



November 30, 2015

Bank of Japan

## **Japan's Economy and Monetary Policy**

*Speech at a Meeting with Business Leaders in Nagoya*

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*Governor of the Bank of Japan*

(English translation based on the Japanese original)

## **Introduction**

It is my great pleasure to have the opportunity today to exchange views with administrative, financial, and business leaders in the Chubu region. I would like to take this opportunity to express my sincerest gratitude for your cooperation with the Bank of Japan's Nagoya Branch.

Looking at recent economic developments, the slowdown in emerging economies, particularly China, has affected Japan's exports and production. Nevertheless, as I will explain, the fundamentals of Japan's economy are sound and the environment surrounding Japan's firms and households has improved significantly compared to a few years ago. The underlying trend in inflation has also been improving steadily. Quantitative and qualitative monetary easing (QQE), which the Bank introduced in April 2013, has been exerting its intended effects toward overcoming deflation.

Today, I would like to explain the Bank's view on the outlook for economic activity and prices, as well as on its monetary policy, and then touch on remaining challenges for Japan's economy to overcoming deflation.

### **I. Developments in Japan's Economic Activity and Prices**

To begin with, let me talk about developments in Japan's economic activity and prices.

#### ***Economic Activity***

The slowdown in emerging economies, particularly China, has recently become more pronounced, and this has affected Japan's exports and production. Mainly reflecting the slowdown in overseas economies, the projected real economic growth rate for fiscal 2015 was revised downward in the *Outlook for Economic Activity and Prices* (Outlook Report) released at the end of last month to 1.2 percent from the 1.7 percent projected in July 2015 (Chart 1).

However, Japan's economic fundamentals are sound and the economy has continued to recover moderately. Real GDP growth in the July-September quarter of 2015 was slightly

negative for the second consecutive quarter, due mainly to inventory adjustments, but final demand as a whole has been increasing.

Regarding the corporate sector, firms' investment stance has continued to be positive reflecting the favorable earnings environment. Corporate profits as a whole have reached record highs, and fixed investment plans have also been robust. According to the September *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the year-on-year rate of growth of planned fixed investment for all enterprises and industries was 6.4 percent, up from the June *Tankan*.

In the household sector, the employment and income situation has been improving steadily; as a result, private consumption has been resilient. Turning to labor market conditions, the active job openings-to-applicants ratio is currently 1.24, a level last seen in 1992, and the unemployment rate has declined to 3.1 percent, a level last seen in 1995. Thus, labor market conditions have continued to tighten and Japan is in a situation close to "full employment." As seen in the diffusion index for employment conditions released in the September *Tankan*, firms' perception that they are facing a shortage of labor has intensified, and labor market conditions seem to continue to be tight despite the flattening of exports and production (Chart 2).

With corporate profits having risen to historically high levels and the tightening in labor market conditions continuing, there has been upward pressure on wages. Scheduled cash earnings have been increasing on a year-on-year basis for three consecutive quarters since the turn of the year, reflecting in part increases in base pay, which has gone up for two years in a row. Moreover, various surveys suggest that summer bonuses this year were raised again following the substantial increase last year (Chart 3). On the back of the steady improvements in the employment and income situation, private consumption in the July-September quarter increased on a quarter-on-quarter basis. Taking, in addition, more recent anecdotal evidence into account, the Bank judges that private consumption has been resilient.

With a virtuous cycle from income to spending in both the corporate and household sectors in place, Japan is likely to continue to see real GDP growth through fiscal 2016 of about 1.0-1.5 percent. This rate exceeds Japan's potential growth rate, which is currently estimated to be around 0.5 percent or lower.

### *Prices*

Let me turn to prices. The year-on-year rate of change in the consumer price index (CPI, all items less fresh food), which was minus 0.5 percent just before the introduction of QQE, increased to as high as 1.5 percent in April 2014, excluding the effects of the consumption tax hike. However, reflecting the substantial decline in crude oil prices since the summer of 2014, annual CPI inflation declined and has been about 0 percent in recent months (Chart 4).

Nevertheless, once the effect of the decline in energy prices is excluded, the underlying trend in inflation has steadily improved. For example, the year-on-year rate of change in the CPI for all items less fresh food and energy had been negative before the introduction of QQE, but turned positive in October 2013. Since then, it has been positive for 25 consecutive months, and increased to 1.2 percent this October. This is the first time since the late 1990s, when Japan's economy fell into deflation, that sustained price increases have been seen. Meanwhile, the rate of increase in the daily and weekly price indices gathered by the University of Tokyo and Hitotsubashi University based on the prices of items such as food and daily necessities has continued to show an accelerating trend since this April. Price hikes by firms have become widespread and sustained, as seen in the fact that the share of items in the CPI for which prices have risen has been outweighing that for which prices have declined by an increasing margin (Chart 5).

Meanwhile, some economists argue that the recent price rises are just a temporary phenomenon brought about by the rise in import prices prompted mainly by the past depreciation of the yen and that therefore it is difficult to judge whether the underlying trend in inflation has been improving. It is certainly the case that the rise in import prices prompted by the depreciation of the yen has contributed to the rise in consumer prices. However, as I mentioned earlier, attempts by firms to raise prices can be seen across a wide

range of items and are not confined to items affected by import prices. In addition, neither the recent extent of inflation nor its persistence can be explained as the result of the depreciation of the yen. Instead, it makes more sense to interpret the extent and persistence of recent inflation as a result of improvements in the employment and income situation as well as changes in firms' and households' perceptions of price developments.

Looking ahead, the year-on-year rate of change in the CPI (all items less fresh food) is likely to be about 0 percent for the time being, due to the effects of the decline in energy prices. However, with the underlying trend in inflation steadily rising and the effects of the decline in crude oil prices dissipating, the rate of increase is expected to accelerate toward 2 percent -- the price stability target. Although the timing of when inflation of around 2 percent is reached depends on developments in crude oil prices, the Bank projects this to be around the second half of fiscal 2016, assuming that crude oil prices will rise moderately from recent levels.

## **II. Developments in Emerging Economies and their Effects on Japan's Economy**

One of the risks to this outlook is the slowdown in emerging economies, particularly China, and its repercussions. Looking around the global economy, a clear contrast can be observed, with the economic situation in advanced economies improving, while emerging and commodity-exporting economies have been decelerating.

In China, economic activity in manufacturing has continued to be sluggish, but that in nonmanufacturing has remained robust (Chart 6). Spending by local governments was one of the reasons for the sluggishness of the Chinese economy in the first half of this year. However, the pace of spending increases has accelerated recently, partly as a result of instructions by the central government and measures to facilitate the financing of local governments (Chart 7). With these initiatives taking effect, China's economic growth is expected to accelerate from the end of 2015 to early 2016. That being said, China continues to suffer from structural problems such as excess capacity and there are uncertainties surrounding the outlook. Even if the Chinese economy were to recover, uncertainty remains to what extent this recovery would push up other economies in East Asia. Looking at emerging economies as a whole, although there have recently been signs

of a pick-up in, for example, the production of IT-related goods in East Asia, commodity prices remain low, so that commodity-exporting economies continue to face difficult circumstances and developments differ across individual economies.

A continued increase in corporate profits, despite lackluster developments in exports and production reflecting the effects of the slowdown in emerging economies, are not something one would normally have observed in Japanese economic recoveries in the past. This suggests that Japan's economic fundamentals have become more resilient to external shocks and the economy is becoming more stable. Reasons for this resilience likely include favorable changes in the external environment -- such as the decline in crude oil prices and the correction of the excessive appreciation of the yen -- as well as the firmness of the nonmanufacturing sector, which has been a key feature of the recent economic recovery. In other words, the fact that a virtuous cycle from income to spending is operating steadily has led to the current resilience of Japan's economy (Chart 8).

Based on these observations, let us consider the repercussions for Japan if emerging economies were to slow down further. The risk that a contraction in exports and production will undermine corporate profits and hence investment does not seem to be that great. Corporate profits are extremely high and some decline in exports and production could be easily absorbed. On the other hand, what does warrant attention is the possibility that increased uncertainty regarding emerging economies undermines business confidence in Japan, which might lead firms to scale down investment and wage increases. Although business confidence has been improving, it would be premature to say that it is sufficiently strong. I will further elaborate on this point later.

### **III. Looking Ahead to the Post-Deflation Era**

In sum, while Japan's economy has continued to recover moderately and the underlying trend in inflation has steadily improved, due attention should be paid to risk factors such as developments in emerging economies. With regard to monetary policy, QQE has been exerting its intended effects, and the Bank will continue with QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. The Bank will make the most appropriate policy decisions by scrutinizing

the current situation of economic activity and prices and their outlook, various risk factors, and developments in financial and capital markets at every Monetary Policy Meeting. Let me reiterate that the Bank will make adjustments without hesitation if judged as necessary to achieve the price stability target of 2 percent at the earliest possible time.

Lastly, I would like to touch on overcoming deflation and corporate strategy. In my recent speeches in Osaka and Tokyo, I said that the data to date give the impression that the pace of increase in fixed investment and wages was still relatively slow when considering that firms have been making record profits. To avoid any misunderstanding, I would like to note that increases in fixed investment and wages are necessary not only for Japan's economy as a whole, but would also benefit themselves. That is, given that Japan's economy is on the road to overcoming deflation and entering a new phase in which the economy will grow in a sustainable manner under price stability with 2 percent inflation, now is the time for firms to wipe out the deflationary mindset and make investment in human and physical capital. Taking actions now is a prerequisite for firms to be among the winners in the future.

In this context, the one key message that the Bank wants to get across is that deflation will be overcome and the price stability target of 2 percent will definitely be achieved. And this will happen at the earliest possible time. The Bank considers it desirable to achieve a situation in which both prices and wages rise in a balanced manner. However, this does not mean that the Bank will adjust its policies aimed at achieving moderate inflation simply in response to the pace of increase in wages. From both a theoretical and an empirical perspective, prices generally move in parallel with wages (Chart 9). If the Bank were to move slowly toward achieving the price stability target, wage adjustments would also be slow. At the end of the day, this issue comes down to a chicken and egg situation. In order to overcome deflation -- in other words, break the deadlock -- somebody has to show an unwavering resolve and change the situation. This means that, when it comes to price developments being at stake, the Bank must be the first-mover. The Bank has been pursuing QQE based on the stance that it will do whatever it can to achieve the price stability target. As a result, conditions in financial markets -- as exemplified by stock prices and foreign exchange rates -- as well as corporate profitability and labor market

conditions -- particularly the unemployment rate -- have improved significantly, so that the underlying trend in inflation has changed markedly. Looking at the CPI for October 2015, the year-on-year rate of change in the CPI for all items less fresh food and energy was 2.0 percentage points higher and that for all items less food and energy was 1.5 percentage points higher than in March 2013, that is, immediately before the introduction of QQE. As evidenced by these figures, the Bank has the capability as well as the strong will to achieve price stability at 2 percent inflation at the earliest possible time.

The Bank of Japan's price stability target of 2 percent provides a benchmark which firms can refer to when adjusting wages and individual prices. Once 2 percent inflation prevails, firms that continue to base their investment, hiring, and price-setting decisions on a deflationary mindset will be at a disadvantage and fall behind their competitors. In our view, the environment for wage increases -- such as a tight labor market and high corporate profits -- is certainly already well established. However, it is of course up to firms' management and labor whether to raise wages in line with the 2 percent inflation benchmark in anticipation of price increases of 2 percent as we move on.

In fact, I see that an increasing number of firms are already moving in new directions. And I am aware that this region, which produced Japan's first domestically-manufactured automobile, is home to many forward-looking entrepreneurs. Coincidentally, the Mitsubishi Regional Jet (MRJ) -- Japan's first domestically-produced passenger jet -- recently made its successful maiden flight. At this juncture, we are witnessing the start of a new legend in this region. I am hoping that the wind of change blowing from the Chubu region will give flight to Japan's economy and lift it to a new, post-deflationary stage.

Thank you.

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Chart 1

## Outlook for Economic Activity and Prices (as of October 2015)

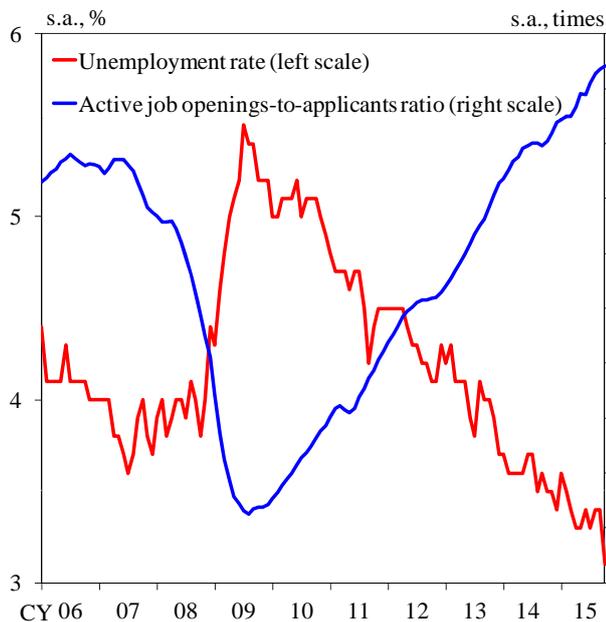
y/y % chg.

	Real GDP	CPI (all items less fresh food)	
			Excluding the effects of the consumption tax hikes
Fiscal 2015	+1.2	+0.1	
Forecasts made in July 2015	+1.7	+0.7	
Fiscal 2016	+1.4	+1.4	
Forecasts made in July 2015	+1.5	+1.9	
Fiscal 2017	+0.3	+3.1	+1.8
Forecasts made in July 2015	+0.2	+3.1	+1.8

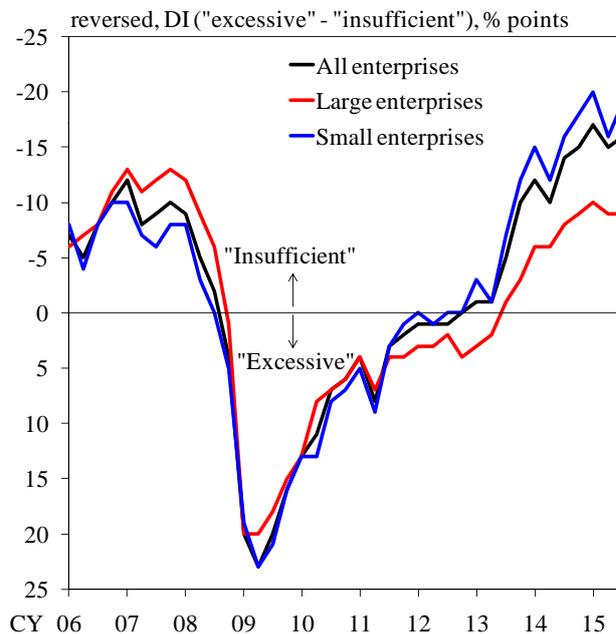
Note: Figures indicate the median of the Policy Board members' forecasts (point estimates).  
Source: Bank of Japan.

# Labor Market Conditions

*Unemployment Rate and Job Openings-to-Applicants Ratio*



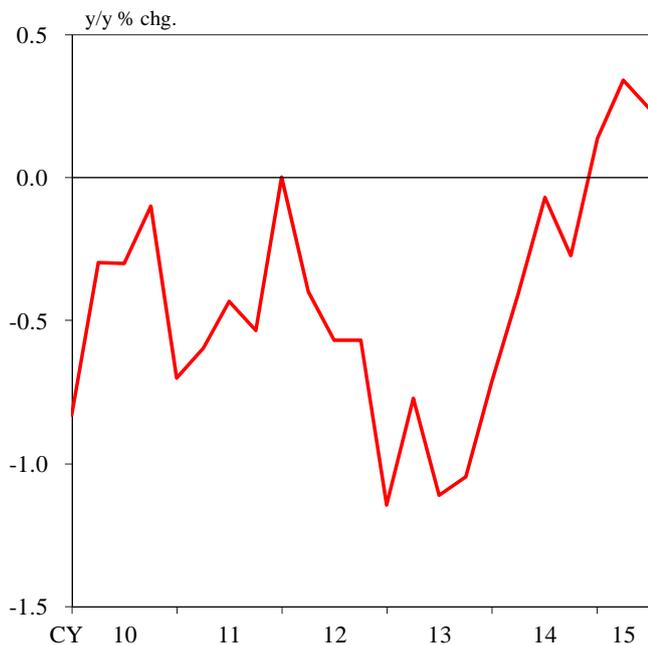
*Tankan: Employment Conditions DI*



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

# Wages

*Scheduled Cash Earnings*

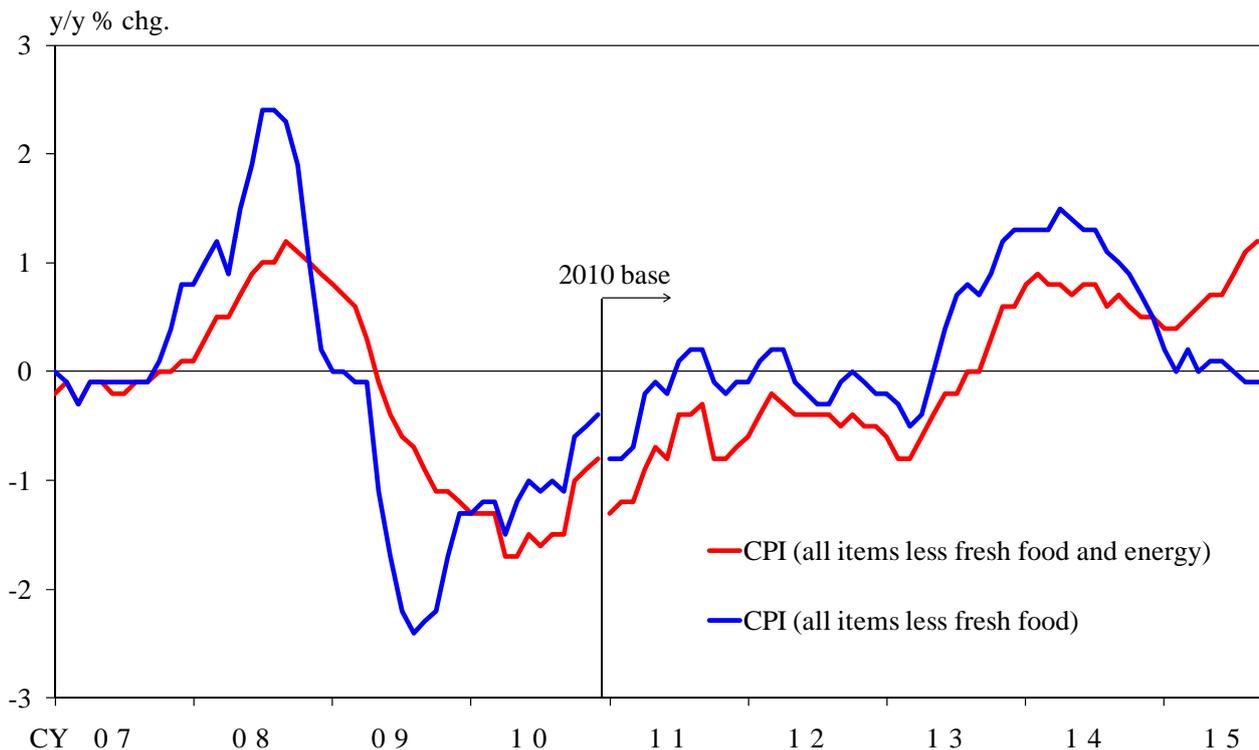


*Summer Bonuses*

Survey conductor	FY2015 summer
Japan Business Federation (Keidanren)	2.8
Nikkei Inc.	2.1
The Institute of Labour Administration	3.0
Ministry of Health, Labour and Welfare	4.0

Sources: Ministry of Health, Labour and Welfare; Japan Business Federation (Keidanren); Nikkei Inc.; The Institute of Labour Administration.

# Consumer Prices



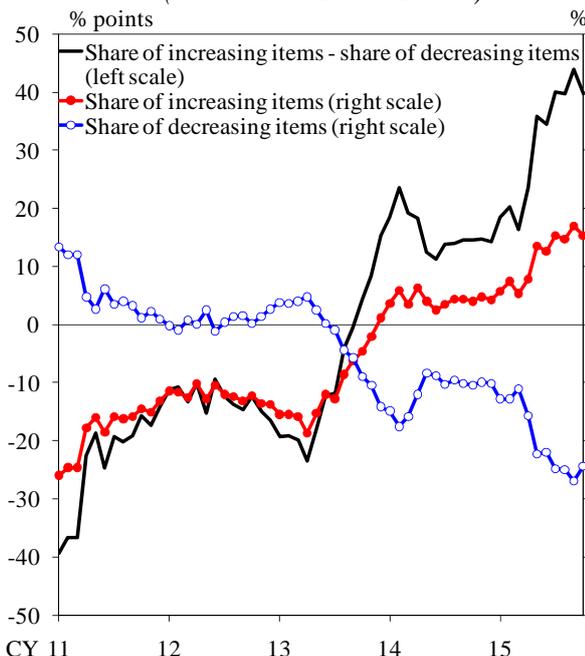
Note: Figures are estimated by adjusting the direct effects of the consumption tax hike in April 2014.

Figures for the CPI (all items less fresh food and energy) are calculated by the Research and Statistics Department, Bank of Japan.

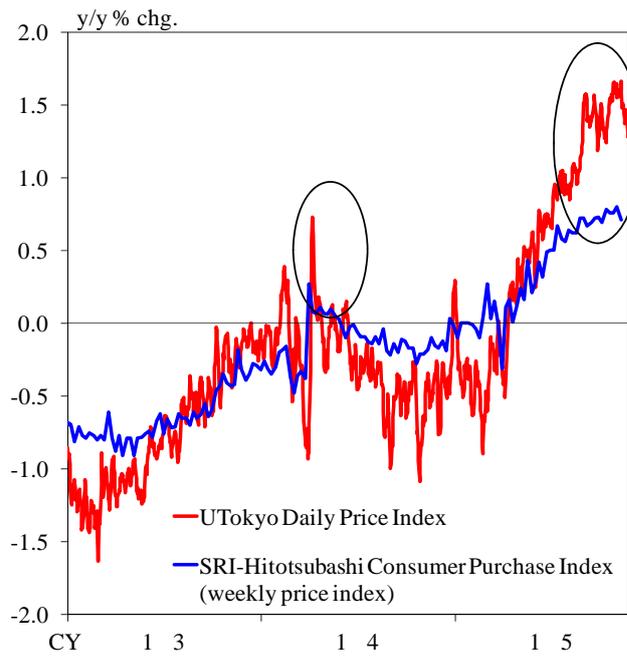
Source: Ministry of Internal Affairs and Communications.

# Price Developments

Share of Increasing and Decreasing Items  
(Consumer Price Index)



UTokyo Daily Price Index and  
SRI-Hitotsubashi Consumer Purchase Index



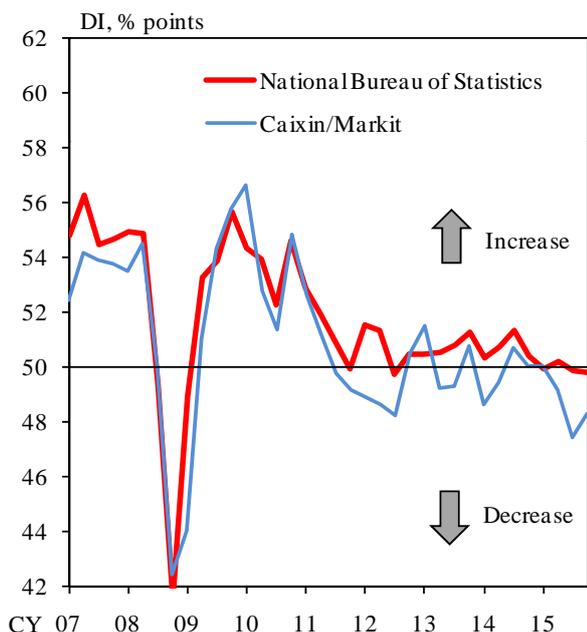
Notes: 1. The share of increasing/decreasing items is the share of items in the consumer price index (all items less fresh food) whose price indices increased/decreased from a year earlier. The price indices are estimated by adjusting the direct effects of the consumption tax hike in April 2014.

2. The UTokyo Daily Price Index is a 7-day backward moving average.

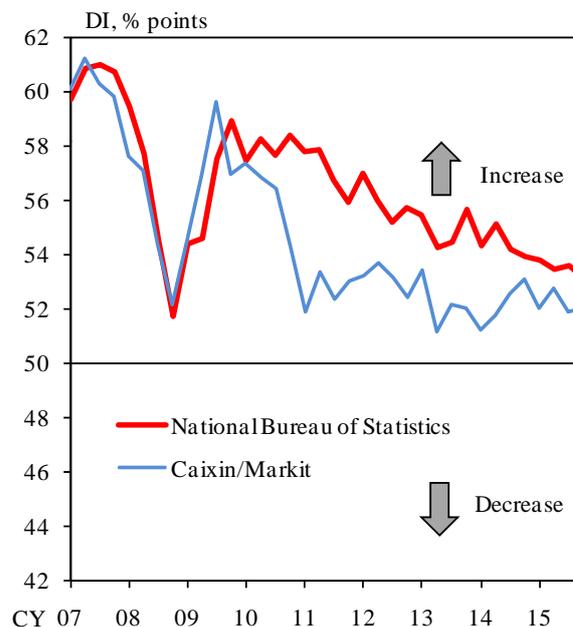
Sources: Ministry of Internal Affairs and Communications; UTokyo Daily Price Index Project; Research Center for Economic and Social Risks, Institute of Economic Research, Hitotsubashi University.

# China's PMI

## Manufacturing



## Nonmanufacturing

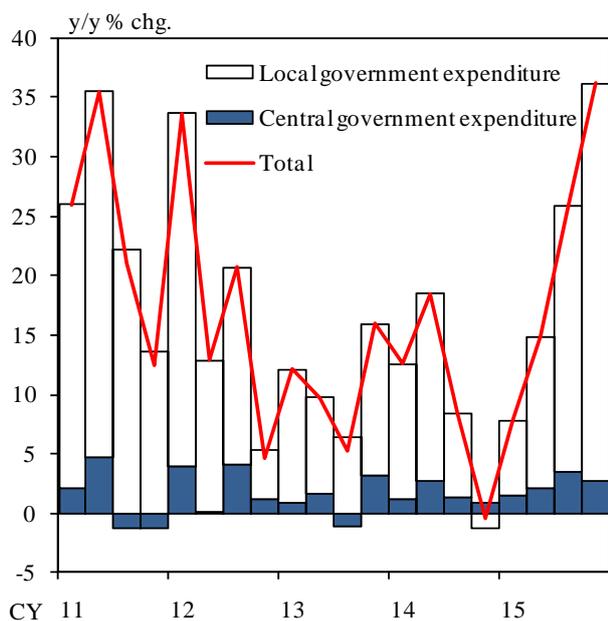


Note: Figures for 2015/Q4 are those of October.

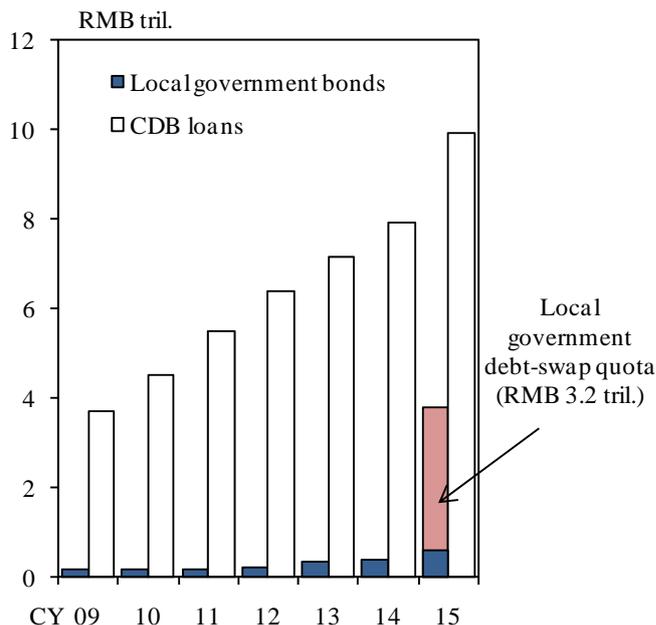
Sources: CEIC; Markit (© and database right Markit Economics Ltd 2015. All rights reserved.)

# China's Fiscal Position

## Government Expenditure



## Local Government Bond Issuance and China Development Bank Loans



Notes: 1. Figures for 2015/Q4 are those of October.

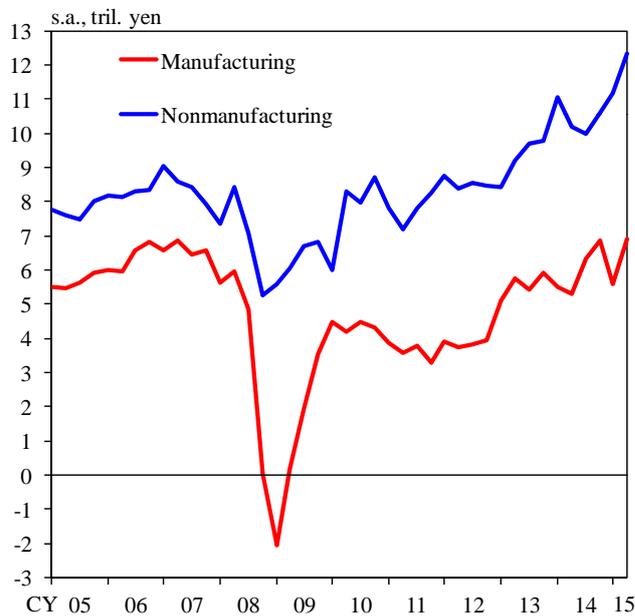
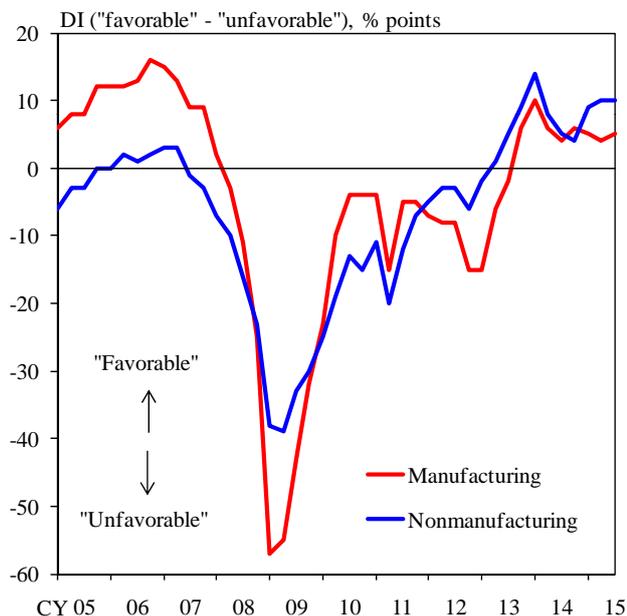
2. The amount of local government bonds for 2015 is based on the budget draft, and the amount outstanding of CDB loans is based on the prospect by Chinese authority.

Sources: CEIC; Ministry of Finance of the People's Republic of China; China Development Bank.

## Business Sentiment and Corporate Profits

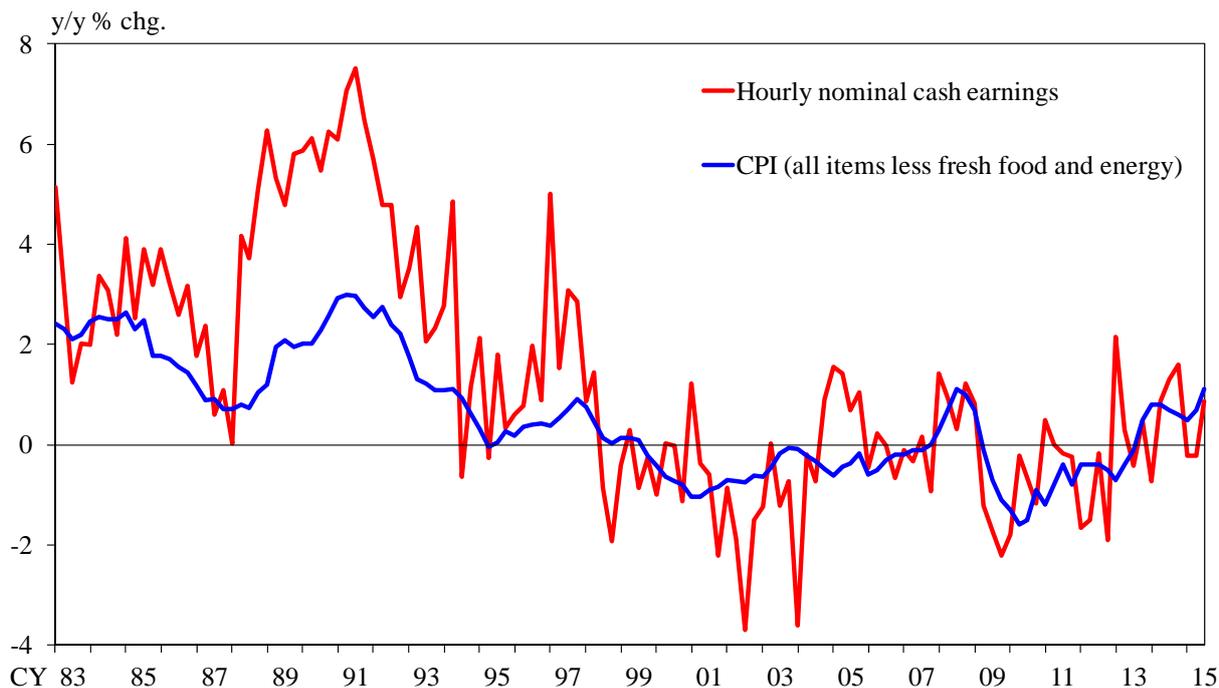
*Tankan: Business Conditions DI*

*Current Profits*



Note: Figures for current profits exclude those for the finance and insurance industry.  
Sources: Bank of Japan; Ministry of Finance.

## Wages and Prices



Notes: 1. Figures for hourly nominal cash earnings up through 1990/Q4 are for establishments with 30 or more employees.  
2. Figures for the CPI (all items less fresh food and energy) are calculated by the Research and Statistics Department, Bank of Japan. Those are adjusted to exclude the estimated effect of changes in the consumption tax rate.

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