May 10, 2017

Bank of Japan

Outlook for Economic Activity and Prices and Monetary Policy

Speech at a Meeting Held by the Naigai Josei Chosa Kai (Research Institute of Japan) in Tokyo

Haruhiko Kuroda

Governor of the Bank of Japan

(English translation based on the Japanese original)

Introduction

It is my great honor to have the opportunity to address you today at the Naigai Josei Chosa Kai.

At the Monetary Policy Meeting (MPM) held at the end of April, the Bank formulated its projections for Japan's economic activity and prices as well as risk factors through fiscal 2019, and released them in the *Outlook for Economic Activity and Prices* (Outlook Report). Today, I would like to talk about the Bank's outlook for Japan's economic activity and prices as well as its thinking behind the conduct of monetary policy, while outlining the Outlook Report.

I. Current Situation of Japan's Economic Activity and Its Outlook

Stronger Global Economic Growth Momentum

Let me start by talking about global economic developments. In the first half of 2016, pessimistic views about the global economy prevailed amid turbulence in global financial markets against the background of the slowdown in emerging economies and uncertainties regarding those economies. With the benefit of hindsight, however, it appears that the global economy hit bottom in the first half of 2016. Since mid-2016, the global economy has continued to improve steadily, and its growth momentum now seems to be strengthening further. In particular, a global improvement in the manufacturing sector and trade activity has become clear. For example, an indicator of the overall business conditions in the manufacturing sector has continued on an improving trend in advanced economies as well as emerging and commodity-exporting economies (Chart 1). In addition, with regard to the world trade volume -- calculated by adding up imports in each country -- a pick-up in the trade volumes has been spreading globally, mainly for Asia and the United States (Chart 2). The world trade volume had tended to grow at a slower pace than world economic growth for a long period since the global financial crisis, and such deceleration in growth of the world trade volume is called "slow trade." As regards the background to this, structural factors such as a pause in the expansion of the global supply chain have been pointed out, in addition to a cyclical decline in demand. The recent global improvement in the manufacturing sector and trade activity draws attention as this may suggest a change is finally taking place from such slow trade.

The World Economic Outlook (WEO) released by the International Monetary Fund (IMF) last month also projects that the global economic growth rate will gradually increase, registering 3.1 percent in 2016, 3.5 percent in 2017, and 3.6 percent in 2018.

Current Situation of Japan's Economic Activity

Reflecting such improvement in the global economy, the economic growth in Japan has taken hold more firmly. While the Bank had previously assessed that the economy had "continued its moderate recovery trend," the assessment was revised upward in the April 2017 Outlook Report, describing the economy as "having been turning toward a moderate expansion." This is based on the fact that, with the virtuous cycle led by exports and production becoming firmer, the output gap -- which shows the utilization of capital and labor and is defined such that its long-term average is 0 percent -- has turned positive (Chart 3).

Let me elaborate on this point. In the corporate sector, exports and production have been on an increasing trend, mainly on the back of the cyclical improvement in the manufacturing sector on a global basis led by IT-related industries, as well as inventory and capital stock adjustments progressing in emerging economies (Chart 4). In this situation, corporate profits have been improving and the ratio of current profits to sales for all industries and enterprises for the October-December quarter of 2016 marked record profits (Chart 5). The March 2017 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) suggested that business sentiment has improved in a wider range of industries. Under such circumstances, business fixed investment has been on a moderate increasing trend.

Improvements also have been observed in the household sector. The employment and income situation has continued to improve steadily. The active job openings-to-applicants ratio is almost comparable to the peak level observed during the "asset bubble" period, with the latest figure being 1.45 times, and a perception of labor shortage suggested by the diffusion index (DI) for employment conditions in the March *Tankan* has heightened further (Chart 6). The unemployment rate has declined to the range of 2.5-3.0 percent recently, which is virtually full employment. Under such tightening of labor market conditions, wages have been rising moderately (Chart 7). In particular, the year-on-year rate of increase in hourly cash earnings of part-time employees, which are responsive to labor market conditions, has accelerated, being at around 2 percent of late. As for scheduled cash earnings of full-time employees, many firms are expected to raise their base pay for the fourth consecutive year in the annual spring labor-management wage negotiations this year. Base pay rises are especially evident this year in small and medium-sized firms that face higher labor shortages. Against the background of such improvement in the employment and income situation, private consumption has been resilient. Although relatively weak developments had been seen in some of its indicators in the first half of 2016, it has picked up thereafter, due mainly to an improvement in consumer sentiment. The Consumption Activity Index (CAI) -- which the Bank calculates by combining various sales and supply-side statistics -- has followed a moderate increasing trend since the second half of 2016 (Chart 8).

Outlook for Japan's Economic Activity

With regard to the outlook, Japan's economy is likely to continue its moderate expansion. Specifically, with the growth rates in overseas economies increasing moderately, a virtuous cycle from income to spending is likely to be 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. Under such circumstances, the economy is likely to continue expanding and maintain growth at a pace above its potential, mainly through fiscal 2018. At present, Japan's potential growth rate as estimated by the Bank is in the range of 0.5-1.0 percent; the medians of the Policy Board members' forecasts of the growth rates for fiscal 2017 and 2018 were 1.6 percent and 1.3 percent, respectively (Chart 9). These projections are more or less unchanged from those presented in the January 2017 Outlook Report.

In fiscal 2019, for which the outlook was newly formulated in the latest Outlook Report, the growth pace is projected to decelerate, although the economy is expected to continue expanding. The first reason for the forecast concerns cyclical adjustments in capital stock. That is, the current economic expansion phase has been continuing since end-2012, and it would have lasted for a considerably long period by fiscal 2019. Considering the business cycle, therefore, business fixed investment in particular is likely to decelerate. Furthermore, peaking out of the Olympic Games-related demand would also exert an impact on the cyclical adjustments. The second reason is the scheduled consumption tax hike. In the April 2017 Outlook Report, economic projections were formulated based on the assumption that the consumption tax will be raised to 10 percent in October 2019 pursuant to the provisions of the law. The scheduled consumption tax hike will affect the growth rates through the following two channels: (1) the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike and (2) the effects of a decline in real income. The negative impact of the consumption tax hike on the projected growth rate for fiscal 2019 is expected to be smaller than that on the rate for fiscal 2014, when the last tax hike took place, mainly because the increase in the consumption tax rate is smaller than that of the previous tax hike and a reduced tax rate will be applied to such items as food and beverages. However, it should be noted that the impact of the consumption tax hike is highly uncertain and varies depending, for example, on the income situation and price developments. The impact of the next tax hike in particular should be regarded as being subject to a considerable margin of error because it is scheduled to take place as far off as two and a half years from now.

II. Current Situation of Prices and Their Outlook

Current Situation of Prices

Next, I will talk about price developments. Since the second half of 2014, the year-on-year rate of change in the consumer price index (CPI) excluding fresh food had remained under downward pressure stemming from the decline in crude oil prices; however, with energy prices now starting to exert upward pressure on general prices, the rate of change turned positive in January 2017 for the first time in 13 months. Meanwhile, looking at the year-on-year rate of change in the CPI excluding fresh food and energy, while this had been in negative territory before the introduction of quantitative and qualitative monetary easing (QQE) in April 2013, it turned positive in autumn 2013. Thereafter, the rate of change has been positive as a trend for more than three years (Chart 10). Japan's economy is no longer in deflation, which is commonly defined as a sustained decline in prices.

Nevertheless, the year-on-year rate of increase in the CPI excluding 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. Some weakness in the CPI observed last year appears to have been affected by firms' cautious price-setting stance against the background of relatively weak private consumption and by the appreciation of the yen. In recent months, the reduction in prices of and charges for mobile phones has exerted a considerable impact on the CPI. Such temporary developments in specific sectors should be considered separately from the underlying trend in inflation. However, looking at the CPI as a whole, it is also true that the inflation momentum is not yet sufficiently firm. Meanwhile, inflation expectations also have remained in a weakening phase. Various market indicators and survey results indicate that inflation expectations have not yet picked up clearly on the whole, although some of them show a rise in such expectations.

Momentum toward Achieving the Price Stability Target of 2 Percent

As I have explained, there is some contrast observed between recent economic activity and prices, in that the real economy has been improving steadily, whereas price developments have remained sluggish thus far. However, we believe that the momentum toward achieving the price stability target of 2 percent has been maintained firmly and the year-on-year rate of change in the CPI excluding fresh food is likely to increase toward 2 percent.

Specifically, we expect the following mechanism for higher inflation going forward. First, further improvement in the output gap, mainly on the back of further tightening of labor market conditions, will lead to a rise in the inflation rate through wage increases. Second, energy prices will push up the CPI and their contribution to it will increase through the second half of 2017. Third, with these factors pushing up actual inflation rates, inflation expectations are expected to rise accordingly, leading to an increase in the underlying trend in inflation. Let me elaborate on this mechanism.

Recently, more firms are taking initiatives to improve working conditions, including wages, in order to address increased demand and labor shortage. Looking at historical developments, there has been a stable relationship observed between the CPI and hourly nominal wages in Japan, where their rates of increase move almost in parallel. In fact, prices of goods and services have been increasing steadily. The Bank aims at a moderate rise in the CPI inflation accompanied by a rise in corporate profits and wages, and these developments are exactly what we expect. However, it is also true that wage increases are relatively moderate despite the tightening of labor market conditions and a rise in corporate profits. One of the reasons behind this is that, after having experienced protracted deflation, the mindset and behavior based on the assumption that prices will not increase have been deeply entrenched among the public. For instance, in the annual spring labor-management wage negotiations, a base pay rise is usually negotiated based on the previous fiscal year's inflation rate. Some firms have started to cut back their services in response to a rise in labor costs in real terms due to wage increases and a reduction in hours worked, instead of raising prices of their goods and services. This is another example of the persistent deflationary mindset. It is not easy to dispel this mindset. That said, the environment surrounding wages and inflation has been improving steadily, albeit at a moderate pace. It is important to ensure that this positive trend continues going forward.

Medium- to long-term inflation expectations -- that is, people's perception of future price developments -- are a crucial factor that determines the inflation rate from a relatively long-term perspective. As pointed out in the Bank's Comprehensive Assessment released in September 2016, inflation expectations going forward in Japan tend to be largely affected by actual inflation rates. This tendency is described as the inflation expectation formation being largely "adaptive," in somewhat technical terms. Since summer 2015, inflation expectations have been in a weakening phase, and this is mainly attributable to the fact that actual inflation rates had declined against the backdrop of a fall in crude oil prices and the headwinds for the global economy, which I mentioned at the outset. However, going forward, this mechanism is expected to work in the opposite direction. That is, if actual inflation rates rise on the back of increases in wages and energy prices, this rise will lead to an increase in inflation expectations, through the adaptive mechanism. The Bank aims to eventually achieve a situation where people's inflation expectations are firmly anchored at 2 percent even if actual inflation rates fluctuate due to various factors. In order to achieve that situation, however, actual inflation rates need to be raised first. While an increase in the CPI due to energy prices is transitory, this rise will work as a driving force for raising inflation expectations.

Against this background, 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 April 2017 Outlook Report are 1.4 percent for fiscal 2017, 1.7 percent for fiscal 2018, and, on a basis excluding the direct effects of the scheduled consumption tax hike, 1.9 percent for fiscal 2019 (Chart 9). The forecasts through fiscal 2018 are more or less unchanged from those presented in the January Outlook Report. The timing of the rate of change in the CPI reaching around 2 percent will likely be around fiscal 2018, which also is unchanged from the previous Outlook Report. In fiscal 2019, the rate of change is expected to remain at around 2 percent as inflation expectations rise.

III. Risk Factors for Economic Activity and Prices Going Forward

There are upside and downside risk factors to the baseline scenario for economic activity and prices that I have explained thus far. Next, I would like to talk about the major risk factors.

The largest risk factor for economic activity is developments in overseas economies. While it is true that the global economic growth momentum has been increasing, uncertainties regarding future developments have remained high.

In particular, the U.S. economic policies and their impact on global financial markets warrant attention. The U.S. government has released the tax reform plan recently; it is necessary to carefully monitor how the specifics of its economic policies as a whole and its initiatives toward implementing these policies will play out. With regard to developments in the financial markets, stock prices and the long-term interest rate have risen significantly since last autumn on the back of expectations for the new administration's aggressive policy conduct. In the meantime, there was a phase where they declined somewhat amid uncertainties regarding its economic policies. Since the U.S. economic policies can largely affect not only its economy but also the global economy and financial markets, the new administration's policy direction and its effects warrant careful attention.

In Europe, there are noticeable risk factors such as (1) national elections scheduled to be held in some major economies, in addition to the presidential election held recently in

France, (2) negotiations on the United Kingdom's exit from the European Union (EU) and their effects, and (3) prospects regarding the European debt problem, including the financial sector. In addition, developments in emerging and commodity-exporting economies as well as various geopolitical risks are uncertain. It is therefore necessary to continue to pay close attention to the possibility that these risk factors will affect the economy through volatility in global financial markets and possible deteriorations in people's sentiment. On the other hand, we also should keep in mind that, given that market participants and economic entities already factor these risks in to a certain extent, the economy could deviate upward from the baseline scenario through a rise in sentiment depending on how they play out.

In addition to the risks mentioned earlier, developments in firms' and households' medium- to long-term inflation expectations warrant due attention as they would directly affect inflation going forward. While we expect that inflation expectations are likely to follow an increasing trend, given that actual inflation rates have been somewhat weak recently, uncertainty remains regarding the momentum to push up inflation expectations through the "adaptive expectation formation mechanism." In the baseline scenario, firms' price- and wage-setting stance is expected to become more positive as inflation expectations increase. However, it should be noted that their price- and wage-setting stance could remain more cautious than the baseline scenario, depending on developments in inflation expectations.

IV. The Bank's Conduct of Monetary Policy

Lastly, I would like to touch upon the thinking behind the Bank's conduct of monetary policy. In September 2016, the Bank introduced "QQE with Yield Curve Control" -- a new framework for monetary easing -- and thereby strengthened the two previous policy frameworks of QQE and "QQE with a Negative Interest Rate." This new framework consists of two components (Chart 11).

The first is an inflation-overshooting commitment. This is a strong commitment that the Bank will continue expanding the monetary base until the year-on-year rate of increase in the actual CPI exceeds 2 percent and stays above that level in a stable manner. As I explained earlier, taking into account that inflation expectation formation is largely adaptive in Japan, it is crucial that the public actually experience inflation above 2 percent and thereby the perception takes hold among them that prices of goods and services tend to go up every year by around 2 percent. With this in mind, the Bank committed itself to continue with large-scale monetary expansion until such situation is achieved through this unique inflation-overshooting commitment.

The second component is yield curve control. This aims to seek a decline in real interest rates, which has been the main transmission mechanism of policy effects since the introduction of QQE, by controlling short- and long-term interest rates. Under yield curve control, the Bank has been facilitating the formation of the yield curve that is considered most appropriate for maintaining the momentum toward achieving the price stability target of 2 percent, taking account of developments in economic activity and prices as well as financial conditions. 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.

Almost eight months have passed since the Bank introduced "QQE with Yield Curve Control." Under this framework, the yield curve has been formed smoothly in a manner consistent with the guideline for market operations. Against this background, financial conditions have been highly accommodative. The year-on-year rate of increase in the amount outstanding of bank lending has been accelerating to around 3 percent recently, on the back of increases in demand for funds related to mergers and acquisitions and in those for business fixed investment. As this indicates, the monetary easing effects have prevailed steadily.

As I explained earlier, although the economic growth in Japan has taken hold more firmly, there is still a long way to go to achieve the price stability target of 2 percent, and the inflation momentum is not yet sufficiently firm. Risks have continued to be skewed to the downside, particularly those regarding developments in overseas economies and in firms' and households' medium- to long-term inflation expectations. Under these circumstances, I believe it is of utmost importance that the Bank maintain the current guideline for market operations and persistently pursue powerful monetary easing.

Meanwhile, as I have stated repeatedly, the Bank's JGB purchases are conducted to achieve the target level of interest rates specified by the guideline for market operations decided at each MPM. The actual conduct of JGB purchases is, in that regard, determined practically. As a result, such factors as the amount of JGB purchases at each individual auction may vary depending on financial market conditions. However, this has no implications for monetary policy going forward.

With regard to the future conduct of monetary policy, the Bank decides the guideline for market operations at each MPM with a view to facilitating the formation of the yield curve that is deemed most appropriate for maintaining the momentum toward achieving the price stability target of 2 percent, taking account of developments in economic activity and prices as well as financial conditions. In this regard, as the global interest rate environment is changing in response to the pick-up in global growth momentum and the Federal Reserve proceeding with the policy rate hikes, some argue that the Bank should take these changes into account in conducting its monetary policy. It should be noted, however, that each central bank pursues monetary policy with the aim of achieving their domestic mandate of supporting economic activity and ensuring price stability. Since the conduct of monetary policy depends on their own economic and price developments, it is natural that there is a divergence in their policy directions reflecting differences in the underlying economic conditions and inflation. The Bank will continue to conduct monetary policy in an appropriate manner, taking into account domestic economic and price developments, in order to achieve the price stability target of 2 percent at the earliest possible time.

Conclusion

Four years have passed since the Bank introduced QQE in April 2013. In the meantime, Japan's economic activity and prices have improved significantly. Although it is taking a long time to change the deflationary mindset that has been entrenched among the public for many years, the situation is improving steadily toward achieving the price stability target of 2 percent. What is of utmost importance is to continue with monetary easing until the Bank achieves the 2 percent target. The current policy framework -- "QQE with Yield Curve Control" -- is a highly sustainable framework that is designed to enable the Bank to take flexible responses to address various changes in the situation. The Bank will achieve the price stability target of 2 percent by persistently pursuing powerful monetary easing under this framework.

Thank you.

Outlook for Economic Activity and Prices and Monetary Policy

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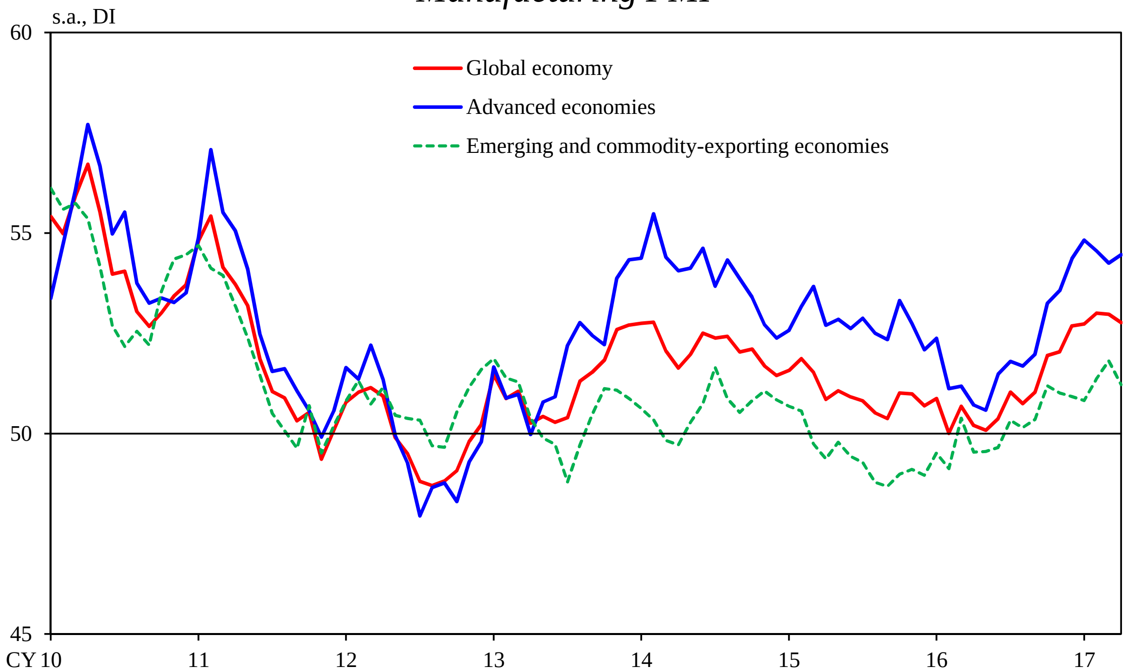
May 10, 2017

Haruhiko Kuroda
Governor of the Bank of Japan

Chart 1

Manufacturing Conditions

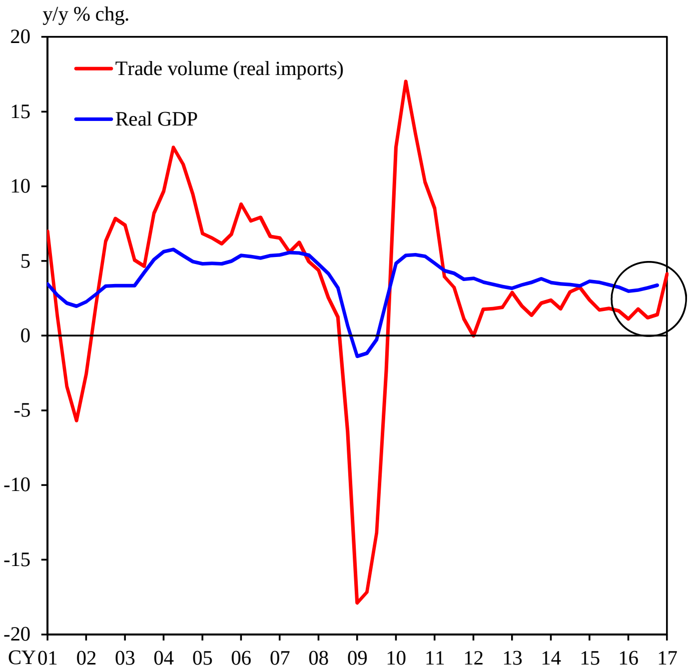
Manufacturing PMI

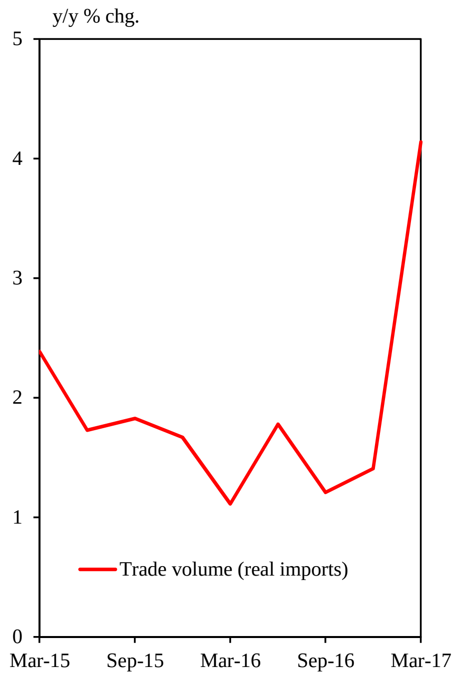


Note: Figures for the global economy are the J.P.Morgan Global Manufacturing PMI. Figures for advanced economies as well as emerging and commodity-exporting economies are calculated as the weighted averages of the Manufacturing PMI using PPP-adjusted GDP shares of world total GDP from the IMF as weights. Advanced economies consist of the United States, the euro area, the United Kingdom, and Japan. Emerging and commodity-exporting economies consist of 17 countries and regions, including China, South Korea, Taiwan, Russia, and Brazil.
Sources: IMF; IHS Markit (© and database right IHS Markit Ltd 2017. All rights reserved.); Haver.

Chart 2

World Trade Volume

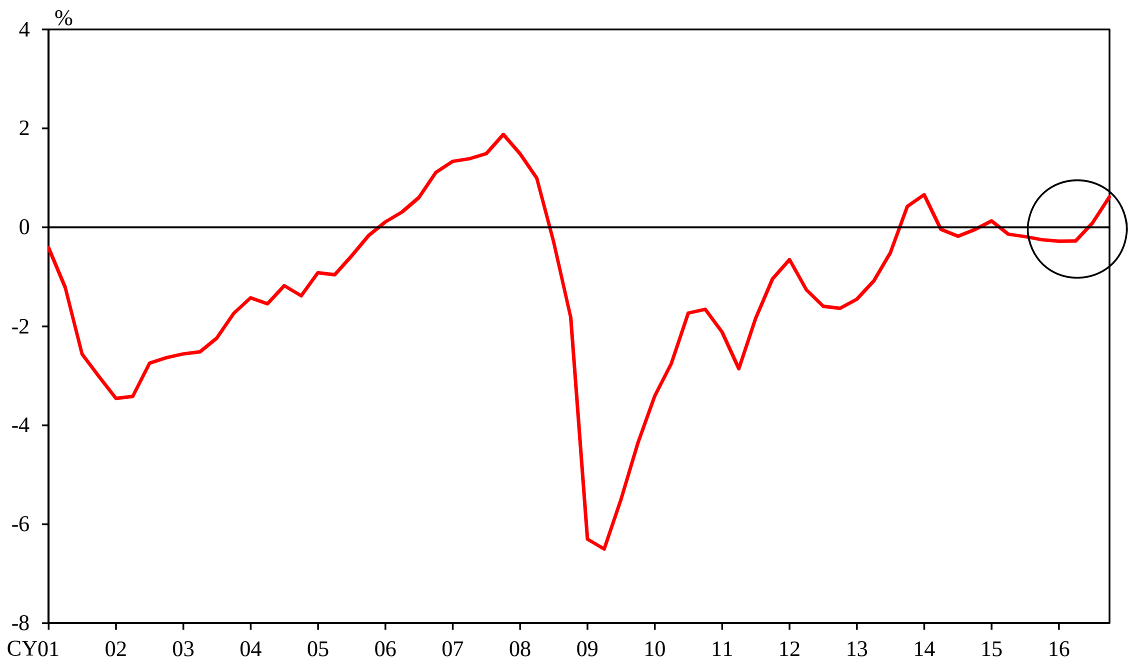




Notes: 1. Figures for 2017/Q1 are January-February averages.
2. Real GDP for the world economy is calculated by the International Department of the Bank of Japan based on IMF data and national and regional GDP growth rates.
Sources: CPB Netherlands Bureau for Economic Policy Analysis; IMF, etc.

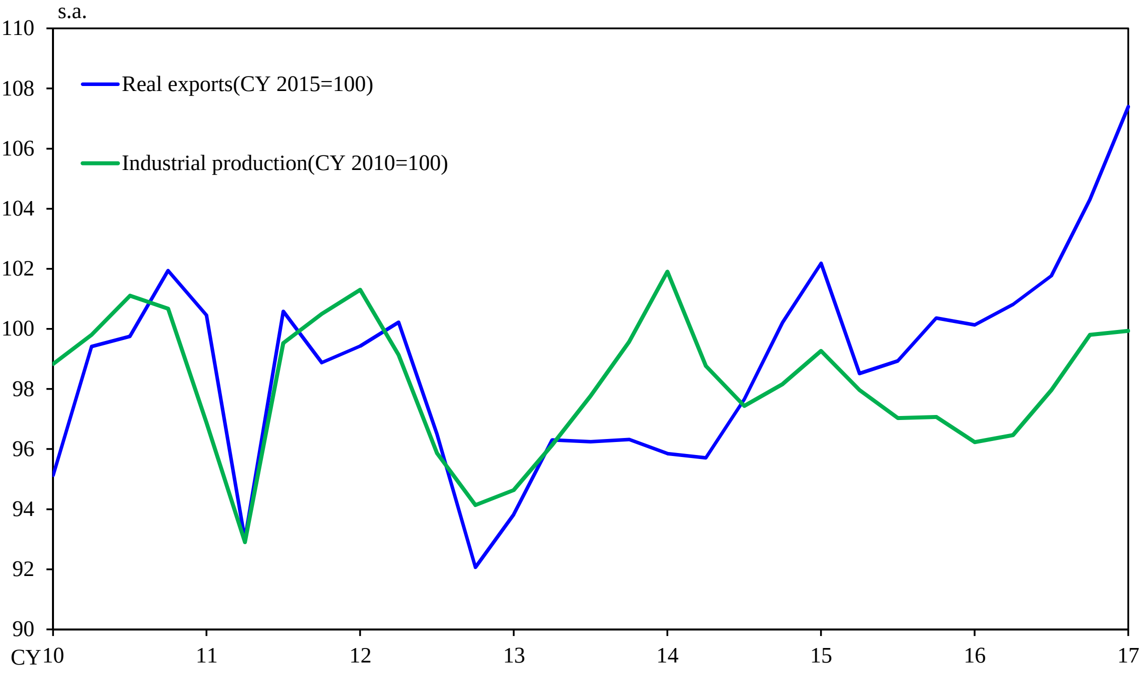
Chart 3

Output Gap



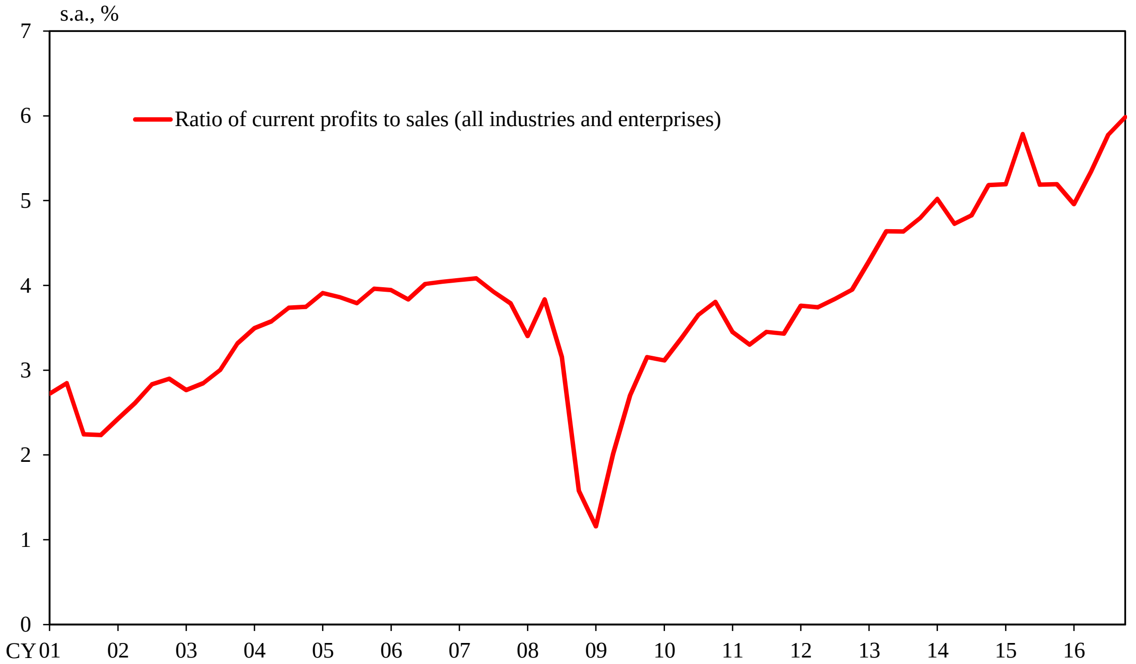
Note: The output gap is estimated by the Research and Statistics Department, Bank of Japan. For the details on the estimation methods, please refer to the forthcoming Bank's research paper "Methodology for Estimating Output Gap and Potential Growth Rate: An Update."
Sources: Cabinet Office; Bank of Japan; Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Ministry of Economy, Trade and Industry; Research Institute of Economy, Trade and Industry.

Exports and Industrial Production



Sources: Bank of Japan; Ministry of Finance; Ministry of Economy, Trade and Industry.

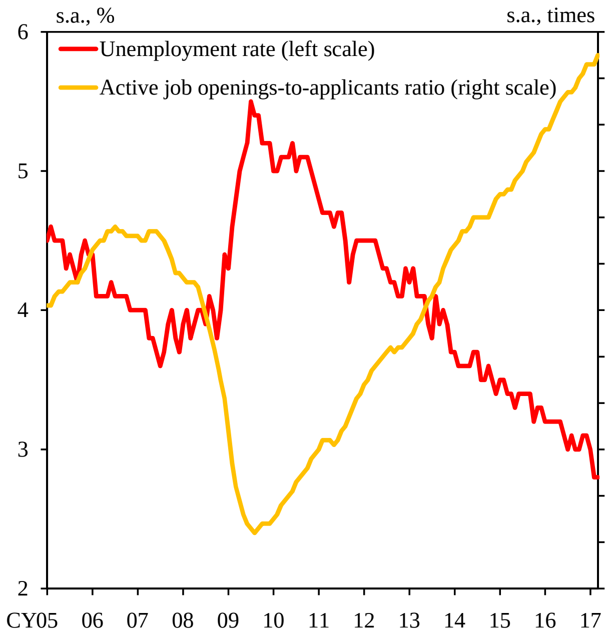
Corporate Profits



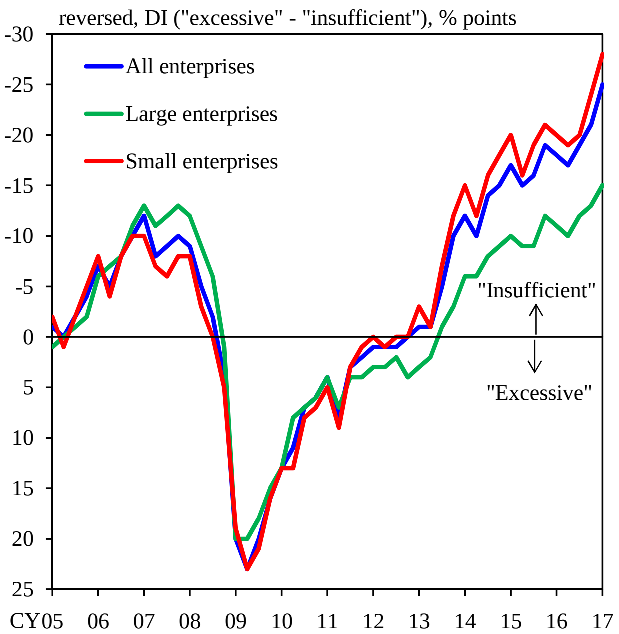
Note: Based on the "Financial Statements Statistics of Corporations by Industry, Quarterly."
Excluding "Finance and Insurance."
Source: Ministry of Finance.

Labor Market Conditions

Unemployment Rate and Active Job Openings-to-Applicants Ratio



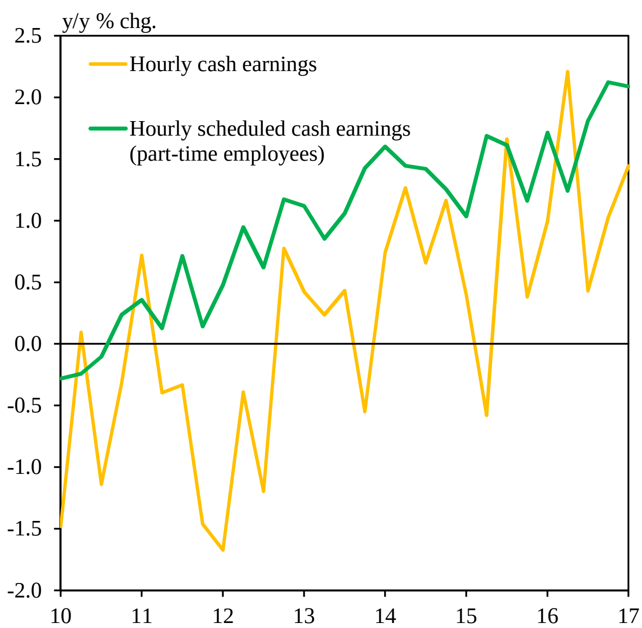
Tankan: Employment Conditions DI



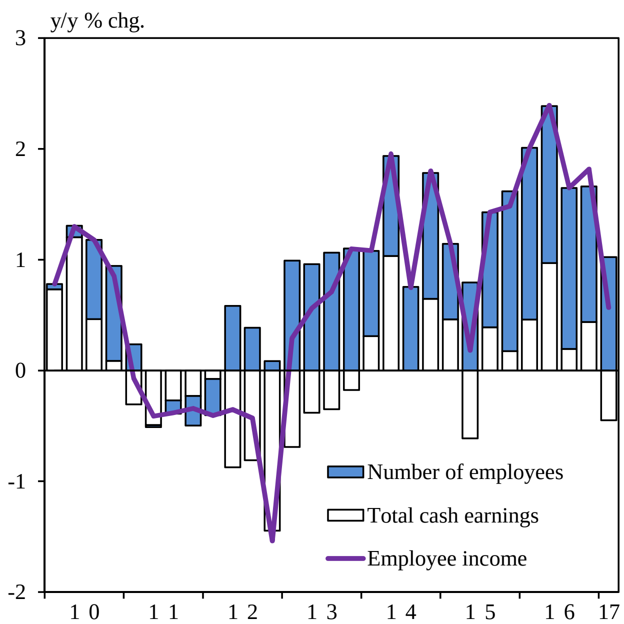
Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Bank of Japan.

Wages

Hourly Cash Earnings

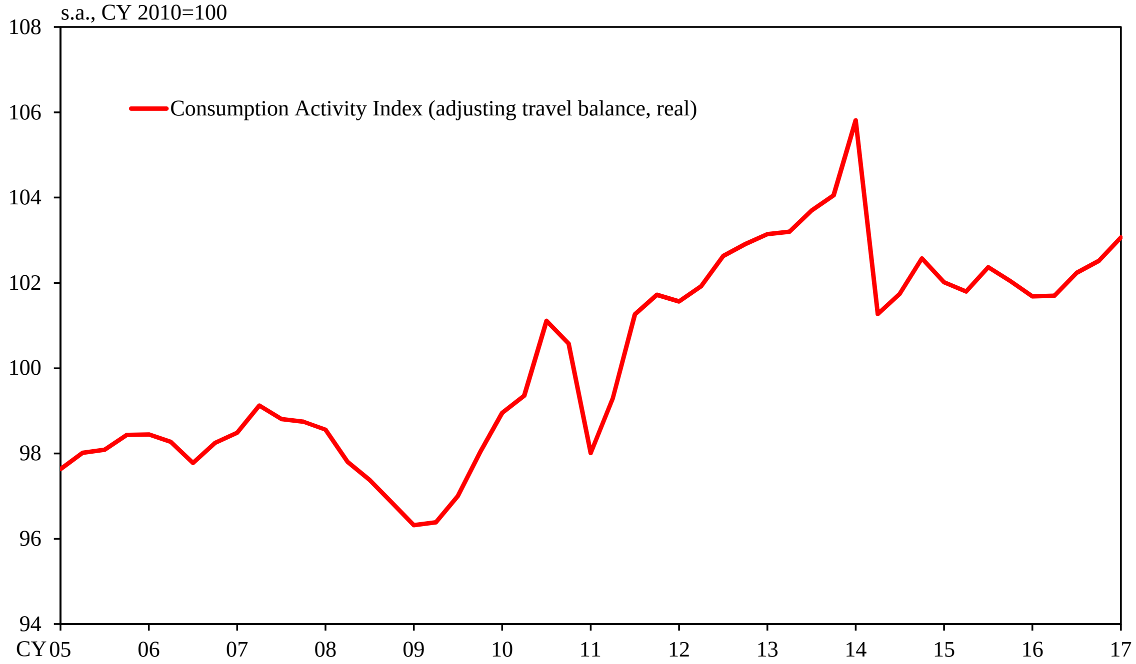


Employee Income



Note: Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. Figures for 2017/Q1 are those of March.
Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

Consumption Activity Index



Note: Figures for the Consumption Activity Index exclude inbound tourism consumption and include outbound tourism consumption.
Sources: Cabinet Office; Bank of Japan; Ministry of Economy, Trade and Industry; Ministry of Internal Affairs and Communications, etc.

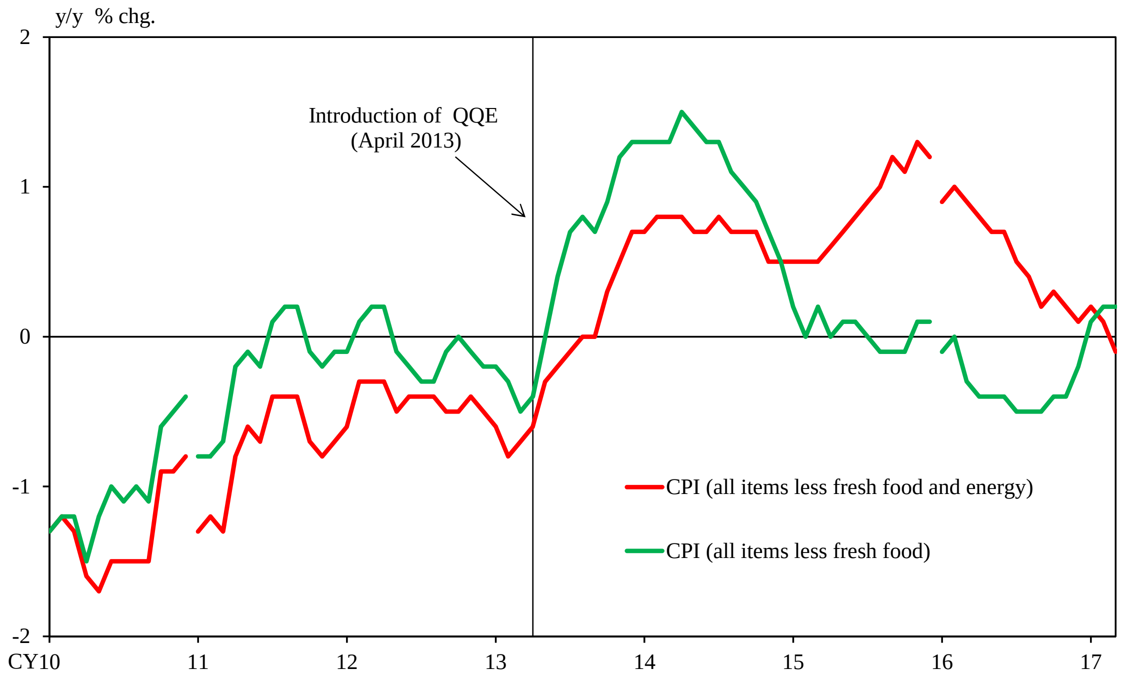
Outlook for Economic Activity and Prices (as of April 2017)

y/y % chg.

	Real GDP	CPI (all items less fresh food)
Fiscal 2017	+1.6	+1.4
Forecasts made in January 2017	+1.5	+1.5
Fiscal 2018	+1.3	+1.7
Forecasts made in January 2017	+1.1	+1.7
Fiscal 2019	+0.7	+1.9

Note: Figures indicate the median of the Policy Board members' forecasts (point estimates). Figures for the CPI (all items less fresh food) exclude the effects of the consumption tax hikes.
Source: Bank of Japan.

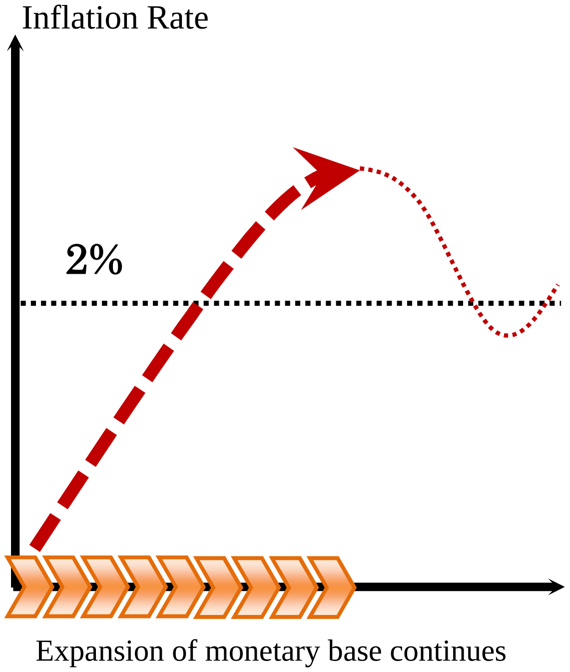
Consumer Prices



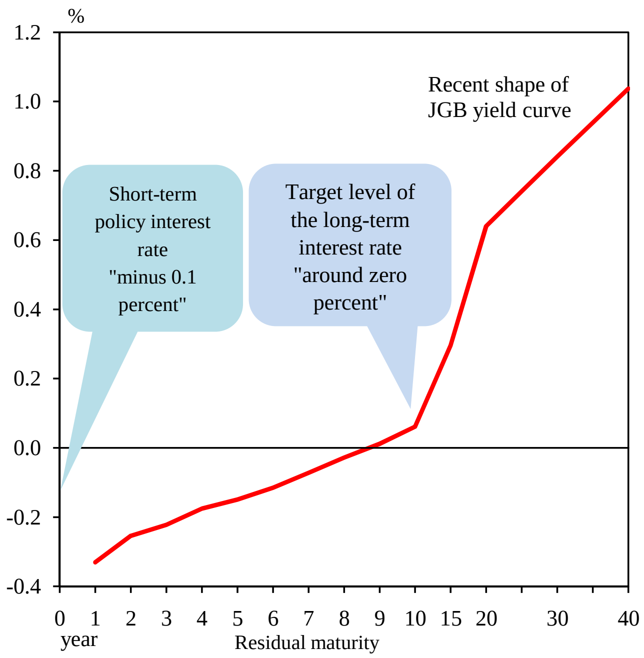
Note: Figures for the CPI are adjusted to exclude the estimated effects of changes in the consumption tax rate.
Source: Ministry of Internal Affairs and Communications.

QQE with Yield Curve Control

Inflation-Overshooting Commitment



Yield Curve Control



Source: Bloomberg.