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Bank of Japan

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

Speech at a Meeting with Business Leaders in Shizuoka

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(English translation based on the Japanese original)

I. Recent Economic and Price Developments

A. Overseas Developments

I would like to begin my speech by talking about developments in overseas economies. An improvement in business sentiment of manufacturing firms has become evident on a global basis, mainly on the back of an increase in IT-related demand and of the progress observed in emerging economies in inventory adjustments of materials. In this situation, overseas economies have continued to grow at a moderate pace.

As for the outlook, the growth rates of overseas economies are expected to increase moderately, as it is likely that advanced economies will continue growing steadily and a recovery in emerging economies will take hold gradually. According to the *World Economic Outlook (WEO) Update*, released in January 2017 by the International Monetary Fund (IMF), global growth projections have factored in the effects of expansionary fiscal policy expected to be taken in the United States and other elements compared to those made in the October 2016 WEO, and the global growth rate is projected to increase from 3.1 percent in 2016 to 3.4 percent in 2017, and to 3.6 percent in 2018.

Looking at developments by major region, the U.S. economy has continued to recover firmly, mainly in household spending, owing to a steady improvement in the employment and income situation. As for the outlook, the economy is expected to continue to see firm growth driven by domestic private demand.

The European economy has continued to recover moderately, mainly in the household sector. As for the outlook, the economy is projected to follow a moderate recovery trend, while uncertainty -- associated with political issues and the European debt problem, including the financial sector -- is likely to be a burden on economic activity.

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. As for the outlook, the economy is likely to broadly follow a stable growth path as authorities proactively carry out measures to support economic activity.

Emerging economies other than China and commodity-exporting economies have continued to pick up on the whole, reflecting in particular a bottoming out of commodity prices and the effects of economic stimulus measures of those economies, although some economies have remained subdued. As for the outlook, the growth rates of emerging economies other than China and commodity-exporting economies are likely to increase gradually, due mainly to the effects of the economic stimulus measures and the spread of the effects of steady growth in advanced economies.

Risk factors to the overseas economic outlook are wide ranging, as exemplified by (1) developments in the U.S. economy and the impact of its monetary policy on global financial markets, (2) developments in emerging and commodity-exporting economies, particularly China, (3) the consequences stemming from the United Kingdom's vote to leave the European Union (EU) and their effects, (4) prospects regarding the European debt problem, including the financial sector, and (5) geopolitical risks. Therefore, I consider it necessary to closely monitor various risk factors from a broad perspective in making projections regarding overseas developments.

B. Japan's Economy and Prices

1. Economic activity

I will now discuss the economic situation in Japan given the overseas developments I have just outlined. Japan's economy has continued its moderate recovery trend. On an annualized quarter-on-quarter basis, the real GDP growth rate for the October-December quarter of 2016 registered 1.2 percent, representing an increase for four consecutive quarters. The rate continued to rise, due mainly to an increase in external demand, although domestic demand was somewhat sluggish.

With regard to the outlook, Japan's economy is likely to turn to a moderate expansion. Domestic demand is likely to follow an uptrend, with a virtuous cycle from income to spending being maintained in both the corporate and household sectors, on the back of highly accommodative financial conditions and fiscal spending through the government's large-scale stimulus measures. Meanwhile, exports are expected to follow a moderate increasing trend as the growth rates of overseas economies increase moderately. According to the Bank's January 2017 *Outlook for Economic Activity and Prices* (hereafter the Outlook

Report), the medians of the Policy Board members' forecasts for the economic growth rate are 1.4 percent for fiscal 2016, 1.5 percent for fiscal 2017, and 1.1 percent for fiscal 2018, and the economy is expected to continue growing at a pace above its potential through the projection period of fiscal 2016-2018.¹

2. Prices

Next, I will talk about price developments. The year-on-year rate of change in the consumer price index (CPI) for all items less fresh food has increased, reflecting a rise in energy prices, and has been about 0 percent. The rate of increase for all items less fresh food and energy had remained on a decelerating trend, following the peak of 1.3 percent in November 2015; thereafter, the rate of change has been fluctuating. Looking at annual price changes across all CPI items less fresh food, the share of price-increasing items minus the share of price-decreasing items has continued on a moderate declining trend, although it remains in positive territory.

With regard to the outlook, as the positive contribution of energy prices increases, albeit with fluctuations, and as the aggregate supply and demand balance (the output gap) improves and inflation expectations rise, the year-on-year rate of change in the CPI (all items less fresh food) will likely reach around 2 percent in around fiscal 2018; nevertheless, it is necessary to closely monitor downside risks. Specifically, the medians of the Policy Board members' forecasts of the year-on-year rate of change in the CPI (all items less fresh food) presented in the January 2017 Outlook Report are minus 0.2 percent for fiscal 2016, 1.5 percent for fiscal 2017, and 1.7 percent for fiscal 2018.²

¹ Under a specific methodology, Japan's potential growth rate is estimated to be around 0.5 percent, revised upward from being in the range of 0.0-0.5 percent due to the comprehensive revision to GDP statistics. However, the estimate of the potential growth rate varies depending on the methodologies employed and could be revised as the sample period becomes longer over time. Thus, it should be regarded as being subject to a considerable margin of error.

² From the January 2015 interim assessment through the October 2016 Outlook Report, each Policy Board member made their forecasts based on the same assumption about crude oil prices due to the fact that such prices had been exerting a considerable impact on consumer prices. In the January 2017 Outlook Report, each member made an assumption about crude oil prices individually in making their forecasts in light of the fact that the contribution of energy prices to the year-on-year rate of change in the CPI (all items less fresh food) had lessened. The contribution was estimated to be approximately minus 0.6 percentage point for fiscal 2016 and reach around 0 percentage point in early 2017, becoming slightly positive thereafter.

II. Keys to Assessing the Outlook for Economic Activity and Prices

In what follows, I will discuss several points that I think deserve particular attention in terms of realizing the outlook that I mentioned earlier.

A. Employment and Income Situation

First, I will talk about developments in the employment and income situation. Supply-demand conditions in the labor market have continued to improve steadily and employee income has increased moderately. According to the *Labour Force Survey*, the rate of increase in the number of employees has remained at a high level of about 1.5 percent. Against this backdrop, the active job openings-to-applicants ratio has followed a steady uptrend, and a perception of labor shortage suggested by the diffusion index (DI) for employment conditions (the proportion of firms responding that employment was "excessive" minus the proportion of those responding that employment was "insufficient") in the December 2016 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) has heightened further; both indicators show a tightening at almost the same levels seen around 1991-1992. The unemployment rate has continued on a moderate declining trend, albeit with some fluctuations, and has been about 3 percent recently. The supply-demand conditions in the labor market are expected to further tighten.

On the wage side, the rise in hourly cash earnings has accelerated moderately, albeit with fluctuations. Specifically, 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 when fluctuations are smoothed out. With regard to the outlook, the pace of increase in full-time employees' cash earnings is expected to accelerate, as corporate profits improve and a heightening of inflation expectations becomes evident. The rate of increase in hourly cash earnings of part-time employees is also likely to accelerate steadily in response to the marked tightening of labor market conditions and an increase in minimum wages.

In light of these prospects for employment and wages, the rate of increase in employee income is expected to continue rising at around the same rate as nominal GDP growth. However, there is a risk that firms will remain cautious with their decisions, particularly on

wage setting. In this context, how the labor-management wage negotiations in spring 2017 will develop warrants particular attention.

B. Private Consumption

I will now discuss developments in private consumption, which has been resilient against the background of steady improvement in the employment and income situation. The Consumption Activity Index (CAI) had continued to be somewhat weak in part since the beginning of 2016, against the background of the negative wealth effects brought about by the decline in stock prices and of irregular weather; however, the CAI has picked up recently. As the employment and income situation has continued to improve, factors such as the wealth effects resulting from a rise in stock prices and the dissipation of the effects of irregular weather are considered to be supporting the pick-up in the CAI.

With regard to the outlook, private consumption is expected to increase moderately, supported by a steady improvement in employee income, as well as the wealth effects stemming from a rise in stock prices and the effects resulting from the set of stimulus measures.

C. Business Fixed Investment

Let me now explain developments in business fixed investment, which has been on a moderate increasing trend as corporate profits have improved. According to the December 2016 *Tankan*, firmness has continued to be seen in business fixed investment plans for fiscal 2016 as a whole, although developments such as delays in the construction progress and postponement of opening new shops, both triggered by labor shortages, have been observed in some small nonmanufacturing firms.

As for the outlook, business fixed investment is likely to continue to see a moderate uptrend, mainly on the back of (1) an improvement in corporate profits, (2) extremely stimulative financial conditions, such as low interest rates and accommodative lending attitudes, (3) the effects of fiscal measures including projects conducted under the Fiscal Investment and Loan Program and tax reductions for capital investment, and (4) moderate improvement in growth expectations.

D. Prices

Next, I will discuss inflation expectations and the output gap, which are the main factors that determine inflation rates. First, medium- to long-term inflation expectations have remained in a weakening phase since summer 2015 as the adaptive formation mechanism has played a large role, reflecting the observed inflation rate having been slightly negative. As for the outlook, firms' price-setting stance is expected to revert to raising prices as private consumption is expected to continue increasing moderately, and their wage-setting stance is likely to shift toward raising wages driven by the tightening of labor market conditions; against this backdrop, medium- to long-term inflation expectations are likely to follow a sustained increasing trend.

Second, the output gap had been more or less unchanged at around 0 percent, but has shown some improvement recently. It is projected that it will turn slightly positive toward the end of fiscal 2016, and from fiscal 2017 continue expanding moderately in positive territory owing to both the capital and labor factors, as domestic and foreign demand increase in a well-balanced manner.

III. Conduct of Monetary Policy

Let me now turn to the Bank's monetary policy.

At the Monetary Policy Meeting (MPM) held in January 2013, the Bank made a commitment to achieving the price stability target of 2 percent in terms of the year-on-year rate of change in the CPI at the earliest possible time, and in April of that year, it decided to introduce Quantitative and Qualitative Monetary Easing (QQE) as a necessary measure to underpin this commitment. In January 2016, the Bank decided to introduce QQE with a Negative Interest Rate in order to pursue monetary easing in terms of the three dimensions of quantity, quality, and the interest rate. Furthermore, in September 2016, the Bank conducted a comprehensive assessment of the developments in Japan's economic activity and prices as well as policy effects since the introduction of QQE, and decided to introduce QQE with Yield Curve Control as a means of strengthening the two previous policy frameworks I just mentioned.

The framework of QQE with Yield Curve Control consists of two major components. The first is yield curve control in which the Bank facilitates the formation of short- and long-term interest rates that are considered most appropriate for maintaining the momentum toward achieving the price stability target, taking account of developments in economic activity and prices as well as financial conditions. Specifically, 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 Japanese government bond (JGB) yields at around 0 percent, conducting JGB purchases so as to achieve this target level. The second component is an inflation-overshooting commitment in which the Bank continues with the monetary easing framework, aiming to achieve the price stability target, as long as it is necessary for maintaining that target in a stable manner. On this point, the Bank makes clear that it will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner.

As shown in the comprehensive assessment, I consider that the main factor that hampers achieving the price stability target of 2 percent is as follows. In the course of the Bank's attempt to raise inflation expectations toward 2 percent, observed inflation rates declined due to a variety of exogenous factors such as a substantial fall in crude oil prices. Under these circumstances, inflation expectations declined, as the adaptive mechanism has been playing a relatively large role in the formation of inflation expectations in Japan. Taking this into consideration, the Bank decided to adopt a commitment that allows inflation to overshoot the price stability target so as to strengthen the forward-looking mechanism in the formation of inflation expectations, enhance the credibility of achieving the price stability target among the public, and raise inflation expectations in a more forceful manner.

As for the future conduct of monetary policy, the Bank will continue with QQE with Yield Curve Control, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. Currently, the momentum toward achieving the price stability target is being maintained, and the year-on-year rate of change in the CPI is expected to increase toward 2 percent. Nevertheless, the momentum is not yet sufficiently firm, and we are only halfway to achieving the price stability target. 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, but considering the current developments in economic activity and prices as well as financial conditions, I believe that it is important that the Bank continue to steadily pursue powerful monetary easing under QQE with Yield Curve Control.

IV. Challenges for Japan's Economy

I would now like to express my thoughts regarding the current situation of Japan's economy from a longer-term perspective.

In order to achieve the Bank's price stability target in a stable manner, one of the necessary requirements is to raise the potential growth rate, which indicates the "basal metabolism" of an economy. Japan's economy has achieved growth through the process of securing resources and making full use of them, as well as developing high-quality products and services and providing them to markets. Through this process, Japan has contributed to global economic growth as well. I believe it is possible to further expand Japan's growth and contribution to global economic growth in various areas. We should continue with proactive efforts to increase Japan's growth potential, rather than being overly pessimistic about structural changes such as the population decline.

To secure and make use of resources, measures have been taken in the public sector, for example, to tackle the problem of the population decline -- such as support for childcare and for women and the elderly to become part of the workforce. In the private sector, in addition to the efficient use of human resources, it is vital to enhance the training of managers and the efficiency of administrative operations. From a global viewpoint, expanding the network for securing such resources as raw materials is highly desirable. Moreover, increasing the number of foreign workers in many fields could be an option.

With regard to developing and providing products and services, Japan needs to develop high-value-added products and services with good reputations and explore new sources of domestic demand through initiatives such as advancing financial technology. It also is

important to expand the channels for capturing overseas demand in neighboring economies, mainly in Asia, where high growth is expected. This includes attracting inbound demand.

In light of the current situation, I believe that Japan should secure demand necessary for its economic growth, both at home and abroad in a balanced manner. At a time of uncertainty regarding such factors as developments in overseas economies, it also is vital to enhance the autonomy of Japan's economy while paying due attention to overseas risk factors. One good example is the situation for exports in 2016, when they remained resilient despite the appreciation of the yen. I see this as evidence that the autonomy of Japan's economy has strengthened, reflecting the heightened non-price competitiveness in which the volume of exports is not directly affected by foreign exchange movements. Going forward, continued efforts are needed to establish a system for developing and providing unique products and services that are not susceptible to economic developments at home and abroad, nor to foreign exchange movements, and to further accelerate innovation that promotes establishment of such a system.

In closing, let me underline that these initiatives toward raising Japan's potential growth rate require a comprehensive approach that includes structural reforms in addition to monetary and fiscal policies. Structural reforms of Japan's economy have been progressing to a certain extent, but further acceleration is required. I expect that growth strategies will bear fruit as smooth procurement of funds proceeds under accommodative financial conditions, and as these are invested in labor-saving machinery and equipment, research and development, and mergers and acquisitions at home and abroad.

Thank you for your attention.