

## Yukitoshi Funo: Economic activity and prices in Japan, and monetary policy

Speech by Mr Yukitoshi Funo, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Hyogo, 23 March 2016.

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### I. Recent economic and price developments

#### A. Overseas developments

I would like to begin my first speech delivered as a Policy Board member of the Bank of Japan by talking about developments in global financial markets and overseas economies. In global financial markets, risk aversion has increased from the end of 2015, against the backdrop of the declines in crude oil prices and Chinese stock prices. In this situation, overseas economies have been decelerating somewhat, mainly in emerging economies, although they have continued to grow at a moderate pace.

As for the outlook, however, the pace of growth in overseas economies is expected to accelerate moderately as the positive effects of the recovery in advanced economies gradually spread to emerging economies. According to the *World Economic Outlook (WEO) Update* released in January 2016 by the International Monetary Fund (IMF), the projection of global economic growth has been revised somewhat downward from the October 2015 WEO, but the longer-term projection that the growth rate will accelerate moderately from the current estimate of 3.1 percent in 2015 to 3.4 percent in 2016, and 3.6 percent in 2017, is unchanged.

Looking at movements by major region, the U.S. economy has been on a recovery trend, assisted by household spending. Amid the steady increase in employment on the whole, private consumption has been increasing steadily, although the pace has been slowing somewhat. Housing investment has followed a moderate uptrend. As for the outlook, the manufacturing sector is likely to remain lackluster for the time being, due mainly to the slowdown in emerging economies, but the economy is expected to continue its recovery centered on the private sector, supported by the firmness in household spending, under accommodative financial conditions.

The euro area economy has continued to recover moderately. Although exports have shown some weakness, mainly due to the effects of the slowdown in emerging economies, private consumption has been on an increasing trend, supported mainly by the improvement in the labor market. As for the outlook, the economy will likely continue to see a moderate recovery, mainly on the back of the improved employment and income situation under accommodative financial conditions.

The Chinese economy has maintained its stable growth on the whole. However, the pace of growth has decelerated somewhat, mainly in exports and production, reflecting (1) persisting excess production capacity and inventory adjustment pressure in the manufacturing sector; and (2) some weakness in external demand, due mainly to a pause in growth in demand for IT-related goods. In this situation, authorities have proactively carried out policy measures to support economic activity, mainly in fiscal spending. As for the outlook, the economy is likely to broadly follow a stable growth path, due in part to authorities' measures to support economic activity.

Emerging economies have been slowing, mainly in terms of exports and production. Although effects of the economic stimulus measures have been observed, exports and production in Asia have shown some weakness due to excess production capacity and inventory adjustments as well as a pause in growth in demand for IT-related goods in

emerging economies, including China. In addition, low commodity prices have been exerting downward pressure on commodity-exporting economies such as Brazil and Russia. As for the outlook, emerging economies are likely to gradually move out of their deceleration phase, mainly on the back of the effects of the recovery in advanced economies and the fiscal and monetary policy measures to stimulate the economy, although differences across countries and regions are likely to remain for the time being. However, the pace of the pick-up will likely remain moderate on the whole.

One of the risks to the outlook for overseas economies is that it is difficult to deduce the pace of growth in the global economy, given that the uncertainties surrounding emerging and commodity-exporting economies – particularly China – remain high and that there are negative effects of the declines in commodity prices. In addition, risk factors to the overseas economic outlook are wide ranging, as exemplified by (1) developments in the U.S. economy and the influences of its monetary policy response to them on the global financial markets, (2) prospects regarding the European debt problem and developments in economic activity and prices in Europe, and (3) geopolitical risks such as those in the Middle East.

Therefore, I consider it necessary to closely monitor various risk factors from a broad perspective.

## **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 to recover moderately as a trend, although exports and production have shown sluggishness, due mainly to the slowdown in emerging economies. The real GDP growth rate for the July-September quarter of 2015 increased by an annualized quarter-on-quarter growth rate of 1.4 percent, which exceeds the potential growth, due mainly to an increase in domestic private demand. That for the October-December quarter registered minus 1.1 percent on an annualized quarter-on-quarter basis, due partly to the effects of irregularly warm weather.

As for the outlook, although the sluggishness in exports and production will probably remain for some time, domestic demand is likely to follow an uptrend, with a virtuous cycle from income to spending being maintained in both the household and corporate sectors, and exports are expected to increase moderately on the back of emerging economies moving out of their deceleration phase. Thus, Japan's economy is likely to be on a moderate expanding trend. Specifically, the economy is expected to continue growing at a pace above its potential through fiscal 2016. Thereafter, through fiscal 2017, it is projected to maintain its positive growth, although with a slowing in its pace to around a level somewhat below the potential growth rate, due mainly to the effects of a front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike planned in April 2017. According to the Bank's January 2016 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), the medians of the Policy Board members' forecasts for the economic growth rate – 1.1 percent for fiscal 2015, 1.5 percent for fiscal 2016, and 0.3 percent for fiscal 2017 – were more or less unchanged from the forecasts presented in October 2015.

### **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 generally been about 0 percent, with the decline in energy prices and the increase in non-energy prices broadly offsetting each other. The rate of change for all items less fresh food and energy – one of the indicators that capture the underlying trend in the CPI – has remained positive for 28 months and has been at a level above 1 percent recently. In addition, looking at annual price changes in all CPI

items less fresh food, the share of price-increasing items minus the share of price-decreasing items has shown a marked increase since spring 2015, albeit with some fluctuations.

With regard to the outlook, the year-on-year rate of change in the CPI for 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, and, as the underlying trend in inflation steadily rises, accelerate toward 2 percent. Meanwhile, assuming that crude oil prices will rise moderately from the recent level, it is likely that the negative contribution of energy prices to the year-on-year rate of change in the CPI will decrease gradually. Based on this assumption, the timing of the year-on-year rate of change in the CPI reaching around 2 percent – the price stability target – is projected to be around the first half of fiscal 2017. Specifically, the medians of the Policy Board members' forecasts of the year-on-year rate of increase in the CPI for all items less fresh food presented in the January 2016 Outlook Report were 0.1 percent for fiscal 2015, 0.8 percent for fiscal 2016, and, on a basis excluding the direct effects of the scheduled consumption tax hike, 1.8 percent for fiscal 2017. Comparing these with the forecasts presented in October 2015, that for fiscal 2016 is lower and that for fiscal 2017 is more or less unchanged. The downward revision of the forecast for the CPI is due to the assumption of lower crude oil prices.<sup>1</sup>

## **II. Keys to assessing the outlook for economic activity and prices**

In what follows, I will discuss the keys to assessing the outlook for economic activity and prices in Japan, including 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 number of employees has been increasing, and the labor force participation of women and the elderly has been rising. Against this backdrop, the active job openings-to-applicants ratio has risen steadily and a perception of labor shortage suggested by the diffusion index 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 2015 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) has heightened. The unemployment rate has declined moderately, albeit with some fluctuations, and recently has been in the range of 3.0–3.5 percent. The supply-demand conditions in the labor market are expected to continue improving steadily. On the wage side, hourly cash earnings of part-time employees, which are responsive to labor market conditions, have shown an especially clear improvement of late, supported in part by a recent increase in minimum wages. With regard to the outlook, as the tightening of labor market conditions and the heightening of inflation expectations will become more evident, these will tend to exert upward pressure on wages.

In light of these prospects for employment and wages, the rate of increase in employee income is expected to moderately accelerate. Nevertheless, given that the unemployment rate has declined to the range of 3.0–3.5 percent in a situation where corporate profits have

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<sup>1</sup> Individual Policy Board members made their forecasts assuming that Dubai crude oil prices would rise moderately from the recent 35 U.S. dollars per barrel to the range of 45–50 dollars per barrel toward the end of the projection period. Under this assumption, the contribution of energy prices to the year-on-year rate of change in the CPI (all items less fresh food) was estimated to be around minus 0.9 percentage point for fiscal 2015, and approximately in the range of minus 0.7 to minus 0.8 percentage point for fiscal 2016. More specifically, the contribution was expected to start to lessen in the second half of fiscal 2016 and reach around 0 percentage point during the first half of fiscal 2017.

been at high levels, it should be noted that the pace of improvement in wages to date has been somewhat slow and the labor share has remained on a downtrend.

## **B. Exports**

I will now discuss developments in exports. The pick-up in exports has paused recently. Specifically, exports of capital goods have continued to be relatively weak, due mainly to the slowdown in emerging economies, including China; with regard to IT-related exports, those of smartphone-related goods have been slowing. However, automobile-related exports have been increasing as a trend, mainly those to the United States and Europe, due partly to shifting of overseas production sites back to Japan.

With regard to the outlook, Japan's exports are expected to tend to mark a fall for the time being, given the decline in expected growth in emerging and commodity-exporting economies, protracted low commodity prices, and the resulting excess in production capacity related to material and energy. I therefore consider that this warrants careful attention. Automobile-related exports, particularly those for advanced economies, are likely to continue to firmly increase. On the other hand, the pick-up in exports of capital goods and IT-related goods are projected to be sluggish, due to the effects of the slowdown in emerging economies, and remain at a pause. I will continue to closely monitor developments in the global economy.

## **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 been at high levels. According to the December 2015 *Tankan*, firms have generally continued to plan to increase fixed investment firmly for fiscal 2015 despite the slowdown in emerging economies. As for the outlook, business fixed investment is projected to continue to increase moderately on the back of (1) the high level of corporate profits, (2) stimulative financial conditions such as low interest rates and accommodative lending attitudes, and (3) manufacturers' positive stance on domestic investment. Machinery orders – a leading indicator of machinery investment – have been increasing moderately. In light of high corporate profits, firms are judged so far as having maintained their restrained fixed investment stance due to sluggish growth expectations. However, their stance is projected to gradually become more positive in response to a moderate rise in growth expectations and a sustained improvement in profitability. Nevertheless, I think that it is necessary to pay close attention to the effects of the recent risk aversion in global financial markets on firms' sentiment, and in turn on their fixed investment stance.

## **D. Prices**

Next, I will discuss the output gap and inflation expectations, which are the main factors that determine inflation rates. First, the output gap is expected to head toward improvement, reflecting a rise in the manufacturing sector's capacity utilization supported by a pick-up in exports and production, and a further improvement in labor market conditions. In fiscal 2016, the output gap is projected to expand within positive territory, reflecting a higher utilization of production inputs accompanying the economic expansion and higher growth due to a front-loaded increase in demand prior to the consumption tax hike planned in April 2017.

Second, medium- to long-term inflation expectations still appear to be rising on the whole from a somewhat longer-term perspective, judging from firms' price-setting and households' spending behavior, although market indicators and various surveys have been somewhat weak recently. Firms' price- and wage-setting stance clearly has changed, and consumers seem to be accepting firms' movements to increase prices, mainly reflecting an improvement in the employment and income situation. In the annual labor-management wage negotiations, movements toward wage increases have been broadening since 2014, reflecting corporate performance and supply-demand conditions in the labor market. Looking

ahead, as the observed inflation rate rises, medium- to long-term inflation expectations are also likely to follow an increasing trend and gradually converge to 2 percent – the price stability target. Nevertheless, I believe that it is still necessary to pay close attention to how factors such as the decline in crude oil prices will affect firms' and consumers' outlook for prices.

### **III. Conduct of monetary policy**

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

The Bank decided to introduce Quantitative and Qualitative Monetary Easing (QQE) with a Negative Interest Rate at the Monetary Policy Meeting (MPM) held in January 2016. Let me look back on how the Bank came to introduce it. About three years ago, at the MPM held in April 2013, the Bank made a commitment to achieving the price stability target of 2 percent at the earliest possible time, and decided to introduce QQE as a necessary measure to underpin this commitment. The main transmission mechanism of QQE is stimulating firms' investment and households' consumption through lowering nominal interest rates across the entire yield curve by making large-scale purchases of Japanese government bonds (JGBs) and showing the Bank's clear commitment toward achieving the price stability target of 2 percent by continuing with massive asset purchases. Thereafter, the Bank decided to expand QQE at the MPM held at the end of October 2014. In January 2016, it introduced QQE with a Negative Interest Rate, which is designed to enable the Bank to make full use of possible monetary easing measures in terms of the three dimensions of quantity, quality, and the interest rate, in which a negative interest rate is added to the existing options of QQE conducted to date.

After the turn of 2016, there had been uncertainty over future developments in emerging and commodity-exporting economies, and financial markets had been volatile. Reflecting such developments, there was an increasing risk that an improvement in the business confidence of Japanese firms and conversion of the deflationary mindset might be delayed, and that the underlying trend in inflation – which had been rising steadily – might be negatively affected. Based on such recognition, the Bank decided to introduce QQE with a Negative Interest Rate to preempt the manifestation of this risk and to maintain momentum toward achieving the price stability target of 2 percent.

For the good of Japan's economy, it is necessary to dispel people's deflationary mindset that has taken hold amid deflation that has lasted for a long period. Therefore, at present, I consider that it is most important to steadily pursue monetary easing to achieve the price stability target of 2 percent while paying attention to various effects that monetary easing may bring.

We are only halfway to achieving the 2 percent price stability target. Given this, I think that it is vital that the Bank continue to steadily pursue QQE with a Negative Interest Rate to achieve the price stability target. The Bank aims to achieve the target of 2 percent at the earliest possible time. In order to do so in a sustainable and stable manner, I think that it is necessary that the target be achieved while the economy as a whole maintains the virtuous cycle in a balanced manner, such as with prices rising along with wage increases. The Bank will continue to steadily pursue monetary easing, making full use of all possible measures in terms of the three dimensions of quantity, quality, and the interest rate to achieve the price stability target of 2 percent.

### **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 my view, the economy, which has experienced deflation for a long period of time, faces the challenge of strengthening its growth potential. Japan's potential growth rate as estimated by the Bank has declined to around 0.5 percent or lower,

and this reflects factors including decreases in (1) the growth rate of capital stock due to postponement of business fixed investment, (2) labor input due to the aging of the population and the decrease in the number of hours worked, and (3) productivity growth due to sluggish innovation. In order to enhance the potential growth rate of the economy, I believe that it is important to steadily proceed with measures that will cause increases in these factors.

Let me elaborate on each of them. First, firms' fixed investment is made based on their future prospects and strict selection of such investment based on the quality criteria and on value added. They recently have been exhibiting moves such as the shifting of production sites back to Japan and expanding investment in research and development. In order to manage risks and maintain sustainable growth, many Japanese firms that face global risks seem to be in the process of adopting a strategy that allocates fixed investment in several areas in a balanced manner and establishing their own competitive supply chains. I believe that, in this process, firms are reaffirming the advantage of having bases in Japan. That is, it has become a widely acknowledged view that there are things that Japanese firms can achieve only in Japan. I expect that investment behavior that takes such a view into account will become more active.

Second, as for labor input, labor market conditions remain tight. Both manufacturers and nonmanufacturers have been voicing concern recently that they cannot provide sufficient goods or services due to labor shortages. This situation reflects the structural issues surrounding Japan's labor market – for example, labor shortages, the rigid labor market, and the insufficient job training framework. It is therefore necessary to make efforts to resolve these issues. That being said, the labor force participation rate both of women raising small children and of the elderly is rising, and this is an encouraging development as a first step to resolving these issues.

Third, in order to increase productivity, I consider it important that not only manufacturers but nonmanufacturers – the services sector, for example – make innovations to increase productivity. Indeed, let me note that there is severe price competition among commoditized goods and services that firms provide, and thus firms need to take initiatives to develop capital goods, materials, or parts with high technology, or unique high value-added goods or services with high brand value. In addition, considering that foreign firms are often pointed out as having higher productivity than Japanese firms, it seems that there is room for enhancing Japanese firms' productivity, and that making efforts to attract foreign firms' inward investment in Japan will contribute to enhancing productivity.

Firms' initiatives are essential to addressing these issues facing Japan's economy. They should not be overly pessimistic about the structural changes to the economy, such as the decrease in population. Rather, they should take these structural changes into account and take active steps toward enhancing the growth potential of the economy. The Bank, for its part, has established the Loan Support Program, through which it provides long-term funds at low interest rates so that firms and households can fully utilize accommodative financial conditions. Moreover, the Bank decided on measures to support firms' investment in physical and human capital at the MPM held in December 2015. There has been progress in converting firms' and households' deflationary mindset since the introduction of QQE, and many firms have become proactive in making investment in physical and human capital. I consider it desirable that these developments spread further.

In closing, let me underline that enhancing the growth potential of the economy is essential for the virtuous cycle in the economy to continue operating. I strongly hope that, in addition to the promotion of a growth strategy by the government, various measures and frameworks introduced by the Bank will be utilized effectively, and that this will contribute to further progress in the efforts to strengthen the growth potential of Japan's economy.

Thank you for your attention.