



August 30, 2023
Bank of Japan

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

Speech at a Meeting with Local Leaders in Eastern Hokkaido

TAMURA Naoki

Member of the Policy Board

(English translation based on the Japanese original)

I. Economic Activity and Prices

A. Economic Activity

1. Current situation

I will begin my speech by talking about recent developments in economic activity in Japan. Japan's economy has recovered moderately. Let me explain its current state in detail from two aspects: the household sector and the corporate sector.

First, a look at the household sector. Private consumption has increased steadily at a moderate pace (Chart 1). Although some indicators suggest that the recent price rises and severe weather have been pushing down consumption, with the reclassification of COVID-19 as a Class V infectious disease under the Infectious Disease Control Law, consumption has been supported by pent-up demand on the back of household savings that accumulated during the pandemic, and also by improvement in consumer sentiment, which partly reflects the results of the annual spring labor-management wage negotiations this year. The propensity to consume, which significantly declined during the pandemic, has continued to improve, and consumers are more willing to spend.

Next, the corporate sector. Although exports and production have been affected by the slowdown in the pace of recovery in overseas economies, they have been more or less flat, supported by the waning of supply-side constraints and high levels of order backlogs (Chart 2). Corporate profits have been at high levels on the whole, although the situation varies across industries and firm sizes (Chart 3). Business fixed investment has increased moderately, and the plan for fiscal 2023 in the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) indicates that investment is likely to increase clearly.

2. Outlook

Next, I will turn to the outlook for economic activity. Although inflation rates in the United States and Europe have become lower, inflationary pressure has remained (Chart 4). In this situation, overseas central banks have continued to raise their policy interest rates. Given these circumstances, the pace of recovery in overseas economies is projected to remain slow for the time being. Although such developments in overseas economies are projected to exert downward pressure, Japan's economy is likely to continue recovering moderately, led by

domestic demand with support from factors such as accommodative financial conditions and the government's economic measures.

As background to Japan's economic outlook, the following are five key developments. First, the waning of supply-side constraints will make a positive contribution to exports and production. Second, pent-up demand, which recently has been pushing up private consumption and business fixed investment, will continue to support the economy's recovery for the time being. Third, inbound tourism demand will keep rising. Fourth, business fixed investment will continue to increase, mainly on the back of high levels of corporate profits. Fifth, as the growth rate of wages becomes higher, reflecting tightening labor market conditions and price rises, a virtuous cycle from income to spending will intensify.

In terms of the median of the Bank of Japan Policy Board members' forecasts -- as presented in the July 2023 *Outlook for Economic Activity and Prices* (Outlook Report) -- Japan's real GDP growth rate is expected to be at 1.3 percent for fiscal 2023, 1.2 percent for fiscal 2024, and 1.0 percent for fiscal 2025 (Chart 5). As Japan's current potential growth rate is estimated to be in the range of 0.0-0.5 percent, the economy is projected to continue growing at a pace above its potential. The pace of growth is expected to decelerate slightly because the outlook factors in a waning of the contributions from pent-up demand and the government's economic measures.

Both upside and downside uncertainties exist over the outlook that I just mentioned depending on developments in overseas economic activity and prices, price developments in commodities, including grain, and firms' and households' medium- to long-term growth expectations. My view is that there is a certain degree of possibility that the growth rate will deviate upward from the Bank's baseline scenario due to factors such as (1) increases in investments associated with the green transformation and with strengthening supply chains, (2) a further acceleration of investment to address labor shortages and digital-related investment as well as the resultant improvement in firms' productivity, and (3) an intensifying virtuous cycle between wages and prices driven by such improvement in productivity.

B. Price Developments

Turning to Japan's price developments, the year-on-year rate of increase in the consumer price index (CPI) has been significantly higher than 2 percent recently; when excluding temporary factors such as the effects of the consumption tax hikes, it has been at a level that has not been seen even going back to the bubble period (Chart 6). The rate of increase in the CPI for all items less fresh food and energy, for which prices fluctuate significantly, has been at a level above 4 percent (Chart 7). This is because import prices have risen on the back of the yen's depreciation and high prices of commodities, including grain, leading to a greater pass-through of cost increases to consumer prices for a wide range of items. Looking at the breakdown of developments in the rate of change in the CPI for all items less fresh food and energy, the rate of increase in goods prices has recorded a high level of 7.3 percent; among services prices, which tend to fluctuate less, the rate of increase in general services prices less housing rent has accelerated to 4.3 percent.¹

What is distinctive about the current situation is the change in firms' price-setting behavior. In Japan, firms had long been hesitant to increase their selling prices even when faced with a rise in input prices. However, because raw material costs have risen too high to be compensated for by reducing costs and curbing profits, firms have been passing on cost increases to selling prices since last year (Chart 8). This is likely because consumption has been solid even when prices have been rising, underpinned by standby funds that accumulated during the pandemic and by pent-up demand. A closer look at the increase in selling prices shows that, in addition to higher raw material prices, increases in shipping costs, utility costs, and even personnel expenses are being passed on to selling prices. Firms' outlook for output prices of their products for one year ahead in the *Tankan* indicates that they intend to raise such prices at a higher rate than the projected rate of increase for general prices, and I believe that this shows the firms' active stance toward passing on cost increases to selling prices.

Looking at monthly developments, the rate of increase in the CPI is likely to decelerate for the time being, with a waning of the effects of the pass-through to consumer prices of cost

¹ In terms of services prices, I am paying close attention to developments in "general services (less housing rent)" because these exclude "housing rent (private and imputed rent)" and "administered prices," which are items that are subject to strong price rigidity due to factors particular to Japan and do not sufficiently reflect economic fundamental conditions.

increases led by the past rise in import prices. Thereafter, however, the rate of increase is projected to accelerate again moderately. In terms of the median of the Policy Board members' forecasts, the CPI for all items less fresh food is projected to see a year-on-year rate of increase of 2.5 percent for fiscal 2023, 1.9 percent for fiscal 2024, and 1.6 percent for fiscal 2025 (Chart 9).

The outlook for prices is highly uncertain as it entails both upside and downside risks. In my opinion, the possibility cannot be denied that prices will rise more than expected, given that (1) firms' pass-through of cost increases to selling prices is ongoing, (2) services prices are increasing at a faster pace, and (3) sustained wage rises could be expected mainly on the back of a tightening of labor market conditions. With regard to wage increases, which considerably affect future price developments, the wage growth rate agreed in the annual spring labor-management wage negotiations this year was significantly higher than in the previous year due to the tightening of labor market conditions and high inflation rates (Chart 10). I expect that the annual spring labor-management wage negotiations to be held next year will also result in agreement on a relatively high wage growth rate, considering that labor shortages and high inflation rates are likely to continue this year.

II. Conduct of Monetary Policy

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

Now, I would like to turn to the Bank's conduct of monetary policy. This is done with the aim of achieving the price stability target in a sustainable and stable manner, accompanied by wage increases. About 10 years ago, when Japan was struggling with deflation, the Bank set the price stability target at 2 percent in terms of the year-on-year rate of change in the CPI, and has since continued with large-scale monetary easing aimed at achieving this target.

What is price stability? It is conceptually defined as "a state where various economic agents including households and firms may make decisions regarding such economic activities as consumption and investments without being concerned about the fluctuations in the general price level" (Chart 11). It is not necessarily true that the lower the inflation rate, the better. Looking back at the period when Japan was experiencing deflation, there emerged a vicious cycle of declining prices, falling sales and profits, stagnating wages, sluggish consumption,

and further price declines. Accordingly, GDP and employee income in nominal terms remained subdued during this period. In order to overcome such deflationary trend and realize a virtuous cycle in Japan's economy, it is essential that the economy improve in a balanced and sustainable manner, accompanied by increases in employment, wages, and corporate profits. With this economic improvement in place, prices are expected to rise moderately.

Next, I will discuss the current framework for monetary easing; namely, Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control (Chart 12). Yield curve control, which the Bank decided to conduct with greater flexibility in July, is one of the policy tools under the current framework. Specifically, yield curve control entails setting the short-term policy interest rate at minus 0.1 percent, while conducting purchases of Japanese government bonds (JGBs) and other operations for the long-term interest rate to ensure that 10-year JGB yields remain at around 0 percent, or more specifically, within the range of around plus and minus 0.5 percentage points from 0 percent.

Around 10 years have passed since the Bank began to aim at achieving the price stability target of 2 percent in a sustainable and stable manner through the large-scale monetary easing I have just outlined, and it seems to me that achievement of the target has clearly come in sight at long last. That said, amid lingering uncertainty over achievement of the target, it is still necessary to keep a careful watch over wage and price developments. For the moment, therefore, I consider it appropriate for the Bank to continue with monetary easing. It will take some more time to assess whether circumstances are sufficient enough to achieve sustainable and stable inflation. Around January through March of next year, however, I expect that a clearer picture of the path toward achieving such inflation will be obtained by observing the momentum for wage hikes at the time and by examining forthcoming data, such as on price developments in the second half of this year.

B. Conduct of Yield Curve Control with Greater Flexibility

Under these circumstances, the Bank decided at the Monetary Policy Meeting held in July to conduct yield curve control with greater flexibility (Chart 13). Specifically, whereas the Bank had previously been strictly capping 10-year JGB yields at the 0.5 percent level, it decided to raise this to 1.0 percent, allowing the yields to move within the range of 0.5 percent and 1.0

percent, depending on market conditions. Interest rates will be determined by the market to a greater degree; however, when speculative moves or sharp fluctuations in such rates deviating from the fundamentals are observed, the Bank will contain excessive upward pressure on them through increasing the amount of JGB purchases, among other measures. While the Bank has set the upper bound at 1.0 percent, it expects that 10-year JGB yields are unlikely to approach that level for the moment; the cap has been set to be prepared for any unexpected rise in interest rates.

Allowing greater flexibility in the conduct of yield curve control is intended to enhance the sustainability of monetary easing under its framework, in light of both upside and downside risks to the outlook for Japan's economic activity and prices. In July, the Bank significantly revised upward its CPI forecasts for fiscal 2023 from those presented in April. As indicated by this revision, there are extremely high uncertainties for Japan's economic activity and prices. Strictly capping 10-year JGB yields at the 0.5 percent level increases the positive effects of monetary easing if upward movements in the inflation rate continue. However, it could also strengthen the side effects on the functioning of bond markets and affect the volatility in other financial markets. The Bank decided to conduct yield curve control with greater flexibility as a result of weighing these positive effects and side effects.

III. Virtuous Cycle between Wages and Prices

When considering the future conduct of Japan's monetary policy, the key is whether a virtuous cycle between wages and prices will be achieved (Chart 14). As I mentioned earlier, my understanding is that, on the whole, firms' price-setting behavior has changed from that observed during the deflation period, although the situation varies across firms.

Furthermore, as reflected in the results of the annual spring labor-management wage negotiations this year, firms' wage-setting behavior has changed, leading to wage increases and moves to pass on higher wage costs to selling prices. At the same time, wage growth has led to improvement in consumer sentiment. In short, a virtuous cycle between wages and prices is beginning to operate.

For the changes in firms' wage- and price-setting behavior to be sustainable and for the virtuous cycle to take hold, labor shortages and an increase in job changes are expected to play important roles. Such factors are likely to not only lead to wage increases by firms trying to recruit and retain workers but also accelerate their labor saving-related investment. In fact, some firms are beginning to make such moves. Furthermore, labor saving-related investment will likely raise firms' productivity, and the resulting benefits are then expected to filter through to wages.

Let me describe this matter from another angle. The recent labor shortages have been posing a great challenge for many firms and Japan's economy. I think that a large number of firms are struggling with this issue. However, this also can be an opportunity for them to leap forward significantly. Here are some examples of expected changes to this end. Individual firms will enhance productivity through their labor saving-related investment and investment in digital transformation. They will shift to new business models so that they can increase wages to recruit and retain workers. They will engage in business realignment and corporate restructuring. All these initiatives by firms will accelerate corporate metabolism, resulting in greater proportions of firms with high productivity, or of people who work in highly productive firms and sectors due to an increase in job changes. Accordingly, productivity in Japan is expected to rise as a whole. Labor shortages may possibly create new supply-side constraints. However, if proactive and forward-looking efforts by firms, in addition to policy responses by the government, bear fruit, this will support strongly the virtuous cycle between wages and prices -- in other words, the virtuous cycle that drives Japan's economy. I think that Japan is in a situation where such a vision can be expected to become a reality.

Thank you.



Economic Activity, Prices, and Monetary Policy in Japan

Speech at a Meeting with Local Leaders in Eastern Hokkaido

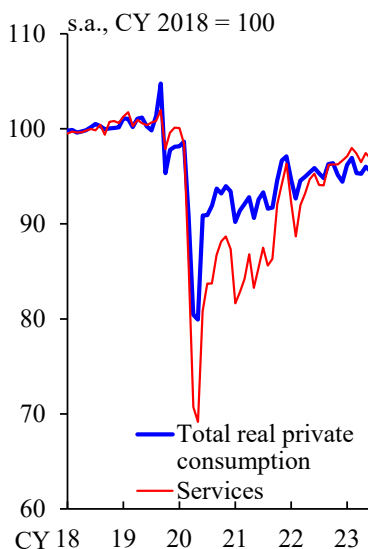
August 30, 2023

TAMURA Naoki
Member of the Policy Board
Bank of Japan

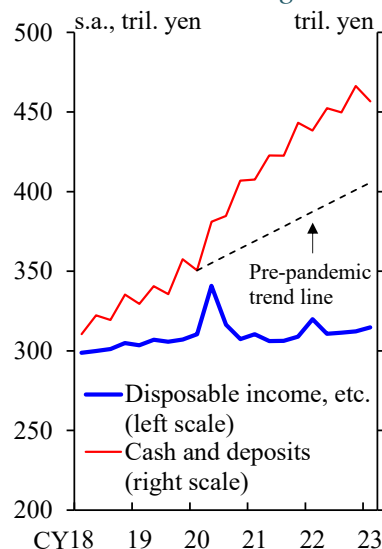
Chart 1

Private Consumption

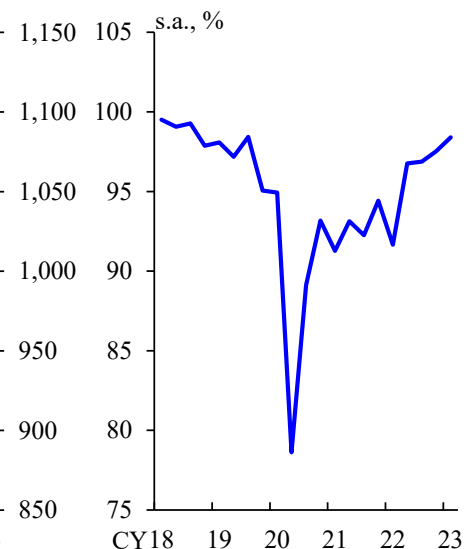
Consumption Activity Index



*Household Income
and Savings*



*Average Propensity
to Consume*



Notes: 1. In the left panel, figures for "total real private consumption" are for the real Consumption Activity Index and are based on Bank staff calculations.

The figures exclude inbound tourism consumption and include outbound tourism consumption.

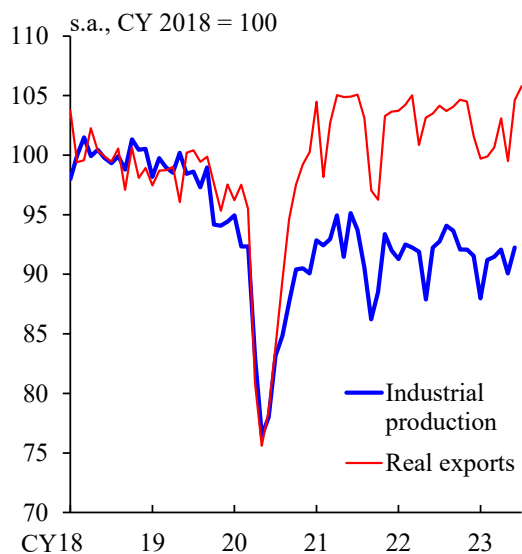
2. In the middle panel, the pre-pandemic trend line is based on the average rate of increase for 2010 through 2019.

3. In the right panel, average propensity to consume = consumption of households / disposable income, etc.

4. Figures for "disposable income, etc." consist of disposable income and adjustment for the change in pension entitlements.

Sources: Cabinet Office; Bank of Japan.

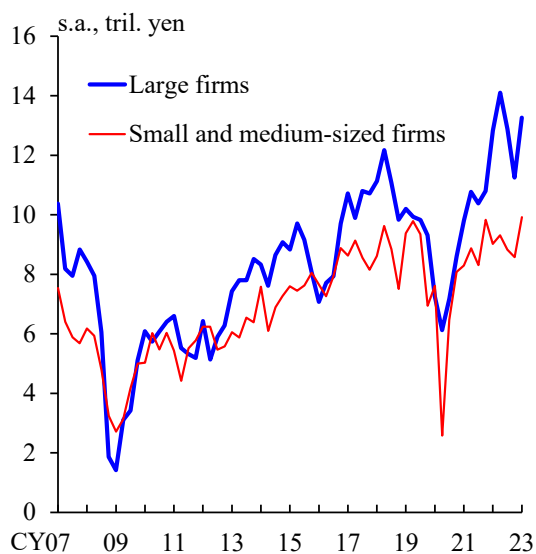
Exports and Production



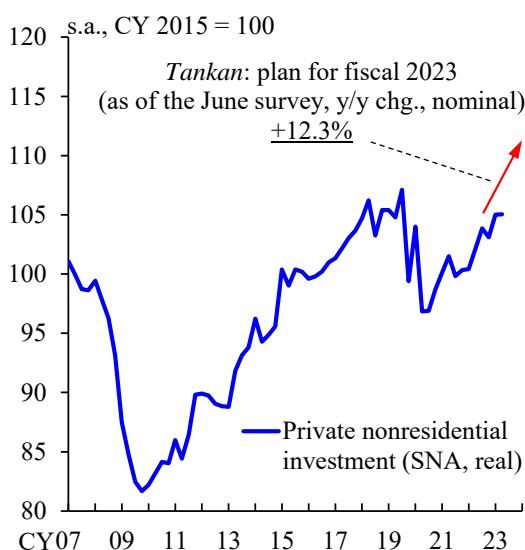
Note: Figures for "real exports" are based on Bank staff calculations.
Sources: Ministry of Economy, Trade and Industry; Bank of Japan.

Corporate Profits and Business Fixed Investment

Corporate Profits



Business Fixed Investment

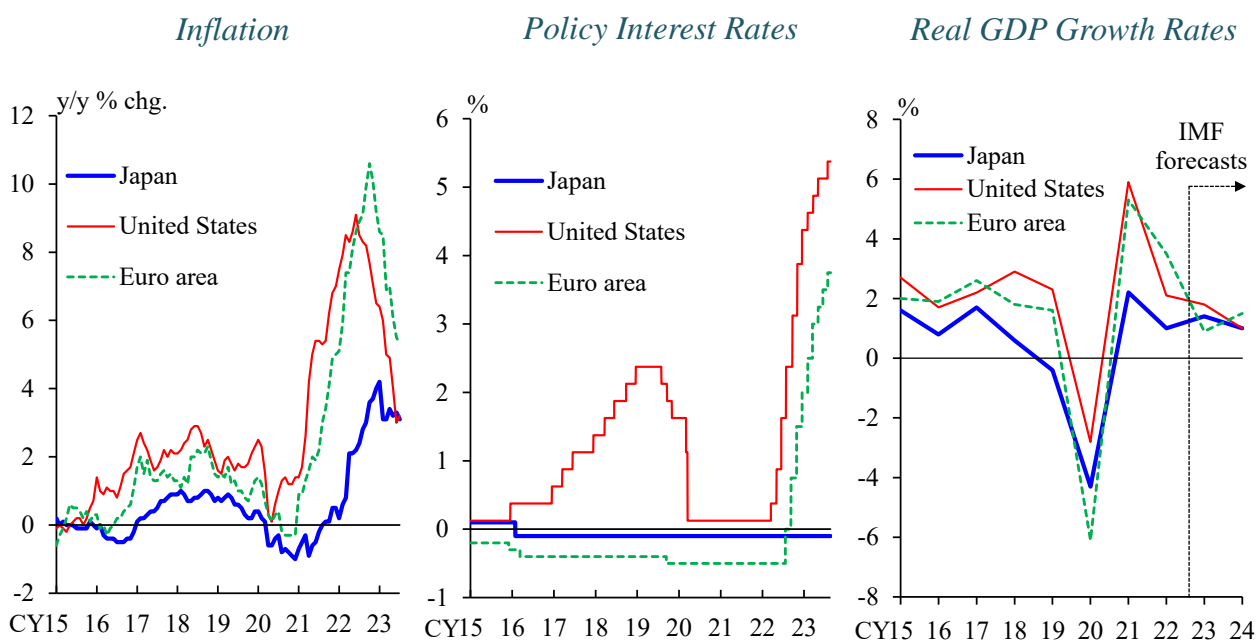


Notes: 1. In the left panel, figures are current profits based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*, and exclude "finance and insurance." Figures from 2009/Q2 onward exclude pure holding companies. Small and medium-sized firms are firms with a capitalization of 10 million yen or more but less than 1 billion yen, while large firms are firms with a capitalization of 1 billion yen or more.

2. In the right panel, the *Tankan* figures include software and R&D investments and exclude land purchasing expenses. The figures are for all industries including financial institutions.

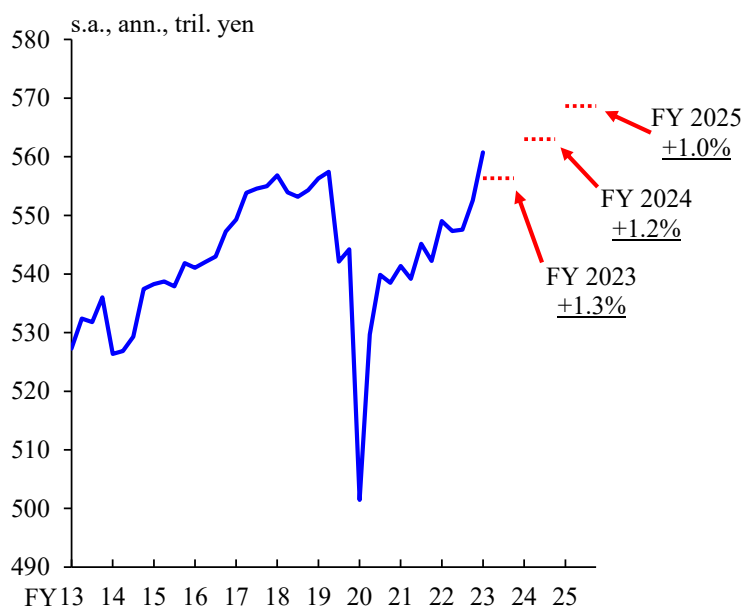
Sources: Cabinet Office; Ministry of Finance; Bank of Japan.

Economic Activity and Prices in Major Economies



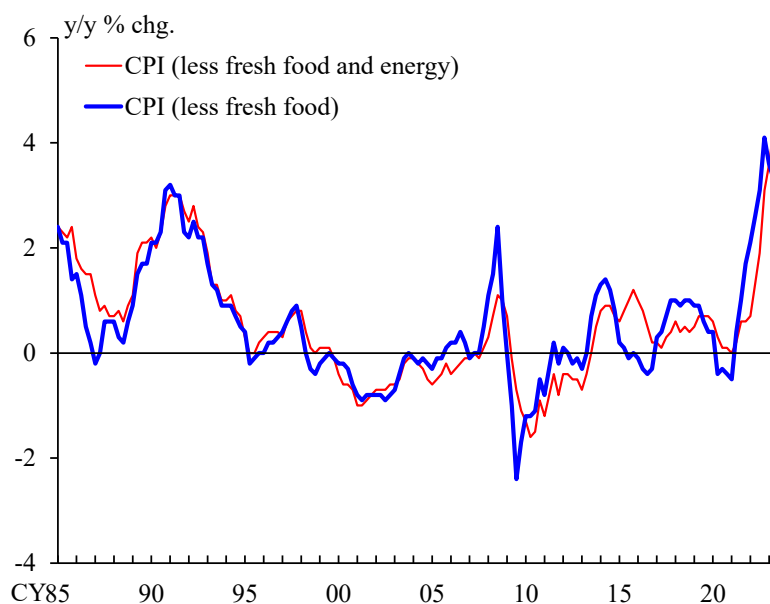
Notes: 1. In the left panel, figures for Japan are the CPI for all items less fresh food, excluding the effects of the consumption tax hike, etc. Those for the United States are the CPI for all items. Those for the euro area are the HICP for all items.
 2. In the middle panel, figures for Japan are the rates applied to financial institutions' current accounts (the Policy-Rate Balances) at the Bank of Japan. Those for the United States are the medians of the target ranges for the federal funds rate. Those for the euro area are the rates on the deposit facility.
 3. In the right panel, figures for IMF forecasts are as of July 2023.
 Sources: Bloomberg; Eurostat; IMF; Ministry of Internal Affairs and Communications; U.S. Bureau of Labor Statistics.

BOJ Forecasts for Real GDP



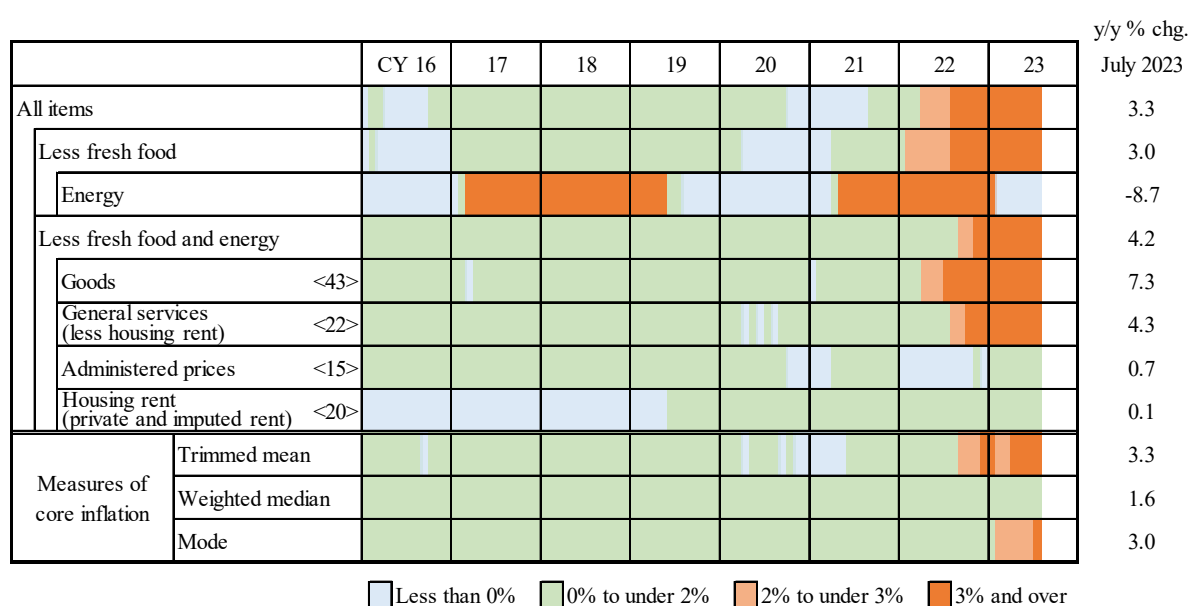
Note: The forecasts presented are the medians of the Policy Board members' forecasts in the July 2023 Outlook Report. The values of real GDP for fiscal 2023 onward are calculated by multiplying the actual figure for fiscal 2022 by all successive projected growth rates for each year.
 Sources: Cabinet Office; Bank of Japan.

Consumer Prices



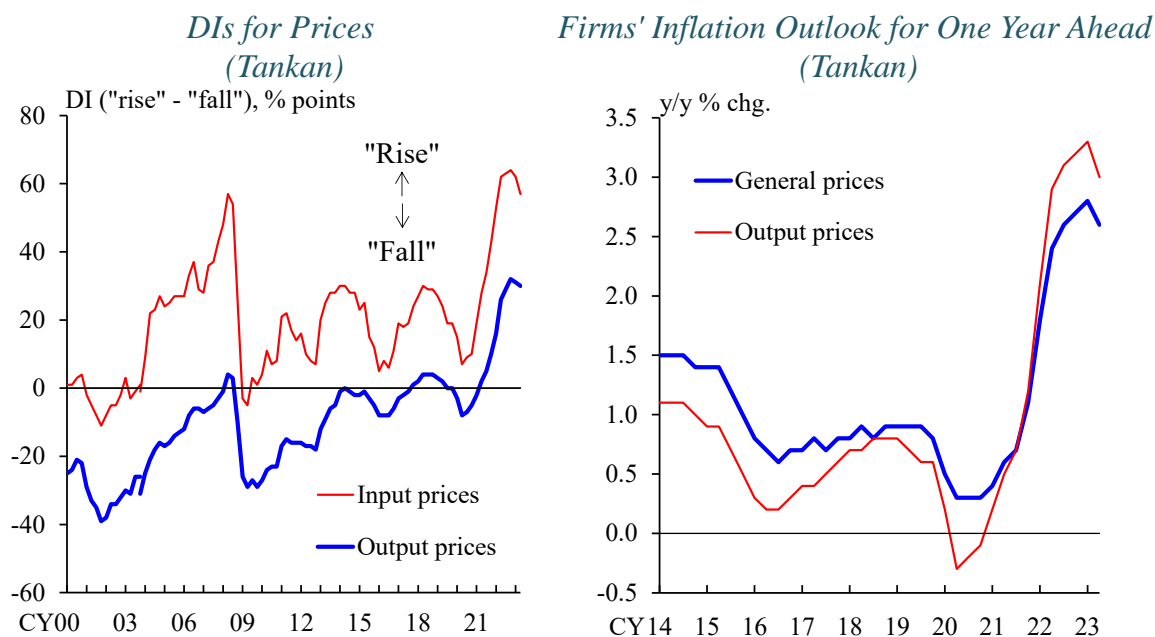
Note: The CPI figures are Bank staff estimates and exclude the effects of the consumption tax hikes, policies concerning the provision of free education, travel subsidy programs, and changes in mobile phone charges.
Source: Ministry of Internal Affairs and Communications.

Various Indicators of Consumer Prices



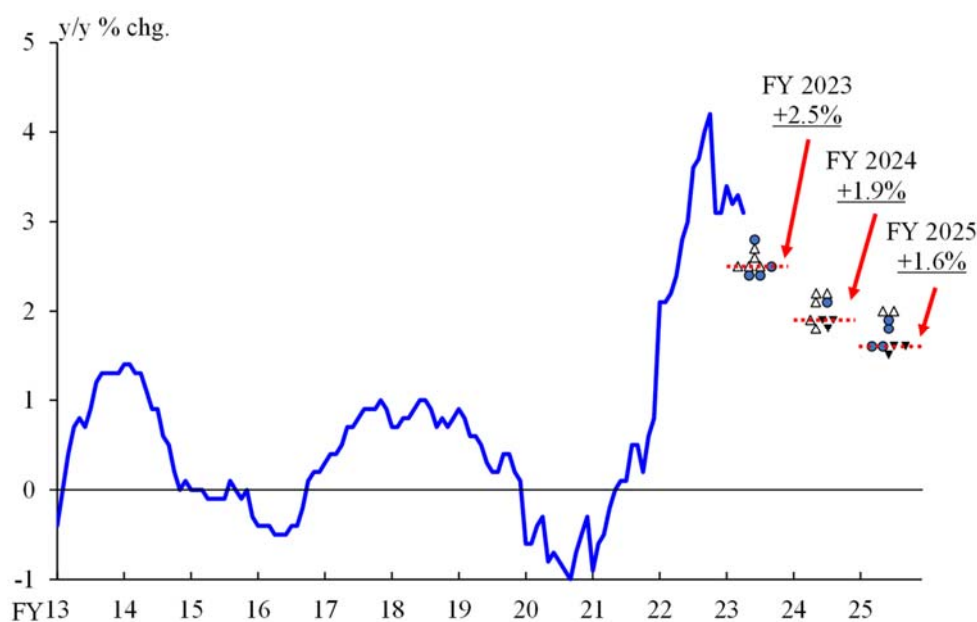
Notes: 1. Figures for "less fresh food," "less fresh food and energy," and "measures of core inflation" are based on Bank staff calculations using the CPI excluding the effects of the consumption tax hike, policies concerning the provision of free education, travel subsidy programs, and changes in mobile phone charges. Figures from April 2020 onward also exclude the effects of measures such as free higher education introduced in April 2020.
2. Figures in angular brackets show the weight of each component in the 2020-base CPI (less fresh food and energy).
3. Figures for "energy" consist of those for petroleum products, electricity, and manufactured and piped gas charges. Figures for "administered prices," which exclude energy, consist of those for public services and water charges.
Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

Changes in Firms' Price-Setting Behavior



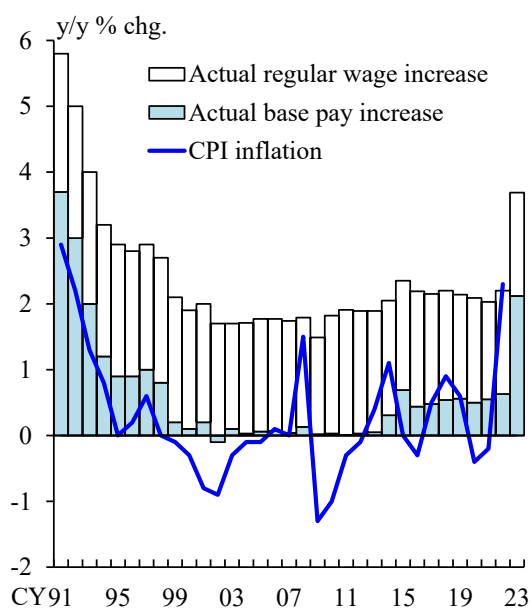
Notes: 1. In the left panel, figures are for all industries and enterprises. There is a discontinuity in the data for December 2003 due to a change in the survey framework.
 2. In the right panel, figures are averages of all industries and enterprises.
 Source: Bank of Japan.

BOJ Forecasts for the CPI



Notes: 1. Figures are the CPI for all items less fresh food, excluding the effects of the consumption tax hikes, etc.
 2. The locations of ●, △, and ▼ in the chart indicate the figures for each Policy Board member's forecasts. The risk balance assessed by each Policy Board member is shown by the following shapes: ● indicates that a member assesses "upside and downside risks as being generally balanced," △ indicates that a member assesses "risks are skewed to the upside," and ▼ indicates that a member assesses "risks are skewed to the downside." The dotted lines show the medians of the Policy Board members' forecasts presented in the July 2023 Outlook Report.
 Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

Prices and Wages



Notes: 1. Figures for CPI inflation are for all items less fresh food, excluding the effects of the consumption tax hikes, etc.
 2. Figures for "actual base pay increase" and "actual regular wage increase" from 1991 to 2014 are those published by the Central Labour Relations Commission, while those from 2015 to 2023 are figures released by the Japanese Trade Union Confederation (Rengo).
 Sources: Central Labour Relations Commission; Ministry of Internal Affairs and Communications; Rengo.

Price Stability Target of 2 Percent

Price Stability

A state where various economic agents including households and firms may make decisions regarding such economic activities as consumption and investments without being concerned about the fluctuations in the general price level.

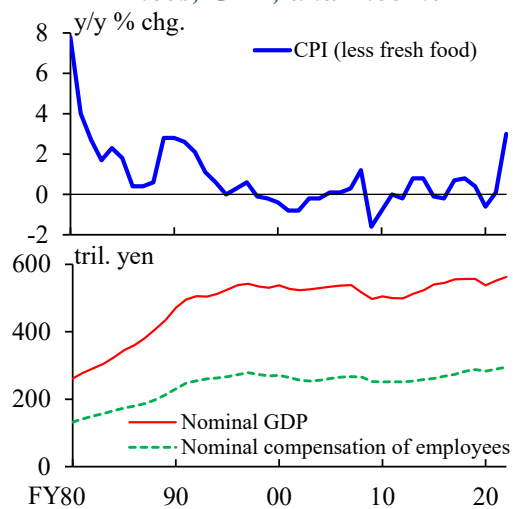
Virtuous Cycle of Japan's Economy

An environment where the economy improves in a balanced and sustainable manner, accompanied by increases in employment, wages, and corporate profits, consequently leading to moderate inflation.

Reasons for Aiming at 2 Percent Inflation

- (1) The measurement bias in the CPI (upward bias)
- (2) The safety margin that acts as a buffer against the risk of a vicious cycle of declining prices and deteriorating economic activity (ensuring room to reduce interest rates)
- (3) 2 percent as a global standard

Prices, GDP, and Income



Note: Figures for CPI (less fresh food) exclude the effects of the consumption tax hikes, etc.
 Sources: Cabinet Office; Ministry of Internal Affairs and Communications.

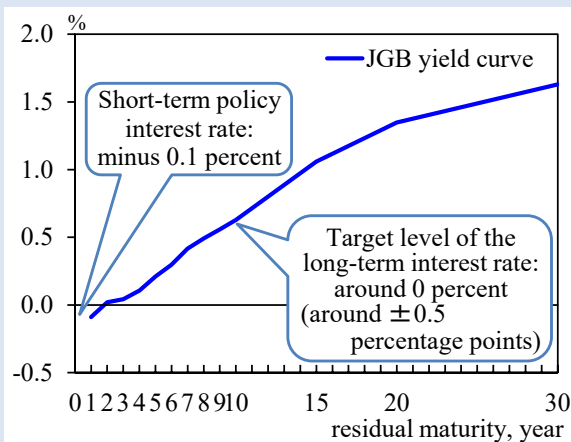
QQE with Yield Curve Control

Stance of Monetary Policy Conduct

With extremely high uncertainties surrounding economies and financial markets at home and abroad, the Bank will patiently continue with monetary easing while nimbly responding to developments in economic activity and prices as well as financial conditions. By doing so, it will aim to achieve the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases.

The Bank will continue with QQE with Yield Curve Control, aiming to achieve the price stability target, as long as it is necessary for maintaining that target in a stable manner. It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner. The Bank will continue to maintain the stability of financing, mainly of firms, and financial markets, and will not hesitate to take additional easing measures if necessary.

(1) Yield Curve Control

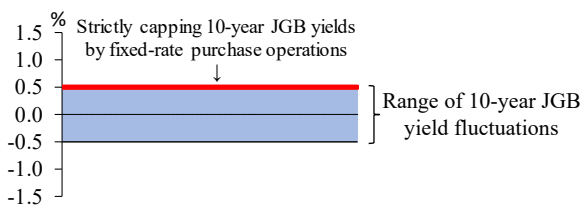


(2) Inflation-Overshooting Commitment

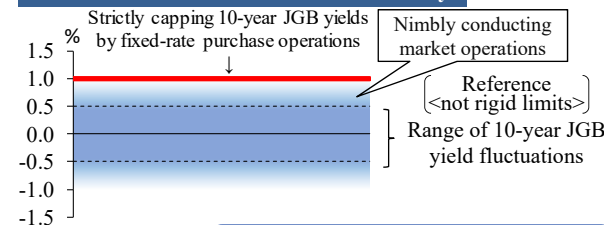
Conducting Yield Curve Control (YCC) with Greater Flexibility

- The Bank judges that sustainable and stable achievement of the price stability target of 2 percent has not yet come in sight, and thus patiently continues with monetary easing.
- With extremely high uncertainties for economic activity and prices, the Bank enhances the sustainability of monetary easing by conducting YCC with greater flexibility.

Previous Conduct of YCC



Conduct of YCC with Greater Flexibility

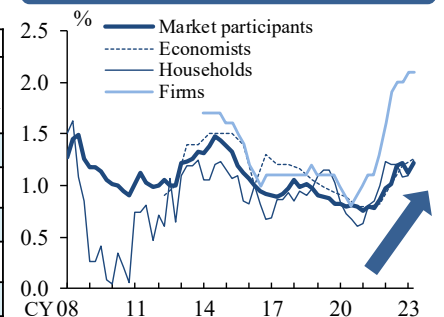


Outlook for Prices

	y/y % chg.	
	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
Fiscal 2023	+2.5	+3.2
Forecasts made in Apr. 2023	+1.8	+2.5
Fiscal 2024	+1.9	+1.7
Forecasts made in Apr. 2023	+2.0	+1.7
Fiscal 2025	+1.6	+1.8
Forecasts made in Apr. 2023	+1.6	+1.8

Note: Figures indicate the medians of the Policy Board members' forecasts (point estimates).

Inflation Expectations



Note: Figures for market participants, economists, households, and firms are from the *QUICK Monthly Market Survey*, the *ESP Forecast*, the *Opinion Survey on the General Public's Views and Behavior*, and the *Tankan*, respectively.

Enhancing the sustainability of monetary easing by conducting YCC with greater flexibility

- If upside risks to Japan's economic activity and prices materialize
 - Decline in real interest rates
 - Mitigating the effects on the functioning of bond markets, etc.
- If downside risks to Japan's economic activity and prices materialize
 - Decline in long-term interest rates

Virtuous Cycle between Wages and Prices

