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Bank of Japan

Japan's Economy and Monetary Policy

Speech at a Meeting with Business Leaders in Kochi

Hiroshi Nakaso

Deputy Governor of the Bank of Japan

(English translation based on the Japanese original)

Introduction

It is my pleasure to have the opportunity today to exchange views with administrative, financial, and business leaders in Kochi Prefecture. I would like to take this opportunity to express my sincerest gratitude for your cooperation with the activities of the Bank of Japan's Kochi Branch. Today, I would like to have your views on the actual situation of the local economy, as well as your candid opinions about the Bank's policies and activities. Let me now start by talking about the Bank's outlook for Japan's economic activity and prices as well as its thinking behind the conduct of monetary policy, while outlining the *Outlook for Economic Activity and Prices* (Outlook Report) released at the end of January 2017.

I. Recent Developments in and Outlook for Economic Activity at Home and Abroad

Japan's economy has continued its moderate recovery trend. As for the outlook, it is likely to continue growing at a pace above its potential on the back of highly accommodative financial conditions and the effects of the government's large-scale stimulus measures, with the growth rates in overseas economies increasing moderately. Specifically, the medians of the Policy Board members' forecasts of the real GDP growth rates presented in the January 2017 Outlook Report were 1.4 percent for fiscal 2016, 1.5 percent for fiscal 2017, and 1.1 percent for fiscal 2018, above Japan's potential growth rate, which is estimated to be around 0.5 percent (Chart 1). Compared to the previous forecasts released at the beginning of November 2016, the projected growth rates are somewhat higher, reflecting improvement in overseas economies and the yen's depreciation in addition to the effects of the comprehensive revision to GDP statistics. In what follows, I will explain the background to these projections.

Overseas Economies

First, I will touch on developments in overseas economies. As you all know, in financial markets, a pessimistic view had prevailed regarding the outlook until around autumn 2016. With the benefit of hindsight, however, the momentum for global economic growth seems to have strengthened since mid-2016. In particular, improvement in manufacturing and trade has been notable. An uptrend has become evident recently in indicators related to business sentiment of the manufacturing sector globally, mainly on the back of an increase in IT-related demand led by that for smartphones and of the progress observed in emerging economies in inventory adjustments of materials (Chart 2). In Asian emerging economies,

domestic demand has been resilient, reflecting the effects of the economic stimulus measures implemented to date, and IT-related and material-related exports have picked up. The Chinese economy has continued to see stable growth on the whole, supported by policy effects resulting from such factors as a rise in public investment and a sales tax cut on small cars. Meanwhile, a recovery in advanced economies, which had been led by the household sector, has spread to the corporate sector recently. Reflecting such recovery in global demand, commodity prices, including crude oil prices, bottomed out in the first half of 2016 and have started to rise.

Since the U.S. presidential election in November 2016, stock prices and long-term interest rates have risen globally. This is certainly attributable to the expectations for the new administration's stimulative economic policy, but improvement in fundamentals also appears to underlie this development.

In terms of the outlook, advanced economies are expected to continue growing steadily, and a recovery in emerging economies is likely to take hold gradually on the back of the steady growth in advanced economies and the effects of economic stimulus measures taken by emerging economies. Looking at the weighted averages of projected real GDP growth rates of individual economies and regions released by the International Monetary Fund (IMF) in January 2017, by value of exports from Japan, the growth rates of overseas economies are projected to increase through 2018; compared to the time when the October 2016 Outlook Report was published, the weighted average has been revised upward marginally (Chart 3).

Corporate Sector

Reflecting such improvement in overseas economies, a pick-up in Japan's exports and production has become evident (Chart 4). Exports and production have started to increase since around last summer, but this had been supported by temporary factors such as an acceleration of automobile production to more than offset the impact of the Kumamoto Earthquake; however, they have maintained their uptrend thereafter and there is a steady rise in the number of items for which volume increased. The recovery in exports and production has been even more persistent, reflecting the progress in inventory adjustments, mainly in capital goods and producer goods, in addition to a moderate increase in demand at home and abroad. As for the outlook, exports and production are projected to moderately

increase, with the growth rates in overseas economies increasing moderately.

In this situation, corporate profits have been at around the historical high levels and are projected to follow a steady increasing trend on the back of an increase in demand at home and abroad and the yen's depreciation. Against the background of such favorable corporate profits, business fixed investment is expected to rise steadily, backed by an increase in growth expectations and a rise in demand related to the 2020 Tokyo Olympics as well as accommodative financial conditions. According to the December 2016 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), corporate profits have continued to be at high levels and firmness has continued to be seen in business fixed investment plans as a whole.

Household Sector

Meanwhile, despite the steady improvement in the employment and income situation, private consumption had been somewhat weak since the beginning of 2016, but it has been on an improving trend recently. As I mentioned earlier, in the first half of last year, consumer sentiment became cautious, reflecting the slowdown in the global economy -- mainly the emerging economies -- and a subsequent decline in stock prices, as well as irregular weather. However, it has improved recently, partly reflecting a rise in stock prices, and private consumption has started to overcome the weakness observed before (Chart 5). In addition to services such as dining-out, which had remained relatively firm, an improving trend has become clear in sales of durable goods -- such as automobiles and household electrical appliances -- and sales at supermarkets and convenience stores. The Consumption Activity Index (CAI), which the Bank calculates by combining various sales and supply-side statistics, has picked up since last summer.

Going forward, private consumption is expected to increase moderately. What underpins this is the steady improvement in the employment and income situation. With regard to supply-demand conditions in the labor market, the active job openings-to-applicants ratio and the diffusion index (DI) for employment conditions in the December *Tankan* have improved to almost the same levels seen around 1991-1992 (Chart 6). The unemployment rate has declined to around 3 percent recently, which is virtually full employment. Under these circumstances, wages have risen moderately, albeit with some fluctuations. In particular, the year-on-year rate of change in hourly cash earnings of part-time employees,

which are responsive to labor market conditions, has seen a relatively high increase, being in the range of around 1.5-2.0 percent. It is expected that more and more firms will raise wages, partly through a base pay rise.

Upside and Downside Risks

I have explained so far the baseline scenario of Japan's economic outlook through fiscal 2018. However, it should be noted that the outlook entails risks, and uncertainty regarding developments in overseas economies warrants particular attention.

Specifically, first of all, developments in the U.S. economy and the impact of its monetary policy on global financial markets should be noted. The details for economic policy of the new U.S. administration are still uncertain, but it is expected that proactive fiscal measures such as a tax cut and infrastructure investment will lead to rises in the economic growth rate and the inflation rate. In this situation, the short- and long-term interest rates in the United States are expected to rise, and how this affects global financial markets -- including those of the emerging economies -- warrants attention. Other risks to which we need to pay attention include (1) developments in emerging and commodity-exporting economies, particularly China, (2) the consequences stemming from the United Kingdom's vote to leave the European Union (EU) and their effects, and (3) prospects regarding the European debt problem, including the financial sector.

These risks, if manifested, are likely to have a negative impact on economic activity. However, they could have a positive impact as well. If market participants and economic entities factor the risks in to a certain extent, the confidence in the economic outlook going forward would be enhanced, leading to an upswing in economic activity, when (1) the view prevails that the actual impact may not be as significant as envisioned beforehand or (2) the probability of manifestation of these risks lessens. What happened after the referendum on Brexit is a case in point. Therefore, we should monitor developments in overseas economies with both upside and downside risks in mind.

II. Price Developments and their Outlook

Price Developments

Next, I will talk about the price developments in Japan. Almost four years have passed since the Bank introduced quantitative and qualitative monetary easing (QQE) in April 2013. During this period, Japan's price developments have improved considerably (Chart 7). Since autumn 2014, crude oil prices have declined significantly, pushing down consumer prices. However, looking at the year-on-year rate of change in the consumer price index (CPI) for all items less fresh food and energy, which had been in negative territory for a prolonged period before the introduction of QQE, it became positive in autumn 2013 and has remained in positive territory for over three years. Japan's economy is no longer in deflation, which is generally defined as a sustained decline in prices.

Nevertheless, it is true that there is still a long way to go to achieve the Bank's price stability target of 2 percent. The year-on-year rate of increase in the CPI for all items less fresh food and energy has remained on a decelerating trend since the beginning of 2016; thereafter, the rate of change has been fluctuating. This is attributable to a slowdown in firms' price hikes reflecting sluggish private consumption, and to price declines such as in durable goods, due mainly to the yen's appreciation last year. From a longer-term perspective, people's inflation expectations also have declined, following the course of the observed inflation rate, which has continued to show somewhat weak developments with the decline in crude oil prices that has lasted for about two and a half years.

Outlook for Prices

While recent price developments have been somewhat sluggish, the Bank judges that the momentum toward achieving the price stability target of 2 percent is maintained. Specifically, the year-on-year rate of change in the CPI for all items less fresh food is likely to increase from about 0 percent and become slightly positive, reflecting a bottoming out of crude oil prices, and thereafter is expected to increase toward 2 percent. The timing of the year-on-year rate of change in the CPI reaching around 2 percent will likely be at the end of the projection period of the Outlook Report -- that is, around fiscal 2018. This outlook for prices is unchanged from that presented in the October 2016 Outlook Report.

Going forward, the inflation rate is expected to rise through the following mechanism. First, the output gap has improved steadily, as evidenced by the tightening of labor market conditions, and this will lead to a rise in the inflation rate through wage increases and other channels. Second, a pick-up in commodity prices, including crude oil prices, and the yen's depreciation are expected to push up consumer prices. Third, along with these developments, people's medium- to long-term inflation expectations are likely to rise.

The tightening of labor market conditions brings about upward pressure on wages. The Bank aims to achieve a situation where the inflation rate increases moderately, accompanied by rises in corporate profits and wages. The past data show that the rates of increase in wages and prices move almost in parallel. From this perspective, we are very interested in how the labor-management wage negotiations in the coming months will play out, as was the case last year. The conditions for wage increases have been met largely as the labor market conditions have tightened with corporate profits at high levels. The Bank strongly expects that both labor and management will negotiate by making the most of the favorable conditions, leading to a virtuous cycle of the economy.

The effects of declines such as that in crude oil prices -- which had been exerting downward pressure on consumer prices -- will dissipate through the end of fiscal 2016 and push up consumer prices thereafter. Specifically, the negative contribution of energy items to consumer prices has lessened gradually and is expected to reach around 0 percentage point in early 2017. The contribution is estimated to be slightly positive in fiscal 2017 on the assumption that crude oil prices will increase at a fairly moderate pace in line with what the futures prices imply.

As I mentioned earlier, inflation expectations in Japan tend to be largely affected by the observed inflation rate. This mechanism is called the adaptive formation mechanism of inflation expectations. The decline in crude oil prices since autumn 2014 had exerted downward pressure on inflation expectations through the adaptive formation mechanism. Looking ahead, however, this effect is likely to be neutral to inflation expectations or slightly push them up. The direct impact on consumer prices of a rise in crude oil prices and the yen's depreciation are observed only temporarily and will dissipate after a while. Nonetheless, if these developments lead to a rise in medium- to long-term inflation

expectations, there will be a persistent rise in the inflation rate. The Bank expects that people's inflation expectations will follow an increasing trend and converge to 2 percent, supported also by the Bank's strong commitment to achieving the price stability target of 2 percent.

III. The Bank's Conduct of Monetary Policy

Next, I would like to talk about the Bank's conduct of monetary policy. In September 2016, the Bank introduced "QQE with Yield Curve Control" -- a new framework for monetary easing -- and thereby strengthened the two previous policy frameworks of QQE and "QQE with a Negative Interest Rate."

This framework consists of two components (Chart 8). The first is the yield curve control in which the Bank controls short- and long-term interest rates. This is designed to facilitate the formation of short- and long-term interest rates that are considered most appropriate for maintaining the momentum toward achieving the price stability target of 2 percent, taking account of developments in economic activity and prices as well as financial conditions. At present, in the guideline for market operations, the Bank sets the short-term policy interest rate at minus 0.1 percent and the target level of the 10-year JGB yields at around 0 percent, conducting JGB purchases so as to achieve this target level.

The second component is an inflation-overshooting commitment. This is a strong commitment that the Bank will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI exceeds 2 percent and stays above that level in a stable manner. As I explained earlier, taking into account that inflation expectation formation is largely adaptive in Japan, it is crucial that the public actually experience inflation above 2 percent in order to raise inflation expectations to 2 percent and anchor them at that level. By demonstrating its strong determination to achieve the price stability target through this commitment, the Bank aims to enhance its credibility with the public that it will achieve 2 percent and to raise inflation expectations in a more forceful manner.

This framework is designed to amplify monetary easing effects when the outlook for economic activity and prices improves. This is because, while there would be upward pressure on interest rates in accordance with such improvement, the degree of monetary

easing will increase through a decline in real interest rates against a rise in the natural rate of interest if the Bank contains such upward pressure and thereby maintains the shape of the yield curve.

With regard to the future conduct of monetary policy, the Bank decides the guideline for market operations at each Monetary Policy Meeting with a view to facilitating the formation of a yield curve that is deemed most appropriate for maintaining the momentum toward achieving the price stability target of 2 percent, taking account of developments in economic activity and prices as well as financial conditions.

Some market participants, taking account of a rise in interest rates overseas, argue that the Bank might consider raising the target level of the long-term interest rate in the near future. However, as described in the Outlook Report, although the momentum toward achieving the price stability target of 2 percent has been maintained, it is not yet sufficiently firm and there is still a long way to go to achieve the target. In addition, the risks to the outlook for economic activity and prices seem to remain skewed to the downside, particularly those regarding developments in overseas economies and medium- to long-term inflation expectations. Under these circumstances, I believe it is of utmost importance at the current phase that the Bank persistently pursue powerful monetary easing under "QQE with Yield Curve Control."

Conclusion

Lastly, let me touch on the economy of Kochi Prefecture.

The economy of Kochi Prefecture is currently recovering moderately. The region is benefiting from the recovery trend of the global economy mentioned earlier, which means that exports to emerging economies are increasing and production is picking up.

Looking at the demand side, public investment and housing investment are increasing, and firms are maintaining a proactive business fixed investment stance against the backdrop of high levels of corporate profits. Moreover, positive developments also can be observed in private consumption, such as a pick-up in car sales reflecting the release of new models. Needless to say, the background to this development in private consumption is the

improvement in the employment and income situation. The active job openings-to-applicants ratio in Kochi Prefecture surpassed the long-hoped-for ratio of 1 a year ago and has continued to follow an uptrend since then. On this basis, wages are rising and employee income is following a moderate increasing trend.

However, the background to this increase in the active job openings-to-applicants ratio is not only the improvement in the business cycle but also labor shortages due to the decline in and aging of the population, which is more than ten years ahead of the national trend. This population decline creates a major issue; namely, a shrinking of the regional demand in Kochi Prefecture.

In order to tackle this issue, the prefecture has been forging ahead with the Kochi Prefecture Industrial Promotion Plan since fiscal 2009. Under the slogans "local production for external sales" and "extended reproduction," the plan aims to strengthen the prefecture's food and tourism industries by making use of the agriculture, forestry, and fishery industries, which are the region's forte, and to expand sales channels outside the prefecture and abroad. In line with this plan, efforts toward the "sixth-order industry" utilizing specialties such as *yuzu*, chestnut, and bonito have been making progress in various places in the prefecture, and the value of production in that industry is also rising. In addition, an increasing number of firms are developing products that take advantage of local uniqueness and traditional technologies and promoting both domestic and international sales channels. These include, for example, firms specializing in disaster-related products utilizing technologies unique to the region, which has a high awareness of the need for disaster prevention, and those making competitive paper products that take advantage of the Tosa Japanese paper tradition. In fact, some of these firms are leaders in their particular niche, holding large market shares both domestically and abroad.

In terms of tourism, a variety of initiatives have been producing steady results. Kochi Prefecture is home to a considerable number of important historical figures such as Ryoma Sakamoto, a patriot *samurai* in the closing days of the Tokugawa shogunate, and is a region endowed with an enterprising spirit. It also is a prefecture rich in touristic resources such as nature, history, and culture, as exemplified by Muroto Global Geopark and Shimanto River. In all parts of the prefecture, the development of touristic resources making full use of the rich

nature, as well as of food and a culture unique to Kochi Prefecture, is going ahead and the number of tourists visiting the prefecture, including foreign tourists, is on an increasing trend. This year and next, an expo called the "Shikoku Kochi Bakumatsu Ishinhaku" will be held to commemorate the 150th anniversary of *Taiseihokan* -- or, returning power to the Emperor -- and the Meiji Restoration, and it is expected that this will provide a further boost to tourist numbers and help spread the word about the prefecture's attractions to the whole country.

In the words of Emori Ueki, a Meiji era activist born in Kochi Prefecture, "freedom comes from the mountains of Tosa." Given the rapid decline in and aging of the population in Kochi Prefecture, it is no exaggeration to say that it is a mirror that reflects the future of Japan. I think that the development of Kochi Prefecture's economy will serve as a signpost pointing to the future direction of Japan's economy as a whole, such that one might say that "the revitalization of Japan's economy comes from the mountains of Tosa." The Bank of Japan, and especially the Kochi Branch, will make every effort to contribute to the revitalization of the region. In closing, let me express my strong hopes for the further development of Kochi Prefecture's economy and convey my best regards.

Thank you.

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February 9, 2017

Hiroshi Nakaso

Deputy Governor of the Bank of Japan

Chart 1

Outlook for Economic Activity and Prices (as of January 2017)

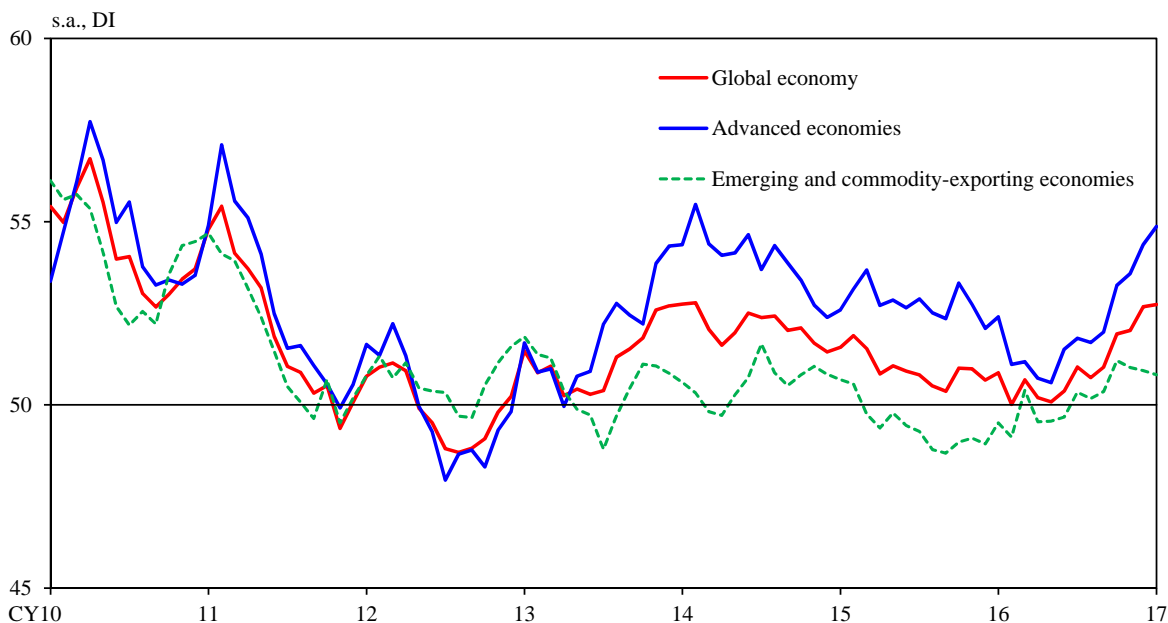
y/y % chg.

	Real GDP	CPI (all items less fresh food)
Fiscal 2016	+1.4	-0.2
Forecasts made in October 2016	+1.0	-0.1
Fiscal 2017	+1.5	+1.5
Forecasts made in October 2016	+1.3	+1.5
Fiscal 2018	+1.1	+1.7
Forecasts made in October 2016	+0.9	+1.7

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

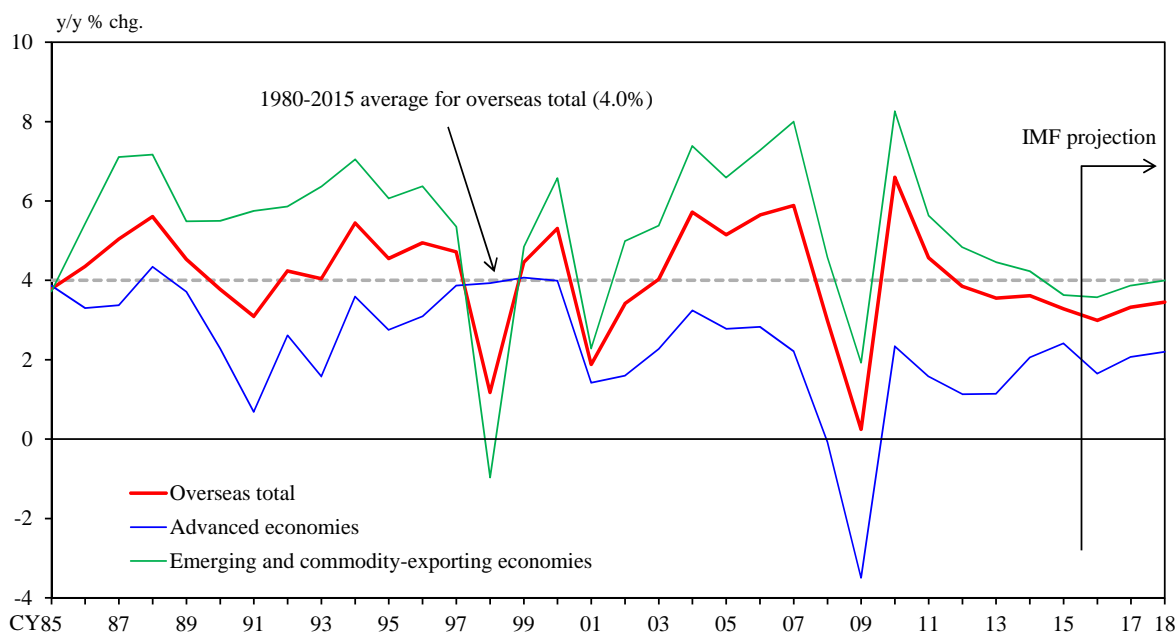
Global Manufacturing Conditions

Manufacturing PMI



Note: Figures for the global economy are the J.P.Morgan Global Manufacturing PMI. Figures for advanced economies as well as emerging and commodity-exporting economies are calculated as the weighted averages of the Manufacturing PMI using PPP-adjusted GDP shares of world total GDP from the IMF as weights. Advanced economies consist of the United States, the euro area, the United Kingdom, and Japan. Emerging and commodity-exporting economies consist of 17 countries and regions, including China, South Korea, Taiwan, Russia, and Brazil. Sources: IMF; IHS Markit (© and database right IHS Markit Ltd 2017. All rights reserved.); Haver.

Real GDP Growth Rates of Overseas Economies



Note: Figures are the weighted averages of real GDP growth rates using countries' share in Japan's exports as weights. Annual GDP growth rates are from the "World Economic Outlook (WEO)" as of January 2017. Since for some countries and regions the IMF does not provide projections in the January WEO, some figures are imputed using information provided in the October WEO. Advanced economies consist of the United States, the euro area, and the United Kingdom. Emerging and commodity-exporting economies consist of the rest of the world economy. Sources: IMF; Ministry of Finance.

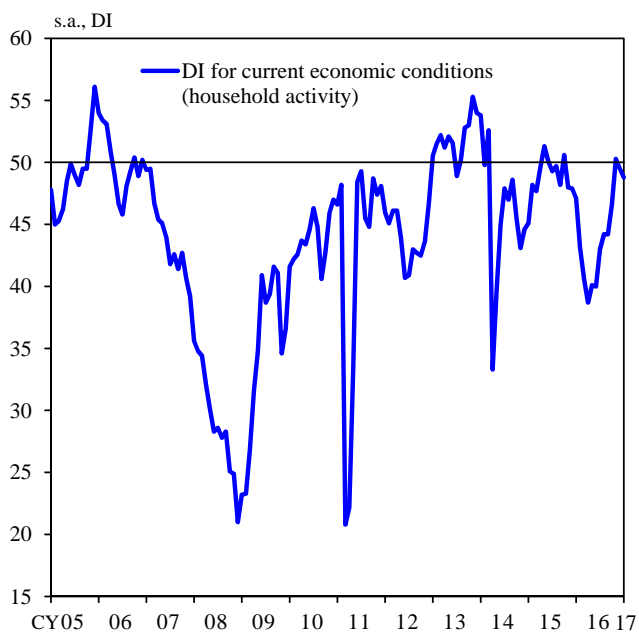
Exports and Industrial Production



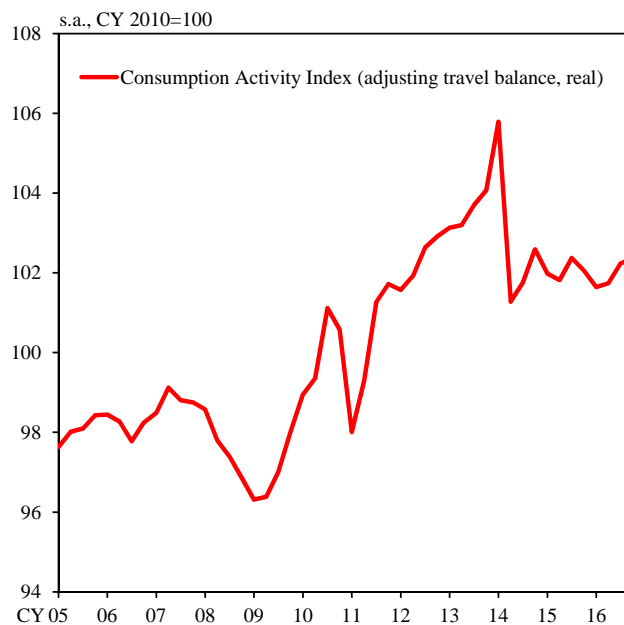
Sources: Bank of Japan; Ministry of Finance; Ministry of Economy, Trade and Industry.

Private Consumption

*DI for Current Economic Conditions
(Economy Watchers Survey)*



Consumption Activity Index



Note: Figures for the Consumption Activity Index exclude inbound tourism consumption and include outbound tourism consumption.
Sources: Cabinet Office; Bank of Japan; Ministry of Economy, Trade and Industry; Ministry of Internal Affairs and Communications, etc.

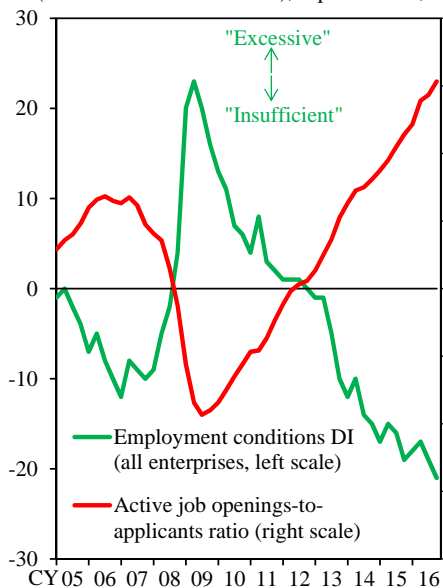
Employment and Income Situation

Job Openings-to-Applicants Ratio and Employment Conditions DI (Tankan)

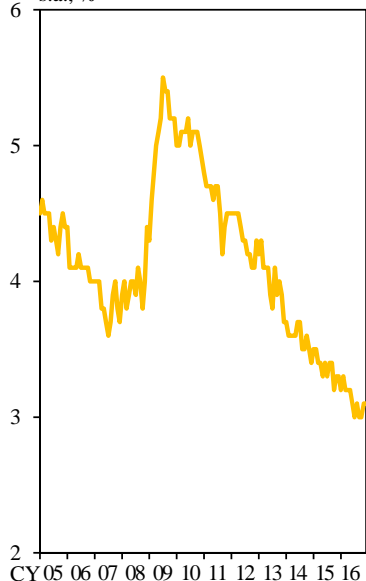
Unemployment Rate

Employee Income

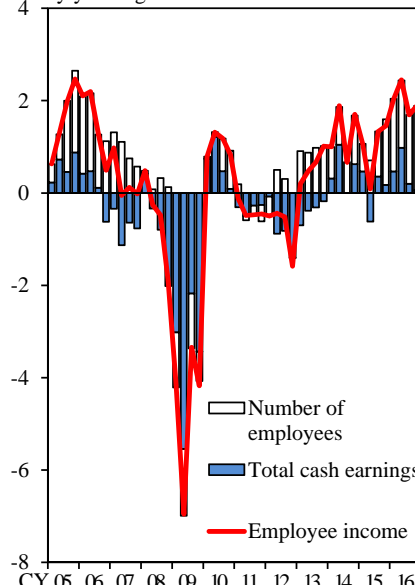
DI ("excessive" - "insufficient"),% points s.a., times



s.a., %



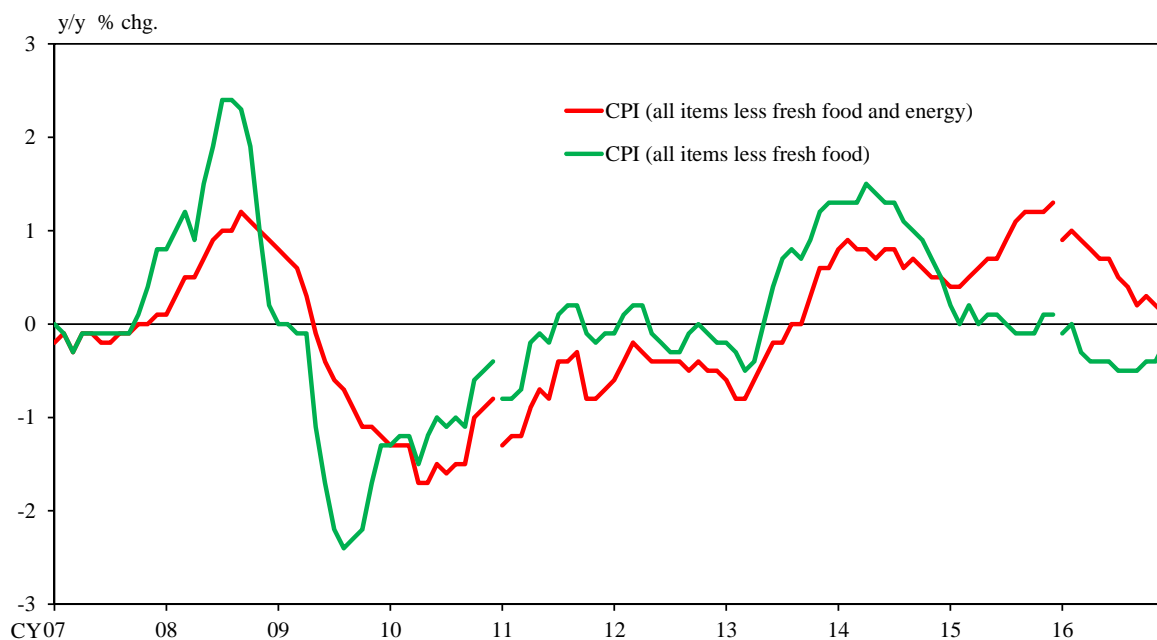
y/y % chg.



Note: Figures for "employee income" are calculated as the "number of employees" (Labour Force Survey) times "total cash earnings" (Monthly Labour Survey). Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. Figures for 2016/Q4 are those of December.

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

Consumer Prices

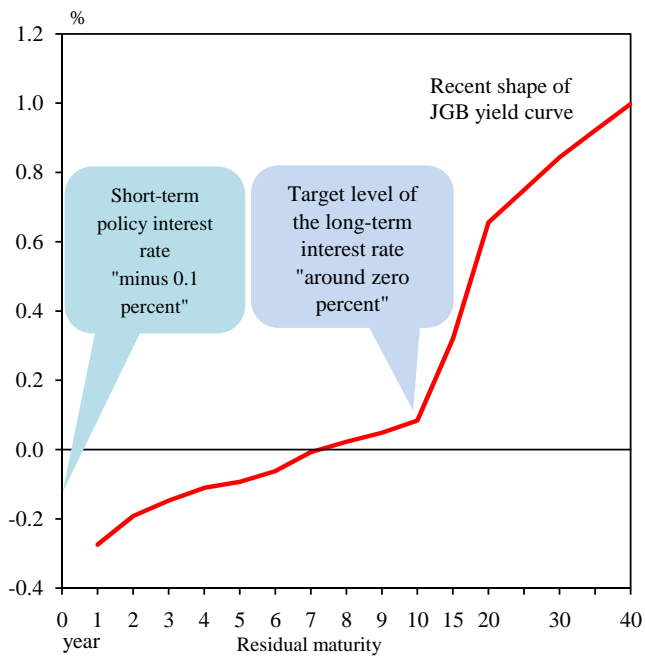


Note: Figures for the CPI (all items less fresh food and energy) are calculated by the Research and Statistics Department, Bank of Japan. Figures for the CPI are adjusted to exclude the estimated effects of changes in the consumption tax rate.

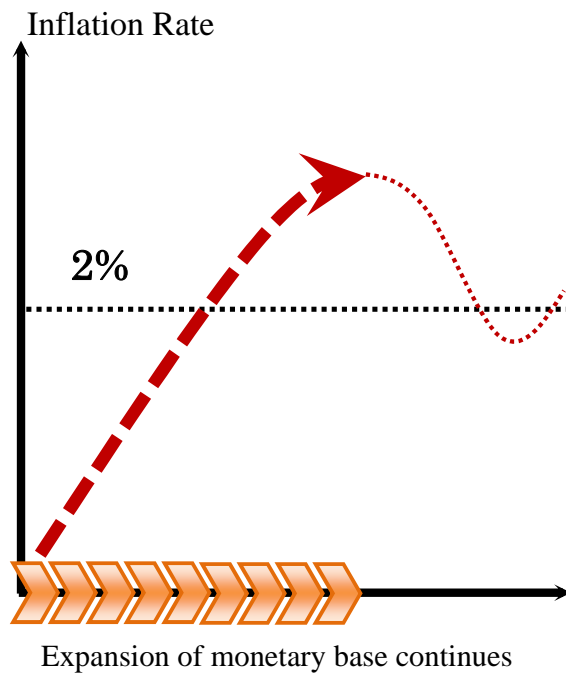
Source: Ministry of Internal Affairs and Communications.

"Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control"

Yield Curve Control



Inflation-Overshooting Commitment



Source: Bloomberg.