility of achieving the price stability target among the public, and to raise inflation expectations.

In this manner, the new policy framework consists of measures that could be regarded as extraordinary for a central bank, including control of the long-term interest rate and commitment linked to the observed CPI. The Bank has considered such flexible and decisive policy conduct as necessary in order to dispel people's deflationary mindset that has taken hold due to deflation that has lasted for a long period, and to push up the inflation rate amid a variety of exogenous factors.

With this framework, the Bank has shifted the operating target for its monetary policy from the quantitative to the interest rate aspect. However, needless to say, these are two sides of the same coin. Under QQE with Yield Curve Control, the Bank will continue with its large-scale purchases of JGBs in order to control interest rates. On this point, I would like to reiterate that there is no change in the Bank's stance that it will continue with monetary easing from both the quantitative and interest rate aspects.

III. Challenges Facing Japan's Economy and Monetary Policy

Next, I would like to elaborate on my own thinking regarding challenges facing Japan's economy and the Bank's monetary policy conduct from a somewhat long-term perspective.

Over many years, the economy continued to see low growth under a moderate decline in prices. In January 2013, the government and the Bank released a joint statement, and they have worked together since then to achieve sustainable economic growth with price stability. The economy is no longer in deflation, which is commonly defined as a sustained decline in prices, but the price stability target of 2 percent has not yet been achieved. Although the economy has been on a moderate recovery trend, it has not yet fully succeeded in achieving sustainable growth as the potential growth rate has remained at a low level.

Under these circumstances, firms and households seem to be conducting their economic activities on the assumption that prices and the economic growth rate will not rise so much going forward. Firms have maintained their cautious stance toward expanding their fixed costs, because they have not been confident regarding whether sales will increase steadily in the future. Growth in business fixed investment and wages -- particularly in base pay, which leads to a permanent increase in wages -- has been slow relative to the improvement in corporate profits and the employment situation. Households have also been cautious in increasing their spending, despite the rise in their incomes, as they see that it seems impossible to project a permanent expansion in income and/or a rise in prices.

I view this current situation as a sort of equilibrium. In general, a virtuous cycle from income to spending among firms and households promotes sustainable economic growth and price stability. An increase in business fixed investment raises the potential growth rate through accumulation of capital and improvement in labor productivity. Wage growth exerts upward pressure on prices mainly through expansion of firms' costs, as I have mentioned earlier, and an increase in household spending brings about improvement in the output gap, also leading to price rises. Currently, however, it seems that the expectations for low inflation and low economic growth that have taken hold among firms and households have been hampering the operation of such a virtuous cycle, thereby constraining the economic growth rate and price rises in a self-fulfilling manner.

What then, is required to get out of such equilibrium? My answer is that it is not a magical wand, but instead strenuous efforts to be made by a wide range of entities. I think that it is all the more important that the Bank, for its part, pursue price stability through pushing up inflation expectations and maintaining accommodative financial conditions under the new monetary policy framework. At the same time, the government and the private sector should play key roles with regard to moving forward. Their actions toward raising wages strongly support the achievement of price stability. Moreover, in order to achieve sustainable economic growth, I think that efforts such as the following are also essential; namely, the government's promotion of a growth strategy and structural reforms, and the private sector's innovations in areas including human resource development as well as research and development. The Bank will underpin these initiatives by maintaining accommodative financial conditions, thereby contributing to strengthening Japan's growth potential in the long term. Also, I expect that the Bank's measures such as purchases of exchange-traded funds (ETFs) composed of stocks issued by firms that are proactively making investment in physical and human capital, as well as loan disbursement under the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth, will assist initiatives by the private sector.

If the outlook for prices and economic growth in Japan brightens, the effects of monetary easing will heighten through a decline in real interest rates and a rise in the natural interest rate. I expect that the endeavors that the government, the private sector, and the Bank are making together as one will bear fruit, and the virtuous cycle of the economy will start to operate vigorously on the new outlook for sustainable economic growth with price stability.