September 5, 2024

Bank of Japan

Economic Activity, Prices, and Monetary Policy in Japan

Speech at a Meeting with Local Leaders in Ishikawa

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(English translation based on the Japanese original)

I. Economic Activity and Prices

Please allow me first to express my deepest sympathy for the lives lost in the Noto Peninsula Earthquake and to offer my sincere condolences to all those affected.

I will begin by talking about the current situation of economic activity and prices. Overseas economies have grown moderately on the whole. Chart 1 shows developments in the global economy as presented in the July 2024 *World Economic Outlook* (WEO) *Update* released by the International Monetary Fund (IMF). Although the U.S. economy has been affected by past policy interest rate hikes, it has grown moderately, mainly led by private consumption, and is likely to continue to do so. European economies have started to bottom out and are expected to pick up moderately. Despite the continued effects of adjustments in the real estate market, the Chinese economy is projected to continue to see moderate growth, partly due to government support. Changes in the WEO projections for 2024 show that upward growth revisions have continued to be made over the past year, especially for the United States. In the first half of August 2024, the results of U.S. employment-related statistics triggered concerns of an economic slowdown, and subsequently stock prices and foreign exchange rates saw significant movement, but they have recently started to regain stability. As central banks in the United States and Europe have continued to conduct tight monetary policy, I consider it necessary to regard developments in overseas economic activity and prices as a risk factor, and to monitor these developments with utmost vigilance, together with market developments.

Japan's economy has recovered moderately, although some weakness has been seen in part. Looking at developments in the household sector, as shown in Chart 2, consumption of nondurable goods such as food has been weak due to the impact of high prices. Meanwhile, private consumption as a whole has remained resilient, mainly led by services consumption, and the wage growth rate has risen recently, reflecting high wage increases agreed in the 2024 annual spring labor-management wage negotiations. With regard to the corporate sector, the June 2024 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) shows that business fixed investment has remained solid on the back of continued favorable business conditions, in that the rate of increase in fixed investment plans for fiscal 2024 has turned out to be high, exceeding 10 percent (Chart 3). As for prices, the latest figure for the year-on-year rate of increase in the consumer price index (CPI) for all items excluding fresh food is above 2.5 percent (Chart 4). This is mainly because services prices have continued to rise moderately, reflecting factors such as wage increases, although the effects of a pass-through to consumer prices of cost increases led by the past rise in import prices have waned.

With regard to the outlook, Japan's economy is likely to keep growing at a pace above its potential growth rate, with overseas economies continuing to grow moderately and as a virtuous cycle from income to spending gradually intensifies against the background of factors such as accommodative financial conditions. Looking at Chart 5, which shows the forecasts for economic activity and prices presented in the July 2024 *Outlook for Economic Activity and Prices* (Outlook Report), the real GDP growth rate in terms of the median of the Bank of Japan Policy Board members' forecasts is projected to be 0.6 percent for fiscal 2024, and 1.0 percent for both fiscal 2025 and fiscal 2026. Private consumption has shown some weakness recently. Although it is expected to be affected by the price rises for the time being, it is projected to increase moderately, mainly reflecting the rise in wage growth. Furthermore, private consumption is also projected to be underpinned by the government's initiatives such as the continuation of measures to reduce the household burden of higher gasoline prices.

In terms of the median of the members' forecasts in the July 2024 Outlook Report, the year-on-year rate of increase in the CPI (all items less fresh food) is projected to be 2.5 percent for fiscal 2024, and then be at around 2 percent: 2.1 percent for fiscal 2025 and 1.9 percent for fiscal 2026. Thus, in the second half of the projection period, the rate of increase in the CPI is likely to be at a level that is generally consistent with the price stability target. Compared with the forecasts made in the April 2024 Outlook Report, the projected rate of increase for fiscal 2024 is lower due to the effects of the government's measures, while that for fiscal 2025 is higher. Nevertheless, the forecasts have been unchanged on the whole.

Despite recent significant movement in stock prices and foreign exchange rates, it is still reasonable, in my view, to expect the price stability target to be achieved. Let me now note that this situation has unfolded against the background where firms' price- and wage-setting behavior has changed, and this change has helped the economy to (1) achieve a virtuous cycle of improvement in corporate profits and continued wage hikes that reflect price increases, and (2) reach an inflection point where there is a long-awaited shift away from the deeply-entrenched norm that wages and prices do not rise. These changes have been achieved through the following three phrases, which I will explain in detail using Chart 6. In the first phase, higher imported raw material prices caused cost-push pressure in the second half of 2022, which is the first big push, and this accelerated the pass-through of cost increases to goods prices. In the second phase, wage hikes caused cost increases, or the second big push, and firms have been passing on some of these cost increases to prices, including services prices. The annual spring labor-management wage negotiations this year resulted in a wage increase of 5.1 percent, marking the highest level in 33 years (Chart 7). In this context, in the third and final phase, inflation expectations have been rising steadily, albeit at a moderate pace.

As for recent price developments, import prices have started to rise again since the turn of fiscal 2024. In terms of projecting price developments, the increase in import prices is not strong enough at this point to bring about a pass-through of cost increases to consumer prices through the three phases I just mentioned, unlike the pass-through that occurred from 2022 onward. That said, it has become easier for firms to pass on cost increases to selling prices, partly because the norm in which firms keep prices unchanged has started to shift. It is therefore necessary to examine without any preconceptions the possibility that another wave of price hikes will occur toward the second half of the fiscal year, while being mindful of the appreciation of the yen during the first half of August. Moreover, apart from the achievement of the price stability target in a strict sense, it is also necessary to recognize that households in particular have started to become more conscious of the likelihood of the target being achieved, with inflation already in its third year above 2 percent.

II. Recent Conduct of Monetary Policy

Let me now present my views on the Bank's conduct of monetary policy.

At the Monetary Policy Meeting (MPM) held in March 2024, the Bank judged that it was now within sight that the price stability target would be achieved in a sustainable and stable manner, and revised the policy framework in this light. The Bank terminated large-scale monetary easing measures, including the yield curve control framework and the negative interest rate policy, as these measures had fulfilled their roles. The Bank decided that it would guide the short-term interest rate as a primary policy tool and that, with the price stability target, it would conduct monetary policy as appropriate, in response to developments in economic activity and prices as well as financial conditions, aiming at sustainable and stable achievement of the target.

Furthermore, at the July 2024 MPM, the Bank decided on a plan for the reduction of its purchase amount of Japanese government bonds (JGBs) for the period until March 2026, while taking into account views from market participants (Chart 8). In principle, long-term interest rates are to be formed in financial markets, and it is appropriate for the Bank to reduce its purchase amount of JGBs in a predictable manner, while allowing enough flexibility to support stability in the JGB markets. Based on this, the Bank formulated the plan so as to make a sizeable reduction in the purchase amount. However, the size of the Bank's balance sheet is large, and the Bank will likely continue with its reduction for a considerable period of time. Therefore, I would like to point out the difficulty in discussing at this point what will be the appropriate terminal amount of the Bank's JGB holdings and how far the Bank should reduce the size of its balance sheet. It is necessary for the Bank to refer to the experience of overseas central banks that have reduced their bond holdings.

In addition, at the July MPM, the Bank decided to raise the short-term interest rate -- the primary tool of our monetary policy -- to around 0.25 percent (Chart 9). While Japan's economic activity and prices have been developing generally in line with the Bank's outlook, upside risks to prices require attention. In view of these circumstances, the Bank judged it appropriate to adjust the degree of monetary accommodation from the perspective of sustainable and stable achievement of the price stability target. The Bank therefore decided to raise the policy interest rate; however, in assessing the degree of monetary accommodation, it is important to identify the natural rate of interest, which can be compared with the real interest rate. That said, the natural rate of interest cannot be directly observed, and different methodologies produce very different estimates. It is therefore extremely difficult to accurately identify recent specific figures for the natural rate of interest (Chart 10). Nonetheless, real interest rates have recently been lower than the various estimates of the natural rate of interest, and accommodative financial conditions seem to be continuing, even after the policy interest rate hike (Chart 11).

There was significant movement in stock prices and foreign exchange rates in the first half of August 2024, and its impact remains. For the time being, it is necessary to pay close attention to market developments and examine the effects of the movement in August. On this basis, with accommodative financial conditions continuing, if it is confirmed that prices are developing generally in line with the Bank's outlook and that positive corporate behavior -- such as solid business fixed investment, sustained wage hikes, and a continued pass-through of cost increases to selling prices -- is being maintained, I think that it will be necessary to shift gears -- that is, proceed with further adjustment of the degree of monetary accommodation -- as appropriate, and make the transition to "a state with positive interest rates." That said, given the difficulty of identifying the natural rate of interest, instead of raising the policy interest rate based on a neutral interest rate that corresponds to the assumed timing of achieving the price stability target, I think that the realistic approach for the Bank is to take sufficient time before making a decision on future policy interest rate hikes, while examining at each MPM the impact such hikes may have on developments in economic activity and prices as well as financial conditions. Looking back, following the shift to a floating exchange rate system in the 1970s, the monetary policy stances of advanced economies and their corresponding economic cycles were largely in sync. However, there has recently been a difference between economic cycles in Japan and those abroad. Although central banks in the United States and Europe are now heading toward policy interest rate reductions, if previous rapid rate hikes affect the global economy and financial conditions with a time lag, there is a risk that Japan's economic activity will be under downward pressure. At the same time, since financial markets could become volatile due to the difference in monetary policy stances, it is necessary to continue carefully monitoring market developments at home and abroad.

III. The Past, Present, and Future of Japan's Economy: Developments since the Collapse of the Bubble

Developments in Japan's economy that have not been seen for more than three decades have been a topic of discussion since spring 2024; specifically, stock prices reaching a record high for the first time in about 35 years, and wage growth exceeding 5 percent for the first time in 33 years. I believe that these developments indicate a historic shift in Japan's post-bubble economy, and that the Bank's recent move away from large-scale monetary easing has played some part. It took longer than expected for Japan to see this historic shift. In what follows, I would like to present my personal view on the changes in Japan's economy after the collapse of the bubble from a past, present, and future perspective, focusing particularly on changes in corporate behavior.

Past: Post-Bubble Changes in Corporate Behavior and the Entrenchment of the Norm

Let me first reflect on the past as a starting point. Looking at trends in the growth rate, Japan's economy continued to experience low growth from the 1990s, with the collapse of the bubble (Chart 12). Although a variety of factors contributed to the slowdown in growth, including demographic changes, I believe that the major cause was the change in corporate behavior in response to post-bubble changes in the economic environment. Specifically, as Chart 13 shows, in the context of significant asset deflation, an increasing number of firms sought to pursue management with minimum assets by paring down assets on their balance sheets and reining in investment, while also engaging in business restructuring to cope with mounting international competition by reducing costs in their income statements. In response to the changing business conditions, these moves were rational for individual firms. From a macroeconomic perspective, however, this approach caused Japan to fall into a shrinking equilibrium due to the "fallacy of composition" -- assuming that what is true of one member of a group is true for the group as a whole. Meanwhile, in a deflationary environment, it was rational for households to hold their assets in cash and deposits. Today, household financial assets in Japan stand at about 2,200 trillion yen. Nevertheless, unlike in the United States and Europe, Japanese households have tended to avoid holding risk assets, with cash and deposits accounting for more than half of their financial assets. This tendency has ended up contributing to a shrinking equilibrium on the macroeconomic level, as households have been unwilling to allocate their assets to risk money. Furthermore, firms' pursuit of both management with minimum assets and business restructuring not only reined in business fixed investment but also suppressed investment in human capital. These factors together are considered to have brought down Japan's potential growth rate (Chart 14).

At this point, I would like to recall from a historical perspective the asset deflation that led firms in Japan to pursue management with minimum assets. At its peak in the 1980s, Japan accounted for nearly half of global market capitalization. However, as Chart 15 shows, from the 1990s, stock prices in Japan fell sharply and real estate prices stagnated. The essence of the post-bubble crisis in Japan was a drop in asset prices, or asset deflation. Turning to national wealth, when comparing the peak recorded during the bubble period with the lowest point recorded after the bubble's collapse, the difference was about 900 trillion yen, nearly double the GDP of Japan. The extent of the impact of the bubble's collapse bears comparison even with the loss of national wealth during World War II.[1] Also during the post-bubble period, a significant decline in capital bases in real terms drove firms to curtail investment and reduce interest-bearing debt. Moreover, firms' concerns over funding stemming from post-bubble financial system instability led to hoarding cash and deposits -- this corporate behavior had a lingering impact until very recently.

Next, I would like to look back on the competitive environment vis-à-vis overseas economies that led to business restructuring among Japanese firms. In the aftermath of World War II, Japan benefited from the tailwind of global trade, for many years serving as the manufacturing hub for the Western bloc. However, the geopolitical environment shifted after the fall of the Berlin Wall in 1989, and Japan was seen to pose a growing economic threat, which led to mounting trade friction with the United States, followed by a rapid appreciation of the yen in the 1990s (Chart 16). Under these circumstances, Japanese firms were forced to curtail their share of production in the semiconductor sector. In addition, firms across a wide range of sectors, including those in the automobile industry, were called on to shift their production sites overseas, leading to a hollowing out of domestic industries. Moreover, despite the yen's appreciation, firms left their export prices unchanged to maintain price competitiveness. The upshot is that it became the established practice for firms in Japan to pursue management aimed at business restructuring and to hold down margins while not raising employee wages. For a long time thereafter, firms grew accustomed to absorbing increases in the cost of raw materials by cutting costs rather than by passing the higher costs on to selling prices. Firms took for granted the practice of leaving wages and selling prices unchanged, and this became established as the norm. Indeed, the rates of increase in both wages and prices continued to hover around 0 percent for many years from the second half of the 1990s, in what was deemed

[1] According to a report on damage and casualties of World War II compiled by the Economic Stabilization Board of Japan, the damage to national wealth reached 64.3 billion yen. This amounts to 86 percent of Japan's GNP for fiscal 1944.

a deflationary period (Chart 17). It has been pointed out that Japanese firms at that time emphasized process innovations to achieve lower selling prices to compete with overseas firms, rather than implementing product innovations that aimed to generate new demand. On this issue, as Chart 18 suggests, Japanese firms, in stark contrast to firms in the United States, faced a decline in pricing power due to sluggish domestic demand, leading to the holding down of selling prices and margins -- a situation referred to in economic theory as "a decline in price markups." At the same time, Japanese firms secured profits in a kind of ongoing war of attrition through increased "wage markdowns," or the tendency to keep wages down.

Present: The Inflection Point of the Norm Shift

Next, I will talk about the present. The norm that wages and prices do not rise has finally reached an inflection point. As I mentioned, this symbolic change can be attributed to the big push observed since 2022 that originated abroad and stemmed from higher import prices (Chart 6). This change was also caused by the shift away from the sluggish asset prices and the intensified competitive environment vis-à-vis overseas economies that drove changes in corporate and household behavior in the post-bubble period. More specifically, as Chart 15 shows, the asset deflation that led firms to pursue management with minimum assets on their balance sheets has improved significantly as asset prices have risen since the early 2010s, mainly in the stock and real estate markets. Firms have also managed to shift away from business restructuring since the 2010s, with the dissipation of the continued excessive appreciation of the yen, which had driven severe international competition in terms of firms' income statements. Moreover, with Japan finding itself in a very different geopolitical position compared with the period around 1990, there were historic moves to bring production sites back home out of concern over economic security, as seen in, for example, the shoring up of domestic production of semiconductors in Kumamoto and Hokkaido prefectures.

On the other hand, although asset prices have risen and the excessive appreciation of the yen has been reversed over the past decade or so, the shift away from the norm is only now coming into sight, and it has taken a long time for the shift to occur. This shows that the wage and price norm that took hold after the collapse of the bubble economy has been deeply entrenched. To show how deeply entrenched it has been, I would like to mention one estimate associated with Japan's negative experience.

Chart 19 shows the cumulative returns on investment by age of investors, assuming that they made a fixed monthly investment in the Nikkei 225 Stock Average starting from age 22, when many people are likely to begin working. With the ongoing rise in stock prices over the past decade or so, although people in their 20s and 30s have experienced hardly any negative returns, those in their 40s and 50s have gone through negative returns for nearly half of their working life, due to the prolonged post-bubble sluggishness in stock prices. While this is merely an estimate using stock prices as an example, it shows that those in their 40s and 50s in particular, the generation that currently makes up the core of firms and other economic entities, have suffered a long-term negative and traumatic experience. This is likely one of the factors that led to the deeply-entrenched cautiousness in corporate behavior after the collapse of the bubble economy. In addition, it also suggests that a shift in the corporate behavior mired in this norm could have taken longer than expected, perhaps the decade it takes to form the next generation. Likewise, in terms of the adaptive formation mechanism of inflation expectations -- for which Japan has a higher degree of adaptiveness compared with other economies, as shown in Chart 20 -- since the norm that wages and prices do not rise has been entrenched for such a long period, it can be assumed that the shift from cautious inflation expectations and the rise in expectations took far longer than initially anticipated. Furthermore, despite the start of a shift away from the norm, the situation seems likely to remain polarized, in that the norm is still entrenched in part.

On this score, the Assessment for Further Effective and Sustainable Monetary Easing, released by the Bank in March 2021, showed that, in addition to the lower funding costs transmission channel, the financial and capital markets channel (stock prices and foreign exchange rates) had also been significantly effective in translating the benefits of lower interest rates into improvement in the output gap (Chart 21). These findings suggest that the Bank's monetary easing has contributed to the shift away from the asset deflation and the so-called six headwinds -- including the headwind of the yen's appreciation -- both of which prompted the changes in corporate behavior in the post-bubble economy. Considering that it may take as long as a decade -- the time it takes for a new generation to be formed -- for the norm to change, I believe that the Bank's patient continuation of monetary easing as well as its support for rises in asset prices and for the reversal in the excessive appreciation of the yen have laid the groundwork for reaching the inflection point of the norm shift, marking a historic change since the collapse of the bubble economy. Looking at Chart 13, the following factors have contributed to this change: (1) in terms of firms' balance sheets, asset prices in the stock and real estate markets have risen; and (2) in terms of firms' income statements, the problem of the excessive appreciation of the yen has been resolved, and the recent geopolitical environment has led firms to bring production sites back to Japan. I believe that Japan has managed to move beyond the traumatic experience with the help of (1) a decade of large-scale monetary easing and (2) the big push observed since 2022 that originated abroad and stemmed from higher import prices. As I have discussed, this has finally led to the symbolic change in 2024 -- the historic shift observed for the first time in more than three decades.

Future: Will the Positive Corporate Behavior Continue?

Before surveying the future, I would like to provide a brief review. In the *past*, changes in corporate behavior in the post-bubble economy led to the entrenchment of the norm that wages and prices do not rise. This norm is finally reaching an inflection point at *present*. Given these developments, I think that the crucial point for the *future* is whether the positive corporate behavior will continue, again in line with Chart 13. This thinking is also the background for my mentioning earlier the need to confirm the sustainability of such positive corporate behavior to make a further gear shift in monetary policy.

As corporate behavior after the bubble's collapse was typified by firms' pursuit of management with minimum assets and of business restructuring, I think that these are the key standpoints in judging the sustainability of positive corporate behavior. That is, from the standpoint of management with minimum assets, an important criterion is whether solid business fixed investment will be maintained. On this score, some firms, including small and medium-sized ones, have started to make forward-looking investments. Since the funding structure of small and medium-sized firms is relatively collateral dependent, increases in real estate and other asset prices could better facilitate business fixed investment. I also see the possibility that such a development could generate even greater momentum for corporate activity than improvement in the profit environment. In the overall corporate sector, the favorable financial positions of firms, with their interest burden falling to such an extent that interest income exceeds interest expenses, are also likely to underpin solid business fixed investment (Chart 22). Additionally, the growing willingness of firms to invest in social transformation -- including moves toward digitalization and the transition to electric vehicles (EVs), and global efforts toward achieving carbon neutrality -- will also be a factor to consider when projecting future developments in business fixed investment.[2]

From the standpoint of business restructuring, the key criteria include increases in wages and selling prices as well as steps to secure margins. In this regard, corporate managers are aware of mounting social expectations for wage hikes and investment in human capital, and there is also a change in their mindset that took for granted the core practice of keeping wages and selling prices unchanged. In fact, a survey conducted as part of the Bank's review of monetary policy from a broad perspective found that around 70 percent of respondent firms thought it preferable for prices and wages to rise moderately (Chart 23). Even small and medium-sized firms and regional firms have started to stimulate a certain degree of innovation, as seen in the recent ongoing increase in business succession and merger and acquisition (M&A) activities, which may suggest that they have started to raise selling prices.[3] Also, as Chart 19 shows, Japan's economy is seeing the rise of a new generation that never experienced the negative economic environment and shrinking equilibrium of the post-bubble period. It can be pointed out that this new generation has the potential to drive a rethinking of the core practice and the norm that have to date been widespread in Japan. Along with this change, the younger generation is also likely to play a central role in moving the asset management of Japanese households away from the traditional focus on cash and deposits.

Will this Time Be a "True Dawn"?

It is true that Japan's economy has undergone several "false dawns,"[4] or temporary economic

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2 The *Survey on Planned Capital Spending* for fiscal 2024 released by the Development Bank of Japan indicates that a high increase in business fixed investment is planned for fiscal 2024, with accelerated digitization driving increased investment in EVs and investment to expand semiconductor production capacity.

3 The *Annual Report on the Japanese Economy and Public Finance* for fiscal 2023 explains the positive relationship between markups and investment in intangible assets such as research and development (R&D) and human capital by drawing on data from the Ministry of Economy, Trade and Industry's *Basic Survey of Japanese Business Structure and Activities*.

4 Shirakawa, M., "Way Out of Economic and Financial Crisis: Lessons and Policy Actions," speech at the Japan Society in New York, April 23, 2009,
https://www2.boj.or.jp/archive/en/announcements/press/koen_2009/ko0904c.htm.

recoveries, in the course of a little over three decades since the bubble's collapse. Hopes for economic recovery in Japan were running high around the turn of the millennium, but that recovery was subsequently derailed by the collapse of the overseas IT bubble. There was another period of economic improvement in the mid-2000s, dubbed a mini-bubble, but the impact of the global financial crisis in 2008 cut that recovery short, and the pattern of "false dawns" repeated itself. In considering future developments in the economy, I would like to reflect on some past economic recoveries -- although they were negatively affected to a significant degree by shocks originating overseas -- from the perspective of firms' pursuit of both management with minimum assets and business restructuring.

First, in the recovery phase around the turn of the millennium, the banking sector had yet to fully dispose of its non-performing loans, while the corporate sector also had not completed its balance-sheet adjustments. This meant that firms continued to pursue management with minimum assets and made inadequate positive fixed investment. As for the economic recovery in the mid-2000s, although balance-sheet adjustments in the corporate and banking sectors were almost completed, amid the lingering impact of the traumatic deeply-rooted post-bubble experience, it was apparent that firms were caught in an ongoing situation in which they were unable to escape from business restructuring, and in which wages and prices remained unchanged. This is why these ended up being "false dawns" and a "true dawn"[5] never materialized, even though, aided by tailwinds from overseas, Japan entered a recovery phase on several occasions.

However, with the completion of balance-sheet adjustments coming into sight, Japan's economy is currently experiencing not only the big push but also a tailwind that has continued for over a decade -- the shift away from sluggish asset prices and the increasingly competitive environment vis-à-vis overseas economies. This has allowed firms to break away from the pursuit of both management with minimum assets and business restructuring. Japan has broken free of its long-standing norm and traumatic experience, warranting hopes that positive corporate behavior will finally be sustained. I would like to pay close attention to

[5] Nakaso, H., "Japan's Way toward Strong, Sustainable, and Balanced Growth: Assessment of the potential of the Japanese economy suggests the sun also rises," speech at a meeting hosted by the Japan Society and the City of London Corporation in London, October 5, 2017, https://www.boj.or.jp/en/about/press/koen_2017/ko171005a.htm.

whether "this time is different" and Japan's economy will experience a "true dawn." It is against the backdrop of this historic shift that Japan's economy is looking ahead to "a state with positive interest rates," as I touched on earlier. That said, I also think that due attention should be paid to economic and market developments abroad, as shocks originating overseas have been a constraint on Japan's economic recovery on a number of occasions in the past.

Balance-Sheet Adjustments during the Post-Bubble Period: From the Perspective of JGBs

So far, I have discussed post-bubble balance-sheet adjustments, with a focus on corporate behavior. I would now like to reflect on the post-bubble period from the perspective of JGBs.

Chart 13 shows the reduction in assets and liabilities by firms -- that is, their balance-sheet adjustments. This reduction caused financial institutions to incur losses in the process of disposing of non-performing loans, which led to the injection of public funds into these institutions. Furthermore, the overall economic downturn brought about an expansionary trend in fiscal spending, leading to an increase in the outstanding amount of JGBs issued. In other words, the increase in JGB issuance during this period can be seen as the result of the government shouldering the burden of excessive private sector debt in the process of balance-sheet adjustments in the sector. By the early 2000s, the end of the problem of excessive private sector debt and financial system instability came into sight. From this perspective, what was seen in the post-bubble period can also be described as a balance-sheet adjustment for the country as a whole. Meanwhile, financial institutions' holdings of JGBs increased, prompted by the slump in corporate sector demand for funds due to its balance-sheet adjustments. In the 2000s, depository corporations held about 40 percent of JGBs issued (Chart 24).

Subsequently, as maintaining price stability became a major challenge, the Bank of Japan implemented large-scale monetary easing. Improvement in financial and capital markets also played a significant part in translating the benefits of lower interest rates into improvement in the output gap (Chart 21). To facilitate the smooth adjustments in corporate balance sheets shown in Chart 13, the Bank's initiative to push down the yield curve over a relatively long period of time is thought to have supported positive corporate behavior. In doing so, the Bank pushed forward with JGB purchases, and the large share of JGB holdings shifted from depository corporations to the Bank. The upshot is that the Bank now holds nearly half of all

JGBs issued, and thus bears much of the interest rate risk previously borne by financial institutions. It can be said that the Bank's large-scale monetary easing, aimed at achieving the price stability target, played a role over time from a financial perspective in supporting the final stages of the balance-sheet adjustment process -- a balance-sheet adjustment for the country as a whole, driven by asset deflation.

As I mentioned earlier, at the July 2024 MPM, the Bank decided on a plan to reduce its purchases of JGBs. This does not lead to a significant change in monetary easing effects at this point, but denotes a major shift from the time when the Bank pursued monetary easing effects through yield curve control. At the same time, from a financial perspective, it will be a process in which the amount of the Bank's JGB holdings declines and the amount held by the private sector increases. It will therefore be important to closely monitor the situation of the private sector (financial institutions included), the government, and the Bank, including their financial conditions, during the Bank's reduction of its JGB purchases. The reduction in the Bank's JGB purchases can, in effect, have an impact similar to expanding JGB issuance in the market, suggesting that the planned reduction will bring about a period of historically large-scale issuance. This is why I think that it is crucial to have wide-ranging discussions about a new market structure from a medium- to long-term perspective, bearing in mind the future structure of JGB holdings. In doing so, it will also be important to discuss issues regarding the environment surrounding market participants. The Bank will maintain communication with the market to respond to the new environment, not only through its regular contact but also by taking advantage of meetings with bond market participants and other opportunities to obtain feedback, while closely monitoring market developments at home and abroad as well as investor trends.

Thank you.

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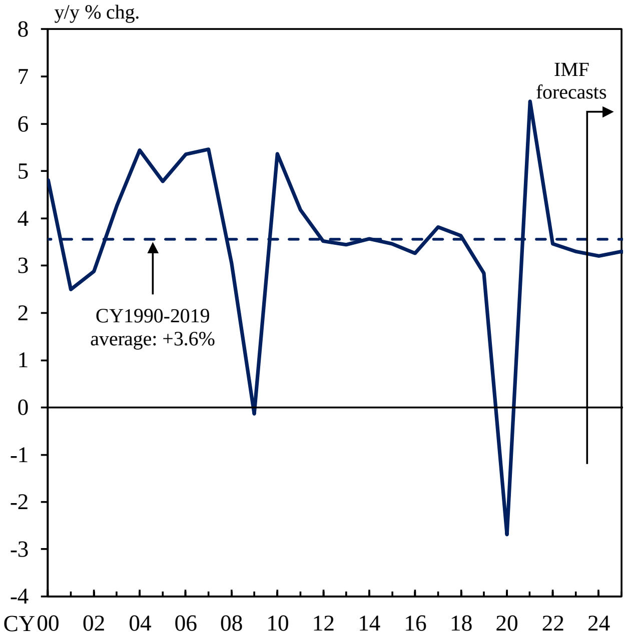
Member of the Policy Board
Bank of Japan

Chart 1

Developments in Overseas Economies (IMF's July 2024 WEO *Update*)

Global Growth Rate

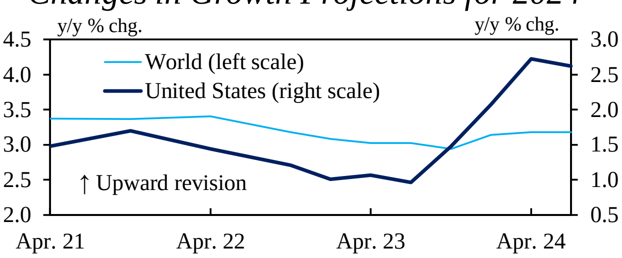


Major Economies' Growth Rates

y/y % chg., % points

	CY 2023	CY 2024 [Forecast]	CY 2025 [Forecast]
World	3.3	3.2 (0.0)	3.3 (0.1)
Advanced economies	1.7	1.7 (0.0)	1.8 (0.0)
United States	2.5	2.6 (-0.1)	1.9 (0.0)
Euro area	0.5	0.9 (0.1)	1.5 (0.0)
Emerging market and developing economies	4.4	4.3 (0.1)	4.3 (0.1)
China	5.2	5.0 (0.4)	4.5 (0.4)

Changes in Growth Projections for 2024

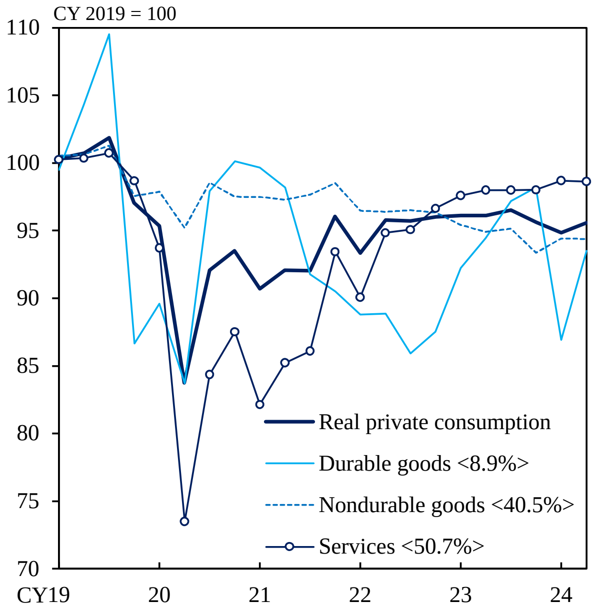


Note: In the table, figures in brackets are the differences from the forecasts in the April 2024 *World Economic Outlook* (WEO).
Source: IMF.

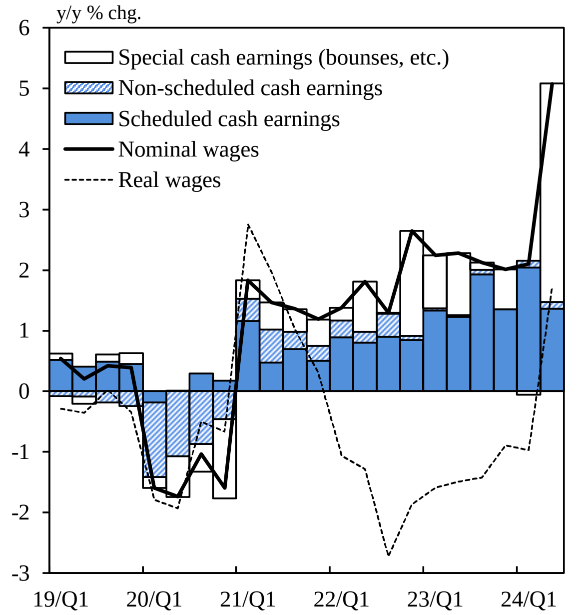
Chart 2

Private Consumption

Real Private Consumption



Wages



Notes: 1. In the left panel, figures for real private consumption are the real Consumption Activity Index (travel balance adjusted) based on Bank staff calculations, which exclude inbound tourism consumption and include outbound tourism consumption. Figures in angle brackets show the weights in the index.

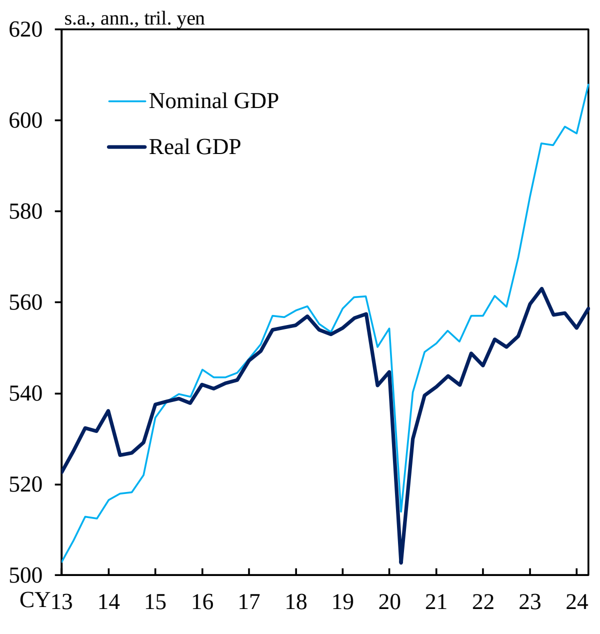
2. In the right panel, figures are based on continuing observations following the sample revisions. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. Figures for 2024/Q2 are those for June.

Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications; Bank of Japan.

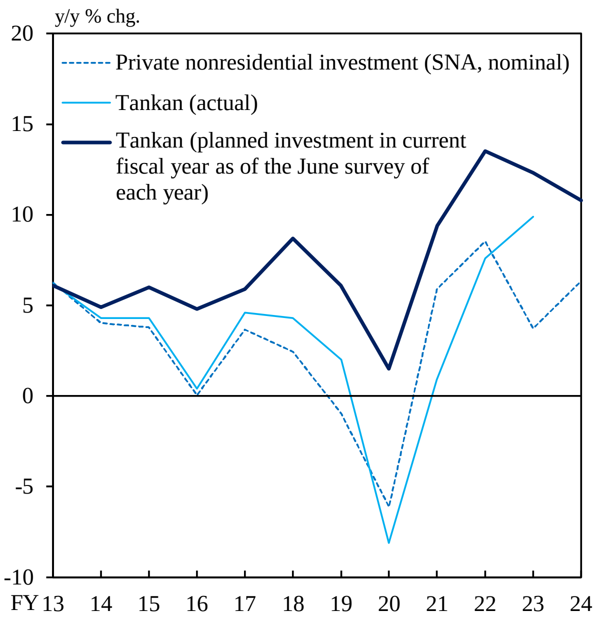
Chart 3

GDP and Business Fixed Investment Plans

GDP



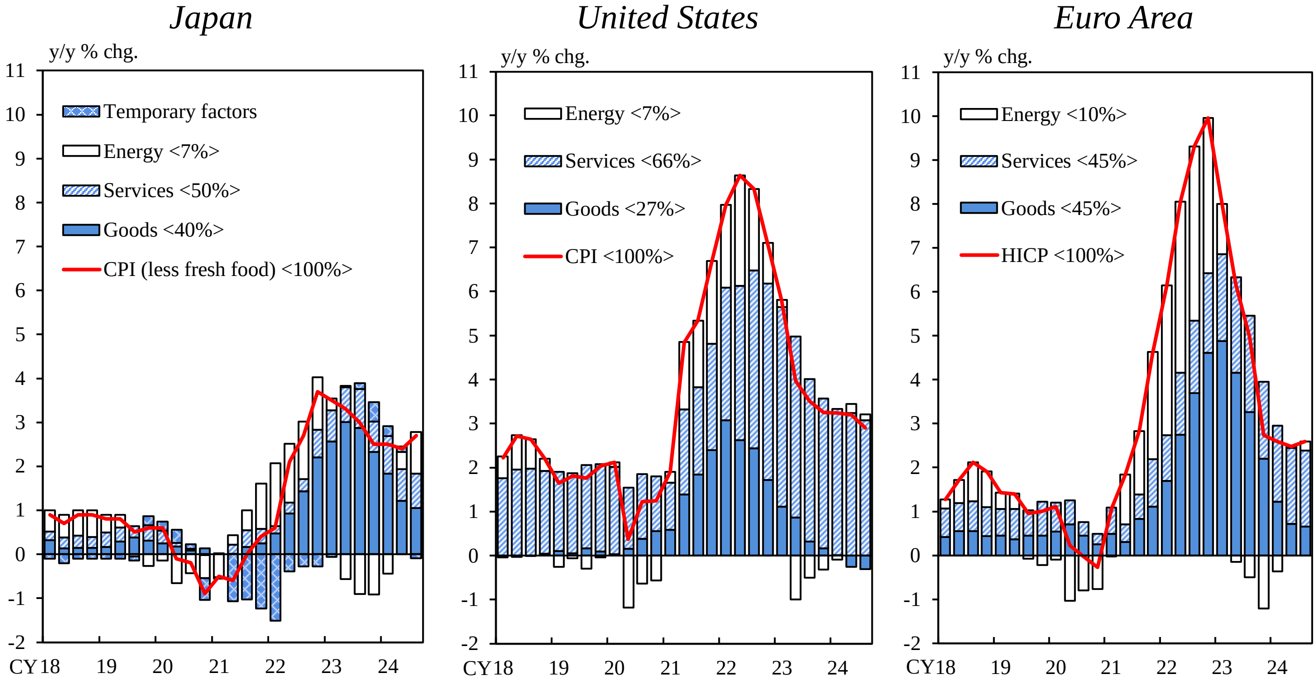
Planned and Actual Business Fixed Investment



Note: In the right panel, the *Tankan* figures are for all industries including financial institutions. The figures include software and R&D investments and exclude land purchasing expenses. R&D investment is not included before the March 2017 survey. The figure for private nonresidential investment for fiscal 2024 is that for 2024/Q2.

Sources: Cabinet Office; Bank of Japan.

Consumer Prices



Notes: 1. Figures for temporary factors for Japan are Bank staff estimates and consist of the effects of the reduction in mobile phone charges, the consumption tax hike, free education policies, and travel subsidy programs.
2. Figures in angle brackets show the share of each component. Figures for 2024/Q3 are those for July.

Sources: Haver; Ministry of Internal Affairs and Communications.

Forecasts of the Majority of the Policy Board Members (July 2024 Outlook Report)

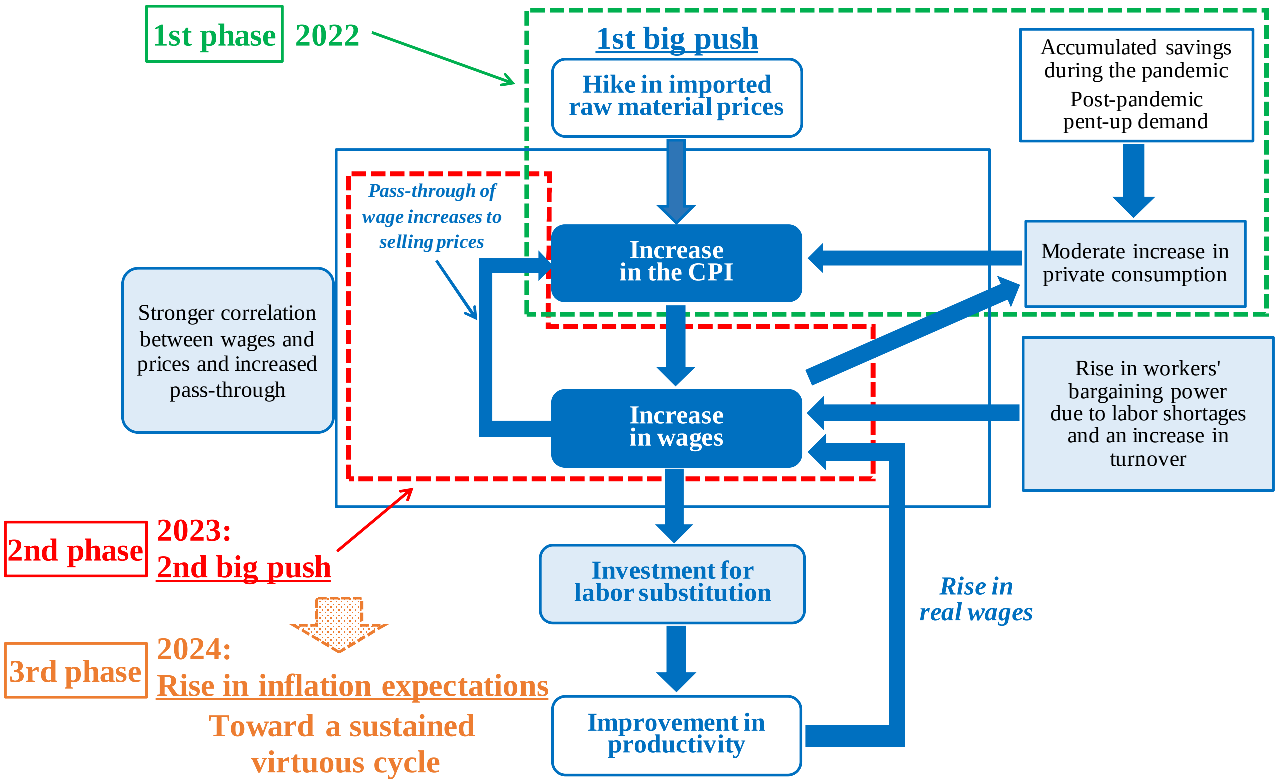
y/y % chg.

	Real GDP	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
Fiscal 2024	+0.5 to +0.7 [+0.6]	+2.5 to +2.6 [+2.5]	+1.8 to +2.0 [+1.9]
Forecasts made in April 2024	+0.7 to +1.0 [+0.8]	+2.6 to +3.0 [+2.8]	+1.7 to +2.1 [+1.9]
Fiscal 2025	+0.9 to +1.1 [+1.0]	+2.0 to +2.3 [+2.1]	+1.8 to +2.0 [+1.9]
Forecasts made in April 2024	+0.8 to +1.1 [+1.0]	+1.7 to +2.1 [+1.9]	+1.8 to +2.0 [+1.9]
Fiscal 2026	+0.8 to +1.0 [+1.0]	+1.8 to +2.0 [+1.9]	+1.9 to +2.2 [+2.1]
Forecasts made in April 2024	+0.8 to +1.0 [+1.0]	+1.6 to +2.0 [+1.9]	+1.9 to +2.1 [+2.1]

Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which they attach the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.
3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

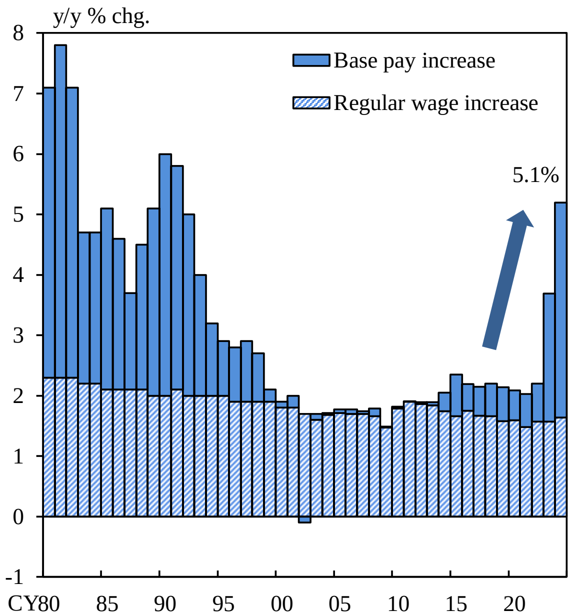
Source: Bank of Japan.

Correlation between Wages and Prices
(Three Phases toward Achieving the 2% Price Stability Target)

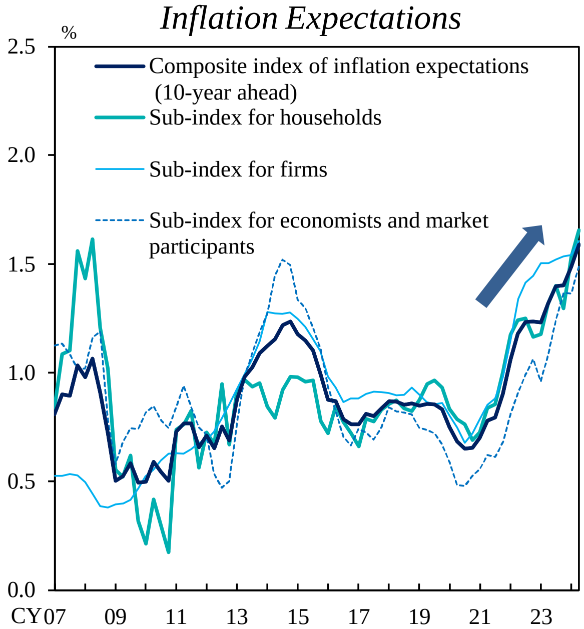


Recent Developments in the Second and Third Phases

2nd Phase: Wage Growth Rate



3rd Phase: Composite Index of Inflation Expectations



Notes: 1. In the left panel, figures from 1980 to 2014 are those published by the Central Labour Relations Commission, while those from 2015 to 2024 are figures released by Rengo.
2. In the right panel, the composite index is calculated by extracting the common components, based on the first principal component, of the inflation expectations of firms, households, and economists and market participants. For details on the calculation method, see Box 4 in the April 2024 Outlook Report.

Sources: Bloomberg; Central Labour Relations Commission; Consensus Economics Inc., *Consensus Forecasts*; Japanese Trade Union Confederation (Rengo); QUICK, *QUICK Monthly Market Survey <Bonds>*; Bank of Japan.

Chart 8

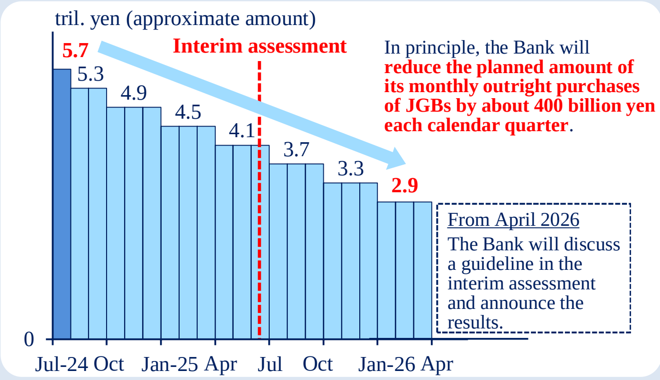
Plan for the Reduction of the Purchase Amount of JGBs

The concept of the plan for the reduction until March 2026

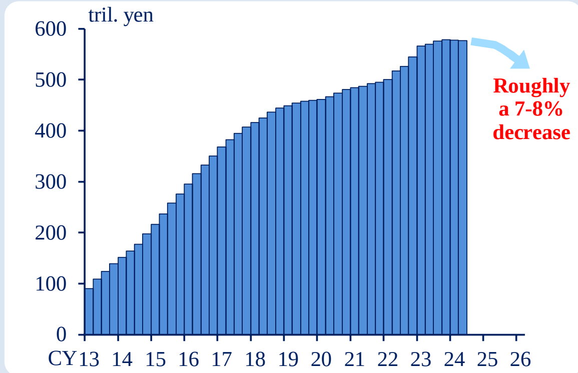
1. Long-term interest rates: to be formed in financial markets in principle
2. JGB purchases: appropriate for the Bank to reduce its purchase amount of JGBs in a predictable manner, while allowing enough flexibility to support stability in the JGB markets

Reduction in a Predictable Manner

Amount of monthly JGB purchases



The Bank's JGB holdings



Allowing Enough Flexibility

1. The Bank will **conduct an interim assessment of the plan at the June 2025 MPM**.
2. In the case of a rapid rise in long-term interest rates, the Bank will make nimble responses by, for example, increasing the amount of JGB purchases.
3. The Bank is prepared to amend the plan at the MPMs, if deemed necessary.

Chart 9

Change in the Guideline for Money Market Operations

- Japan's economic activity and prices have been **developing generally in line with the Bank's outlook**. Moves to raise wages have been spreading.
- The year-on-year rate of change in import prices has turned positive again, and **upside risks to prices require attention**.

Medians of the Policy Board members' forecasts (y/y % chg.)

	Fiscal 2024		Fiscal 2025		Fiscal 2026	
Real GDP	0.6	(-0.2)	1.0	(−)	1.0	(−)
CPI (all items less fresh food)	2.5	(-0.3)	2.1	(+0.2)	1.9	(−)
CPI (all items less fresh food and energy)	1.9	(−)	1.9	(−)	2.1	(−)

Note: Figures in parentheses indicate changes from the April Outlook Report.

Risk balance assessments on prices

Fiscal 2024	Fiscal 2025	Fiscal 2026
Upside	Upside	Balanced

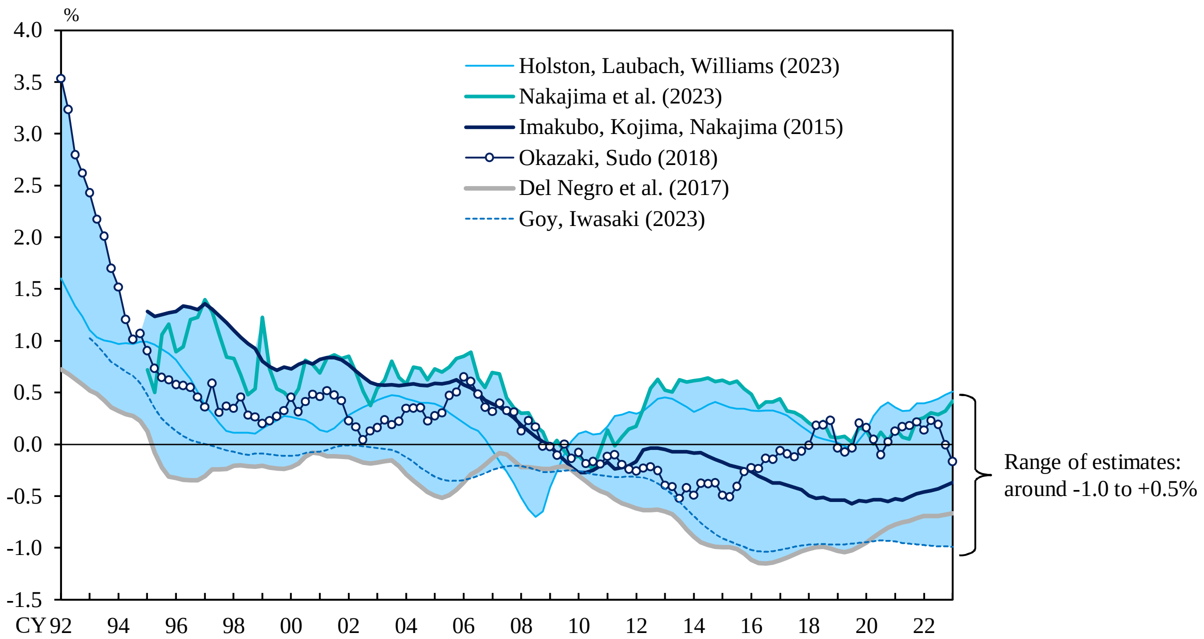
Adjusting the degree of monetary accommodation from the perspective of sustainable and stable achievement of the price stability target of 2 percent

Short-term interest rate: raised to "around 0.25%"

(uncollateralized overnight call rate) (previously "around 0 to 0.1%")

- Real interest rates are expected to remain significantly negative, and accommodative financial conditions will continue to **firmly support economic activity**.
- If the outlook presented in the July Outlook Report will be realized, the Bank will accordingly continue to raise the policy interest rate and adjust the degree of monetary accommodation.

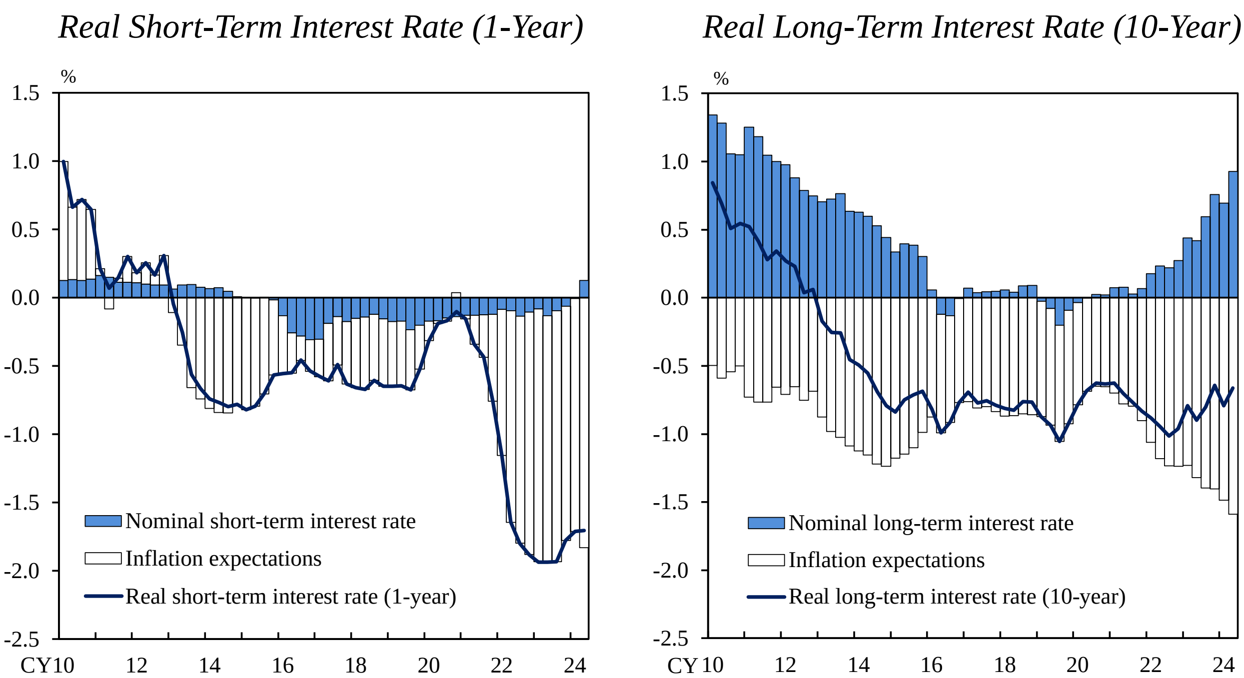
Natural Rate of Interest



Note: The estimates are based on Bank staff calculations using the models proposed in the respective papers. The shaded area indicates the range of natural interest rate estimates between the lowest and the highest values.

Sources: Bloomberg; Cabinet Office; Consensus Economics Inc., *Consensus Forecasts*; Ministry of Finance; Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications; Bank of Japan.

Real Interest Rate

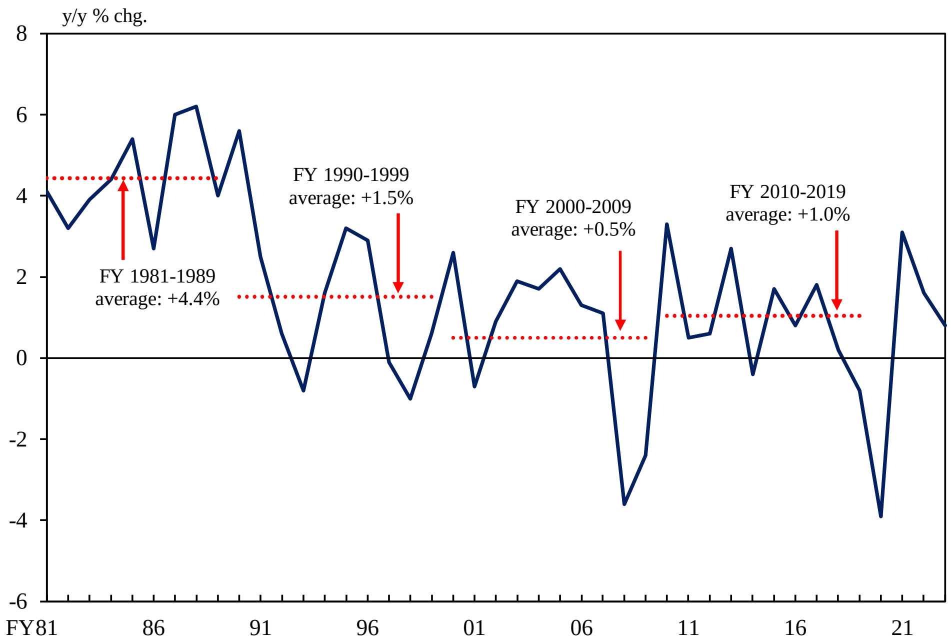


Note: Figures for real interest rates are calculated by deducting inflation expectations from JGB yields for each maturity. Figures for inflation expectations are based on Bank staff calculations using the expectations of various economic entities (firms, households, and experts) at different horizons. Specifically, the data used in the calculations are as follows: for firms, the *Tankan*; for households, the *Opinion Survey on the General Public's Views and Behavior*; for experts, the *QUICK Survey*, the *Consensus Forecasts*, and inflation swap rates.

Sources: Bloomberg; Consensus Economics Inc., *Consensus Forecasts*; QUICK, *QUICK Monthly Market Survey <Bonds>*; Bank of Japan.

Chart 12

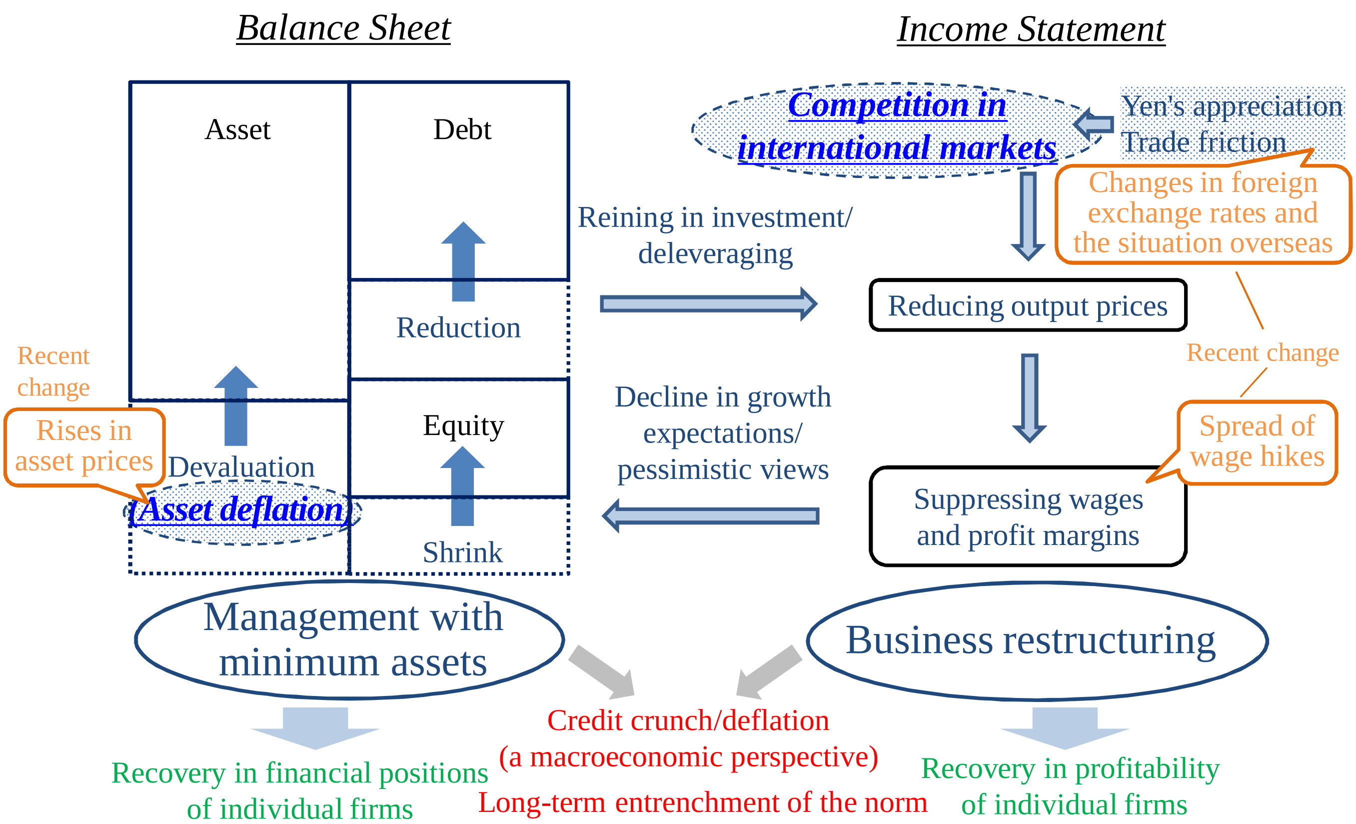
Long-Term Developments in Real GDP Growth Rate



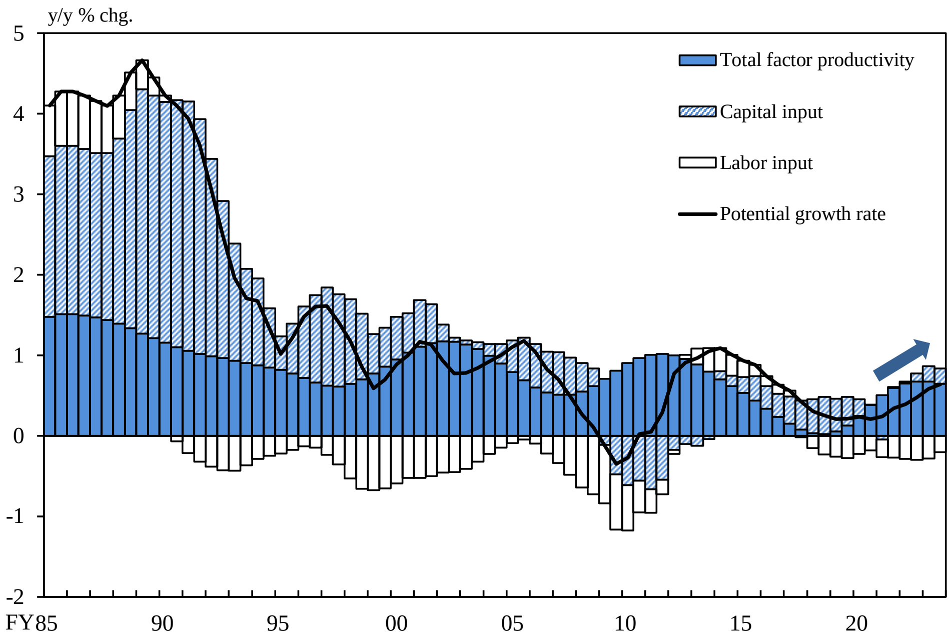
Note: Figures from fiscal 1981 to 1994 are based on simplified retroactive adjustments.
Source: Cabinet Office.

Chart 13

My View on Corporate Behavior in the Post-Bubble Period

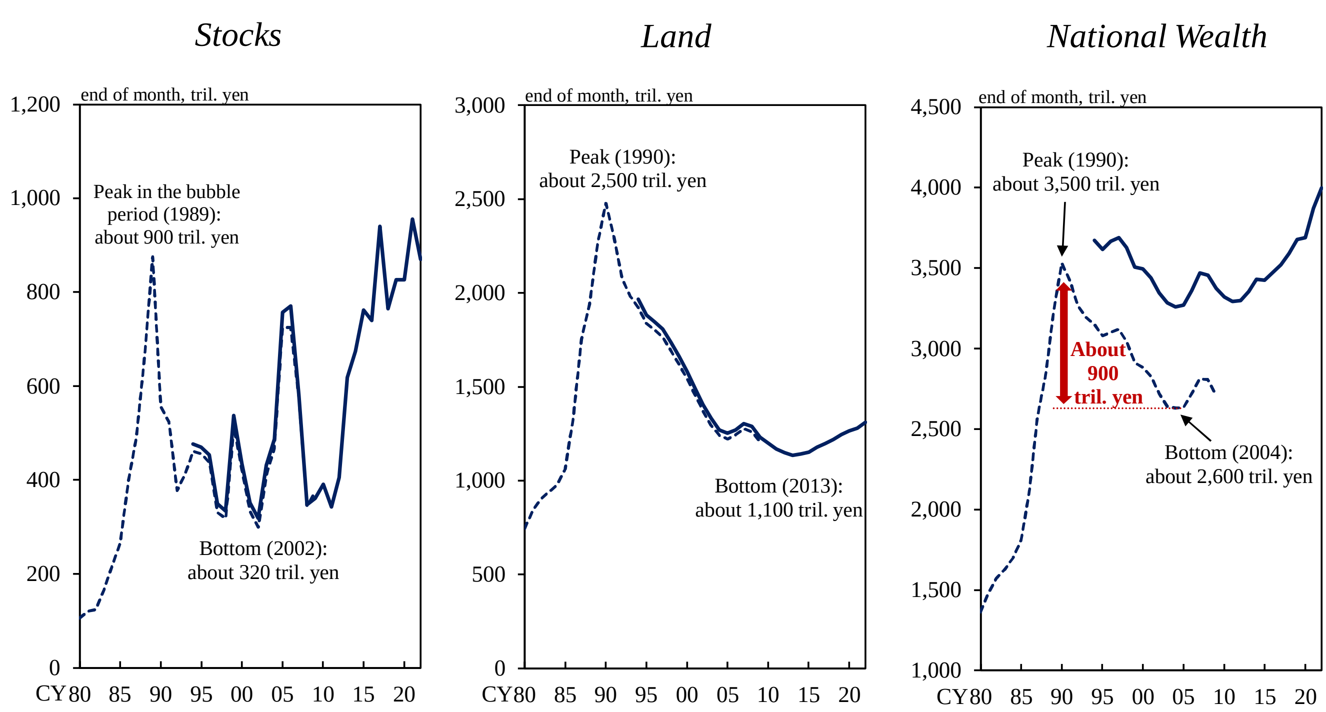


Potential Growth Rate



Note: Figures are Bank staff estimates.
Source: Bank of Japan.

Asset Prices and National Wealth

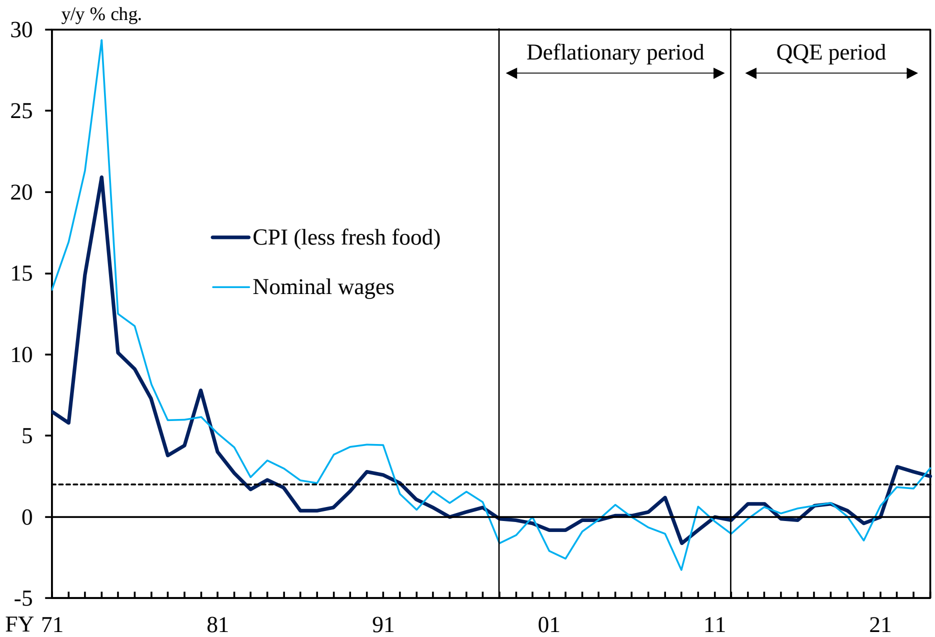


Note: Figures are based on the SNA. Dotted lines are based on the 1993SNA (benchmark year: 2000).
Source: Cabinet Office.

U.S. Dollar/Yen

Source: Bank of Japan.

Prices and Wages



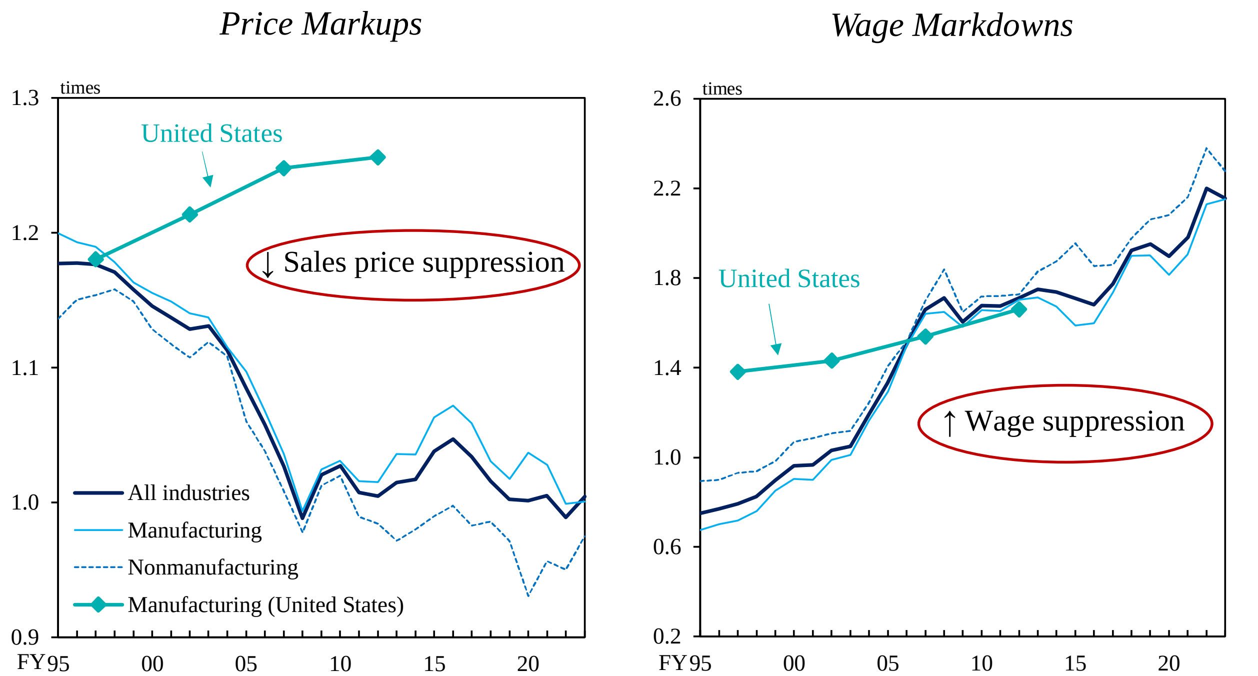
Notes: 1. The CPI figures are Bank staff estimates and exclude temporary factors, which consist of the effects of the reduction in mobile phone charges, consumption tax hikes, free education policies, and travel subsidy programs. The figure for fiscal 2024 is the April-July average.

2. Figures for nominal wages are for establishments with 30 or more employees up through fiscal 1990, and with 5 or more employees from fiscal 1991 onward. The figure for fiscal 2024 is the April-June average.

Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

Chart 18

Price Markups and Wage Markdowns

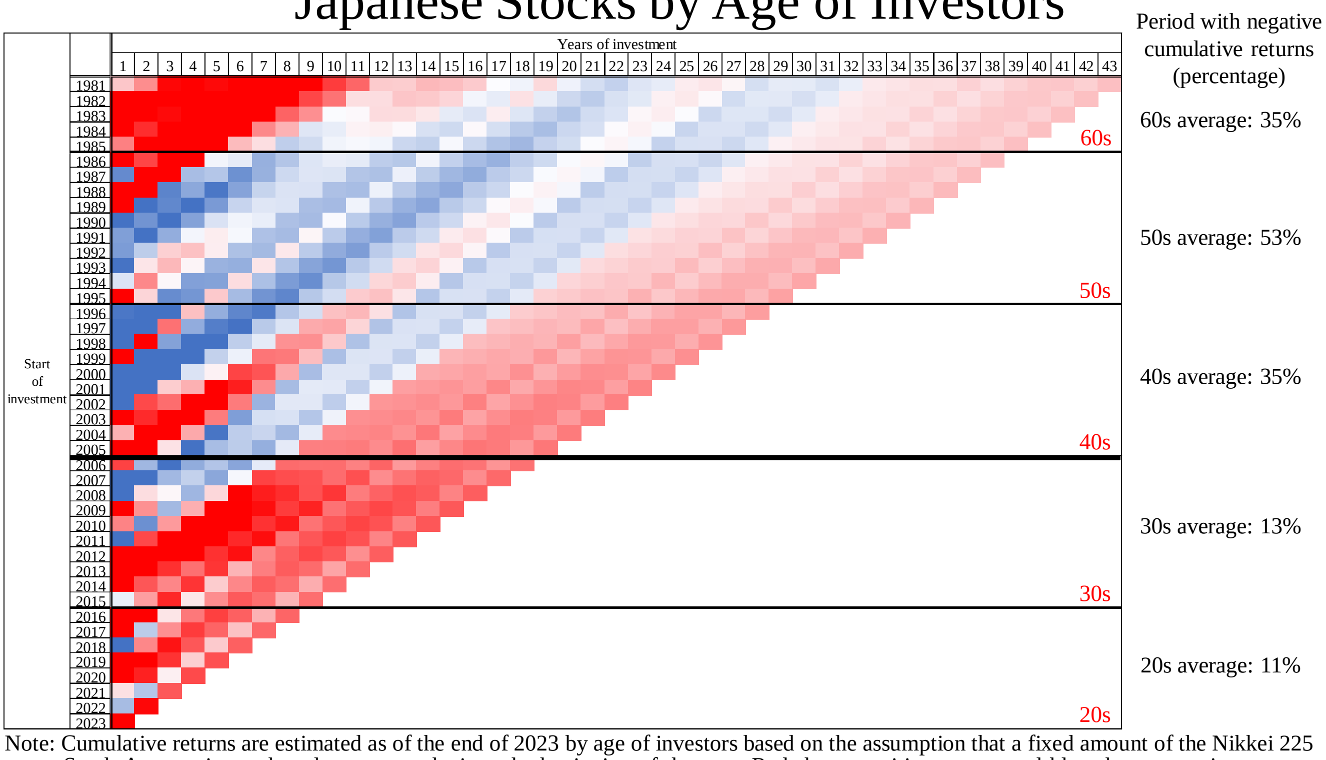


Note: Price markups and wage markdowns are estimated based on the method of Aoki, Hogen, and Takatomi (2023) using individual firm data from the Development Bank of Japan's "Corporate Financial Databank." Calculations for the U.S. manufacturing sector are based on the results of Yeh et al. (2022). Figures for fiscal 2023 are the April-December averages.

Sources: Cabinet Office; Development Bank of Japan; Ministry of Finance; Research Institute of Economy, Trade and Industry; Yeh et al. (2022).

Chart 19

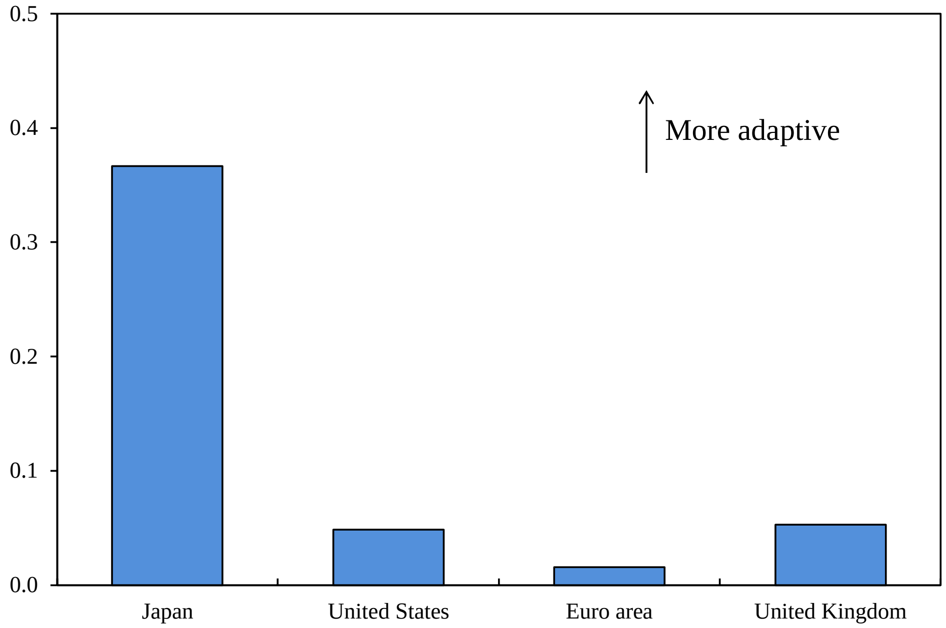
Cumulative Returns from Investment in Japanese Stocks by Age of Investors



Note: Cumulative returns are estimated as of the end of 2023 by age of investors based on the assumption that a fixed amount of the Nikkei 225 Stock Average is purchased every month since the beginning of the year. Red shows positive returns and blue shows negative returns. Darker shadows show larger positive or negative returns. Percentages for the period with negative cumulative returns are calculated by dividing "years with negative cumulative returns as of the year end" by "total years of investment."

Source: Bloomberg.

Degree of Adaptiveness in Inflation Expectations



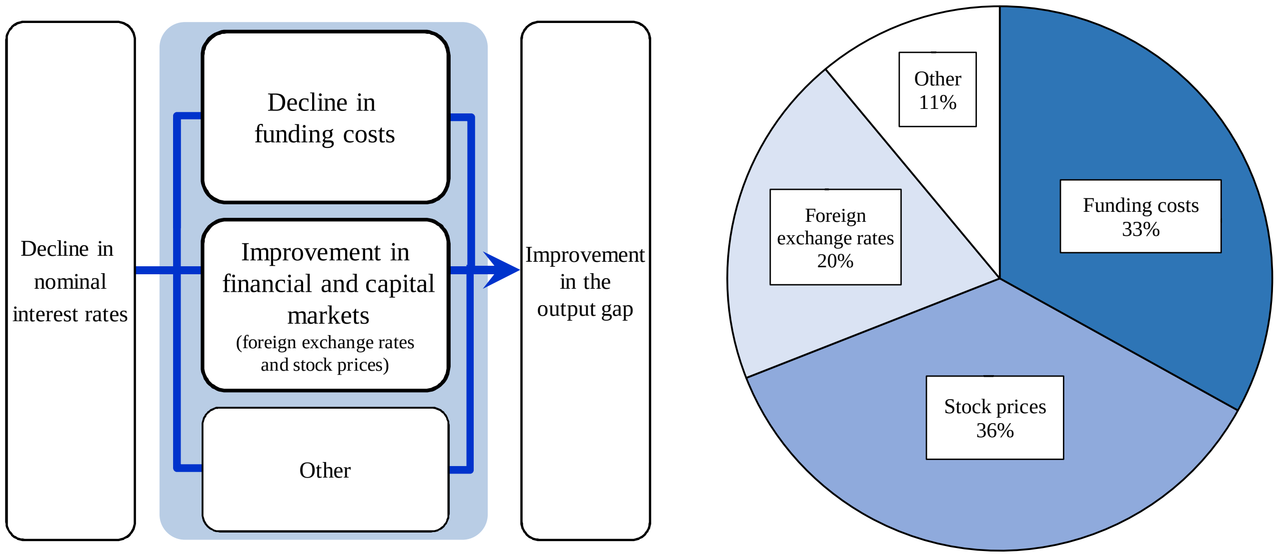
Notes: 1. Figures show the contribution of observed inflation to inflation expectations 6-10 years ahead using the following equation:
Inflation expectations 6-10 years ahead (%) = θ × observed headline inflation rate (lagged 1 quarter, %) + (1 - θ) × central bank price stability target (2%).
2. The estimation periods are as follows: 2000/Q1-2024/Q1 for Japan and the United States; 2003/Q2-2024/Q1 for the euro area; and 2005/Q1-2024/Q1 for the United Kingdom.

Sources: Bureau of Labor Statistics; Consensus Economics Inc., *Consensus Forecasts*; Eurostat; Ministry of Internal Affairs and Communications; Office for National Statistics.

Transmission Channels of Lower Interest Rates

Overview

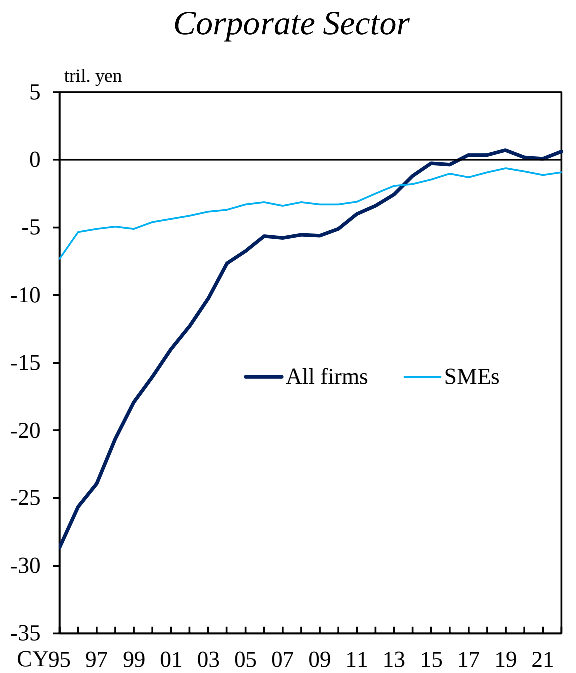
Improvement in the Output Gap (Breakdown by Channel)

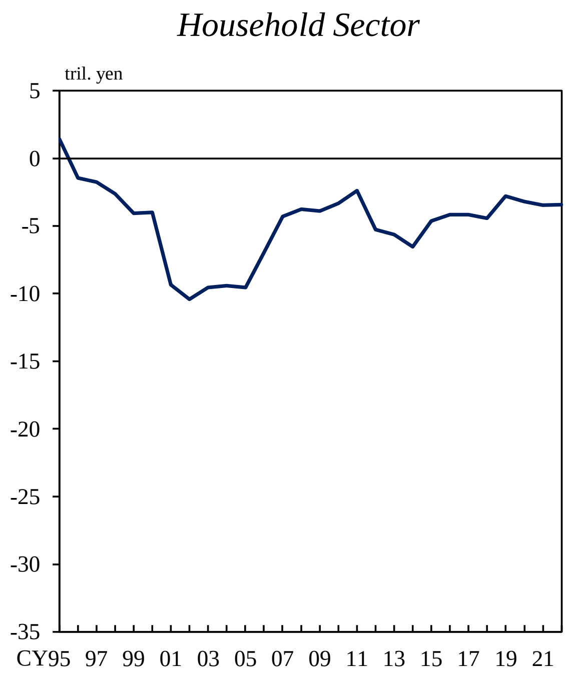


Notes: 1. Figures are based on a VAR model with coefficient restrictions using eight variables: output gap, interest rates (3-month), interest rate spreads (2-year minus 3-month, 5-year minus 2-year, 10-year minus 5-year), aggregate funding costs, nominal effective exchange rates of the yen, and stock prices.
2. Aggregate funding costs are the weighted average of bank lending rates and issuance yields for CP and corporate bonds.
3. In the right panel, figures show the 5-year cumulative effects.
4. For details, see Bank of Japan, "Assessment for Further Effective and Sustainable Monetary Easing," 2021.

Sources: Bloomberg; Bank of Japan; etc.

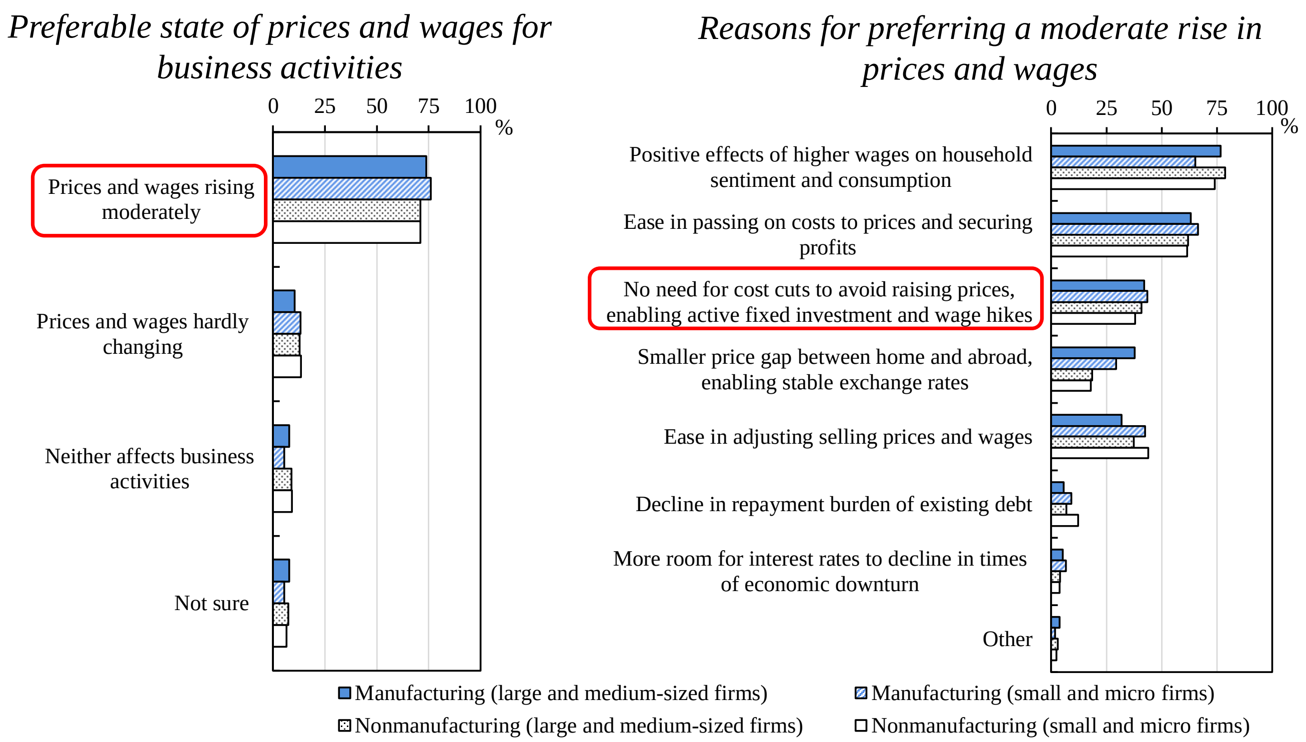
Interest Balance





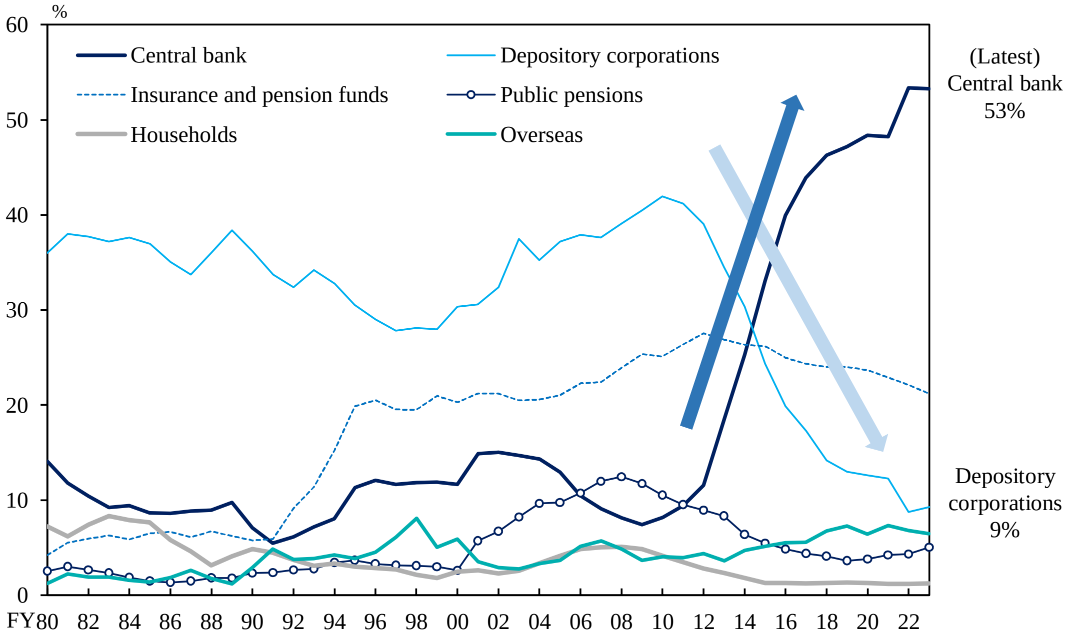
Note: Interest balance for small and medium-sized enterprises (SMEs) in the left panel includes dividend income.
Sources: Cabinet Office; Ministry of Finance.

Large-Scale Survey on the Corporate Sector



Note: In the right panel, figures are the ratios among firms that responded "prices and wages rising moderately" as a preferable state in the left panel.
Source: Bank of Japan.

Share of JGB Holdings by Sector



Note: Figures are based on the *Flow of Funds Accounts*. In the *Flow of Funds Accounts*, treasury discount bills are not included in government bonds. Prior to the issuance of treasury discount bills, which integrated financing bills and treasury bills, starting in February 2009, treasury bills were included in government bonds.

Source: Bank of Japan.