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Bank of Japan

Japan's Economy and Monetary Policy

Speech at a Meeting with Business Leaders in Nagoya

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(English translation based on the Japanese original)

Introduction

It is my great pleasure to have the opportunity today to exchange views with administrative, financial, and business leaders in the Chubu region. I would like to take this opportunity to express my sincerest gratitude for your cooperation with the Bank of Japan's Nagoya Branch.

At the September Monetary Policy Meeting (MPM), the Bank conducted a comprehensive assessment of monetary easing measures implemented since the introduction of quantitative and qualitative monetary easing (QQE) and, based on its findings, decided to introduce "QQE with Yield Curve Control." The new policy framework consists of two major components: the first is "yield curve control," in which the Bank facilitates the formation of the yield curve that is deemed most appropriate with a view to maintaining the momentum toward achieving the price stability target of 2 percent, and the second is an "inflation-overshooting commitment," in which the Bank commits itself to expanding the monetary base until the year-on-year rate of increase in the observed consumer price index (CPI) exceeds the price stability target of 2 percent and stays above the target in a stable manner.

Almost two months have passed since the introduction of the Bank's new policy framework, and it appears to have been perceived as positive by market participants. Looking at developments in long- and short-term interest rates, the yield curve for Japanese government bonds (JGBs) has been formed smoothly and stably in line with the guideline for market operations -- in which the short-term policy interest rate is set at minus 0.1 percent and the target level of 10-year JGB yields at around 0 percent (Chart 1). Turning to other developments in the financial markets, the yen has depreciated somewhat against the U.S. dollar in the foreign exchange market, amid the heightening speculation over the policy rate hike in the United States. In this situation, stock prices have been relatively firm. Meanwhile, in response to the outcome of the U.S. presidential election, the yen had appreciated and stock prices had declined, both to a large degree temporarily, but thereafter reverted to situations of a depreciation and an increase, respectively. The Bank will continue to carefully monitor market developments.

At the MPM held at the beginning of November, the Bank released its projections through fiscal 2018 in the *Outlook for Economic Activity and Prices* (Outlook Report). Today, I would like to explain the Bank's projections for economic activity and prices based on this Outlook Report, as well as its thinking on the conduct of monetary policy.

I. The Current Situation of and Outlook for Japan's Economic Activity and Prices

To begin with, let me make three points on the outlook for Japan's economy. Please refer to Chart 2.

The first point is that extremely powerful economic stimulus measures are being implemented, both on the monetary and fiscal sides. The Bank will adhere to powerful monetary easing under the new policy framework in order to achieve the price stability target of 2 percent, while the government will steadily implement its large-scale stimulus measures, amounting to 28 trillion yen in project size, with the Diet's recent approval of the supplementary budget. Synergy effects are produced in a case where a government proactively carries out fiscal spending while a central bank provides accommodative financial conditions with a view to achieving its price stability target; this is known to make the stimulative effects on economic activity more powerful. Indeed, such effects of the so-called policy mix are expected to be seen going forward.

The second point is that, on the back of the effects of a policy mix as well as the recovery in overseas economies, Japan's economy is likely to expand moderately, with a virtuous cycle from income to spending being maintained in both the corporate and household sectors. Specifically, as indicated in red in the chart, it is likely to continue growing at a pace above its potential through the projection period -- that is, through fiscal 2018 -- at around 1 percent.

Third, on the price front, the year-on-year rate of change in the CPI for all items less fresh food is likely to be slightly negative or about 0 percent for the time being, as shown in blue in the chart. Thereafter, the rate of change is expected to increase toward 2 percent in the second half of the projection period in line with an improvement in the output gap, as will likely be evidenced by a further decline in the unemployment rate, and a rise in medium- to long-term inflation expectations.

In what follows, I will explain the outlook for economic activity and prices in more detail.

A. The Current Situation of Economic Activity and Its Outlook

Developments in the Corporate Sector

Looking at developments in the corporate sector, exports and production have been sluggish recently, due mainly to the effects of the slowdown in emerging economies. Exports, mainly automobile-related exports, to advanced economies have remained on a steady increasing trend, whereas those to emerging economies have been sluggish, especially of capital goods. Exports as a whole have therefore been flat. Against this background, production also has been almost flat.

In terms of corporate profits, profits of manufacturing firms have been negatively affected by the slowdown in emerging economies and the yen's appreciation (Chart 3). Nevertheless, those of all industries, including nonmanufacturing firms, have been at a level close to record highs, reflecting an improvement in the terms of trade resulting from the low crude oil prices. The diffusion index (DI) for business conditions in the September 2016 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) has generally stayed at a favorable level. Against this backdrop, firms, including large manufacturers, have maintained their positive fixed investment stance.

With regard to the outlook, although overseas economies are projected to remain slightly subdued for some time, they are expected to gradually increase their growth rates as advanced economies continue growing steadily and the effects of such steady growth spread to emerging economies. Against this background, exports and production are expected to start increasing moderately. Business fixed investment may be affected temporarily partly by the slowdown in overseas economies and the past yen appreciation. However, it is likely to continue increasing moderately as the highly accommodative financial conditions continue and growth expectations rise moderately.

Developments in the Household Sector

Next, I would like to turn to developments in the household sector. Positive developments in the corporate sector have steadily exerted positive effects on the employment and income situation (Chart 4). The tightening trend of labor market conditions has become more evident and the latest active job openings-to-applicants ratio was 1.38 times, marking the highest level seen since 1991. The unemployment rate has been about 3 percent, which is virtually "full employment." A perception of labor shortage suggested by the employment conditions DI in the September *Tankan* has heightened further. Against this background, wages have increased moderately.

Despite such improvements in the employment and income situation, private consumption has lacked momentum somewhat. Looking back, private consumption was relatively weak in the first half of 2016, due mainly to the negative wealth effects brought about by the decline in stock prices. However, various sales statistics show that it has started to pick up recently, despite being affected by bad weather conditions such as typhoons. Confidence indicators related to private consumption also have been picking up (Chart 5). Based on this situation, private consumption is expected to increase moderately on the back of the continued steady improvement in the employment and income situation.

B. The Current Situation of Prices and Their Outlook

Next, I would like to touch on price developments. The year-on-year rate of change in the CPI for all items less fresh food has been slightly negative due to the effects of the decline in energy prices (Chart 6). Meanwhile, that for all items less fresh food and energy has remained positive for exactly three years since October 2013. This is the first time since the late 1990s, when Japan's economy fell into deflation, that the inflation rate has been positive for such a long period. However, it has slowed recently. This is mainly attributable to the fact that prices, such as for durable goods, have declined due to the effects of the past appreciation of the yen, and that firms' price-setting stance has become slightly cautious, reflecting weakness in private consumption in the first half of 2016.

The year-on-year rate of change in the CPI for all items less fresh food is likely to be slightly negative or about 0 percent for the time being, and increase toward 2 percent in the second half of the projection period -- that is, through fiscal 2018. The following four points can be highlighted as the background to this outlook.

The first point is with regard to developments in energy prices, such as crude oil prices. The downward pressure of the past decline in energy prices on the CPI is expected to dissipate going forward and the negative contribution of energy items is estimated to reach around 0 percentage point in early 2017 (Chart 7). Therefore, the CPI for all items less fresh food -- for which the year-on-year rate of change is currently minus 0.5 percent -- is expected to reduce its rate of decline rapidly and turn positive.

The second point is that, as I have explained earlier, private consumption has bottomed out recently on the back of improvement in the employment and income situation, and is expected to increase moderately. With such developments, firms' price-setting stance is expected to revert to raising prices.

The third point is that labor market conditions are expected to further tighten, exerting upward pressure on wages accordingly. In this context, how the labor-management wage negotiations next spring develop warrants particular attention. Corporate profits have been at a level close to record highs, and labor market conditions have tightened, as evidenced by the fact that the unemployment rate has declined to around 3 percent. Under these circumstances, the environment for wage increases is certainly well established.

The fourth point is that, as the Bank pursues powerful monetary easing under its "inflation-overshooting commitment," inflation expectations will likely rise. I will elaborate on this later.

In this manner, it is the Bank's assessment that, despite the recent weakness in price developments, the momentum toward achieving the price stability target of 2 percent seems to be maintained. However, risks to both economic activity and prices are skewed to the downside, particularly those regarding overseas factors. Moreover, the projections for prices in the October 2016 Outlook Report have been revised slightly downward compared with those in July, and the timing of the year-on-year rate of change in the CPI reaching around 2 percent will likely be around fiscal 2018. The momentum toward achieving the 2 percent target is somewhat weaker than the previous outlook, and thus developments in prices warrant careful attention going forward. The major reason behind these downward revisions lies in developments in medium- to long-term inflation expectations. Let me now move on to this point.

II. Inflation Expectations and the Conduct of Monetary Policy

To put it simply, inflation expectations are people's outlook for prices, or their perception of future price developments. In a situation where the price stability target of 2 percent is achieved in a stable manner, people will share the view that annual inflation will be around 2 percent, and such view will be a key determinant of prices of goods and services, as well as wages. With the aim of dramatically changing the deflationary mindset that had been entrenched among people and raising inflation expectations to 2 percent, the Bank -- under QQE introduced in April 2013 -- has strongly and clearly committed itself to achieving the price stability target and conducted large-scale monetary expansion to underpin this commitment.

After the introduction of QQE, inflation expectations increased significantly through around summer 2014 (Chart 8). This clearly shows that monetary policy is effective in raising inflation expectations. Thereafter, however, with headwinds such as a significant decline in crude oil prices, weak demand following the consumption tax hike, and volatility in global financial markets reflecting the slowdown in emerging economies, inflation expectations resumed their decline from summer 2015 and have remained in a weakening phase. In Japan, where deflation has been persistent for a prolonged period, inflation expectation formation still tends to be largely affected by developments in observed inflation rates. As observed inflation rates had actually declined before the conversion in people's perception about inflation toward 2 percent, the decline in actual inflation seemed to have brought inflation expectations down as well.

In order to address this situation, the Bank judged it necessary to adopt more forceful measures to raise inflation expectations and introduced an "inflation-overshooting commitment." Specifically, under this commitment, 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 the target in a stable manner. The price stability target needs to be achieved on average over the business cycle. Thus, it naturally is assumed that there would be phases when the observed CPI exceeds 2 percent. As it takes some time for monetary policy to have an impact on economic activity and prices, it is exceptional for the central bank to make such a strong commitment that is based on the observed CPI. Through this exceptional commitment, the Bank aims to enhance the credibility of achieving 2 percent among the public.

Let me elaborate on this point. Given that the inflation rate in Japan has been lower than 2 percent for a long period, it is necessary for the public to experience the process whereby the inflation rate actually exceeds 2 percent before converging to the 2 percent target. Through such experience, the perception that annual inflation will be around 2 percent will take hold among the public. The Bank committed itself to continue with large-scale monetary expansion until this process is completed. The new policy framework is designed to enable the Bank to pursue monetary easing in a flexible manner through yield curve control. Under "QQE with Yield Curve Control," the Bank will pursue powerful monetary easing and make policy adjustments as appropriate, taking account of developments in economic activity and prices as well as financial conditions, with a view to maintaining the momentum toward achieving the price stability target of 2 percent.

As described in the Bank's "Comprehensive Assessment," the annual labor-management wage negotiations in Japan tend to be influenced by the inflation rate in the preceding year, and this is one of the reasons why inflation expectations are affected by the past inflation rate. On the other hand, in Europe and the United States, medium- to long-term inflation expectations that are anchored by central banks' price stability targets are the crucial factor that determines wages. As I mentioned earlier, labor market conditions are likely to continue tightening and the inflation rate will increase steadily toward 2 percent as the Bank pursues aggressive monetary easing. In the course of Japan's economy experiencing such a significant change, making proactive investment in human capital, including determining wages based on the 2 percent inflation benchmark, will benefit individual firms in terms of medium- to long-run management, not to mention that it is crucial for Japan's economy as a whole.

Conclusion

In concluding, let me touch on the economy of the Chubu region. The economy centered on Nagoya is the core of Japan's manufacturing. Challenges taken by many industries and firms in anticipation of future potential can become the driving force for raising Japan's potential growth rate, which is at a low level currently. For example, in the automobile industry, which is the leading industry of the region, initiatives to introduce next-generation technology -- such as environmentally friendly features as well as automatic- and safe-driving systems -- are proceeding rapidly. In addition, in aircraft-related industries, formation of industrial clusters in the region is starting to make steady progress, and there are increasing numbers of cases where small and medium-sized parts manufacturers are working in an integrated manner in terms of receiving orders and producing parts. Furthermore, such proactive production activities by manufacturers are inducing fixed investment by a wide range of firms, including nonmanufacturers. I would like to close my speech by expressing my sincere hope that these dynamic initiatives by the industrial sector, combined with financial institutions' and the local government's support, will lead to further growth and development of the Chubu region.

Thank you.

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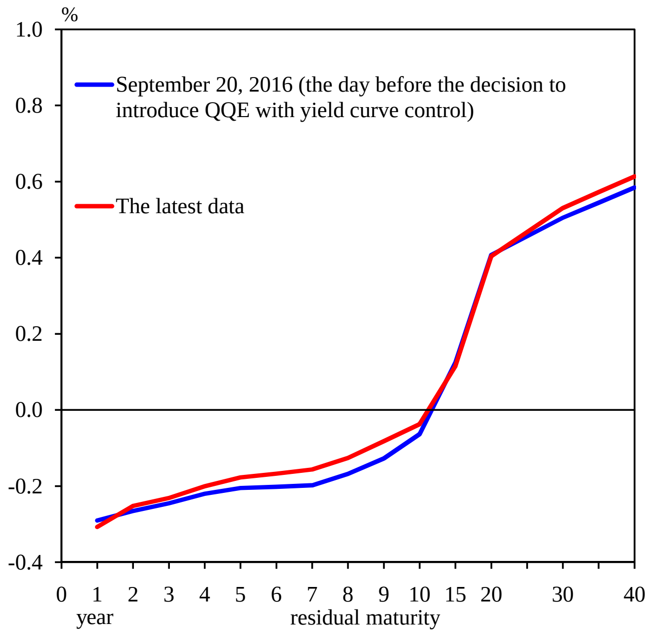
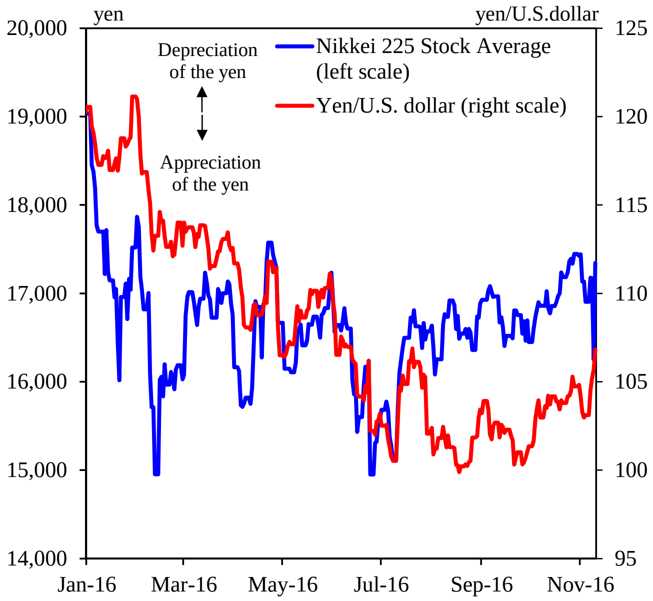
Chart 1

Developments in Financial Markets

Changes in JGB Yield Curve



Exchange Rates and Stock Prices



Source: Bloomberg.

Outlook for Economic Activity and Prices (as of October 2016)

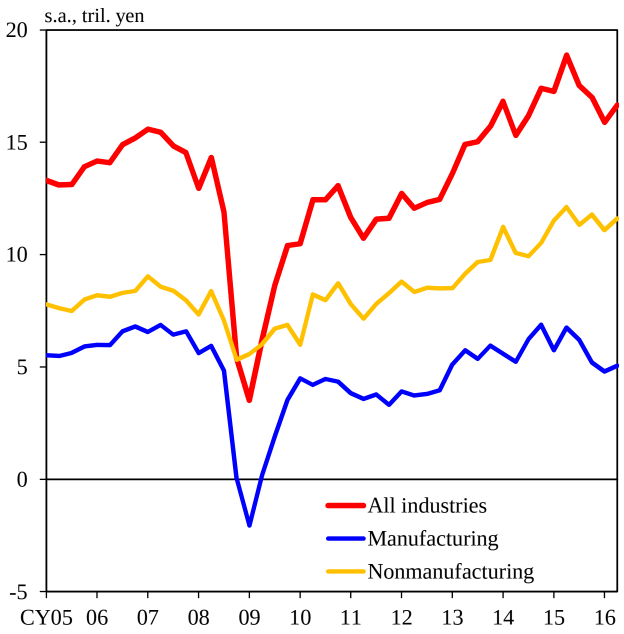
y/y % chg.

	Real GDP	CPI (all items less fresh food)
Fiscal 2016	＋1.0	－0.1
Forecasts made in July 2016	＋1.0	＋0.1
Fiscal 2017	＋1.3	＋1.5
Forecasts made in July 2016	＋1.3	＋1.7
Fiscal 2018	＋0.9	＋1.7
Forecasts made in July 2016	＋0.9	＋1.9

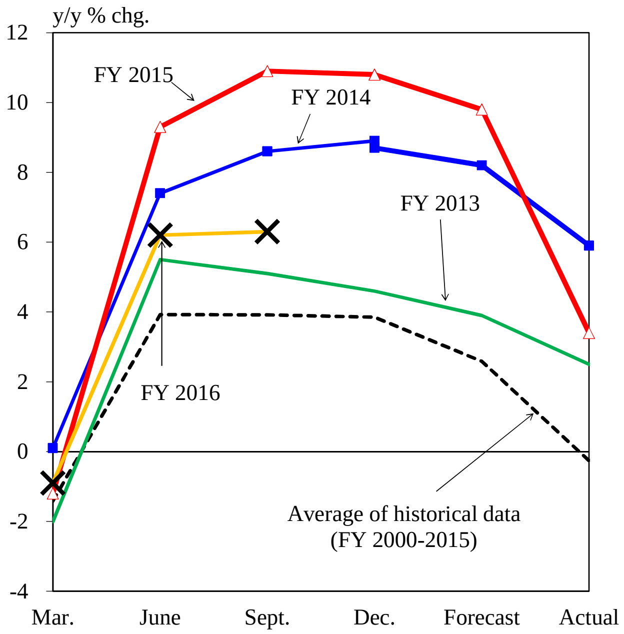
Note: Figures indicate the median of the Policy Board members' forecasts (point estimates).
Source: Bank of Japan.

Corporate Profits and Business Fixed Investment

Current Profits



Business Fixed Investment Plans (Tankan, Large Enterprises)

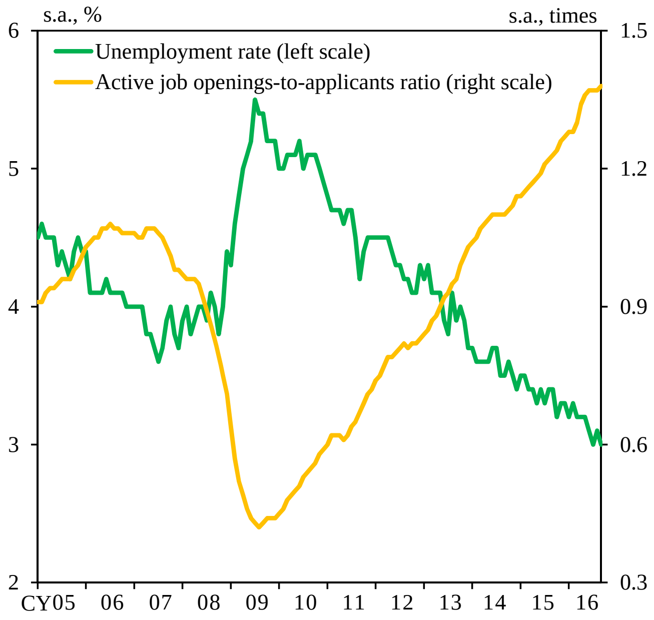


Notes: 1. Figures for current profits exclude "Finance and Insurance."
2. Figures for business fixed investment plans include land purchasing expenses and exclude software investment.
Sources: Ministry of Finance; Bank of Japan.

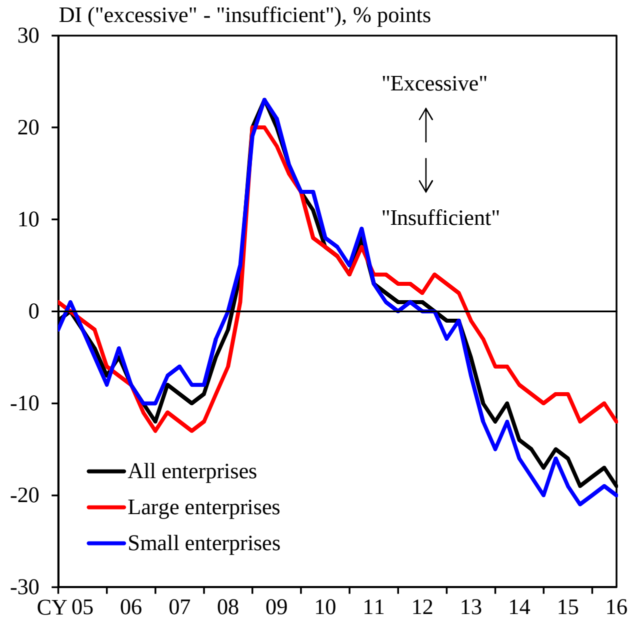
Chart 4

Labor Market Conditions

Unemployment Rate and Active Job Openings-to-Applicants Ratio



Tankan: Employment Conditions DI

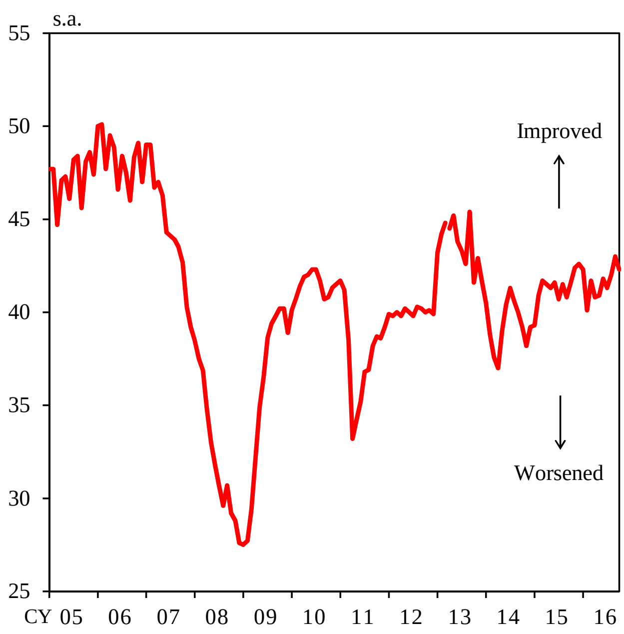


Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Bank of Japan.

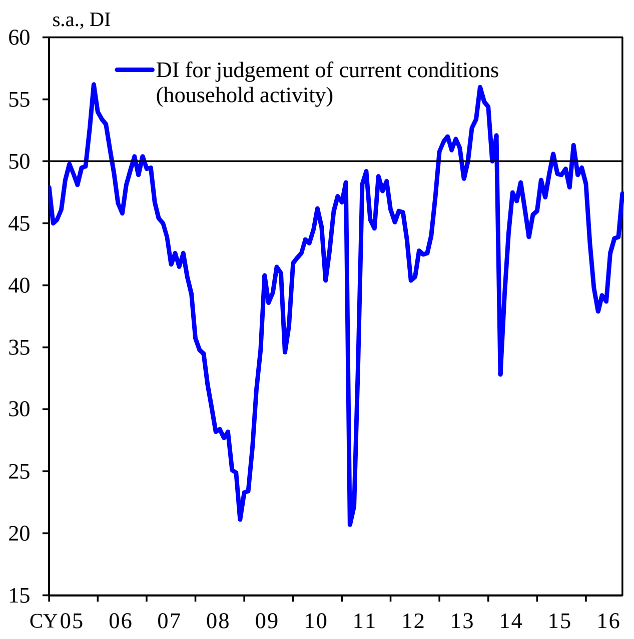
Chart 5

Confidence Indicators Related to Private Consumption

Consumer Confidence Index

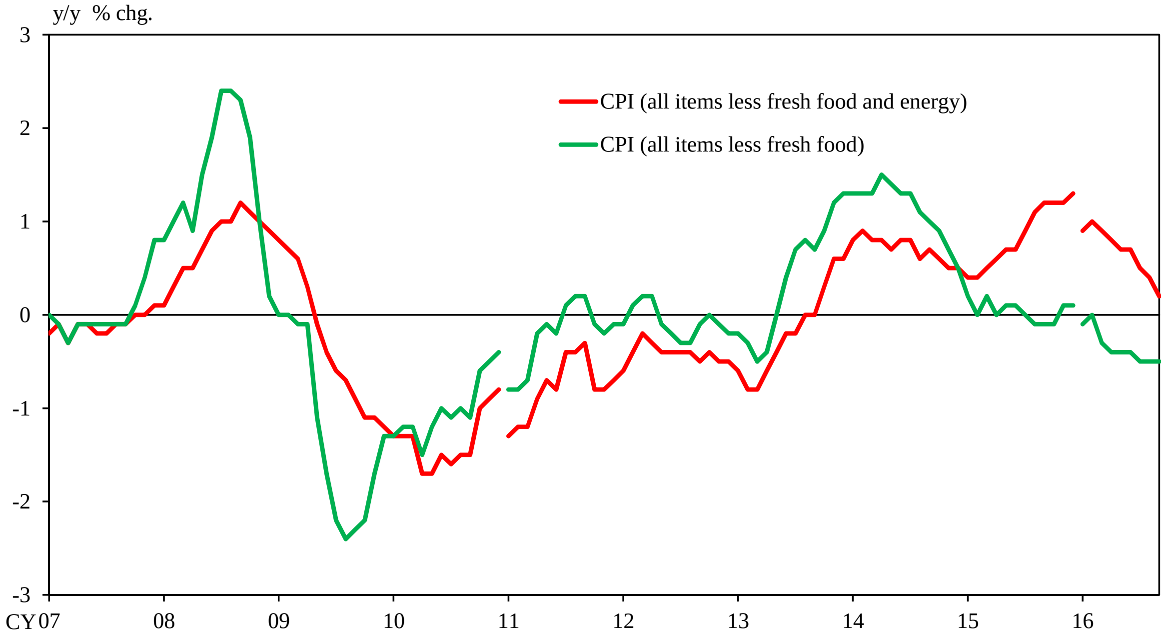


DI for Judgement of Current Conditions (Economy Watchers Survey)



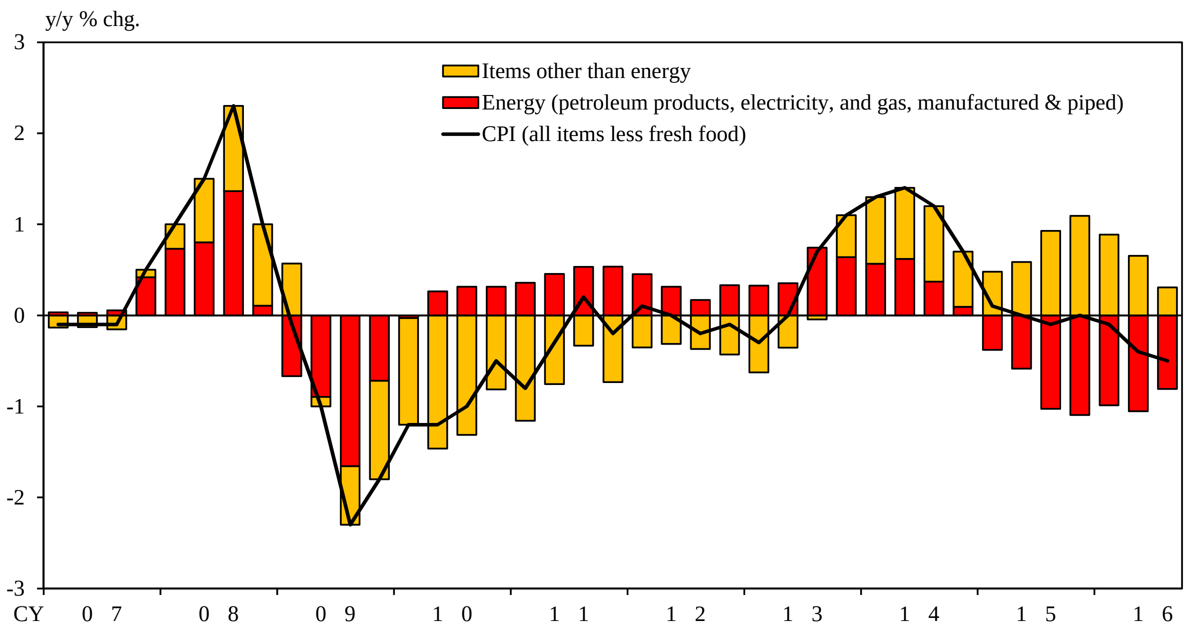
Note: There is a discontinuity in the data for the Consumer Confidence Index in April 2013 due to a change in the survey method.
Source: Cabinet Office.

Consumer Prices



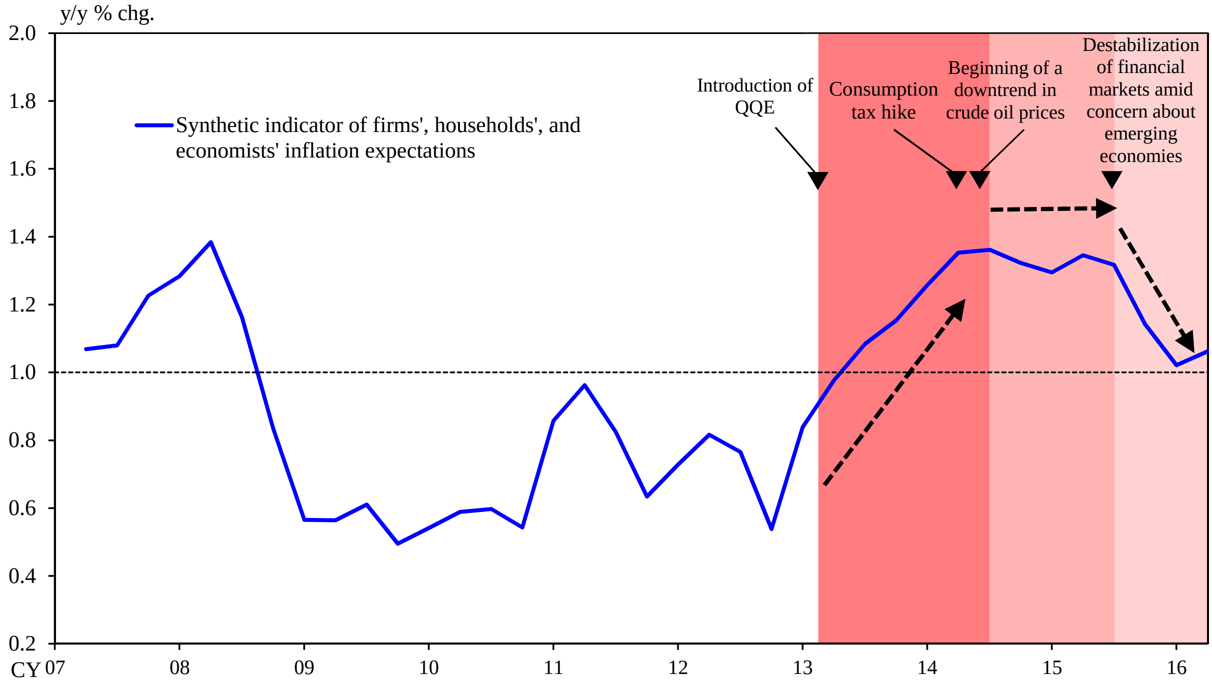
Note: Figures for the CPI (all items less fresh food and energy) are calculated by the Research and Statistics Department, Bank of Japan. Figures for the CPI are adjusted to exclude the estimated effects of changes in the consumption tax rate.
Source: Ministry of Internal Affairs and Communications.

Consumer Price Index and Energy Prices



Note: 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.

Inflation Expectations after the Introduction of QQE



Notes: 1. Inflation expectations of firms, households, and economists are represented by the *Tankan*, the "Opinion Survey," and the "Consensus Forecasts," respectively.
2. Semiannual data from the "Consensus Forecasts" up through 2014/Q2 are linearly interpolated. "Opinion Survey" figures exclude inflation expectations by respondents whose annual inflation expectations were +5% percent or greater and -5% percent or smaller. The output prices DI in the *Tankan* represents the difference between the share of firms that raised prices in the preceding three months and the share of firms that lowered prices.

Sources: Consensus Economics Inc., "Consensus Forecasts"; Bank of Japan.