

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, Niigata, 31 August 2016.

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I. Recent economic and price developments

A. Overseas developments

I would like to begin my speech by talking about developments in overseas economies. In global financial markets, uncertainty over the global economy going forward heightened and investors' risk aversion rapidly strengthened in response to the result of the United Kingdom's referendum in late June, in which the majority voted to leave the European Union (EU). However, global financial markets have been regaining calmness. In this situation, overseas economies have continued to grow at a moderate pace as a whole, although the pace of growth has somewhat decelerated, mainly in emerging and commodity-exporting economies.

As for the outlook, overseas economies are expected to moderately increase their growth rates, as it is likely that advanced economies will see steady growth, and emerging economies in particular will gradually move out of their deceleration phase, mainly through their policy measures. According to the *World Economic Outlook (WEO) Update* released in July 2016 by the International Monetary Fund (IMF), global growth projections have been revised slightly downward from the April 2016 WEO, particularly for Europe, but the longer-term projection that the global growth rate will moderately increase from 2015 through 2017, from 3.1 percent in 2015 and 2016 to 3.4 percent in 2017, is unchanged.

Looking at developments by major region, the U.S. economy has been on a recovery trend on the back of firmness in household spending. As for the outlook, the industrial sector and overseas demand will likely continue to show mixed developments for the time being, but the economy is expected to continue to see firm growth driven by private demand under accommodative financial conditions.

The European economy has continued to recover moderately as private consumption continues to increase. As for the outlook, the economy is projected to see a temporary slowdown in its pace of recovery as firms' and households' sentiment is becoming cautious due to uncertainty, mainly associated with the United Kingdom's vote to leave the EU, but is likely to return to a moderate growth path.

The Chinese economy has been slightly subdued, particularly in the manufacturing sector, which faces an overhang of production capacities. As for the outlook, the economy is likely to broadly follow a stable growth path as authorities have been proactively carrying out both fiscal and financial measures to support economic activity.

Emerging economies have remained subdued, due mainly to developments in the Chinese economy, although the effects of economic stimulus measures have materialized in some economies. Commodity-exporting economies such as Brazil and Russia remain in a severe state but have started to bottom out, mainly because commodity prices have hit the bottom. As for the outlook, the growth rates of emerging economies are likely to increase gradually, due mainly to the spread of the effects of the recovery in advanced economies and to the effects of the economic stimulus measures, although differences across countries and regions are likely to remain for the time being.

Risk factors to the overseas economic outlook are wide ranging, as exemplified by (1) uncertainties associated with the United Kingdom's vote to leave the EU, (2) developments in emerging and commodity-exporting economies including China, (3) developments in the U.S.

economy and the influences of its monetary policy, (4) the European debt problem among banks, and (5) geopolitical risks such as those in the Middle East. Therefore, I consider it necessary to closely monitor various risk factors from a broad perspective in making projections regarding the outlook for 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, although exports and production have been sluggish, due mainly to the effects of the slowdown in emerging economies. On an annualized basis, after the real GDP growth rate for the October-December quarter of 2015 registered minus 1.7 percent, due partly to the effects of irregularly warm weather, that for the January-March quarter of 2016 increased, registering 2.0 percent, and that for the April-June quarter, which was released in mid-August, registered 0.2 percent; this was broadly about the same level as the growth potential when fluctuations are smoothed out.

Looking ahead, sluggishness is expected to remain in exports and production for some time, and the pace of economic recovery is likely to remain slow. Thereafter, domestic demand is likely to follow an uptrend, underpinned by a virtuous cycle from income to spending being maintained in both the household and corporate sectors, and by large-scale economic measures, and exports are expected to head toward a moderate increase as overseas economies move out of their deceleration phase. Thus, Japan's economy is likely to be on a moderate expanding trend. According to the Bank's July 2016 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), the medians of the Policy Board members' forecasts for the economic growth rate are 1.0 percent for fiscal 2016, 1.3 percent for fiscal 2017, and 0.9 percent for fiscal 2018, and the economy is expected to continue growing at a pace above its potential through the projection period.

2. Prices

Next, I will talk about price developments. The year-on-year rate of increase in the consumer price index (CPI) for all items less fresh food and energy has decelerated somewhat recently, as firms' price-setting stance has become relatively cautious against the background of relatively weak developments in some indicators of private consumption. The rate of change for all items less fresh food has been slightly negative. 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 maintained its historically high level, but is declining slightly at present.

With regard to the outlook, the year-on-year rate of change in the CPI (all items less fresh food) is likely to be slightly negative or 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, the baseline scenario is that the timing of the year-on-year rate of change in the CPI reaching around 2 percent will be during fiscal 2017, although this is accompanied by considerable uncertainties including those surrounding overseas economies going forward. Specifically, the medians of the Policy Board members' forecasts of the year-on-year rate of increase in the CPI (all items less fresh food) presented in the July 2016 Outlook Report are 0.1 percent for fiscal 2016, 1.7 percent for fiscal 2017, and 1.9 percent for fiscal 2018.¹

¹ Individual Policy Board members made their forecasts assuming that Dubai crude oil prices would rise moderately from the recent 45 U.S. dollars per barrel to around 50 dollars per barrel toward the end of the projection period; that is, fiscal 2018. Under this assumption, the contribution of energy prices to the year-on-

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 pace of increase in the number of employees has been accelerating, and the labor force participation – especially that of women and the elderly – has continued to rise. Against this backdrop, the active job openings-to-applicants ratio has continued to see a steady rise, 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 June 2016 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) has generally heightened; both indicators are almost at the same levels as around 1991–1992. The unemployment rate has continued on a moderate improving trend, albeit with some fluctuations, and has been in the range of 3.0–3.5 percent. The supply-demand conditions in the labor market are expected to further tighten. On the wage side, hourly cash earnings of part-time employees in particular, which are responsive to labor market conditions, have continued to show relatively high growth at around 1.5–2.0 percent. With regard to the outlook, on the back of the heightening of inflation expectations and the marked tightening of labor market conditions, wages are projected to rise moderately.

In light of these prospects for employment and wages, employee income is expected to continue rising moderately. Base pay for fiscal 2016 was revised upward for a third consecutive year, but to a marginally smaller extent than last year. Attention therefore should be given to how funds from profits in the corporate sector will circulate in the economy.

B. Private consumption

I will now discuss developments in private consumption, which has generally maintained its resilience against the background of steady improvement in the employment and income situation, although relatively weak developments have been seen in some indicators. The Consumption Activity Index is heading toward a pick-up, mainly in durable and non-durable goods, albeit with fluctuations. Looking at confidence indicators related to private consumption, the Consumer Confidence Index has continued to be more or less flat, while the *Economy Watchers Survey* and the DIs for business conditions of industries related to private consumption in the *Tankan* have been declining, reflecting effects such as those stemming from the wealthy being less motivated to spend on expensive goods and services, and the sluggish increase in demand from foreign visitors to Japan. With regard to the outlook, private consumption is expected to increase its resilience gradually, supported by an improvement in real employee income and the effects of various policy measures. However, I believe that it is necessary to pay attention to how the virtuous cycle from income to spending – which has been showing lackluster performance recently – will operate in the future.

year rate of change in the CPI (all items less fresh food) was estimated to be approximately in the range of minus 0.6 to minus 0.7 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 in early fiscal 2017.

C. Business fixed investment

Let me now explain developments in business fixed investment, which has been on a moderate increasing trend from a somewhat longer-term perspective, as corporate profits have been at high levels. According to the June 2016 *Tankan*, firmness is seen in business fixed investment plans for fiscal 2016 as a whole, including those of large manufacturers, for which profit projections have deteriorated as the expected exchange rate has shifted toward appreciation of the yen. As for the outlook, business fixed investment is projected to continue to see a moderate uptrend on the back of (1) corporate profits at high levels, (2) extremely stimulative financial conditions such as low interest rates and accommodative lending attitudes, (3) the effects of various policy measures from the fiscal side, and (4) moderate improvement in growth expectations. Investment for maintenance and replacement of equipment and investment in labor-saving machinery and equipment – both of which have been increasing in recent years – as well as investment in growth areas, all tend to be undertaken independently from temporary developments in corporate profits; therefore, the effects on such investment of changes in the environment surrounding corporate profits, such as the yen's appreciation and the rise in crude oil prices, are expected to be relatively small. Nevertheless, I think that it is necessary to closely monitor whether firms will shift production sites back to Japan for manufacturing products to be sold mainly in overseas markets.

D. Prices

Next, I will discuss the aggregate supply and demand balance (the output gap) and inflation expectations, which are the main factors that determine inflation rates. First, the output gap has been more or less unchanged at around 0 percent recently. It is likely to remain so for some time, but thereafter is projected to start increasing through the end of fiscal 2016, at which time it is expected that the effects of the slowdown in overseas economies will wane and that the effects resulting from the set of economic measures will become evident. From fiscal 2017, the output gap is projected to continue expanding steadily in positive territory owing to both the capital and labor factors, as domestic and foreign demand increase.

Second, medium- to long-term inflation expectations have weakened recently, although they appear to be rising on the whole from a somewhat longer-term perspective. Against the backdrop of relatively weak developments in private consumption, firms seem to be putting off price increases – mainly those of goods such as food products and durable consumer goods – since the turn of the fiscal year. As for the outlook, firms' price-setting stance is expected to revert to raising prices accompanied by a pick-up in private consumption. Turning to their wage-setting stance, the high corporate profits have continued to positively affect employee income, and the mechanism in which inflation rises moderately accompanied by wage increases has continued to operate. In such a situation, medium- to long-term inflation expectations are also likely to return to an increasing trend and gradually converge to around 2 percent – the price stability target.

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 it decided to introduce Quantitative and Qualitative Monetary Easing (QQE) as a necessary measure to underpin this commitment. The main transmission mechanism of QQE is stimulating firms' investment and households' consumption by lowering nominal interest rates through large-scale purchases of Japanese government bonds (JGBs), and by transforming people's deflationary mindset through the Bank's clear commitment and large-scale monetary easing to underpin the commitment. 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, with the new option of a negative interest rate being added.

In addition, at the MPM held in July 2016, the Bank decided on an increase in purchases of exchange-traded funds (ETFs) and measures to ensure smooth funding in foreign currencies, for two reasons: in order to prevent uncertainties that have been heightening against the backdrop of the United Kingdom's vote to leave the EU and the slowdown in emerging economies from leading to a deterioration in business confidence and consumer sentiment, and to ensure smooth funding in foreign currencies by Japanese firms and financial institutions, thereby supporting their proactive economic activities. Against the backdrop of considerable uncertainty over the outlook for prices in view of uncertainties surrounding overseas economies and global financial markets, the Bank – with a view to achieving the price stability target at the earliest possible time – also decided that it would conduct a comprehensive assessment of the developments in economic activity and prices under QQE and QQE with a Negative Interest Rate, as well as the effects of these policies, at the next MPM.

For the good of Japan's economy, it is necessary to make progress in the conversion of people's deflationary mindset that has taken hold amid the prolonged deflation, and we are only halfway to achieving the price stability target. 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 at the earliest possible time.

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.

Japan's potential growth rate, as estimated by the Bank, has declined to the range of 0.0–0.5 percent, and this reflects that the economy has experienced deflation for a long period of time.

Especially recently, it is common to hear that the future of Japan's economy is bleak because of the decrease in population and other factors. Similar opinions that arouse anxiety are expressed on an almost daily basis through various channels; as a result, a vague anxiety hangs over the society.

However, I believe that we can be more reassuring about the future of the economy. It is true that the population decline has a substantial impact on the regional and national economies. Still, in this day and age, there is enough ground for being optimistic about the future.

In this age, it is possible to plan broad-based – cross-regional or even cross-border – distribution and sales of goods and services. For example, having inbound customers means that customers from abroad are being attracted. I believe that many firms in Niigata Prefecture have customers not only inside but also outside the prefecture. The use of the internet opens up the possibility of conducting business with overseas customers, in addition to domestic customers outside the prefecture, of course. It should be noted that Japan is in Asia, the world's most rapidly growing market. If Japanese firms manage to capture such growth, it is reasonably possible to reduce the impact of the demand-side problem, or the demand shortage, caused by the population decline.

Let me turn to the supply side. The proportion of the population that is young will surely decrease, but firms are expected to increasingly make use of women and the elderly in the workforce. In terms of utilization of human resources, Japan in fact still has room for better use of personnel compared to the United States and Europe. In other words, there is enough room for further improvement in productivity. Another option is to gradually increase the

number of foreign workers in many fields. It is likely that labor-saving initiatives, such as through the use of industrial robots, will advance rapidly in factories and the like. Let me remind you that Japan is a world-class manufacturer of robots.

As illustrated, if the demographic challenges are decomposed and examined in detail, it can be said that there is no need to be completely pessimistic.

So, how should we address the demographic challenges to a better future? One possible answer is that the private sector should actively pursue structural reforms by taking advantage of the opportunity currently afforded by the bold economic measures of the government and the accommodative financial conditions generated by the Bank.

In advancing structural reforms, firms, regardless of whether they are in manufacturing or nonmanufacturing, will pursue changes in operational processes – i.e., scrap and build – in various areas such as production and sales. As a result, substantial costs will be incurred with, for example, new investment, worker retraining programs, and retirement allowances, and it will be necessary to procure funds for such costs. On this basis, cooperation between firms and financial institutions will become very important.

In closing, let me underline that firms' initiatives are essential to addressing these issues facing Japan's economy. At the same time, 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 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. Many firms have become proactive in making investment in physical and human capital. I consider it desirable that these developments spread further.

Thank you for your attention.