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Bank of Japan

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

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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 by talking about overseas economies, which have been growing moderately on the whole, although slowdowns have continued to be observed. In terms of the outlook, slowdowns are likely to continue for the time being; thereafter, however, overseas economies are expected to grow moderately on the whole with their growth rates rising somewhat. According to the July 2019 *World Economic Outlook Update* released by the International Monetary Fund (IMF), global growth is forecast at 3.2 percent for 2019 and 3.5 percent for 2020. However, as downside risks concerning the global economy seem to be increasing, careful attention is warranted on the timing and pace of its pick-up.

Looking at developments by major region, the U.S. economy has been expanding moderately, although relatively weak developments have been observed in the manufacturing sector. The European economy has remained in its deceleration phase. The Chinese economy has continued to see stable growth on the whole, but weakness has been observed in the manufacturing sector. Other emerging and commodity-exporting economies have maintained their recovery trend as domestic demand has been firm on the whole. As for the outlook, the U.S. economy is expected to maintain its moderate expansion and the European economy is projected to gradually move out of its deceleration phase. The Chinese economy is likely to broadly follow a stable growth path as authorities implement fiscal and monetary policies in a gradual manner. The growth rates of other emerging and commodity-exporting economies are likely to rise on the whole, mainly on the back of the effects of those economies' stimulus measures.

Risk factors to the overseas economic outlook are wide ranging and likely to be significant, as exemplified by (1) the U.S. macroeconomic policies and their impact on global financial markets, (2) the consequences of protectionist moves, including those observed in the U.S.-China trade friction, and their effects, (3) developments in emerging and commodity-exporting economies, (4) the progress in global adjustments in IT-related goods, (5) negotiations on the United Kingdom's exit from the European Union (EU) and their effects, and (6) geopolitical risks. In particular, uncertainties regarding the effects of protectionist moves have been heightening. As it can be said that the situation surrounding

overseas economies is uncertain, it is necessary to stay vigilant regarding these risk factors, including their impact on the sentiment of firms and households in Japan.

B. Japan's Economy and Prices

1. Economic activity

I will now discuss the economic situation in Japan. The economy has been on a moderate expanding trend, with a virtuous cycle from income to spending operating, although exports, production, and business sentiment have been affected by the slowdown in overseas economies. This is evidenced by the real GDP growth rate having registered 1.3 percent for the April-June quarter of 2019 on an annualized quarter-on-quarter basis, representing positive growth for three consecutive quarters. While the contribution of net exports on real GDP growth has turned negative, that of domestic demand has remained positive. According to the Bank of Japan's September 2019 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) released at the beginning of October, the diffusion index (DI) for business conditions for all industries and enterprises has remained positive, although the effects of such factors as the slowdown in overseas economies have continued to be observed.

With regard to the outlook, Japan's economy is likely to continue on a moderate expanding trend on average, although it is projected to be affected by the slowdown in overseas economies for the time being and due attention needs to be paid to the effects of the October 2019 consumption tax hike on private consumption. In terms of specific figures for the economic growth rate, as provided in the July 2019 *Outlook for Economic Activity and Prices* (Outlook Report) released by the Bank, the medians of the Policy Board members' forecasts are 0.7 percent for fiscal 2019, 0.9 percent for fiscal 2020, and 1.1 percent for fiscal 2021. The Bank estimates that the economic growth rate that can be achieved in the long term, or the so-called potential growth rate, is in the range of 0.5-1.0 percent. Thus, Japan's economy is expected to continue growing at a pace consistent with its potential.

To elaborate on Japan's economy by demand component, exports are projected to continue showing some weakness for the time being, but thereafter are expected to return to their moderate increasing trend as the growth rates of overseas economies rise. Domestic demand

is likely to follow a moderate uptrend. Specifically, business fixed investment is expected to increase moderately amid highly accommodative financial conditions. Private consumption also is likely to continue on a moderate increasing trend as the employment and income situation continues to improve steadily. However, it is necessary to pay close attention to the effects of the consumption tax hike on private consumption.

2. Prices

Let me now turn to price developments. The year-on-year rate of change in the consumer price index (CPI) for all items less fresh food and that for all items excluding the effects of energy prices are both at around 0.5 percent, together suggesting that the CPI has continued to show relatively weak developments compared to the economic expansion and tight labor market conditions.

However, with the economy continuing on an expanding trend, the mechanism for moderate increases in wages and prices driven by a positive output gap has continued to operate. Thus, with regard to the outlook, medium- to long-term inflation expectations are projected to rise gradually as firms' stance is likely to gradually shift toward further raising wages and prices. As a result, the year-on-year rate of change in the CPI (all items less fresh food) is likely to increase gradually over time. In terms of specific figures, the medians of the Policy Board members' forecasts of the year-on-year rate of change presented in the July 2019 Outlook Report are 1.0 percent for fiscal 2019, 1.3 percent for fiscal 2020, and 1.6 percent for fiscal 2021.¹

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

In what follows, I would like to discuss several points that I think deserve particular attention in examining whether the outlook for economic activity and prices in Japan that I mentioned earlier will be realized.

¹ The forecasts assume the following: (1) the consumption tax will be raised to 10 percent in October 2019 and a reduced tax rate will be applied to food and beverages -- excluding alcohol and dining out -- and newspapers, and (2) measures for free early childhood education will be introduced in October 2019, and other measures including free higher education will be introduced in April 2020.

A. Employment and Income Situation

Let me first talk about the employment and income situation. As Japan's economy has continued its moderate expansion, the output gap -- which shows the utilization of labor and capital -- has remained positive. The *Labour Force Survey*-based number of employees has continued to increase, when smoothing out fluctuations, and the active job openings-to-applicants ratio has been at a high level that exceeds the peak marked during the bubble period. In addition, the unemployment rate has remained at a low level.

Amid the tight supply-demand conditions in the labor market, the year-on-year rate of increase in scheduled cash earnings of full-time employees has been in the range of around 0.5-1.0 percent. In addition, that in hourly scheduled cash earnings of part-time employees, which are responsive to supply-demand conditions in the labor market, has registered relatively high growth at around 2 percent. As a result, although total cash earnings per employee have risen moderately, albeit with fluctuations, the increases have remained relatively weak compared to tight labor market conditions, partly due to the high wage elasticity of labor supply in recent years, mainly among women and seniors.

As Japan's economy is likely to continue on an expanding trend, it is expected that the supply-demand conditions in the labor market will remain tight. I therefore expect the rate of increase in total cash earnings per employee to gradually accelerate. However, there is a risk that firms will remain cautious with their decisions on wage setting, and in this context, I am paying close attention to developments in their stance regarding wages.

B. Prices

Next, I will turn to price developments, taking into account the employment and income situation. The year-on-year rate of change in the CPI (all items less fresh food) has remained at around 0.5 percent.

The relatively weak price developments compared to the economic expansion and tight labor market conditions are attributed to the mindset and behavior based on the assumption that wages and prices will not increase easily. These mindset and behavior have been deeply entrenched among firms and households, due mainly to the experience of prolonged low

growth and deflation. This will not change overnight, and it may in fact take a considerable amount of time. Also, firms have been making efforts to absorb the upward pressure of costs on prices by increasing labor-saving investment and streamlining their business process, and this has allowed firms to maintain their cautious stance toward raising prices.

Meanwhile, firms' moves to pass on increases in, for example, personnel expenses and distribution costs, to sales prices have been slowly spreading. Looking at annual price changes across all CPI items less fresh food, the share of price-increasing items minus that of price-decreasing items recently has been increasing moderately. This is a result of continued price rises in a wide range of items in response to rising personnel expenses and distribution costs.

While price developments are affected by a number of factors, I believe the underlying trend in prices is determined by the aggregate supply-demand balance. With the output gap remaining positive, it is projected that wage growth rates and the tolerance of households toward price rises will improve, and that firms' stance will shift toward further raising prices. In this situation, firms' moves to raise prices are likely to become more widespread. The actual rise in wages and prices is then expected to gradually weaken the mindset and behavior based on the assumption that wages and prices will not increase easily. Medium- to long-term inflation expectations are projected to rise gradually as a result. I therefore consider that the momentum toward achieving the price stability target of 2 percent has been maintained. However, attention should be paid to the possibility that such momentum will be lost as downside risks regarding the global economy are significant.

III. Conduct of Monetary Policy

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

The Bank has set the price stability target at 2 percent in terms of the year-on-year rate of change in the CPI and has been conducting monetary policy to achieve this target at the earliest possible time, under the framework of Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control. Under this framework, the Bank has been conducting yield curve control, in which it controls short- and long-term interest rates.

Specifically, according to the guideline for market operations, the Bank currently sets the short-term policy interest rate at minus 0.1 percent and purchases Japanese government bonds (JGBs) so that 10-year JGB yields will remain at around 0 percent. With a view to lowering risk premia of asset prices, the Bank also purchases assets such as exchange-traded funds (ETFs).

I consider that the highly accommodative financial conditions, brought about by powerful monetary easing, have stimulated the spending activities of firms and households, and have contributed significantly to the positive output gap. Given the current situation where prices and inflation expectations have remained sluggish, I think that it is important to sustain the momentum toward achieving the price stability target through maintaining a positive output gap for as long as possible by keeping interest rates at sufficiently low levels for a prolonged time.

I also believe that any possible loss in momentum toward achieving the price stability target needs to be preempted. To further clarify the Bank's stance on monetary policy conduct in the current situation where downside risks to economic activity and prices are significant, the Bank stated at the Monetary Policy Meeting (MPM) held in July 2019, that it "will not hesitate to take additional easing measures if there is a greater possibility that the momentum toward achieving the price stability target will be lost." There are various possible measures for additional easing, such as cutting the short-term policy interest rate, lowering the target level of 10-year JGB yields, expanding asset purchases, and accelerating the expansion of the monetary base. Given that, recently, slowdowns in overseas economies have continued to be observed and their downside risks seem to be increasing, it is becoming necessary to pay closer attention to the possibility that the momentum toward achieving the price stability target will be lost. While taking this situation into account, the Bank will reexamine economic and price developments at the next MPM in October.

IV. Challenges for Japan's Economy

I would now like to express my opinions regarding Japan's current economic situation from a longer-term perspective.

According to the Bank's estimates, the potential growth rate has been in the range of 0.5-1.0 percent recently. Although the rate has risen compared to around 2010, it can be said that Japan's growth potential has been sluggish of late. This is also an indication of the various challenges that Japan faces in achieving a rise in productivity. For example, it is difficult in Japan to establish business models through which firms can benefit from economies of scale, and where cost efficiency improves along with an expansion of business size. Although Japan's economy is the world's third largest, it is far smaller than that of the United States or China, and smaller also than that of the EU taken as a whole. Let me note that the rise of Chinese firms is backed by a rapid expansion of the Chinese economy. I think that the sluggish improvement in productivity among Japanese firms in recent years is partly attributable to the economic situation in Japan that I just outlined.

Cross-border mergers and acquisitions undertaken by Japanese firms recently can be considered as one of the initiatives addressing the challenges. However, managing foreign firms is a new experience for many Japanese firms, and is likely to be quite difficult as there are a number of issues to be tackled, such as securing managers and adapting to different corporate cultures. Recent protectionist moves could also become an obstacle to the free mobility of labor, goods, money, and information. Since Japan's domestic market is small, I think that the business environment is becoming increasingly severe for Japanese firms.

Despite these trends, I see the potential growth rate rising through improvements in productivity as a wide range of entities continue to introduce structural reforms and implement growth strategies. With the output gap remaining positive, firms have continued to undertake labor-saving investment, mainly through the use of information technology. Furthermore, they have proceeded with working-style reforms and other initiatives that reflect demographic changes and the considerably tight labor market conditions. Steady progress has also been made in achieving diversity in the labor force, through the hiring of women, seniors, and foreign workers. As managers and workers have become aware of the need for greater efficiency and productivity, an increasing number of firms have been working to this end, not only in manufacturing, but also mainly in the administrative field, where robotic process automation (RPA) has been introduced. There is still significant room for improvement, mainly in the use of human resources and the enhancement of business

efficiency, and I think we can expect a further rise in productivity through such initiatives.

Although these structural reforms and growth strategies may exert downward pressure on wages in the short term, I believe that they will play a role in underpinning the virtuous cycle from income to spending in the long term. Specifically, rising productivity will act as the starting point of such a cycle, stimulating price rises through increased wages and private consumption. Let me note, however, that raising productivity and growth potential does not occur overnight. It is therefore important to ensure a sustained virtuous cycle, in which increased demand encourages progress in various initiatives, as the Bank's monetary policy stimulates aggregate demand and reasonably tight supply-demand conditions are maintained. Thus, to achieve its price stability target and realize sustainable economic growth in a coordinated manner, the Bank should persistently continue with its powerful monetary easing and firmly support the initiatives of a wide range of entities.