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Bank of Japan

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

Speech at a Meeting with Business Leaders in Saitama

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(English translation based on the Japanese original)

I. Developments in Economic Activity and Prices

I would like to start my speech with a look at developments in economic activity and prices.

At the Monetary Policy Meeting held on October 31 and November 1, 2016, the Bank of Japan published the *Outlook for Economic Activity and Prices*, or the Outlook Report. In this report, the Bank presented its projections for Japan's economic activity and prices through fiscal 2018.

I will explain developments in economic activity and prices by presenting the main content of the Outlook Report.

A. Overseas Economies

Let me first touch on developments in overseas economies. The Bank's assessment is that overseas economies have continued to grow at a moderate pace, but the pace of growth has decelerated somewhat, mainly in emerging economies.

In terms of the outlook, overseas economies are projected to remain in the current situation for some time; thereafter, it is likely that advanced economies will continue to realize steady growth and emerging economies will see a gradual increase in their growth rates on the back of the developments in advanced economies and emerging economies' policy effects. A similar view was presented in the *World Economic Outlook* published in October 2016 by the International Monetary Fund (IMF).

Looking at developments by major region, the U.S. economy has continued to recover steadily, assisted by firmness in household spending, although the industrial sector lacks momentum. As for the outlook, the economy is expected to continue to see firm growth driven by private demand, underpinned by accommodative financial conditions.

The European economy is likely to generally follow a moderate recovery path, while uncertainty associated with the United Kingdom's exit from the European Union (EU) is likely to be a burden on the economy.

The Chinese economy has remained slightly subdued, particularly in exports and production. As for the outlook, the economy is likely to broadly follow a stable growth path as authorities proactively carry out measures to support economic activity, although sluggishness in the growth pace is expected to remain in the manufacturing sector.

Other emerging economies and commodity-exporting economies as a whole have remained subdued, although positive developments have been observed, reflecting the effects of economic stimulus measures and a recovery in IT-related demand. These economies will probably remain as they have been for some time, but the growth rates are likely to increase gradually thereafter, due mainly to the effects of the economic stimulus measures and the spread of the effects of steady growth in advanced economies.

B. Japan's Economy and Price Developments

1. Current situation

Now I would like to discuss developments in economic activity and prices in Japan.

The Bank's assessment is that Japan's economy has continued its moderate recovery trend, although exports and production have been sluggish, due mainly to the effects of the slowdown in emerging economies. On the domestic demand side, business fixed investment has been on a moderate increasing trend as corporate profits have been at high levels. According to business plans for fiscal 2016 in the September *Tankan* (Short-Term Economic Survey of Enterprises in Japan), fixed investment on a basis close to GDP definition has remained firm on the whole, although profit projections have been revised down slightly. Against the background of steady improvement in the employment and income situation, private consumption has been resilient, although relatively weak developments have been seen in some indicators. Housing investment also has continued to pick up. Exports have been more or less flat against the backdrop of developments in overseas economies that I mentioned earlier. Reflecting these developments in demand both at home and abroad, industrial production has continued to be more or less flat.

On the price front, the year-on-year rate of change in the consumer price index (CPI) for all items less fresh food has been slightly negative.

2. Outlook

I will now look at the outlook for Japan's economy during the projection period, which covers from fiscal 2016 through fiscal 2018. Although sluggishness is expected to remain in exports and production for some time, the economy is likely to expand moderately thereafter. Domestic demand is likely to follow an uptrend on the back of highly accommodative financial conditions and fiscal spending through the government's large-scale stimulus measures. Exports are expected to start increasing moderately along with the recovery in overseas economies. Reflecting this outlook, Japan's economy is likely to continue growing at a pace above its potential through the projection period. Looking at the medians of the Policy Board members' forecasts in the October 2016 Outlook Report, the real GDP growth rate is projected to be 1.0 percent for fiscal 2016, 1.3 percent for fiscal 2017, and 0.9 percent for fiscal 2018.

Let me explain the outlook in detail by major component. Business fixed investment, mainly in manufacturing firms, is likely to be affected temporarily toward the end of fiscal 2016 by the slowdown in overseas economies and the past yen appreciation. However, it is likely to continue to see a moderate uptrend thereafter. This is because, in a situation where corporate profits are expected to be at high levels as extremely stimulative financial conditions are maintained, fixed investment will be positively affected by the effects of fiscal measures including projects conducted under the Fiscal Investment and Loan Program and tax reductions for capital investment, as well as by moderate improvement in growth expectations. Moreover, even if corporate profits become weaker than expected to some degree, business fixed investment is likely to be underpinned in particular by investment (1) for growth areas, in view of the 2020 Tokyo Olympics, (2) in labor-saving machinery and equipment in order to deal with labor shortages, and (3) for maintenance and replacement of equipment to address deterioration from aging. Private consumption is expected to increase moderately, on the back of a rise in real disposable income supported in part by the set of economic stimulus measures, and housing investment is likely to continue picking up. From the middle of the projection period, exports are projected to modestly rise as, for example, exports of capital goods -- in which Japan has a comparative advantage -- gradually pick up with the effects of the slowdown in emerging economies waning. Industrial production is

likely to head toward a moderate increase as the effects of the set of stimulus measures become evident from the turn of fiscal 2017.

The year-on-year rate of change in the CPI (all items less fresh food) is likely to be slightly negative or about 0 percent for the time being due to the effects of the decline in energy prices. As the output gap improves and medium- to long-term inflation expectations rise, the rate of change is expected to increase toward 2 percent in the second half of the projection period. Looking at the medians of the Policy Board members' forecasts in the October 2016 Outlook Report, the year-on-year rate of change in the CPI (all items less fresh food) is projected to be minus 0.1 percent for fiscal 2016, 1.5 percent for fiscal 2017, and 1.7 percent for fiscal 2018.

3. Risks to the outlook for economic activity and prices

So far, I have talked about the Bank's baseline scenario of the outlook for Japan's economic activity and prices through fiscal 2018. This scenario, of course, entails upside and downside risks, and I consider that risks to both economic activity and prices remain skewed to the downside.

I am particularly concerned by the risk that global financial markets may experience sudden volatile movements, reflecting increased uncertainty about overseas economic developments. Uncertainty will remain high for some time with the incoming U.S. administration's economic management, the ongoing negotiations on the United Kingdom's exit from the EU, and the prospects for the financial sector in Europe. Such developments tend to create volatility in the financial markets. Japan's household and business sentiment has shown resilience recently. My impression is that such sentiment hung on well despite the turbulence in global financial markets in early 2016 and situations at home -- such as the Kumamoto Earthquake and irregular weather in summer -- where sentiment continued to deteriorate easily. This resilience in sentiment is encouraging, but possible sudden volatility in financial markets still requires vigilance, because this could hit sentiment, which has shown resilience in the face of considerable continued uncertainty, especially given the situation abroad. Under these circumstances, it is important for the Bank not to add to market volatility inadvertently in conducting monetary policy.

II. The Bank's Monetary Policy

Next, I will talk about the Bank's monetary policy.

At the Monetary Policy Meeting held in September 2016, the Bank conducted a comprehensive assessment of the developments in economic activity and prices as well as policy effects since the introduction of quantitative and qualitative monetary easing (QQE). In light of the findings of the assessment, with a view to achieving the price stability target of 2 percent at the earliest possible time, it decided to introduce QQE with Yield Curve Control as a means of strengthening the existing framework for monetary easing. The Bank accordingly published a detailed report of the findings entitled "Comprehensive Assessment." In what follows, I take this opportunity to explain the main points of this report and the new policy framework.

A. Main Points of the Comprehensive Assessment

I will highlight three points regarding the Comprehensive Assessment.

1. Positive effects of QQE

During the roughly three years since the introduction of QQE in April 2013, Japan's economic activity and prices have improved substantially. The main transmission channel of QQE envisaged by the Bank was the reduction in real interest rates. Indeed, QQE has lowered real interest rates by raising inflation expectations and pushing down nominal interest rates. Although the natural rate of interest has followed a downward trend, real interest rates have been well below the natural rate of interest since the introduction of QQE, leading to an improvement in financial conditions. Through the achievement of highly accommodative financial conditions, Japan's economy has reached a state of being no longer in deflation, which is commonly defined as a sustained decline in prices. It is reasonable to regard this as achievements accomplished under QQE. This is the first point of the Comprehensive Assessment.

2. Mechanism of inflation expectation formation in Japan

The second point is about the inflation expectation formation. Inflation expectations indicate households' and firms' views on future price changes. The mechanism of formation

of inflation expectations in Japan tends to be heavily influenced by the course of the past inflation rate, considerably more than in other countries. This tendency is phrased as an adaptive mechanism. The Bank has attempted to make expectation formation more forward-looking by implementing QQE. The forward-looking expectation formation is based on the idea that the observed inflation rate will, in due course, converge to the price stability target set by the central bank, even if it fluctuates due to a variety of factors. In reality, however, before the forward-looking expectation formation fully took hold, the observed inflation rate declined, due mainly to the fall in crude oil prices. As a result, people's inflation expectations also declined in an adaptive manner. This is the main factor that has hampered achieving the price stability target of 2 percent to date. That is to say, in order to achieve the price stability target, it is very important that the forward-looking expectation formation be firmly entrenched among people, or that inflation expectations be anchored.

3. Effects of the decline in the yield curve and points to be considered

The third point of the Comprehensive Assessment is that the combination of large-scale purchases of Japanese government bonds (JGBs) and the negative interest rate policy is effective in exerting influence on the entire yield curve and consequently in achieving highly accommodative financial conditions. Given this, lending rates as well as interest rates on corporate bonds and CP have clearly declined.

On the other hand, there is a possibility that the excessive decline in interest rates could have a negative impact on the functioning of financial intermediation. It should be noted that financial institutions' loan-deposit interest margins have been on a declining trend since the 1990s. In that sense, this has been a challenge faced by financial institutions' management even before the introduction of the negative interest rate policy. Since the introduction, it is true that the decline in deposit rates has been smaller than the decline in lending rates. Therefore, this should have spurred on the declining trend in interest margins. Let me also mention that the excessive declines in long-term and super-long-term rates lower the rate of return on insurance and pension products. It is possible that such developments can cause uncertainty regarding the sustainability of financial functioning in a broad sense, thereby having a negative impact on economic activity through a deterioration

in people's sentiment. It is therefore necessary for the Bank to pay due attention to the impact on financial functioning when conducting monetary policy.

B. Main Points of QQE with Yield Curve Control

Based on the deliberations I have explained so far, the Bank decided to introduce a new framework for monetary easing, QQE with Yield Curve Control. This consists of two major components. The first is an "inflation-overshooting commitment" in which the Bank commits itself to continuing to expand the monetary base until the year-on-year rate of increase in the observed CPI exceeds the price stability target of 2 percent and stays above the target in a stable manner. And the second is "yield curve control" in which the Bank controls short-term and long-term interest rates.

1. Inflation-overshooting commitment

I will first talk about the inflation-overshooting commitment, which corresponds to the second point of the Comprehensive Assessment I mentioned earlier. The Bank has adopted this commitment as a means of raising inflation expectations. The Bank's existing commitment is to continue with monetary easing, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. In addition to this commitment, under the new policy framework, the Bank has committed to continuing to expand the monetary base until the year-on-year rate of increase in the observed CPI exceeds the price stability target of 2 percent and stays above the target in a stable manner. The Bank has demonstrated its unwavering determination by making a commitment based on the observed CPI -- that is, continuing to expand the monetary base until the rate of increase in the observed CPI stays above 2 percent in a stable manner.

2. Yield curve control

Let me turn to yield curve control. This corresponds to the second and third points of the Comprehensive Assessment that I mentioned earlier. In terms of yield curve control, nothing has changed in terms of the Bank's commitment, in that it is continuing with large-scale JGB purchases. The difference from the existing policy framework is that, while the Bank used to set the paces of increase in the monetary base and the amount outstanding of its JGB holdings as its operating targets, in the new framework it has set the levels of the

short-term policy interest rate and 10-year JGB yields as its operating targets. Under the existing framework, it was clear how JGB purchases are conducted, but there was a possibility that the purchases could push down yields either insufficiently or excessively, in comparison with an appropriate yield curve. Under the new framework, the Bank is able to conduct monetary policy in a flexible and effective manner by taking account of the economic, price, and financial conditions, as it directly targets long-term interest rates. This in turn should enhance the sustainability of monetary easing and prove to be a powerful policy scheme in raising inflation expectations. Furthermore, I would note that the new framework enables the Bank to conduct monetary policy while also paying due attention to the impact on the functioning of financial intermediation, as I mentioned earlier in the third point of the Comprehensive Assessment.

III. Toward Achieving the Price Stability Target of 2 Percent

The Bank judged in the Comprehensive Assessment that Japan's economy is no longer in deflation in terms of a sustained decline in prices, and at the same time introduced a policy scheme that is even more powerful than before, with a view to achieving the price stability target of 2 percent at the earliest possible time. I will now turn to this point.

A. The "Price Stability Target" Revisited

To begin with, why does the Bank consider it necessary to achieve the price stability target of 2 percent? The Bank's view on this was clearly indicated in the joint statement released in January 2013, in which the government and the Bank aimed at strengthening their policy coordination in order to overcome deflation and achieve sustainable economic growth. The Bank simultaneously decided to introduce the price stability target of 2 percent in terms of the year-on-year rate of increase in the CPI. Until then, it had judged the "price stability goal in the medium to long term" to be in a positive range of 2 percent or lower in terms of the year-on-year rate of change in the CPI, and had set a goal of 1 percent for the time being. The reason the Bank introduced the price stability target and set it at 2 percent was based on the following understanding. I will quote from the joint statement, as I think it would be worthwhile to revisit the document now that almost four years have passed since its release.

The Bank recognizes that the inflation rate consistent with price stability on a

sustainable basis will rise as efforts by a wide range of entities toward strengthening competitiveness and growth potential of Japan's economy make progress. Based on this recognition, the Bank sets the price stability target at 2 percent in terms of the year-on-year rate of change in the consumer price index.

Under the price stability target specified above, the Bank will pursue monetary easing and aim to achieve this target at the earliest possible time.

-- From "Joint Statement of the Government and the Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth," released on January 22, 2013.

What is important here is that the 2 percent price stability target is set based on the recognition that the inflation rate consistent with sustainable price stability will rise along with the enhancement of competitiveness and growth potential of Japan's economy. I am aware that some argue that the Bank should not simply push through price rises alone, or that there is no point in conducting monetary easing without an increase in potential growth through structural reforms. That being said, as is clear from the quote, the 2 percent price stability target certainly is not about achieving a rise in prices alone; rather, the target stays with efforts made by a wide range of entities toward improving competitiveness and growth potential of Japan's economy, including structural reforms. In other words, although I often hear debate over whether to stimulate demand or strengthen the supply side, or about monetary easing or structural reforms, these are not either/or choices. One is generally more focused than the other depending on the situation, but I believe that now is the time when both should be pursued.

As illustrated, the 2 percent price stability target has always been one that coexists with improvement in growth potential. Otherwise, I think it would create vague uneasiness with regard to a rise in prices as Japan has been caught in a long-standing situation of deflation.

B. Importance of a Three-Pronged Approach

Efforts toward boosting both competitiveness and growth potential of the economy have become particularly important, and this is a challenge not unique to Japan. According to the IMF executive board's discussion that appeared in the April 2016 *World Economic Outlook*,

executive directors broadly agreed that, in advanced economies, securing higher sustainable growth requires a three-pronged approach consisting of mutually reinforcing (1) structural reforms, (2) continued monetary policy accommodation, and (3) prudent fiscal support. The importance of using all policy tools -- monetary, fiscal, and structural -- was also expressed in the Group of Seven (G-7) Leaders' Declaration and in the Group of Twenty (G-20) communiqué.

Let me reiterate that what is necessary for Japan's economy is a rise in prices under increased growth potential with acceleration in positive developments for the household and corporate sectors. The Bank will continue to pursue powerful monetary easing in order to achieve the price stability target of 2 percent. On this basis, I believe that increasing the momentum of initiatives toward enhancing growth potential will also lead to raising inflation expectations. I would like to emphasize here that it may take some time for the growth potential to lift; once it gains momentum, however, inflation expectations would likely be lifted.

Inflation expectations are, so to speak, the sense of price trends among individuals and firms, and to change such expectations is not an easy task. This is even more the case in a country like Japan that has experienced protracted deflation. When QQE was introduced, the Bank set a time frame of about two years to achieve the price stability target in order to emphasize its strong and clear commitment to ensuring the economy's exit from deflation. Therefore, it may seem like it has taken a long time for the Bank to achieve this target. On the other side of the coin, only three and a half years have passed since the target was set. Needless to say, this does not mean that taking a long time to meet the objective is acceptable. First, it remains important to have the Bank's strong commitment to achieving the price stability target and express it in various different ways. Then, under the highly accommodative financial conditions maintained by the Bank in addition to the large-scale economic stimulus package implemented by the government, I consider it essential to enhance private demand by further accelerating efforts in both the public and private sectors to strengthen the growth potential.

In fact, such efforts are already being undertaken. The government recently decided on the

large-scale stimulus package. With regard to the working-style reform, it aims to compile a concrete action plan within the fiscal year. Also, the Council on Investments for the Future was set up as a new control tower for the government's growth strategy. In general, of course, efforts toward boosting growth potential will not bear fruit overnight. For example, there is the case of attracting foreign visitors to Japan, the significance of which increasingly has been voiced recently. It was in 2002 when the government first presented the Inbound Tourism Initiative of Japan as part of its economic revitalization strategy, and the Visit Japan Campaign was launched in 2003. Since then, the number of foreign tourists to Japan has doubled over the decade, and in 2013, more than 10 million tourists visited the country; for 2016, the figure already has surpassed 20 million. Also, spending by foreign visitors has expanded to over 3 trillion yen, which is more than four times the amount recorded five years ago. In the *Regional Economic Report* released in October 2016, the Bank introduced some recent initiatives taken by firms to capture the demand of inbound tourists. These included reaching out to overseas travel agencies and engaging in PR activities that made use of social networking sites (SNS); other examples included progressive approaches aimed at capturing visitors' demand after they have returned to their home countries through cross-border e-commerce. Such initiatives, which also have been seen in nonmetropolitan areas, have become increasingly widespread. In an aging society such as Japan, uneasiness over the future often tends to be overemphasized. Even if it may be difficult to produce immediate results, endless and constant efforts will lead Japan's economy to grow further.