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Japan's Economy and Monetary Policy

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(English translation based on the Japanese original)

Introduction

Good morning. I am honored to have this opportunity today to exchange views with leaders in the fields of local government, economy, and finance in Wakayama Prefecture. I was dearly hoping to visit Wakayama and meet you in person but, in light of the current situation of the novel coronavirus (COVID-19) pandemic, we had to decide to hold this meeting online. I would like to take this chance to express my sincere gratitude for your cooperation with the activities of the Bank of Japan's Osaka Branch. Wakayama Prefecture is a region full of history and culture that has produced world-renowned intellectuals such as Minakata Kumagusu and outstanding entrepreneurs such as Matsushita Konosuke. It is also famous for the fact that successive lords of the Kishu clan recruited resourceful farmers like Ohata Saizo to work on civil engineering and flood control projects in the Kino River basin, and appointed Hanaoka Seishu and Motoori Norinaga to promote learning.[1]

Today, I would like to talk about the current situation and outlook for the global and Japan's economies, the Bank's conduct of monetary policy, and the current economic situation of Wakayama Prefecture.

I. Current Situation and Outlook for Economic Activity

A. Global Economy

I would like to start by talking about the global economy. Looking back at developments in the global economy since the outbreak of COVID-19, economic activity dropped sharply for the April-June quarter of 2020, immediately after the start of the pandemic, but has been recovering at a relatively rapid pace since then (Chart 1). Since the turn of 2021, vaccination has progressed and economic activity has resumed in earnest, especially in advanced economies; at the same time, however, inflation has soared. The year-on-year rates of change in consumer prices have risen to about 7 percent in the United States and about 5 percent in Europe, both registering their highest rates in decades. Before the COVID-19 pandemic, it was generally viewed that inflation in the United States and Europe, as in Japan, was unlikely to see a clear increase, due to advances in digitalization and other

[1] Ando, S., "Chihō no kikigaki: Kaidai" [Regional Accounts: Synopses] in *Nihon nōsho zenshū* [The Complete Collection of Agricultural Books], vol. 28 (Tokyo: Rural Culture Association, 1982), pp. 96-119.

factors. Therefore, recent high inflation in the United States and Europe has been a great surprise even to many experts.[2] To gain a rough understanding of global developments in economic activity and prices since the start of the pandemic, it is useful to employ a basic tool of macroeconomics: the aggregate demand-aggregate supply model.[3]

Immediately after the start of the pandemic in spring 2020, economic activity was restricted in a wide range of fields due to lockdowns and other severe restrictions on day-to-day activities. As a result, a plunge was seen in demand, including private consumption, and the aggregate demand curve shifted significantly to the left (Chart 2). The aggregate supply curve also shifted to the left, as the labor supply decreased due to the impact of restrictions on going out and traveling and vigilance against COVID-19. As a consequence of the simultaneous decline in aggregate demand and supply, economic activity fell substantially, whereas the decline in prices was relatively modest.

Subsequently, as governments and central banks around the world implemented large-scale fiscal and monetary stimulus, demand, which had been suppressed due to the pandemic, rebounded all at once with the resumption of economic activity. Against this background, demand has increased rapidly for goods in particular, which had been less affected by the pandemic compared with services. At the same time, although it was expected that those who had exited the labor market would return to work with the lifting of restrictions, they have been slow to return to the labor market, particularly seniors, who are more vigilant against COVID-19, and those taking care of their children. Especially, in the United States, the early retirement of seniors triggered by the pandemic has become so widespread that it has been called the "Great Retirement." As such, while the aggregate demand curve shifted significantly to the right with the resumption of economic activity, the shift to the right of

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[2] Furman, J., "Why Did Almost Nobody See Inflation Coming?" Project Syndicate, January 17, 2022, https://www.project-syndicate.org/commentary/2021-us-inflation-forecasting-errors-economic-models-by-jason-furman-2022-01.

[3] In practice, sectoral differences are an essential factor in examining economic and price developments during the pandemic, as exemplified by the fact that the pandemic has had a particularly negative impact on the face-to-face services sector. Nevertheless, existing analytical methods are still useful in understanding overall economic and price developments.

the aggregate supply curve has been only marginal, suggesting that supply has not fully kept up with buoyant demand. Thus, the level of economic activity has increased, and inflation has also risen markedly. The reason for the recent rise in inflation in the United States and Europe is that the pandemic is having a non-negligible impact on the supply side, in addition to the demand side (Chart 3).

I have explained the current situation of the global economy, focusing on the United States and Europe. Regarding the outlook, as the impact of COVID-19 gradually wanes, the global economy is likely to continue registering relatively high growth, albeit with variation across countries and regions, supported by aggressive macroeconomic policies taken mainly in advanced economies. For the time being, supply-side constraints seen particularly in labor markets, such as in the United States, are likely to weigh on economic activity while pushing up wages and prices. It is expected that these constraints will be gradually resolved and inflation will decline moderately as a result. However, attention needs to be paid to the risk that the impact of supply-side constraints will be prolonged or amplified. Among other risks to the global economy are future developments in macroeconomic policies taken by the respective countries and regions. Of particular attention is how the course of U.S. monetary policy will affect asset markets and global financial markets. Changes in capital flows in global financial markets could affect emerging economies, which are still on their way to recovery.[4] In addition, attention should be paid to whether adjustments in the Chinese economy, such as in the real estate sector, will lead to a decline in the economy's potential growth rate. Moreover, it is important to closely monitor the effects of geopolitical risks on commodity prices and market sentiment.

B. Japan's Economy

Let me now turn to Japan's economy. The pace of recovery in demand in the economy had been only moderate when compared with the U.S. and European economies. This was mainly because of persistent vigilance against COVID-19 among consumers in Japan, especially among seniors. However, since early autumn last year, services consumption in Japan has turned to a recovery trend on the back of the low level of confirmed COVID-19

[4] For a review of global financial cycles, see Miranda-Agrippino, S. and Rey, H., "The Global Financial Cycle," *NBER Working Paper*, no. 29327, 2021, https://www.nber.org/papers/w29327.

cases and the lifting of the state of emergency. In this situation, a pick-up in Japan's economy has become evident.

Japan's economy is likely to recover as downward pressure stemming from COVID-19 on services consumption and the effects of supply-side constraints wane, while being supported by the increase in external demand, accommodative financial conditions, and the government's economic measures. Thereafter, as a virtuous cycle from income to spending intensifies in the overall economy, including the household sector, the economy is expected to continue growing at a pace above its potential growth rate. In terms of Japan's real GDP growth rate, although it was minus 4.5 percent for fiscal 2020, the Bank projects that it will turn positive to 2.8 percent for fiscal 2021, and then accelerate to 3.8 percent for fiscal 2022, mainly due to the effects of the government's economic measures (Chart 4). However, risks to this baseline scenario are skewed to the downside for the time being, mainly because of the course of COVID-19, including the Omicron variant, and its impact on domestic and overseas economies. With this in mind, I will next explain in some detail the mechanism behind the baseline scenario.

In the corporate sector, the virtuous cycle from income to spending, triggered by steady external demand, is projected to continue operating (Chart 5). Exports and production declined temporarily during summer last year due to the impact of parts procurement difficulties stemming from the spread of COVID-19 in Southeast Asia, but they have recovered since autumn with the waning of procurement difficulties (Chart 6). Exports and production are likely to continue increasing as a trend, supported by firm expansion in global demand, mainly for digital-related goods, but attention needs to be paid to the impact of the Omicron variant on supply chains. Corporate profits are projected to continue on an improving trend on the back of an increase in domestic and external demand, despite being affected by deterioration in the terms of trade that reflects a rise in commodity prices. In this situation, an uptrend in business fixed investment is expected to become clear -- mainly for investment in growth areas such as digital-related investment and research and development investment related to decarbonization -- supported mainly by improvement in corporate profits and accommodative financial conditions, although weakness is projected to remain for the time being in investment by the face-to-face services sector.

It is expected that the virtuous cycle from income to spending will spread gradually from the corporate sector to the household sector (Chart 5). Private consumption is projected to be restrained for the time being, through vigilance against COVID-19, including the Omicron variant. However, it is expected to recover, supported by the materialization of pent-up demand, such as for services, as the resumption of consumption activities progresses while public health is being protected, mainly due to widespread vaccination, including the rollout of booster shots (Chart 7). Thereafter, private consumption is projected to continue increasing moderately, albeit at a slower pace, with improvement in employee income that mainly reflects wage increases in industries with acute labor shortage and a rise in the number of regular employees.

C. Price Developments in Japan

I will move on to price developments in Japan. Despite being affected by a reduction in mobile phone charges, the year-on-year rate of change in the consumer price index (CPI) for all items excluding fresh food has been 0.5 percent recently, reflecting a rise in energy prices (Chart 8). For the time being, it is likely to increase in positive territory, reaching around 1 percent in spring, albeit with fluctuations. This will likely occur on the back of the rise in energy prices, a moderate pass-through of raw material cost increases, and dissipation of the effects of the reduction in mobile phone charges. Thereafter, although the positive contribution of the rise in energy prices is projected to wane, the rate of increase in the CPI is expected to stay at around 1 percent through fiscal 2023, the end of the projection period, because the underlying inflationary pressure is projected to increase, mainly on the back of improvement in the output gap and a rise in inflation expectations.

In this baseline scenario of the outlook for prices, it is expected that the output gap will continue to improve, and against this background, firms' price-setting stance will gradually become active and raw material cost increases will be passed on moderately to selling prices. Up until the previous *Outlook for Economic Activity and Prices* (Outlook Report), published in October 2021, it was assessed that risks to prices were skewed to the downside. Attention was paid to a risk that downward pressure on Japan's economy, stemming from the impact of COVID-19 and developments in overseas economies, would weigh on prices. On top of that, consideration was given to the risk that the rate of increase in prices would

slow despite improvement in the output gap and an increase in raw material costs, amid the deeply entrenched behavior and mindset, mainly among firms, based on the assumption that prices will not increase easily. In the baseline scenario presented in the January 2022 Outlook Report, however, not only downside risks but also upside risks are taken into account, given, for example, the recent rise in producer prices and an increase in firms' inflation expectations shown in the December 2021 *Tankan* (Short-Term Economic Survey of Enterprises in Japan). Specifically, as private consumption continues to recover, cost increases are likely to be passed on to selling prices not only at the producer level but also at the consumer level or downstream at a faster-than-expected pace. Therefore, the Bank judged in the January Outlook Report that upside and downside risks to overall prices are generally balanced.

II. Conduct of Monetary Policy

I will now talk about the conduct of monetary policy. At the December Monetary Policy Meeting, the Bank made decisions regarding the Special Program to Support Financing in Response to the Novel Coronavirus (COVID-19), which was set to expire at the end of this March. Specifically, it decided to extend the implementation period by six months until the end of September regarding financing support, mainly for small and medium-sized firms, while completing the support mainly for large firms as scheduled. The Special Program was originally set up to respond to the liquidity crisis. When COVID-19 first spread in Japan, firms' demand for liquidity soared in the market due to the emergency. In this situation, the number of lenders could have decreased, leading to a surge in interest rates and making it difficult for firms to smoothly raise the necessary amount of funds. However, this was avoided partly owing to the Special Program, which aims to support financing, mainly of firms.[5] Although the pandemic has not completely subsided, firms' funding environment has mostly improved. That said, the financial positions of small and medium-sized firms have remained uncertain, and the Bank will therefore continue to firmly support their financing.

[5] In this sense, the Special Program is similar to the supply of liquidity at times of financial crises.

The adjustments to the Special Program do not mean the end of the current monetary easing. Japan's CPI developments I explained earlier show that the price stability target of 2 percent is yet to be achieved in a stable and sustainable manner. As central banks abroad have started taking steps toward reducing monetary accommodation with inflation rates exceeding targets, some have been arguing that the Bank should also adjust its monetary easing, and there has been speculation that the Bank is actually discussing making adjustments. However, in the first place, monetary policy these days is conducted with the aim of stabilizing prices in one's own country so that employment and income in that country develop in a stable manner. Japan no longer adopts the gold standard or a fixed exchange rate system. Under the floating exchange rate system, central banks should basically focus on stabilizing their own economy, and the normalization of monetary policy in Japan is associated with achieving the Bank's price stability target in a stable and sustainable manner.[6] Given the current situation where Japan's economy has finally started to pick up from the pandemic, it is definitely too early for the Bank to start tightening monetary policy when the target has not yet been achieved as this could hinder the economic recovery.

A. Price Developments in Japan Compared with the United States and Europe

Let me explain this in further detail by looking at recent price developments. As mentioned earlier, the year-on-year rate of change in the CPI for all items excluding fresh food (core CPI) has recently reached 0.5 percent. Meanwhile, the rate of change in the "core core CPI," which excludes both fresh food and energy, has been minus 0.7 percent. Price statistics tend to be affected by temporary factors, and this negative figure is largely due to the reduction in mobile phone charges last April. In fact, the rate of change in the CPI that excludes

[6] However, the spillover effects of monetary policy via capital flows, trade, and commodity markets, as well as the financial cycle and trade flows brought about by the effects, are important issues. That said, these issues do not restrict the autonomy of the Bank's monetary policy conduct.

energy as well as temporary factors such as the reduction in mobile phone charges, which can be regarded as underlying inflation, has been 0.7 percent.[7]

Since various individual prices in an economy fluctuate on a regular basis, overall prices in any country can fluctuate temporarily. However, if overall prices are considerably affected by temporary factors, prices cannot be said to be stable. Essentially, even if prices of certain goods and services decline, the amount of money saved will be used to increase spending on other items, and thus the effects of temporary factors on overall prices should be small from a somewhat long-term perspective. Temporary factors have a significant effect on Japan's CPI because underlying inflation is low. While there are several reasons why the Bank has set the price stability target at 2 percent, rather than 0 percent, one reason is that if inflation is 0 percent, temporary factors can easily lead to deflation.

Price developments in Japan have two characteristics that stand out when compared with the United States and Europe. First, services prices have hardly risen in Japan (Chart 9). In all three economies, prices of goods were showing similar developments before the outbreak of COVID-19. Services prices have not risen in Japan, and this is mainly because wages, a major determinant of services prices, have not increased. Since the start of the pandemic, goods prices have risen in the United States and Europe, reflecting supply shortages and a shift in consumption patterns from face-to-face services to goods.

Second, people's expectations of what prices will be in five or ten years' time -- i.e., medium- to long-term inflation expectations -- differ between these three economies (Chart 10). For example, the medium- to long-term inflation expectations of economists are highest in the United States, followed by Europe, while they are at low levels in Japan.

[7] Other issues concerning the consumer price statistics include the calculation of imputed rent. For details, see Statistics Bureau of Japan, *Shōhisha bukka shisū ni okeru kadai to sono taiō ni tsuite* [Issues in the Consumer Price Index and Responses], April 19, 2017. Moreover, there are often questions on how price adjustments are made for items whose price remains unchanged but whose quantity changes. Such hidden price increases are basically reflected in the CPI. For details, see "Shōhisha bukka shisū ni kansuru Q&A (kaitō)" [Q&A about the Consumer Price Index (Answers)], Statistics Bureau of Japan. The following book is also helpful in understanding issues of price indices: Watanabe, T., *Bukka to wa nani ka* [What Are Prices?] (Tokyo: Kodansha, 2022), pp. 11-75.

When households and firms, as with economists, expect that prices will not rise in the future, it is unlikely that prices will in fact rise.

B. Direction of Monetary Policy

These considerations show the direction that the Bank's monetary policy needs to take; that is, to raise both wages and medium- to long-term inflation expectations in Japan. So, how can wages be raised? There is an argument that, for wages to rise, labor productivity needs to improve. While this is generally valid over the business cycle, there are some caveats. In situations such as the present, where supply in the overall economy exceeds demand -- i.e., when the output gap is negative -- the measured productivity figures are not necessarily accurate. This is because many products remain unsold due to a lack of demand, which in turn makes labor productivity appear to be low.[8] Since Japan's labor market has not yet reached full employment, attention needs to be paid when measuring labor productivity. In addition, there is a mutually reinforcing relationship between the business cycle and economic growth. Labor productivity growth requires investment in a variety of tangible and intangible assets, including capital equipment, education and training, and research and development. Such investment increases during economic expansions and decreases during recessions. Only when these various types of investment are made will wages and productivity rise.[9]

Therefore, for wages to increase, the "temperature" of the economy needs to rise as demand in the overall economy increases, and the labor market needs to tighten accordingly. This, together with an increase in investment, will raise labor productivity. Such an economy is

[8] Yoshikawa, H., *Makuro keizaigaku no saikōchiku: Keinzu to Shunpētā* [Reconstructing Macroeconomics: Keynes and Schumpeter] (Tokyo: Iwanami Shoten, Publishing, 2020), pp. 73-123; Iwata, K., *"Nihon-gata kakusa shakai" kara no dakkyaku* [Overcoming a "Japanese-Style Unequal Society"] (Tokyo: Kobunsha Shinsho, 2021), pp. 137-64.

[9] For a study on the possibility of monetary policy affecting the automation of the economy through a change in the labor force participation rate, see Fornaro, L. and Wolf, M., "Monetary Policy in the Age of Automation," *BSE Working Paper*, no. 1290, 2021, https://bse.eu/research/working-papers/monetary-policy-age-automation.

known as a "high-pressure economy," an idea originally proposed in the United States.[10] This is the kind of economy that today's Japan requires. That said, if firms merely raise wages while keeping their selling prices unchanged, their profits will be squeezed. It is therefore important to have an environment where firms can lift their selling prices. For firms, there is a mutually reinforcing relationship between wages and prices (Chart 11). It is necessary to create a virtuous cycle where firms raise their selling prices, then in turn increase wages and investment, and households use their increased wages to boost consumption (Chart 12).

On the demand side, firms and households currently hold a large amount of "standby" funds (Chart 13).[11] In the corporate sector, cash and deposits have accumulated since the start of the pandemic because firms have tended to constrain spending, such as on business fixed investment, relative to improvement in profits, mainly against the background of heightened uncertainties. Funds on hand have accumulated significantly in the household sector as well due to the loss of consumption opportunities -- which mainly reflects restrictions on going out -- and to an increase in precautionary savings. When these standby funds are spent, the virtuous cycle will intensify. For these funds to be utilized, firms' and households' two "expectations" -- that is, growth expectations and inflation expectations -- need to rise

[10] The idea of a "high-pressure economy" has its origins in Okun, A. M., "Upward Mobility in a High-Pressure Economy," *Brookings Papers on Economic Activity*, Spring, 1973, pp. 207-61, https://www.brookings.edu/wp-content/uploads/1973/01/1973a_bpea_okun_fellner_greenspan.pdf. For studies conducted by the Bank, see Bank of Japan, Research and Statistics Department, "Minutes of the 7th Joint Conference Organized by the University of Tokyo Center for Advanced Research in Finance and the Bank of Japan's Research and Statistics Department, 'New Developments in Macroeconomic Analysis: Interaction between Business Cycles and Economic Growth,'" *BOJ Reports and Research Papers*, March 2018 (available in Japanese only); Kaihatsu, S. et al., "Interaction between Business Cycles and Economic Growth," *Bank of Japan Working Paper Series*, no. 18-E-12, June 2018, https://www.boj.or.jp/en/research/wps_rev/wps_2018/data/wp18e12.pdf. The following article assesses a "high-pressure economy" in the United States: Fatás, A., "The Short-Lived High-Pressure Economy," *VoxEU*, October 27, 2021, https://voxeu.org/article/short-lived-high-pressure-economy.

[11] I will cover only the key points today as I also talked about this in my previous speech. See Wakatabe, M., "Japan's Economy and Monetary Policy," speech at a meeting with local leaders in Hiroshima, September 1, 2021, https://www.boj.or.jp/en/announcements/press/koen_2021/ko210901a.htm/.

(Chart 14). I hope that the synergy between macroeconomic policies, such as the government's fiscal policy and the Bank's monetary policy, and the government's growth and distribution policies will lead to an expansion in aggregate demand.

With regard to the transmission of monetary policy effects, some have recently been advocating the "bad yen depreciation" argument. While the impact of foreign exchange rates on the economy was examined in detail in Governor Kuroda's speech last December and in the January 2022 Outlook Report, I would like to highlight three points here.[12] First, although the terms of trade have indeed deteriorated lately, this is mostly due to the rise in import prices, such as crude oil prices, in foreign currency terms, and relatively less affected by exchange rates (Chart 15).[13] Second, when crude oil prices rise, the global economy will likely be on a recovery trend, except in situations such as the oil shocks. Therefore, corporate profits tend to improve during periods when the terms of trade deteriorate. And third, there is an argument that the real effective exchange rate can be regarded as an indicator of "national strength." This rate is determined by the following three factors: prices in Japan, prices in other countries, and the nominal exchange rate, which is the relative value of the yen against other currencies. Although the definition of "national strength" is vague, when we think of this in terms of real GDP for example, the real GDP of both the United States and Germany is growing steadily, but there is no specific trend in the real effective exchange rates of these countries (Chart 16).[14]

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[12] Kuroda, H., "Monetary Policy and Firms' Behavior: Transmission Channels of Monetary Policy and Japanese Firms' Structural Changes," speech at the meeting of Councillors of Nippon Keidanren (Japan Business Federation) in Tokyo, December 23, 2021, https://www.boj.or.jp/en/announcements/press/koen_2021/ko211223a.htm/; Box 1 "Impact of Exchange Rate Movements on Japan's Real Economy" in the January 2022 Outlook Report, https://www.boj.or.jp/en/mopo/outlook/gor2201b.pdf.

[13] The year-on-year rate of change in the import price index (IPI) for December 2021, the latest figures available, was 41.9 percent in yen terms and 33.3 percent in contract currency terms. The difference between the two figures, which is a little less than 9 percent, corresponds to the direct impact of the yen's depreciation.

[14] In the case of Japan, the real effective exchange rate rose through 1995 but has declined since then. The rise was due to the appreciation of the yen in terms of the nominal effective exchange rate, whereas the decline was due to Japan's economy falling into deflation because of price cuts by firms. For details, see Iwata, K., *Shihon shugi keizai no mirai* [The Future of the Capitalist Economy] (Kanagawa: Yuhishobo, 2021), pp. 296-8.

C. Toward Achieving the Price Stability Target in a Stable and Sustainable Manner

Let me briefly reconfirm what we mean by achieving the price stability target of 2 percent in a stable and sustainable manner. The Bank's current policy stance is that it "will continue with Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control as long as it is necessary for maintaining the 2 percent target in a stable manner." Having the year-on-year rate of change in the CPI simply reach 2 percent and remain at that level merely for one month or a few months is not what is meant by "maintaining the 2 percent target in a stable manner." It also matters whether medium- to long-term inflation expectations will be anchored. Ben S. Bernanke, former chair of the Federal Reserve, said that "anchored" inflation expectations means those that are "relatively insensitive" to economic shocks.[15] In this regard, medium- to long-term inflation expectations in Japan have been reacting to shocks, implying that they have not yet been anchored at 2 percent.[16]

How can inflation expectations become anchored at 2 percent? Current price rises in Japan are due to a combination of factors: not only an "import" factor, an increase in commodity prices that reflects the recovery in overseas economies, but also a "domestic" factor, a resumption of domestic economic activity. Both firms' and households' sentiment has been recovering. Monetary policy cannot directly affect crude oil prices. Hence, facing price rises driven by the "import" factor, central banks should in general tighten their monetary policy only if the impact of this factor feeds through to the economy and in turn produces spillover effects, whereby wage inflation and inflation expectations spiral upward and inflation consequently exceeds the target level. In Japan, however, since medium- to long-term inflation expectations have not been anchored at 2 percent, a rise in inflation expectations,

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[15] Bernanke, B. S., "Inflation Expectations and Inflation Forecasting," speech at the Monetary Economics Workshop of the National Bureau of Economic Research Summer Institute held in Cambridge, Massachusetts, July 10, 2007, https://www.federalreserve.gov/newsevents/speech/bernanke20070710a.htm.

[16] Hogen and Okuma (2018) estimate that long-term inflation expectations enter the "anchor zone" when they rise to around 1.5 percent. That said, the estimate entails uncertainties regarding the extent to which actual inflation expectations obtained from sources such as survey results need to increase to enter the zone or the duration for which they stay within the zone. For details, see Hogen, Y. and Okuma, R., "The Anchoring of Inflation Expectations in Japan: A Learning-Approach Perspective," *Bank of Japan Working Paper Series*, no. 18-E-8, April 2018, https://www.boj.or.jp/en/research/wps_rev/wps_2018/data/wp18e08.pdf.

including through the spillover effects, is hoped for. It is therefore appropriate for the Bank to continue with monetary easing. In addition, since people's inflation expectations in Japan are largely adaptive to actual inflation, it is necessary for the underlying trend in observed inflation to stay at the level of 2 percent or higher for a certain period of time.[17]

III. Recent and Future Economic Activity in Wakayama Prefecture

Next, I would like to talk about the economy of Wakayama Prefecture. The prefecture has a thriving basic materials sector, including petroleum, steel, and chemicals, and is also renowned for its fruit tree farming. Given this context, the prefecture's economy has shown almost the same developments to Japan's economy. That is, although the indices of industrial production (IIP) and private consumption in the prefecture were both hit hard by COVID-19 in early 2020, they have been on a pick-up trend recently. Meanwhile, the active job openings-to-applicants ratio has moderately improved on the back of an increase in job openings.

From a medium- to long-term perspective, the population of Wakayama Prefecture has continued to decline. However, I have always believed that the negative impact of a declining and aging population has been overestimated in economic debates. For example, the global trend shows that there is no clear correlation between population growth rates and economic growth rates per capita. Although Wakayama Prefecture is currently being affected by COVID-19, in the decade leading up to the pandemic, gross prefectural product per capita was on an uptrend (Chart 17).[18] While a declining and aging population is an important issue to be addressed, it is quite possible to achieve growth even in this situation. It is crucial not to be overly pessimistic but rather to move forward steadily with initiatives that contribute to regional revitalization. What is essential is to make a comfortable

[17] The following paper examines how to capture underlying inflation: Hogen, Y., Kawamoto, T., and Nakahama, M., "Core Inflation and the Business Cycle," *Bank of Japan Review Series*, no. 15-E-6, November 2015, https://www.boj.or.jp/en/research/wps_rev/rev_2015/data/rev15e06.pdf.

[18] As for the relationship between a declining and aging population and economic growth, see Wakatabe, M., "Japan's Economy and Monetary Policy," speech at a meeting with business leaders in Ehime, February 5, 2020, https://www.boj.or.jp/en/announcements/press/koen_2020/ko200205a.htm/.

environment to live and work in. Here, I would like to highlight three of the prefecture's initiatives.

The first is investment for the future. In 2017, Wakayama Prefecture drafted a 10-year plan for prefectural development that includes the creation of new industries. In this regard, working to attract firms in the fields of space and information and communication technology (ICT), the prefecture has seen concrete results, such as the decision to build Japan's first private rocket launch site, Space Port Kii, in Kushimoto Town. The prefecture is also taking steps to generate renewable energy, including solar, wind, and biomass power, by drawing on its abundant natural resources. These efforts are expected to contribute to the revitalization of the regional economy.

The second initiative is urban development. Wakayama City is pursuing new urban development under the guiding concept of creating commercially viable spaces through renovation by public-private partnerships. The city is promoting activities to create distinctive, lively spaces in the city center by making use of public spaces and idle real estate. This has helped bring about an increase in population by mitigating the net outflow of young people and attracting child-rearing families. It is hoped that these efforts will enhance the appeal of Wakayama City and, in turn, the prefecture as a whole.

The third initiative is to employ new technologies and take advantage of the prefecture's nature, history, and tradition. In addition to the two World Heritage Sites of Mt. Koya and the Kumano Kodo, an ancient network of pilgrimage routes, Wakayama Prefecture has ample tourism resources, such as forests that occupy around 80 percent of the prefecture's land area, abundant water resources, and its vast and spectacular coastline. Making use of these natural resources, the prefecture has been promoting experience tourism, and in recent years, green tourism. Meanwhile, Wakayama Prefecture is building up its communications infrastructure, boasting 99.9 percent ultra-high-speed broadband coverage and Japan's second-highest per-capita Wi-Fi spots. Drawing on these strengths in tourism and digital infrastructure, the prefecture is focusing on taking the lead in Japan in promoting "workcation" tourism. I am hopeful that such efforts to capitalize on shifts in society, such

as the spread of remote working under the pandemic, will lead to further development of the region.

Wakayama Prefecture marked its 150th anniversary last year. For 150 years, the prefecture's residents, local businesses, financial institutions, and government agencies have worked together to contribute to the development of the prefecture. My hope is that Wakayama Prefecture will grow even more as industry, government, academia, and finance continue to collaborate in steadily pursuing a variety of initiatives, including the ones I have touched on today.

Conclusion

Japan's economy is no longer in deflation, after having suffered from moderate but persistent deflation for many years. Alan Greenspan, former chair of the Federal Reserve, once warned that deflation was a matter of concern because it could make it difficult for firms to set prices and in turn impede the vitality of the economy.[19] In fact, since Japanese firms were unable to raise their selling prices under prolonged deflation, they could not increase wages and had to make enormous efforts to curb costs.

The Bank's objective in setting the price stability target of 2 percent and continuing with monetary easing is not merely to achieve inflation. Based on the lessons learned from past experience where wages, income, employment, and business activity were subdued amid a decline in prices, monetary easing aims to create a virtuous cycle where inflation leads to increases in wages, income, and employment, thereby boosting business activity. It may yet take time to create this virtuous cycle, but positive moves have been made as we progress toward the post-pandemic era at home and abroad. With a view to ensuring such positive moves, the Bank will continue to fulfill its mandate and communicate clearly its policy intention without misunderstanding.

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[19] Greenspan, A., "Issues for Monetary Policy," remarks before the Economic Club of New York held in New York City, December 19, 2002, https://www.federalreserve.gov/boarddocs/speeches/2002/20021219/default.htm. For reference, see also Watanabe, *Bukka to wa nani ka*, pp. 285-7.

Japan's Economy and Monetary Policy

Speech at a Meeting with Local Leaders in Wakayama
(via webcast)

February 3, 2022

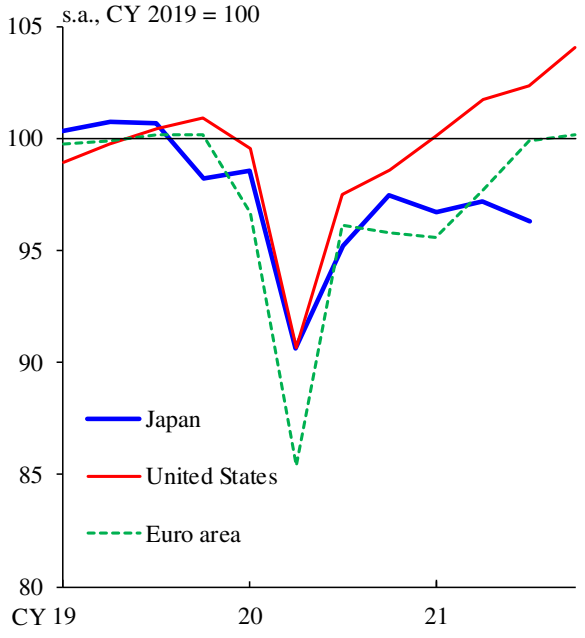
WAKATABE Masazumi
Deputy Governor of the Bank of Japan

I. Current Situation and Outlook for Economic Activity

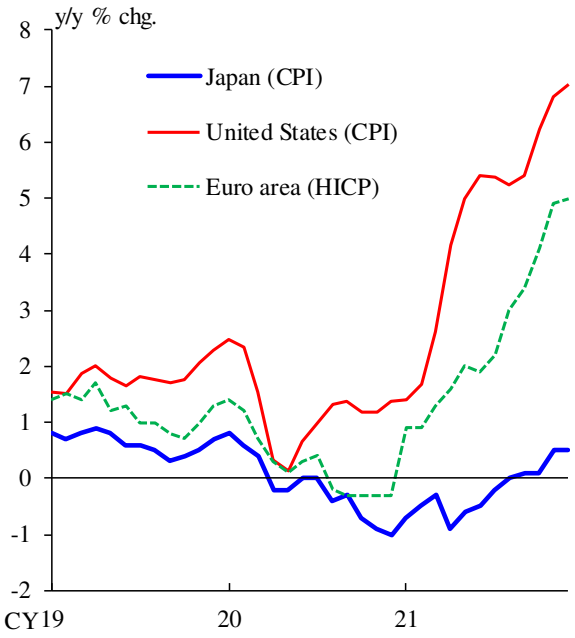
Chart 1

Global Economy and Prices

GDP in Japan, United States, and Europe



Consumer Prices in Japan, United States, and Europe



Note: In the right-hand chart, figures for Japan are the CPI for all items excluding fresh food.
Sources: Haver; Cabinet Office; Ministry of Internal Affairs and Communications.

Chart 2

Supply and Demand since the Outbreak of COVID-19

Immediately after the Outbreak ➡ *Since Responses to the Pandemic*

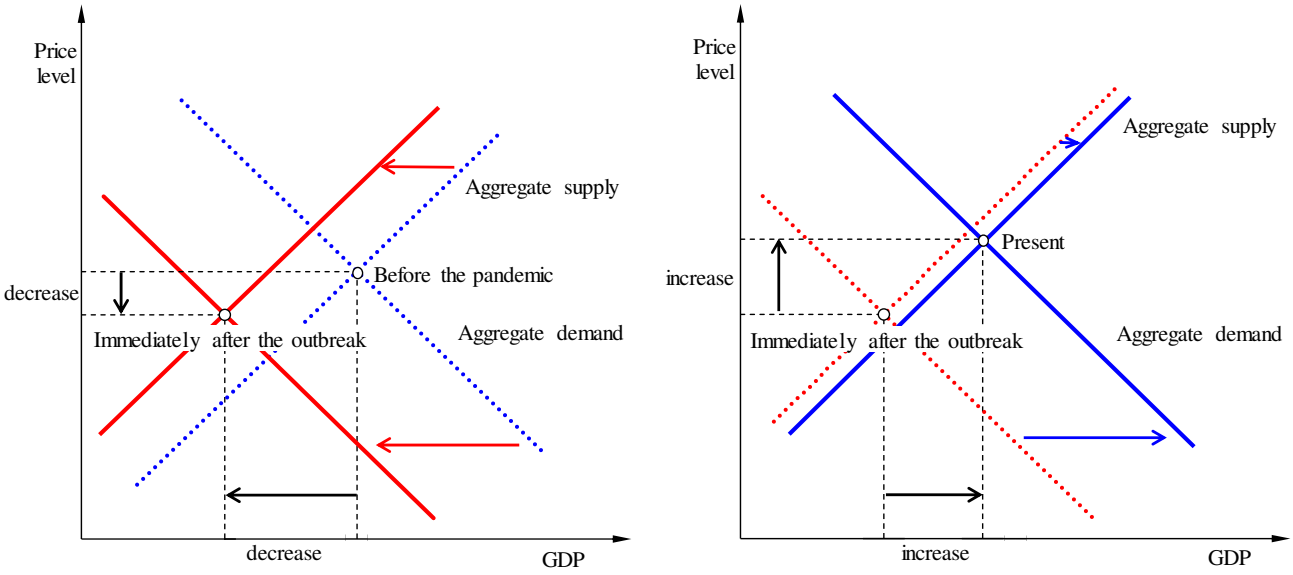
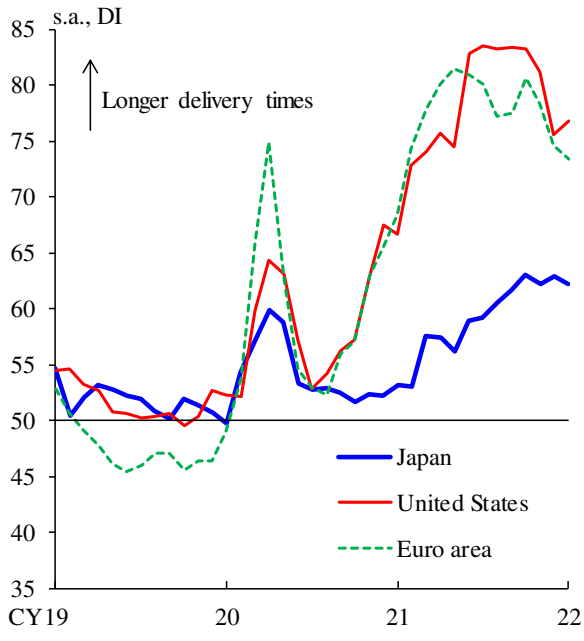


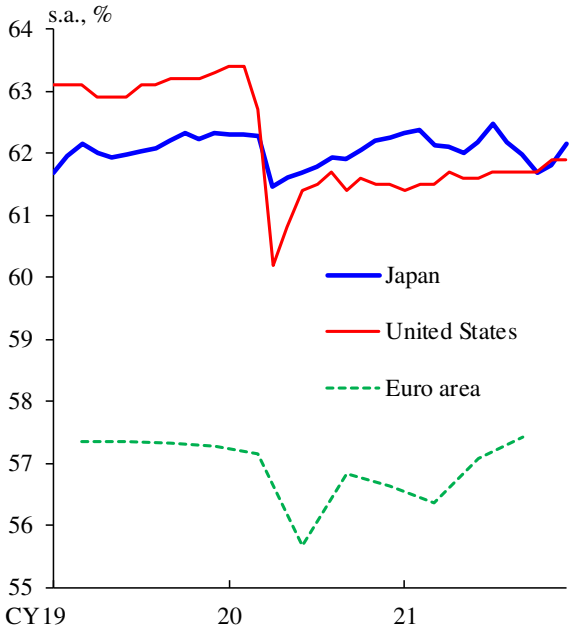
Chart 3

Impact on Supply Side

Delivery Delays Index (PMI)



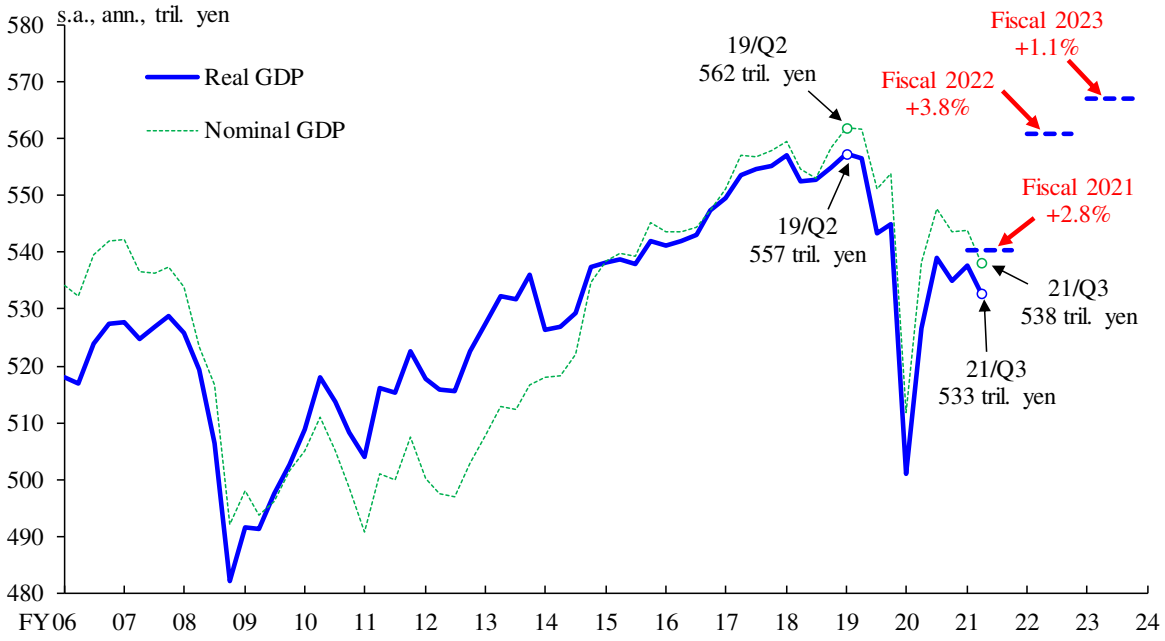
Labor Force Participation Rates in Japan, United States, and Europe



Notes: 1. In the left-hand chart, Delivery delay index = 100 - Suppliers' delivery times index. Figures for the United States and the euro area are for the respective manufacturing PMIs. Those for Japan are for the au Jibun Bank Japan Manufacturing PMI.
2. In the right-hand chart, figures for the euro area are quarterly.
Sources: IHS Markit (© and database right IHS Markit Ltd 2022. All rights reserved.); Haver; Ministry of Internal Affairs and Communications.

Chart 4

The Bank's Forecasts for Economic Activity (January 2022 Outlook Report)



Note: Percentage figures indicate the medians of the Policy Board members' forecasts (point estimates).
Sources: Cabinet Office; Bank of Japan.

Chart 5

Virtuous Cycle

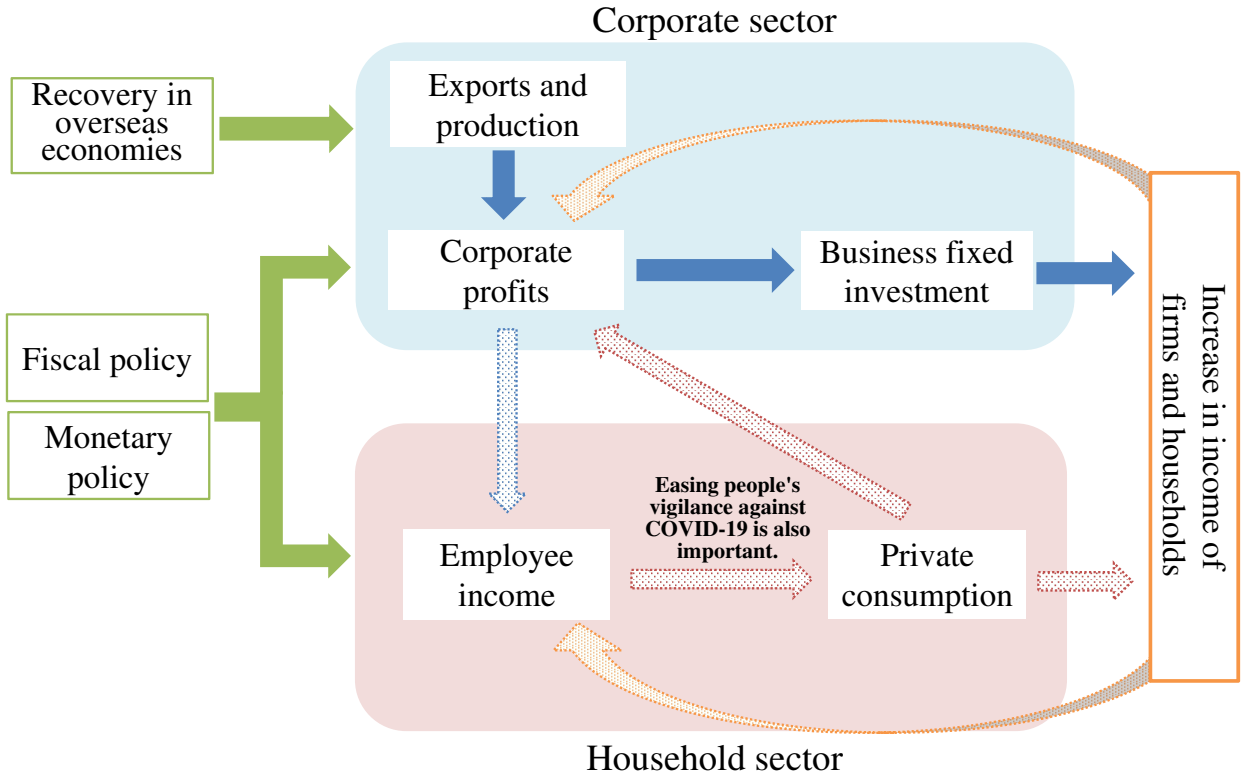
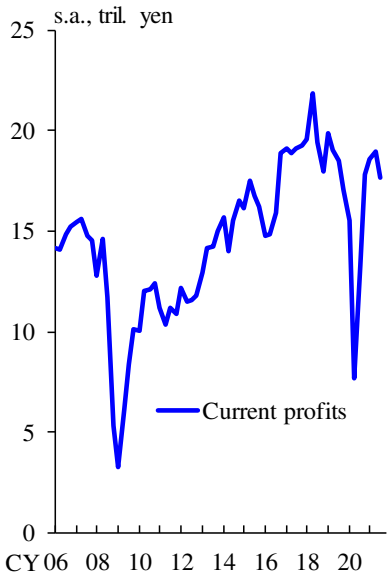


Chart 6

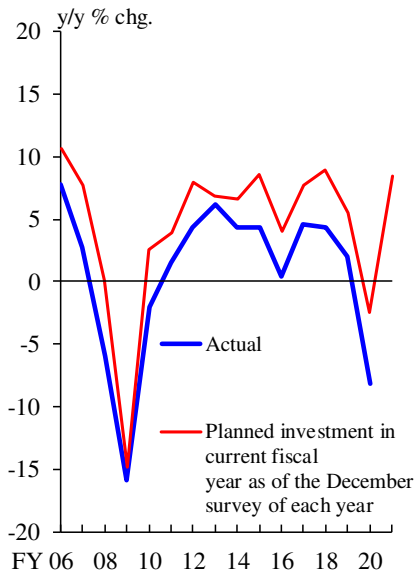
Corporate Sector

Exports and Production

Corporate Profits



Business Fixed Investment (Tankan)

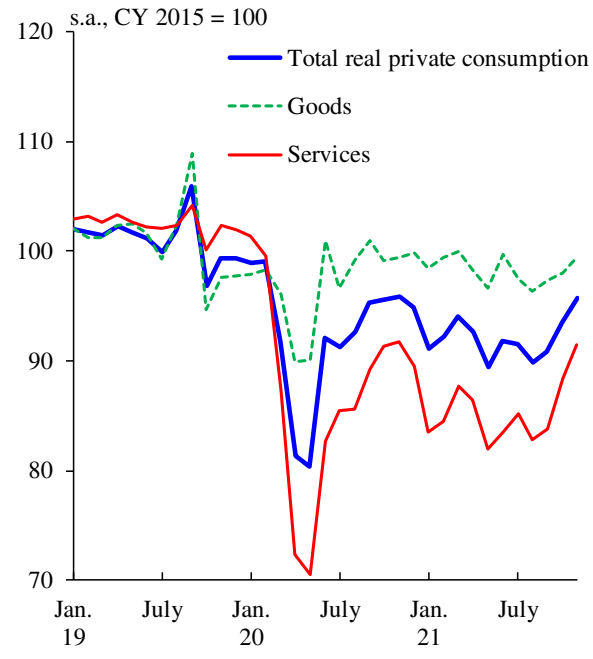


Notes: 1. In the middle chart, figures are based on the *Financial Statements Statistics of Corporations by Industry, Quarterly* and exclude "finance and insurance." Figures from 2009/Q2 onward exclude pure holding companies.
2. In the right-hand chart, figures include software and R&D investments and exclude land purchasing expenses. R&D investment is not included before the March 2017 survey. The figures are for all industries and enterprises.
Sources: Ministry of Economy, Trade and Industry; Ministry of Finance; Bank of Japan.

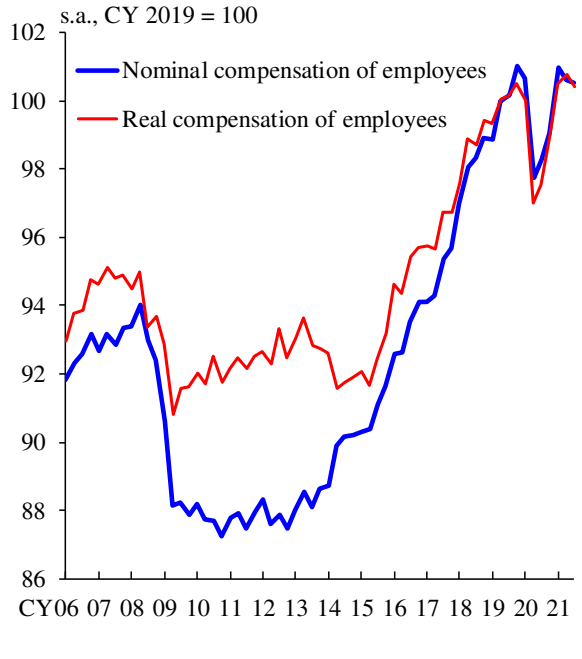
Chart 7

Household Sector

Private Consumption



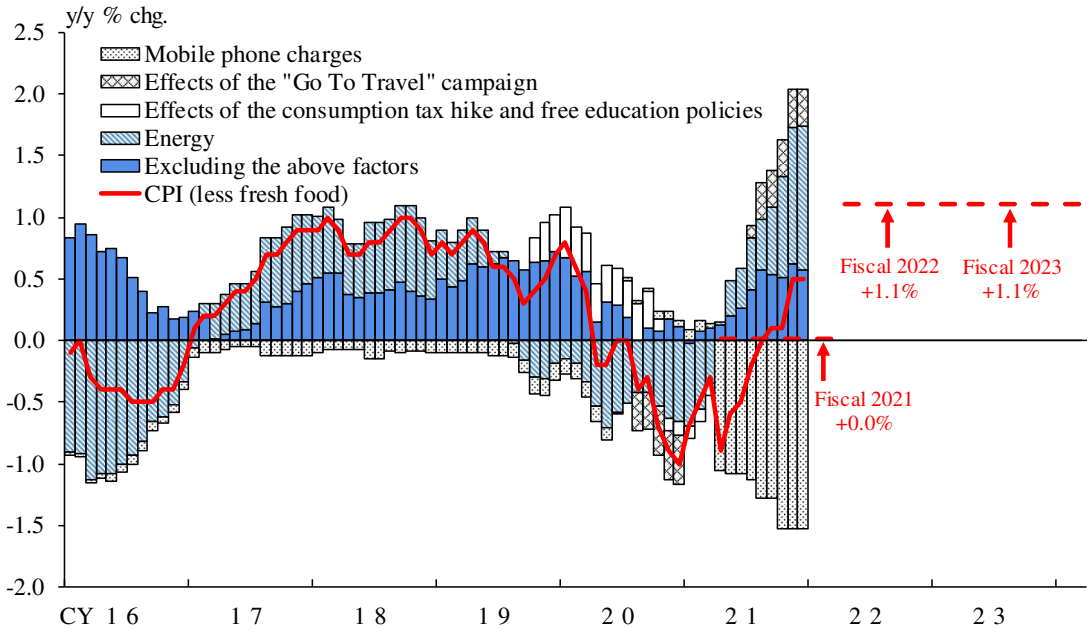
Employee Income



Sources: Bank of Japan; Cabinet Office, etc.

Chart 8

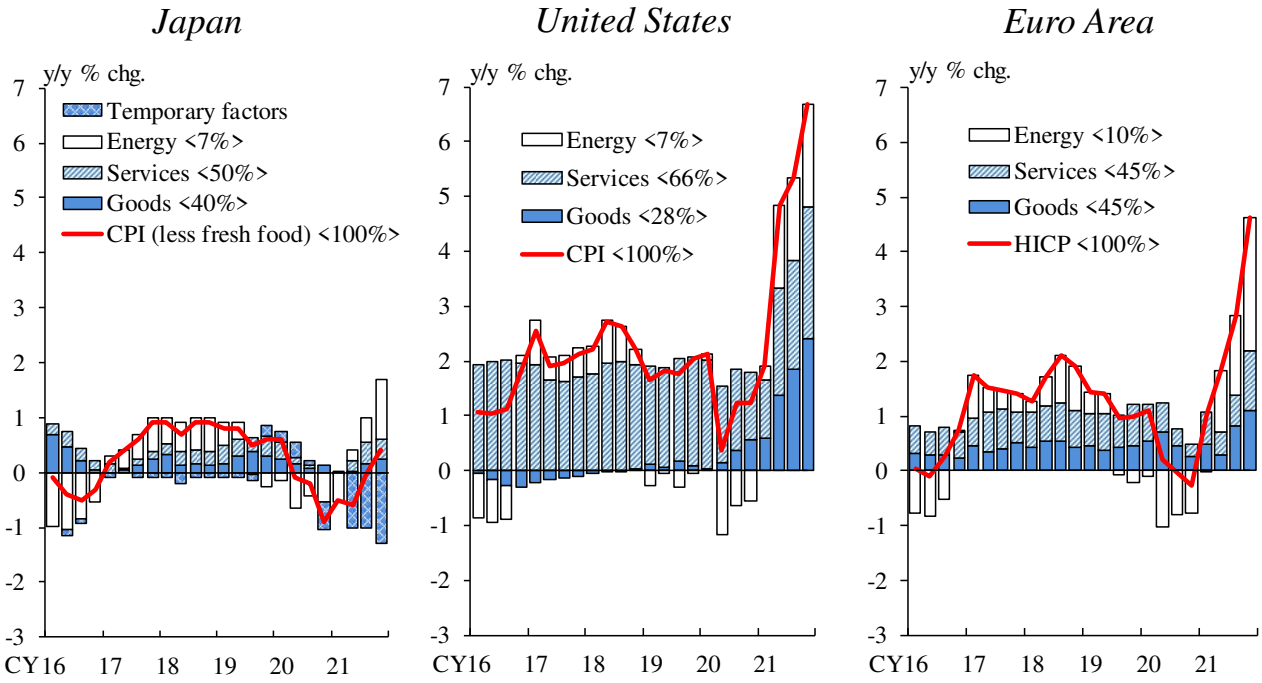
The Bank's Forecasts for Prices (January 2022 Outlook Report)



Notes: 1. Figures for energy consist of those for petroleum products, electricity, and gas, manufactured & piped.
2. Figures for the "effects of the consumption tax hike and free education policies" from April 2020 onward are staff estimates and include the effects of measures such as free higher education introduced in April 2020.
3. Percentage figures indicate the medians of the Policy Board members' forecasts (point estimates).
Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

Chart 9

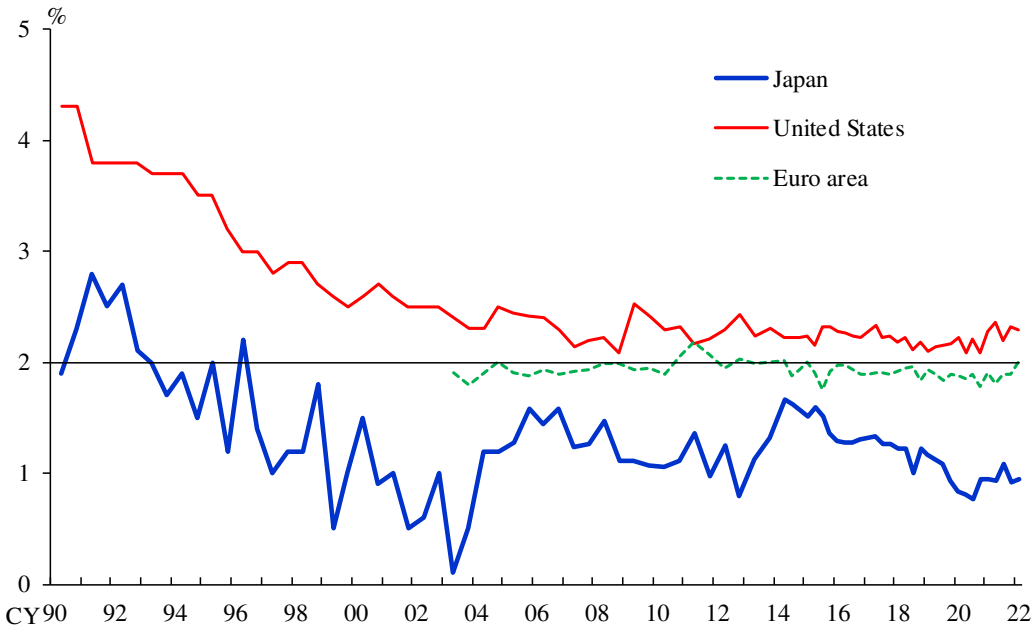
Price Developments in Japan, United States, and Europe



Notes: 1. Figures for services include administered prices.
2. Figures for temporary factors for Japan are staff estimates and consist of mobile phone charges and the effects of the consumption tax hike, policies concerning the provision of free education, and the "Go To Travel" campaign, which covers a portion of domestic travel expenses.
3. Figures in angular brackets show the share of each component. Figures for temporary factors for Japan include mobile phone charges (weight: 3%).
Sources: Ministry of Internal Affairs and Communications; Haver

Chart 10

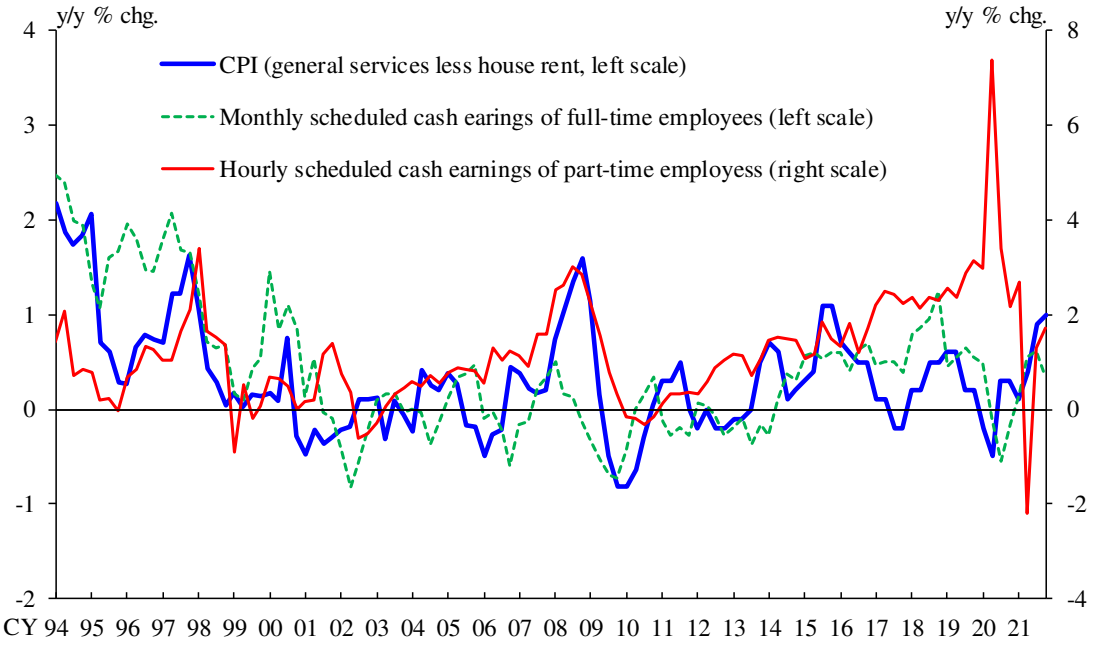
Medium- to Long-Term Inflation Expectations in Japan, United States, and Europe



Source: Consensus Economics Inc., "Consensus Forecasts."

Chart 11

Wages and Services Prices



Note: Figures for CPI are staff estimates and exclude the effects of the consumption tax hikes, policies concerning the provision of free education, and the "Go To Travel" campaign, which covers a portion of domestic travel expenses. Figures from 2021/Q1 onward also exclude mobile phone charges. The latest figures for wages are October-November averages.
Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare.

Chart 12

Cycle from Income to Spending

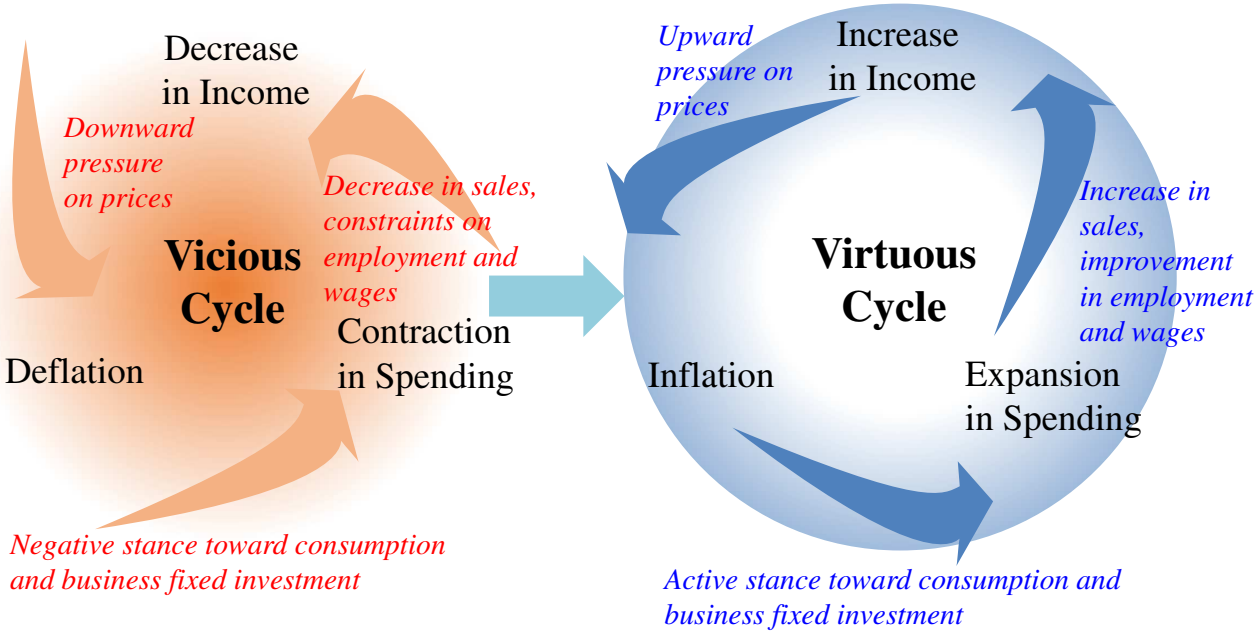
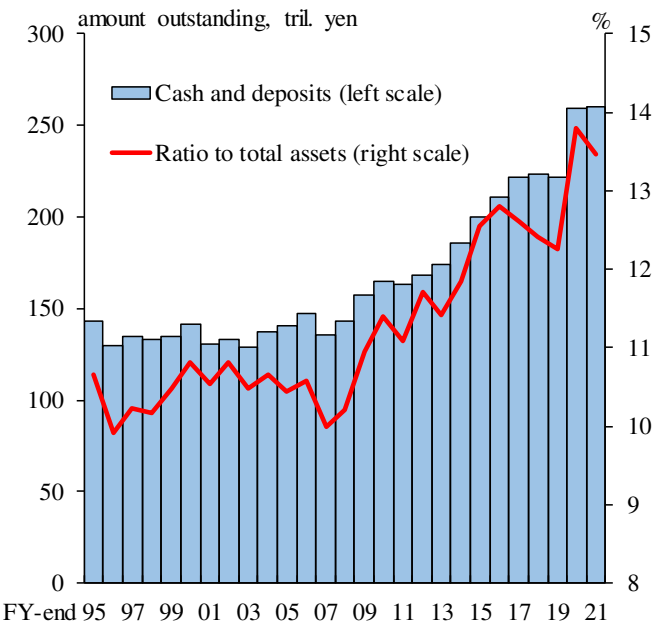


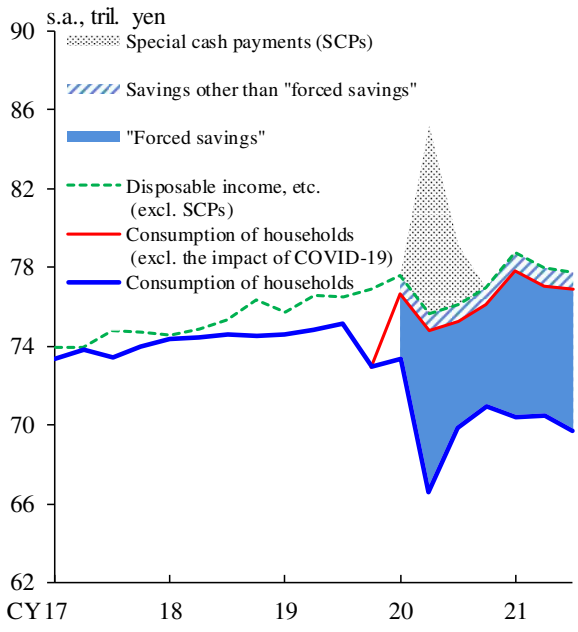
Chart 13

Two "Standby" Funds

Total Amount Outstanding of Cash and Deposits in Corporate Sector



Private Consumption and Loss of Consumption Opportunities



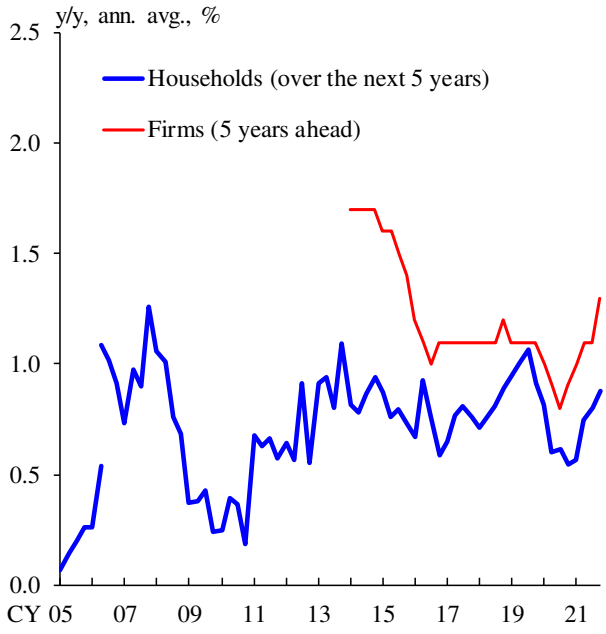
Notes: 1. In the left-hand chart, figures are based on the *Financial Statements Statistics of Corporations by Industry* and exclude "finance and insurance." Figures for the end of fiscal 2021 are calculated using the growth rate for 2021/Q3 relative to 2021/Q1.
2. For details of the right-hand chart, see Box 3 "Effects of Widespread Vaccinations and Outlook for Private Consumption" in the April 2021 Outlook Report.
Sources: Ministry of Finance; Bank of Japan; Cabinet Office, etc.

Chart 14

Two "Expectations"

Firms' Growth Expectations

Inflation Expectations

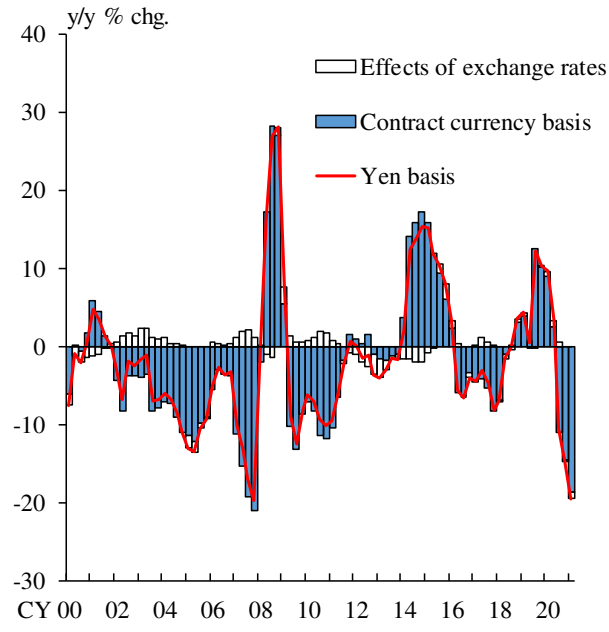


Notes: 1. In the left-hand chart, figures are based on the *Annual Survey of Corporate Behavior* (listed firms).
2. In the right-hand chart, figures for households are from the *Opinion Survey on the General Public's Views and Behavior*, estimated using the modified Carlson-Parkin method. Figures for firms show the inflation outlook of enterprises for general prices (all industries and enterprises, average) in the *Tankan*.
Sources: Cabinet Office; Bank of Japan.

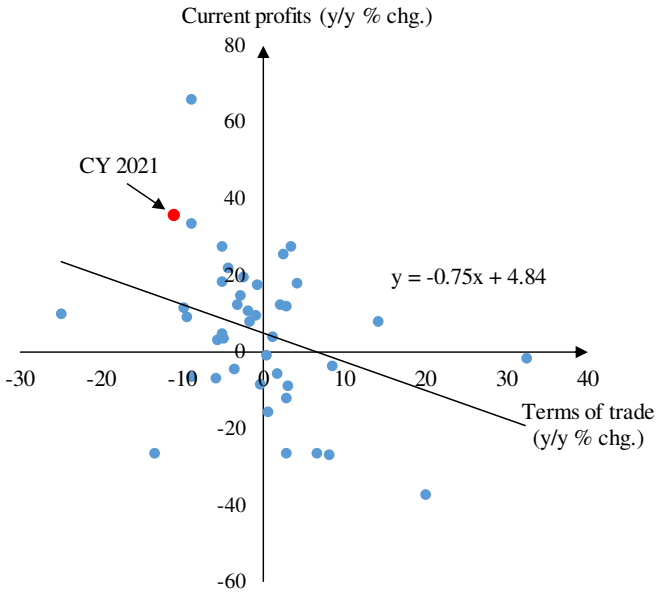
Chart 15

Terms of Trade and Corporate Profits

Terms of Trade



Correlation between Terms of Trade and Corporate Profits

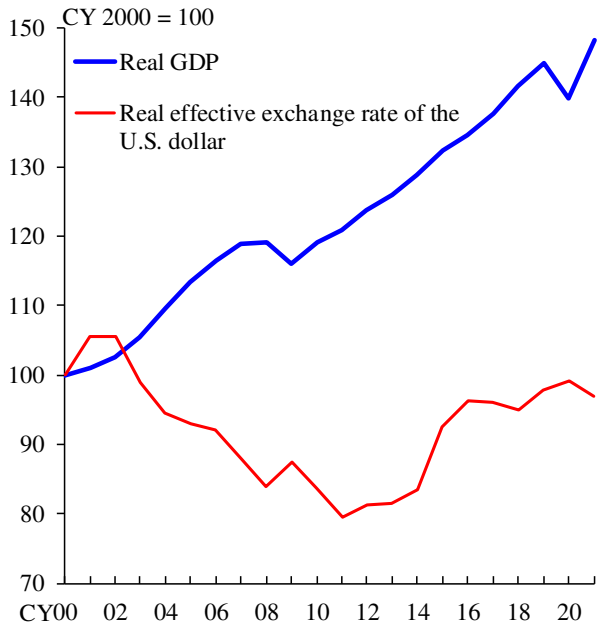


Note: In the right-hand chart, figures for current profits are based on the *Financial Statements Statistics of Corporations by Industry, Quarterly* and exclude "finance and insurance." Figures from 2009/Q2 onward exclude pure holding companies. The figure for CY 2021 is the seasonally adjusted annualized amount for 2021/Q1-Q3.
Sources: Bank of Japan; Ministry of Finance.

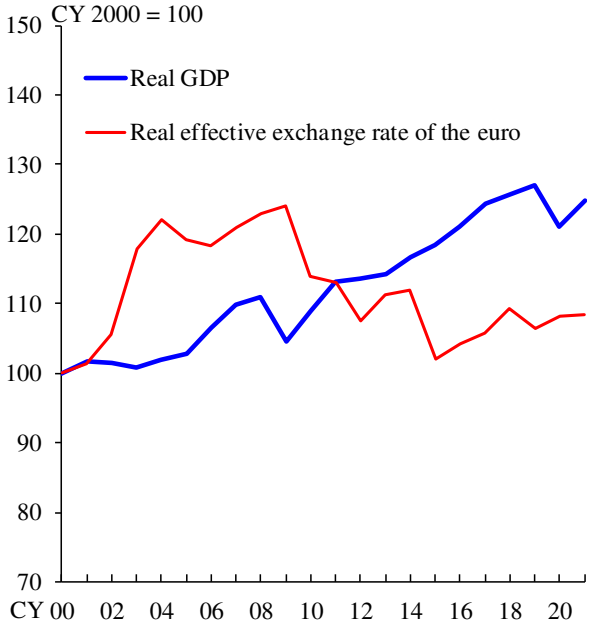
Chart 16

GDP and Real Effective Exchange Rates

United States



Germany

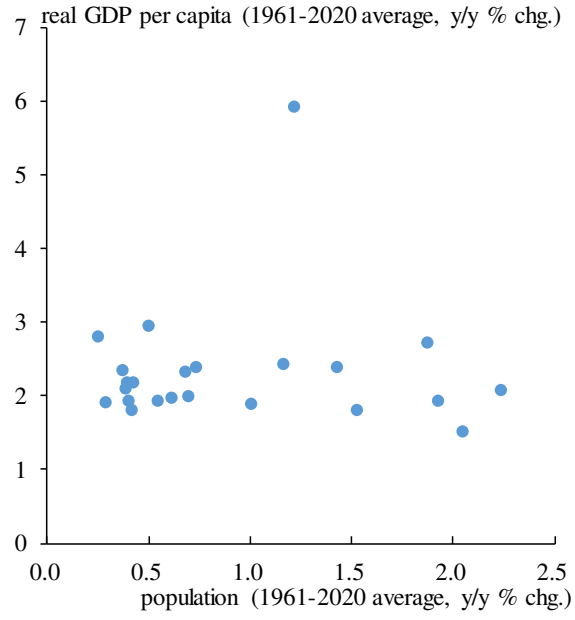


Note: Figures for real GDP for CY 2021 are IMF projections.
Sources: BIS; IMF.

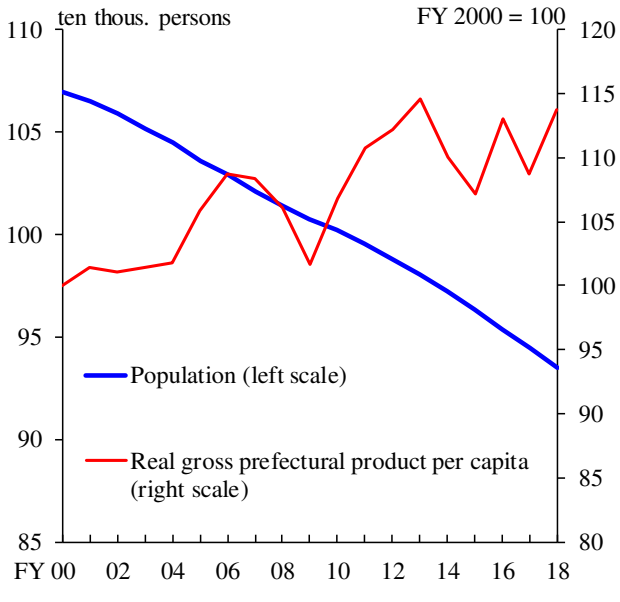
Chart 17

Population Growth Rate and GDP

Global Population Growth and GDP Growth per Capita



Population and Gross Prefectural Product per Capita in Wakayama Prefecture



Note: In the left-hand chart, figures are those for 23 OECD member countries for which data from 1961 onward are available.
Sources: World Bank; Cabinet Office.