



August 2, 2017

Bank of Japan

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

Speech at a Meeting with Business Leaders in Sapporo

Yukitoshi Funo

Member of the Policy Board

(English translation based on the Japanese original)

I. Recent Economic and Price Developments

A. Overseas Developments

I would like to begin my speech by talking about developments in overseas economies. Business sentiment of manufacturing firms has been on an improving trend on a global basis, and the world trade volume has been recovering. In this situation, overseas economies have continued to grow at a moderate pace on the whole.

As for the outlook, the growth rates of overseas economies are expected to increase moderately. According to the *World Economic Outlook Update*, released in July 2017 by the International Monetary Fund (IMF), the global growth rate is projected to increase from 3.2 percent in 2016 to 3.5 percent in 2017, and to 3.6 percent in 2018.

Looking at developments by major region, the U.S. economy has continued to recover firmly, mainly in household spending, owing to a steady improvement in the employment and income situation. As for the outlook, the economy is expected to continue to see firm growth driven by domestic private demand.

The European economy has continued to recover steadily, albeit at a moderate pace, mainly in the household sector. As for the outlook, the economy is projected to follow a moderate recovery trend, while uncertainty -- associated with political issues such as those regarding negotiations on the United Kingdom's exit from the European Union (EU) and with the European debt problem, including the financial sector -- is likely to be a burden on economic activity.

The Chinese economy has continued to see stable growth on the whole, partly due to the effects of authorities' measures to support economic activity. As for the outlook, the economy is likely to broadly follow a stable growth path as authorities conduct fiscal and monetary policy in a timely manner.

Emerging economies other than China and commodity-exporting economies have picked up on the whole. As for the outlook, their growth rates are likely to increase gradually, due

mainly to the spread of the effects of steady growth in advanced economies and the effects of the economic stimulus measures.

Risk factors to the overseas economic outlook are wide ranging, as exemplified by (1) the U.S. economic policies and their impact on global financial markets, (2) developments in emerging and commodity-exporting economies, (3) negotiations on the United Kingdom's exit from the EU and their effects, (4) prospects regarding the European debt problem, including the financial sector, and (5) geopolitical risks. I hold the view that it is important to stay vigilant regarding these risk factors, especially now that the growth rates of overseas economies are rising.

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 is expanding moderately, with a virtuous cycle from income to spending operating. For the first time in about 11 years, real GDP registered positive growth for five consecutive quarters, through the January-March quarter of 2017; by component, demand both at home and abroad has increased and the economy has been growing at a pace slightly above its potential, which is estimated to be in the range of 0.5-1.0 percent.¹

With regard to the outlook, Japan's economy is likely to continue its moderate expansion. Through fiscal 2018, domestic demand is likely to follow an uptrend, with a virtuous cycle from income to spending being 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. Meanwhile, exports are expected to continue their moderate increasing trend as the growth rates of overseas economies increase moderately. In fiscal 2019, the economy is expected to continue expanding, supported by external demand, although the growth pace is projected to decelerate due to a slowdown in

¹ Under a specific methodology, Japan's potential growth rate is estimated to be in the range of 0.5-1.0 percent. However, the estimate of the potential growth rate varies depending on the methodologies employed and could be revised as the sample period becomes longer over time. Thus, it should be regarded as being subject to a considerable margin of error.

domestic demand.² According to the July 2017 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), released by the Bank of Japan, the medians of the Policy Board members' forecasts of the economic growth rate are 1.8 percent for fiscal 2017, 1.4 percent for fiscal 2018, and 0.7 percent for fiscal 2019.

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 is in the range of 0.0-0.5 percent. The rate of increase for all items less fresh food and energy had remained on a decelerating trend, following the peak of 1.2 percent in winter 2015; recently, the rate of change has been at around 0 percent.

With regard to the outlook, the year-on-year rate of change in the CPI for all items less fresh food is likely to continue on an uptrend mainly on the back of the improvement in the output gap and the rise in medium- to long-term inflation expectations. The rate will likely reach around 2 percent in around fiscal 2019. Specifically, the medians of the Policy Board members' forecasts of the year-on-year rate of change in the CPI for all items less fresh food presented in the July 2017 Outlook Report are 1.1 percent for fiscal 2017, 1.5 percent for fiscal 2018, and, excluding the direct effects of the scheduled consumption tax hike, 1.8 percent for fiscal 2019.³

² It is assumed that the consumption tax will be raised to 10 percent in October 2019 and that a reduced tax rate will be applied to food and beverages -- excluding alcohol and dining-out -- and newspapers.

³ The consumption tax hike scheduled to take place in October 2019 -- to 10 percent -- and the reduced tax rate to be applied to food and beverages -- excluding alcohol and dining-out -- and newspapers are incorporated in the forecasts, but individual Policy Board members make their forecasts of the CPI based on figures excluding the direct effects of the consumption tax hike. The forecasts for the CPI for fiscal 2019 that incorporate the direct effects of the consumption tax hike are constructed as follows. First, the contribution to prices from the tax hike is mechanically computed on the assumption that the tax increase will be fully passed on for taxable items. The CPI will be pushed up by 0.5 percentage point. Second, this figure is added to the forecasts made by the Policy Board members.

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 tighten steadily and employee income has increased moderately. The rate of increase in the number of employees has remained at around 1 percent. Against this backdrop, the active job openings-to-applicants ratio, which has followed a steady uptrend, has exceeded its highest figure during the bubble period in the first half of the 1990s, and a perception of labor shortage suggested by indicators related to employment has heightened. The unemployment rate has continued on a moderate declining trend, albeit with some fluctuations, and has been around 3 percent recently. It is expected that the number of employees will keep increasing and that the supply-demand conditions in the labor market will further tighten.

On the wage side, the rise in hourly cash earnings has generally accelerated, albeit with fluctuations. Specifically, the year-on-year rate of increase in hourly cash earnings of part-time employees recently registered relatively high growth in the range of 2.0-2.5 percent. With regard to the outlook, the pace of increase in full-time employees' cash earnings is expected to accelerate moderately, with that in base pay accelerating as the rise in inflation expectations becomes more evident.

In light of these prospects for employment and wages, employee income is expected to increase at a moderate pace, and its pace of increase is expected to be slightly above the nominal GDP growth rate in the second half of the projection period of fiscal 2016-2019. However, there is a risk that firms will remain cautious with their decisions, particularly on wage setting. In this context, I am paying attention to firms' wage-setting stance going forward.

B. Private Consumption

Next, I will discuss developments in private consumption, which has increased its resilience against the background of steady improvement in the employment and income situation. The consumption activity index has continued to increase. Looking at private consumption by type, durable goods have been on a moderate uptrend, mainly due to replacement demand for automobiles and household electrical appliances. Nondurable goods had seen somewhat weak developments for a prolonged period, particularly in clothes, but have started to pick up recently. Meanwhile, services consumption has continued to increase moderately, albeit with fluctuations, reflecting a trend rise in communications charges as well as medical, health care, and welfare fees.

With regard to the outlook, private consumption is expected to follow a moderate increasing trend -- albeit with fluctuations due to the scheduled consumption tax hike -- supported mainly by an increase in employee income and replacement demand for durable goods.

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 improved. Business fixed investment plans for fiscal 2017, especially those of large enterprises, show firms' solid stance. Specifically, on a year-on-year basis, firms' fixed investment increased by 0.4 percent in fiscal 2016, and investment plans for fiscal 2017 project an increase of 5.9 percent.

As for the outlook, business fixed investment is likely to continue increasing moderately on the back of (1) an improvement in corporate profits, (2) extremely stimulative financial conditions, such as low interest rates and accommodative lending attitudes, (3) the effects of fiscal measures including projects conducted under the Fiscal Investment and Loan Program and tax reductions for capital investment, and (4) moderate improvement in growth expectations.

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 -- after turning slightly positive in the July-September quarter of 2016 -- has continued to improve, and it has expanded somewhat within positive territory recently. With regard to the outlook, it is projected to widen further within such territory in fiscal 2017; thereafter, it is projected to continue expanding moderately within positive territory both on the capital and labor sides, reflecting the increase in demand at home and abroad. In the second half of fiscal 2019, although such expansion is likely to pause due to the effects of the scheduled consumption tax hike, the output gap is expected to remain substantially positive.

Second, medium- to long-term inflation expectations have remained in a weakening phase; however, some indicators show a rise in such expectations recently. As for the outlook, medium- to long-term inflation expectations are likely to follow an increasing trend on the back of the following: (1) in terms of the adaptive expectation formation mechanism, firms' stance is likely to gradually shift toward raising wages and prices with the improvement in the output gap, and (2) in terms of the forward-looking expectation formation mechanism, the Bank will pursue monetary easing through its strong commitment to achieving the price stability target.

III. Conduct of Monetary Policy

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

In January 2013, the Bank announced that it would aim to achieve 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 of that year, it decided to introduce Quantitative and Qualitative Monetary Easing (QQE) as a necessary measure to underpin this commitment. The Bank took several measures thereafter, and in September 2016 it conducted a comprehensive assessment of the developments in Japan's economic activity and prices as well as policy effects since the introduction of QQE, and decided to introduce QQE with Yield Curve Control.

The framework of QQE with Yield Curve Control consists of two major components. The first is yield curve control in which the Bank facilitates the formation of short- and long-term interest rates that are considered most appropriate for maintaining the momentum toward achieving the price stability target, taking account of developments in economic activity and prices as well as financial conditions. Specifically, at present, according to the guideline for market operations, the Bank sets the short-term policy interest rate at minus 0.1 percent and purchases Japanese government bonds (JGBs) so that 10-year JGB yields will remain at around 0 percent. The second component is an inflation-overshooting commitment in which the Bank continues with the monetary easing framework, aiming to achieve the price stability target, as long as it is necessary for maintaining that target in a stable manner. On this point, the Bank makes clear that it will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner.

As shown in the comprehensive assessment, I consider that the main factor that hampers achieving the price stability target of 2 percent is as follows. In the course of the Bank's attempt to raise inflation expectations, observed inflation rates declined due to a variety of exogenous factors such as a substantial fall in crude oil prices. Under these circumstances, inflation expectations declined, as the adaptive mechanism has been playing a relatively large role in the formation of inflation expectations in Japan. Taking this into consideration, the Bank decided to adopt a commitment that allows inflation to overshoot the price stability target so as to strengthen the forward-looking mechanism in the formation of inflation expectations, enhance the credibility of achieving the price stability target among the public, and raise inflation expectations in a more forceful manner.

As for the future conduct of monetary policy, the Bank will continue with QQE with Yield Curve Control, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. In Japan, there is some argument that the Bank does not need to aim at 2 percent inflation. However, when adverse shocks hit the economy, it becomes necessary to lower real interest rates sufficiently to support the economy effectively. Therefore, it is important to aim at achieving the price stability target of 2 percent in order to secure sufficient room for a reduction in real interest rates by

keeping the inflation rate stable at around 2 percent and anchoring inflation expectations at 2 percent. Currently, the momentum toward achieving the price stability target is being maintained, and the year-on-year rate of change in the CPI is expected to increase toward 2 percent. Nevertheless, this momentum is not yet sufficiently firm, and we are only halfway to achieving the price stability target. Considering the current developments in economic activity and prices as well as financial conditions, I believe that it is important that the Bank continue to steadily pursue powerful monetary easing under QQE with Yield Curve Control.

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.

The Bank aims to achieve price stability that is sustainable. I recognize that the inflation rate consistent with sustainable price stability will rise as efforts by a wide range of entities toward strengthening the competitiveness and growth potential of Japan's economy make progress. Based on this recognition, the Bank sets the price stability target at 2 percent in terms of the year-on-year rate of change in the CPI -- a main price index.

To strengthen the competitiveness and growth potential of the economy, a structural reform that will lead to an increase in productivity is necessary. In implementing such a reform, from the viewpoint of the management of firms, it is important to adjust supply to the trend in demand. In an economy with a declining population, as is the case in Japan, demand is expected to decrease for many goods and services; therefore, it will be important to adequately adjust supply capacity; that is, employees and production capacity to meet such a decreasing trend. In Japan, there is room for enhancing productivity relative to international standards. Firms, regardless of whether they are in manufacturing or nonmanufacturing, are faced with an uneven distribution of employees and production capacity, as well as excessive inventories and discounts. It is necessary to adequately correct such uneven distribution and reduce excessiveness in all areas.

In order to make progress with such a structural reform smoothly while easing the pain arising from the reform, a growth strategy that will foster new areas with growth potential is

essential. That is, it is necessary to develop and provide goods and services that will explore new demand, and at the same time expand the channels for capturing demand in neighboring economies. Japan's economy has made progress toward this end for many years despite the severe situation for the management of firms, and has exhibited strong compatibility. It is expected to make continued progress in the future.

Currently, financial conditions are highly accommodative and labor market conditions are tight. It is a good time to proceed with the structural reform and growth strategy, and we should not miss this chance. I consider that the private sector, which plays the main role in the economy, should take the initiative to enhance productivity and create demand in a more proactive manner. Financial institutions are expected to provide consulting services to their counterpart firms making these efforts. In particular, in rural areas, financial institutions, which are endowed with information, knowledge, and experience, not to mention personnel, are expected to take such initiative.

Moreover, it is a highly difficult task to increase labor input in the current situation where labor shortages are becoming severe. However, given that the tightness in labor market conditions varies by industry, the current moderate tightness can be regarded as a chance to increase mobility in the labor market -- including inter-industry labor reallocation -- in wider areas. Each firm will need to retrain its management staff to enhance their ability and adjust their mindset. Also, measures should be taken to change the decision-making process and reduce operations that do not produce value-added, such as duplicated operations, as well as excessive services. Progress toward improving the operation process that will lead to utilization of the workforce of women and the elderly also should be made. In this regard, the Bank conducted a survey on firms' efforts toward promoting women's labor force participation by region and released the results as the annex to the *Regional Economic Report* in June 2017.⁴ According to this annex, women's labor participation is increasing in many regions and has led to improvement in business performance and productivity.

Thank you for your attention.

⁴ The annex to the *Regional Economic Report* is available only in Japanese.