September 25, 2017

Bank of Japan

Japan's Economy and Monetary Policy

Speech at a Meeting with Business Leaders in Osaka

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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 a distinguished gathering of business leaders in the Kansai region. I would like to take this opportunity to express my sincerest gratitude for your cooperation with the various activities of the Bank of Japan's branches in Osaka, Kobe, and Kyoto.

In my speech today, I would like to first explain the Bank's view on the recent developments in economic activity and prices, and then talk about its thinking behind the conduct of monetary policy.

I. Economic Developments

Let me start by talking about developments in Japan's economy. The economy is expanding moderately, and the real GDP growth rate for the April-June quarter registered a firm increase of 2.5 percent on an annualized basis. It is the first time in eleven years, since 2006, that it has continued to mark positive growth for six consecutive quarters (Chart 1). Looking ahead, the economy is likely to continue its moderate expansion. Some of the recent characteristics of the economic expansion are as follows.

The first feature is that the economic growth has been led by both external and domestic demand in a well-balanced manner. Looking at overseas economies, business sentiment in the manufacturing sector has been on an improving trend in both the advanced and the emerging economies, and the world trade volume has been recovering. Under such circumstances, Japan's exports have been on an increasing trend, such as those of automobile-related and capital goods (Chart 2). Regarding domestic demand, business fixed investment has been on a moderate increasing trend as corporate profits have been at record high levels. Private consumption has increased its resilience recently against the background of steady improvement in the employment and income situation. Furthermore, as the effects of the government's large-scale stimulus measures formulated last year have been emerging lately, public investment has been increasing (Chart 3). The economy has been expanding, not on the basis of a single factor, but rather supported by multiple factors -- namely, external demand, domestic private demand, and domestic public demand -- in a well-balanced manner. For this reason, the economic expansion can be expected to sustain itself going forward.

The second feature of the recent economic expansion is that its effects have been spreading to a wide range of economic entities. The differences in the degree of improvement in the diffusion index (DI) for business conditions either by firm size or by region are not as large as those during the recovery phase in the mid-2000s before the global financial crisis (Chart 4). The DI for the Kinki region had been below the national average from 2015 toward 2016, but has been improving rapidly since the second half of 2016, reflecting a remarkable recovery in overseas economies. Looking at the employment and income situation, the current economic expansion has benefitted a wide range of households. The year-on-year rate of increase in hourly wages of part-time employees, which are particularly sensitive to the tightening of the labor market, has registered about 2.5 percent. This is higher than that of full-time employees, implying that the difference in wage levels between part-time and full-time employees has become smaller. There have been many cases where those who had worked as part-timers but wanted to become employed as full-timers have been able to do so. Moreover, the active job openings-to-applicants ratio of full-time employees exceeded 1 in June for the first time since the statistics started to be compiled in 2004 (Chart 5). As just described, the economic expansion has been benefitting both full-time and part-time employees. In the labor market as a whole, the unemployment rate has declined to around 3 percent, which is equivalent to virtually full employment, and the active job openings-to-applicants ratio stands at 1.52, exceeding the highest figure during the bubble period and reaching a level last seen as far back as in 1974 (Chart 6).

Triggered in part by the tightening of labor market conditions, it has become another feature of Japan's economy of late that a wide range of firms and industries have been taking measures to raise labor productivity. Since wage increases resulting from labor shortage mean rises in labor costs for firms, many firms have been making various efforts to avoid passing on a rise in labor costs directly to their customers. A typical example is labor-saving and efficiency-improving investment with the use of information technology. In fact, in labor-intensive sectors such as retailing as well as accommodations, eating and drinking services, software investment has increased to a remarkable degree recently (Chart 7).

Furthermore, firms have been streamlining their business processes. For instance, some supermarkets and chain restaurants have discontinued services late at night and early in the morning, at which time the number of customers is relatively small, and instead allocated their limited employees to daytime services. Even with reduced labor input due to shorter business hours, sales will not decrease so much, thereby lifting firms' labor productivity.

Of these measures, increasing labor-saving and efficiency-improving investment has certainly contributed to the recent growth in business fixed investment. In addition, from a longer-term perspective, firms' various efforts are expected to play an important role in raising Japan's growth potential. In Japan, it is essential to raise labor productivity to compensate for the decline in labor force. Although this is not easy, firms' increasing efforts of various kinds amid the widespread labor shortage of late have become a driving force toward raising productivity, which is a long-standing challenge to Japan's economy.

II. Price Developments

Now I will move to price developments. The year-on-year rate of change in the consumer price index (CPI) excluding fresh food has increased to around 0.5 percent recently, but that which also excludes the effects of a rise in energy prices has been relatively weak, remaining at around 0 percent (Chart 8). Looking ahead, the Bank of Japan projects that the rate of change in the CPI is likely to continue on an uptrend and increase toward 2 percent. In what follows, let me describe how this process will operate, especially from firms' standpoint.

What lies behind the fact that inflation has been relatively weak despite the increase in labor costs is firms' efforts to absorb the costs that I mentioned earlier. Specifically, many Japanese firms have raised wages for their employees but kept the prices of products and services unchanged, through labor-saving investment and streamlining of their business processes, for example. It often is pointed out that one reason why firms do not raise their sales prices is a kind of caution that, if they raise their prices but competitors do not, they may lose customers and competitiveness in the market. Given that their competitors have the same thought, perhaps all the competing firms wait and see what others will do and none make the first move. This strategy itself would be reasonable for firms facing stiff competition. At the same time, however, it also makes it unlikely that firms will raise their sales prices by passing on increased costs to those prices as necessary.

What will happen going forward? Given that firms have already been working on streamlining their business processes in many ways, it will gradually become difficult for them to continue to absorb increases in wage costs through those measures. In addition to continuing efforts to streamline their business processes, firms will need to reflect in their sales prices the increased costs that they cannot absorb. Lately, it also seems to be becoming more likely that competitors will follow suit when a firm moves toward increasing its prices. This is because it is highly likely that, facing a tight labor market, every firm feels that it has been reaching the limit to which it can absorb increasing labor costs. On the consumer side, their perception of price rises seems to be changing gradually, as the employment and income situation has improved due to the better labor market conditions. After one of the major transportation companies announced this spring that it planned to raise the prices of its delivery services, competitors followed suit. According to a news report, slightly more than 30 percent of firms in the restaurant business are planning to raise the prices on their menus within this fiscal year, mainly due to increases in labor costs. These developments appear to show the possibility that firms' price-setting stance has been changing in response to the tightening of the labor market and improvement in the economy.

These kinds of changes in firms' price-setting stance have not yet become widespread in the entire economy. However, as firms' and consumers' stance on the passing on of costs changes with the economy continuing to expand moderately, firms' attempts to raise sales prices will likely gradually become more widespread across a broad range of industries. Furthermore, as this process lifts actual prices, firms' and households' medium- to long-term inflation expectations, or people's perception of future inflation, will increase. The Bank of Japan projects that, through these mechanisms, the inflation rate is likely to increase gradually toward the price stability target of 2 percent.

III. The Bank's Conduct of Monetary Policy

Next, I will elaborate on the Bank's thinking behind the conduct of monetary policy. As stipulated in the Bank of Japan Act, the objective of the Bank's monetary policy is "achieving price stability, thereby contributing to the sound development of the national economy." The specific number representing "price stability" is "2 percent" in terms of the year-on-year rate of change in the CPI.

For reasons why this needs to be 2 percent, I will explain three points in sequence: a bias in price statistics, securing policy room for the future, and a global standard.

Let me start with a bias in price statistics. Although I am not going into detail since this might be a bit technical, the inflation rate based on the CPI that the Bank refers to tends to be higher than actual inflation. Given this, aiming at zero inflation in terms of the CPI means aiming at negative inflation, in effect. Therefore, in order to ensure price stability, the inflation rate should be sufficiently positive.

The next point regards securing policy room for the future. The level of nominal interest rates is usually determined in accordance with that of inflation rates. Looking at the interest rate levels around 2007, right before the global financial crisis, whereas the policy interest rates in the United States and Europe were around 4 to 5 percent with inflation of around 2 percent, the policy interest rate in Japan, or the uncollateralized overnight call rate, was only 0.5 percent with almost zero inflation (Chart 9). In response to the global financial crisis, which exerted a significantly negative impact on the global economy, the United States and Europe counteracted this shock with monetary easing that pushed down the policy interest rates by 4 to 5 percentage points to around 0 percent. On that occasion, although Japan also reduced the policy interest rate to around 0 percent, as the United States and Europe did, it was only able to exert limited monetary easing effects of 0.5 percentage point. As you remember, the real GDP in Japan dropped more significantly than that in Europe and in the United States, the epicenter of the crisis. This implies the possibility that the fact that Japan had less room for policy responses in lowering interest rates became a contributing factor to the severer downturn of the economy. With the level of nominal interest rates being high, Japan's economy will have more policy room to mitigate the impact of future economic downturns, or will be equipped with a sort of insurance for sustained economic growth.

So far, I have mentioned a bias in price statistics and securing policy room for the future, but these alone do not give a good enough reason why the target level of inflation has to be 2 percent. There are some proposals advocated overseas that the target level of inflation should be 3 to 4 percent in order to further increase policy room, although these proposals themselves do not seem realistic. So, why is 2 percent considered most appropriate?

To answer this question, the third reason, a global standard, is key. Central banks in major economies are currently conducting monetary policy with the aim of achieving around 2 percent inflation. Given this, the Bank of Japan's monetary policy conduct with the aim of achieving 2 percent inflation is also likely to contribute to stable foreign exchange rates in the long run. Foreign exchange rates fluctuate due to various factors in the short run, but they are considered to reflect inflation differentials between at home and abroad in the long run. From the long-run perspective, if the inflation rate at home remains stable at around the same level as those in other major economies, stability in foreign exchange rates consequently will be ensured.

For the preceding three reasons, the Bank sets the price stability target of 2 percent in terms of the year-on-year rate of change in the CPI. However, some may feel uncomfortable about aiming at a positive inflation rate of 2 percent. For example, in the Bank's *Opinion Survey on the General Public's Views and Behavior*, a questionnaire survey of individuals, about 80 percent of respondents answered that price rises are rather unfavorable.

I would like to emphasize that what the Bank aims at in the conduct of monetary policy is not simply an increase in inflation. It aims to achieve an economy with a virtuous cycle in which the incomes of people increase firmly as the price stability target of 2 percent in terms of the year-on-year rate of change in the CPI is achieved. The historical data show that consumer prices and wages have generally been moving in parallel. In Japan in the 1980s and in the United States, with positive inflation, nominal wages generally increased at a higher pace than the CPI (Chart 10). Given that developments in actual prices are factored in at annual spring labor-management wage negotiations, the parallel relationship between inflation and wage growth is easy to understand. In such an economic environment, nominal interest rates usually will increase as well. Since interest rates are the rates of return on investment for each economic activity within the economy as a whole, they are expected to converge to the level consistent with the nominal growth rate of the country in the medium to long run. In an economy with economic expansion and steady positive inflation, both nominal wages and nominal interest rates increase, which means that the incomes of wage and salary earners, and of those who are living off their deposits, will increase.

I would like to underscore the fact that the Bank, through achieving the price stability target of 2 percent, is aiming at realizing a well-balanced economy in which people's incomes increase accordingly.

Conclusion

Lastly, I would like to conclude my speech by briefly explaining the Bank's recent conduct of monetary policy.

The Bank has been implementing powerful monetary easing under "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control," aiming to achieve the price stability target of 2 percent. This policy framework was introduced exactly a year ago, and at this meeting with you last year, I talked about the new policy, which had just been introduced.

"QQE with Yield Curve Control" consists of two components. The first 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 actual CPI exceeds 2 percent and stays above that level in a stable manner. The second component is yield curve control, in which the Bank controls short- and long-term interest rates under the guideline for market operations decided at every Monetary Policy Meeting. Looking back at the one year since its introduction, Japan's long-term interest rate has been stable at around zero percent, which is the target level, and bank lending rates as well as issuance rates for corporate bonds have been at extremely low levels. Moreover, financial institutions' lending attitudes as perceived by firms have remained positive both for large and small firms, and the year-on-year rate of increase in the amount outstanding of bank lending has been in the range of 3.0-3.5 percent recently. Such highly accommodative financial conditions, as well as proactive initiatives by financial institutions, have been firmly supporting corporate activities in Japan.

Although there is still a long way to go to achieve the price stability target of 2 percent, the Bank will continue to persistently pursue powerful monetary easing with a view to achieving the target at the earliest possible time.

Thank you.

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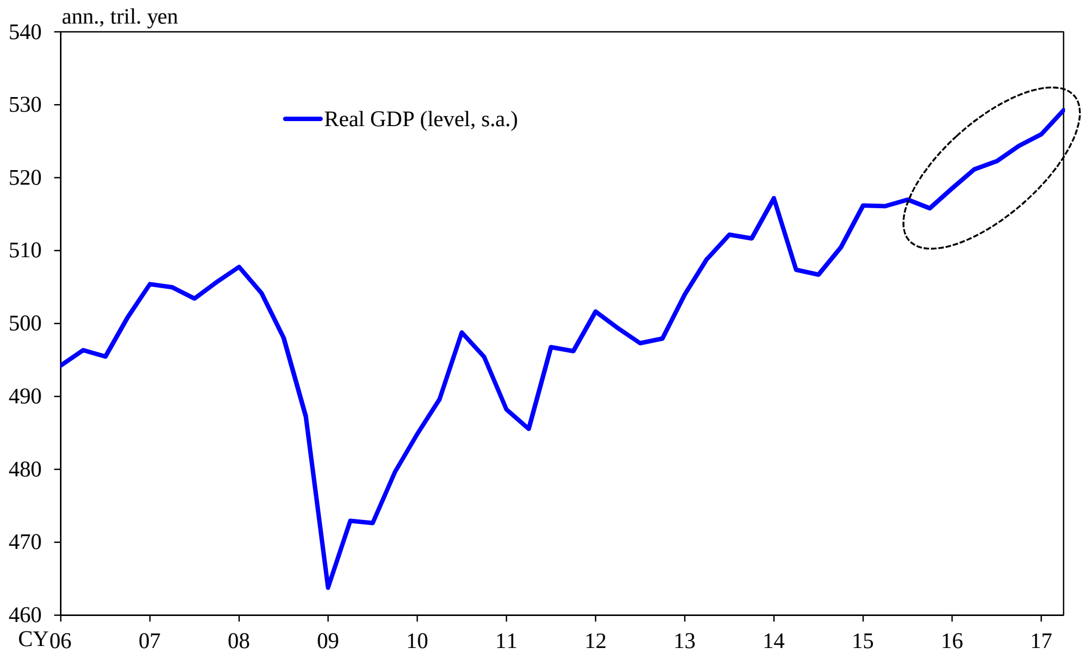
Chart 1

Real GDP

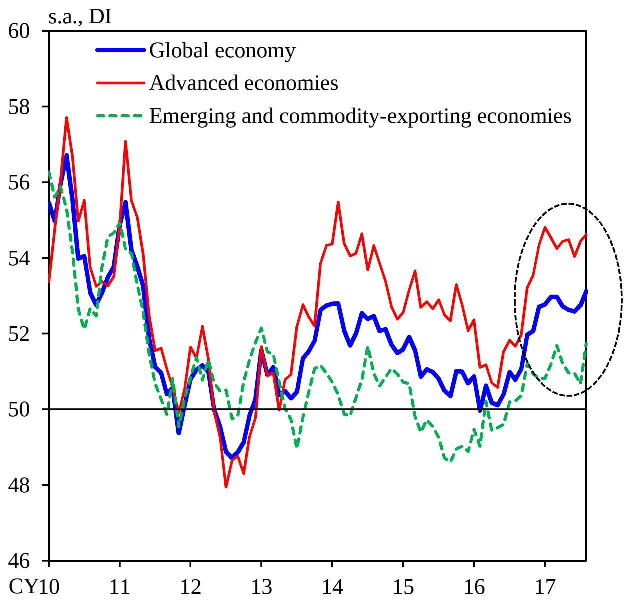


Source: Cabinet Office.

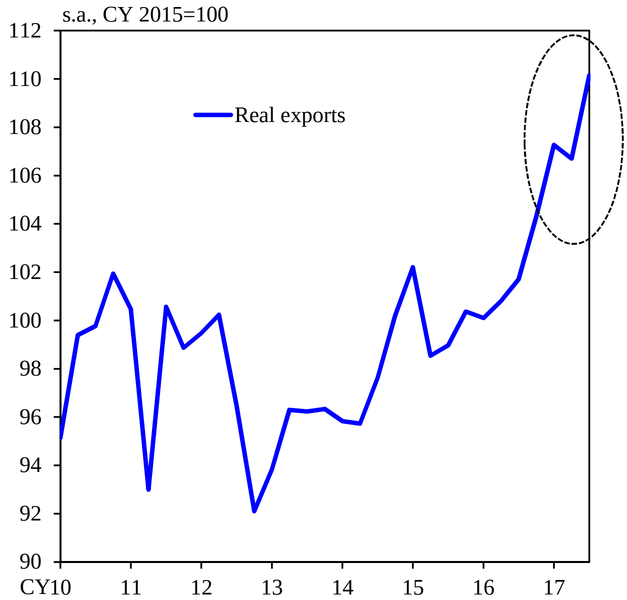
Chart 2

External Demand

Global Manufacturing PMI



Exports

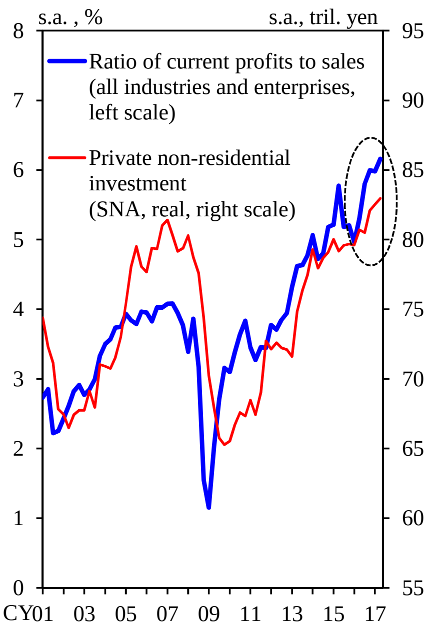


Notes: 1. Figures in the left chart for the global economy are the "J.P. Morgan Global Manufacturing PMI." Figures for advanced economies as well as emerging and commodity-exporting economies are calculated as the weighted averages of the Manufacturing PMI using PPP-adjusted GDP shares of world total 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 16 countries and regions, such as China, South Korea, Taiwan, Russia, and Brazil.
2. Figures for real exports are based on BOJ staff calculations. The figure for 2017/Q3 is the July-August average.
Sources: IHS Markit (© and database right IHS Markit Ltd 2017. All rights reserved.); Bank of Japan; Ministry of Finance, etc.

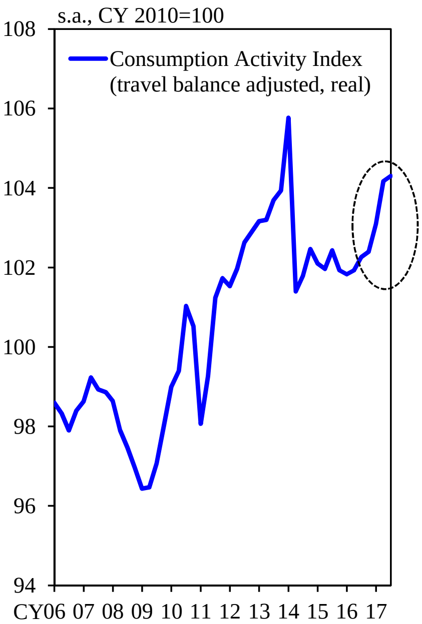
Chart 3

Domestic Demand

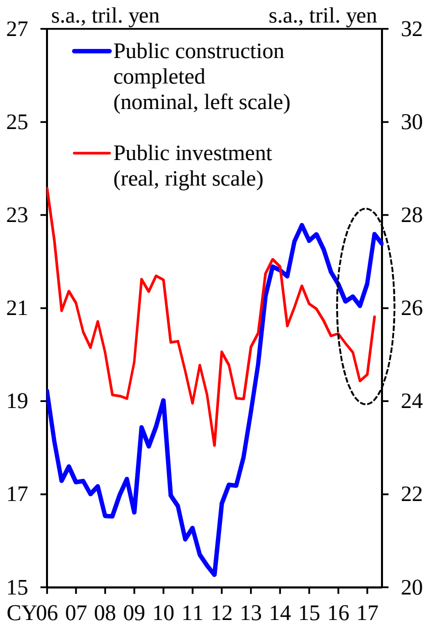
Corporate Profits and Business Fixed Investment



Private Consumption



Public Investment

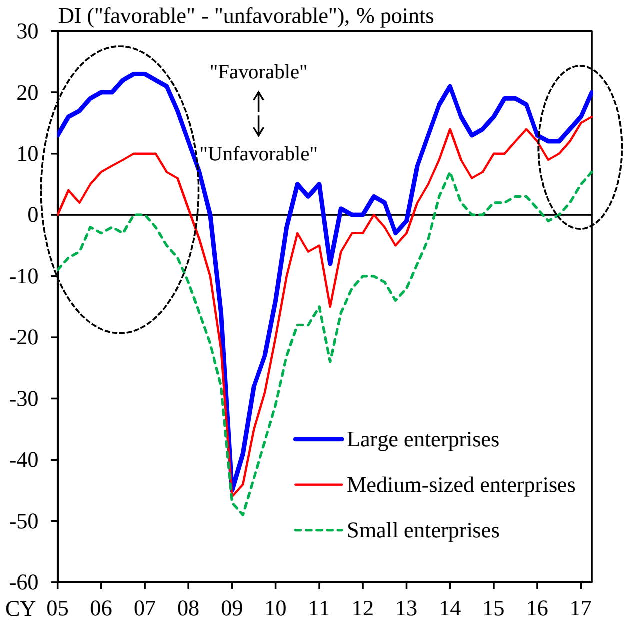


Notes: 1. Figures for corporate profits are based on the "Financial Statements Statistics of Corporations by Industry, Quarterly." Excluding "finance and insurance."
2. Figures for private consumption are based on BOJ staff calculations (as of September 7). Figures exclude inbound tourism consumption and include outbound tourism consumption. The figure for 2017/Q3 is that for July.
3. The figure for public construction completed for 2017/Q3 is that for July.
4. Figures for private non-residential investment, public construction completed and public investment are annualized.
Sources: Ministry of Finance; Cabinet Office; Bank of Japan; Ministry of Land, Infrastructure, Transport and Tourism.

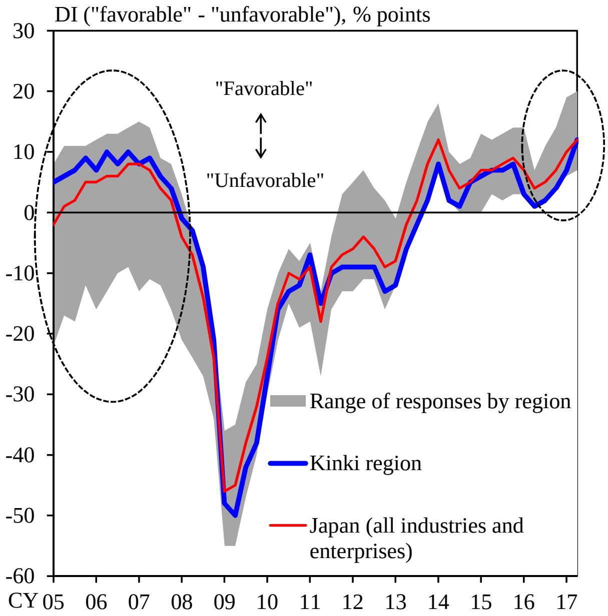
Chart 4

Business Conditions DI (*Tankan*)

By Firm Size



By Region

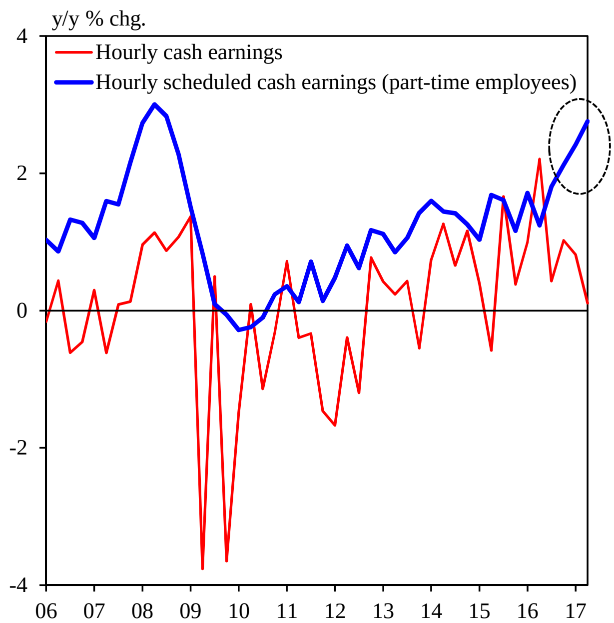


Source: Bank of Japan.

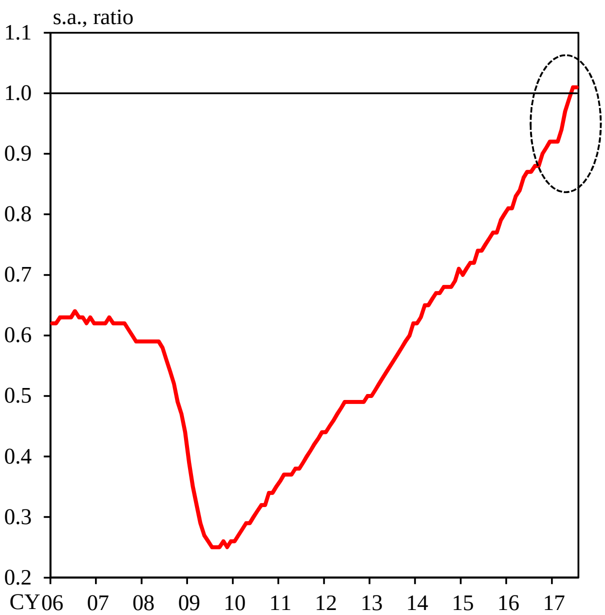
Chart 5

Employment and Income Situation (1)

Hourly Cash Earnings



Active Job Openings-to-Applicants Ratio of Full-time Employees

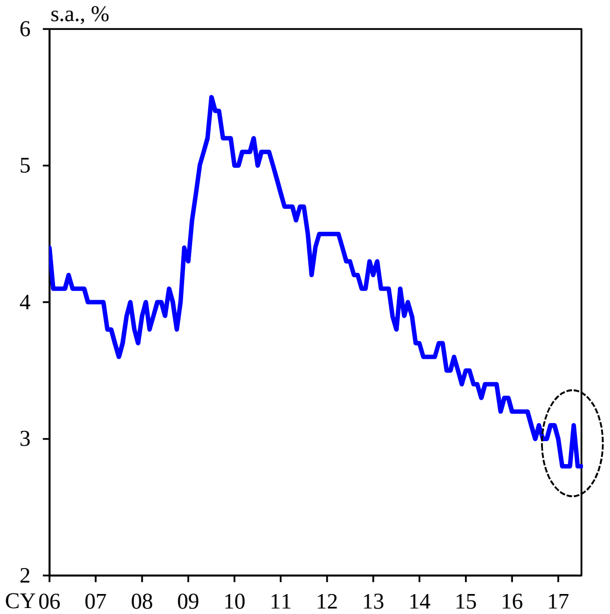


Note: For hourly cash earnings, Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. Figures for 2017/Q3 are those for June-July averages.
Source: Ministry of Health, Labour and Welfare.

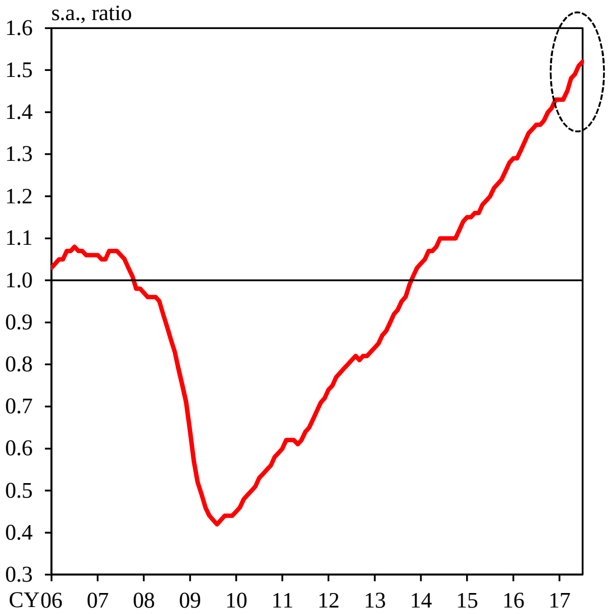
Chart 6

Employment and Income Situation (2)

Unemployment Rate



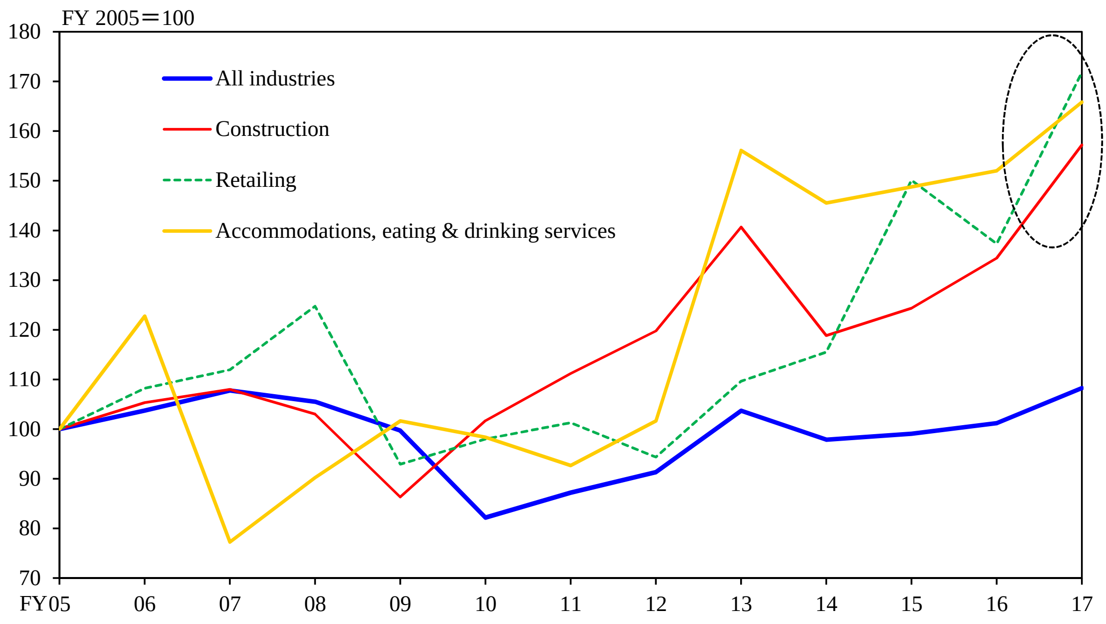
Active Job Openings-to-Applicants Ratio



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

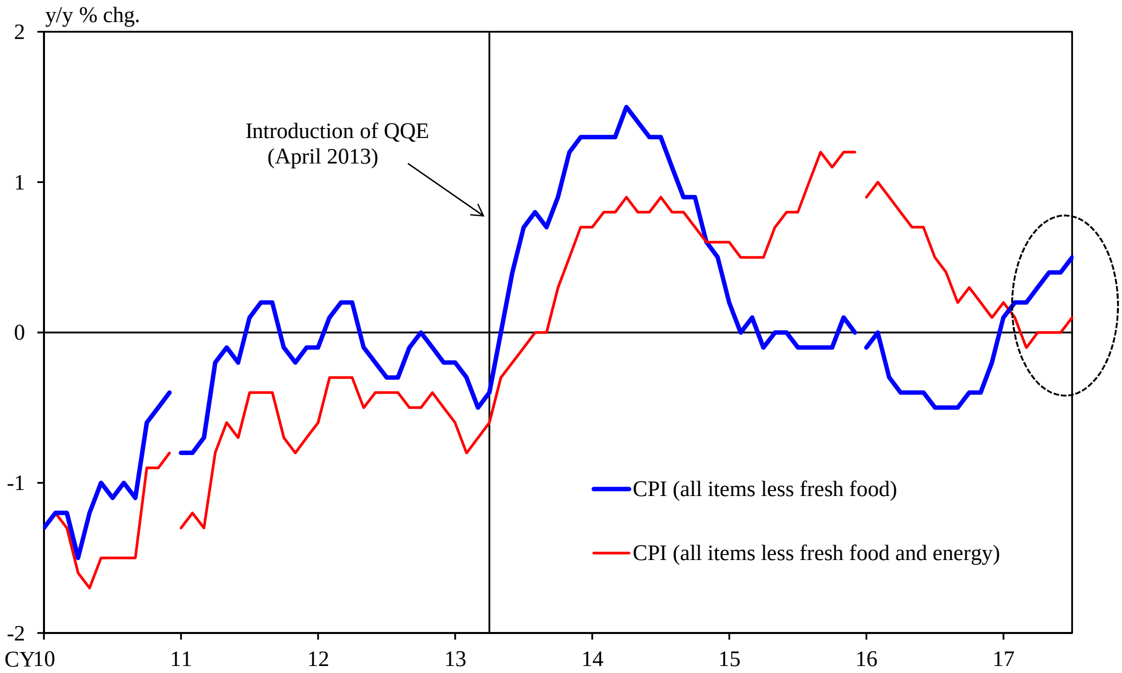
Chart 7

Software Investment



Note: Figures up through fiscal 2016 are actual results, and figures for fiscal 2017 are forecasts from the June 2017 survey (*Tankan*).
Source: Bank of Japan.

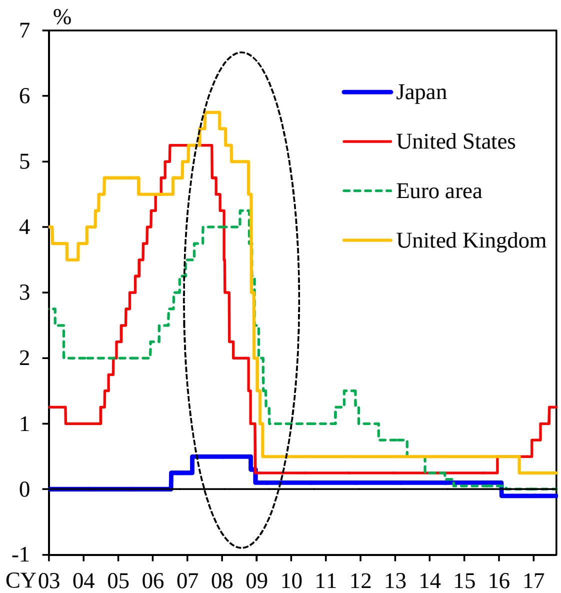
Consumer Prices



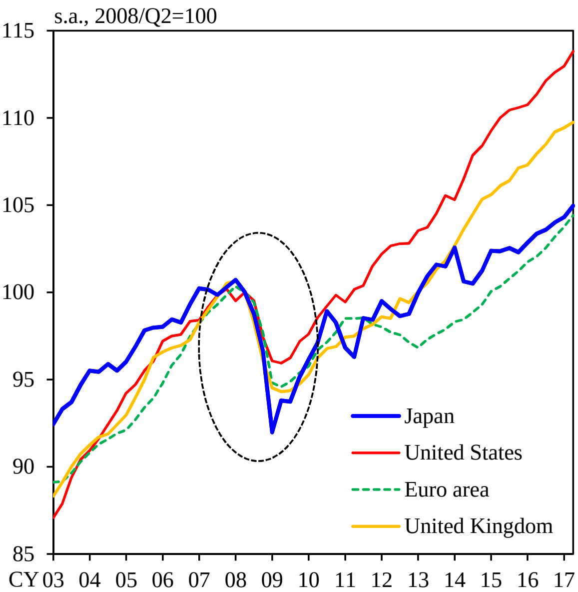
Note: The CPI figures are adjusted for changes in the consumption tax rate.
Source: Ministry of Internal Affairs and Communications.

Monetary Policy Responses and Developments in Real GDP after the Global Financial Crisis

Policy Interest Rates

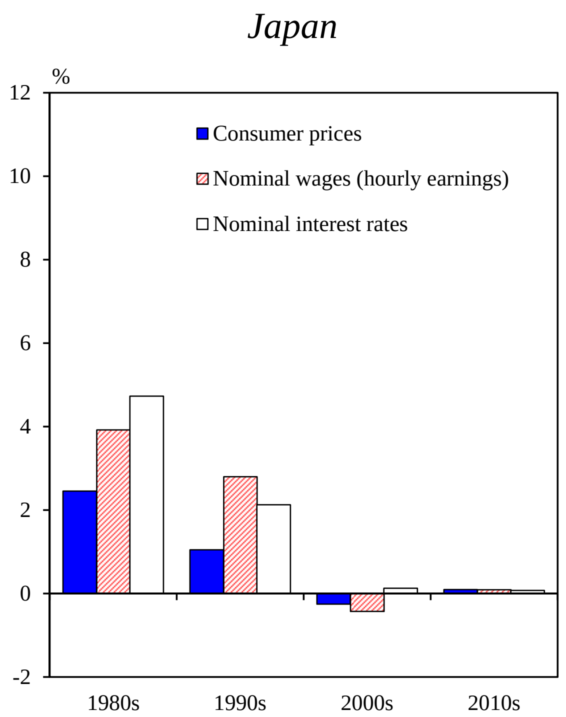


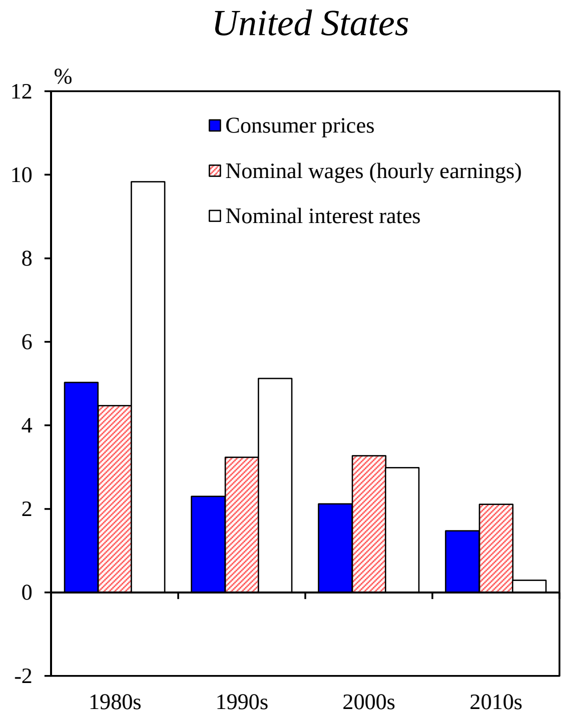
Real GDP



Note: For Japan, for the period when no target interest rate was adopted, figures for the policy rate are the interest rate applied on excess reserves.
Sources: Bank of Japan; Federal Reserve; European Central Bank; Bank of England; Cabinet Office; Haver.

Prices, Nominal Wages, and Nominal Interest Rates





Notes: 1. Figures for the 2010s are 2010-2016 averages. Figures for consumer prices and nominal wages are the averages of the year-on-year rates of change.
2. Figures for consumer prices are the CPI (all items, adjusted for changes in the consumption tax rate) for Japan and the PCE deflator (all items) for the United States.
3. Figures for nominal wages for the United States are "average hourly earnings of production and nonsupervisory employees: total private."
4. Figures for nominal interest rates include those for policy interest rates.

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