

# Makoto Sakurai: Economic activity, prices, and monetary policy in Japan

Speech by Mr Makoto Sakurai, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Hakodate, 18 October 2017.

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## I. Economic Activity at Home and Abroad: Recent Developments and the Outlook

### A. Overseas Economies

Let me start with developments in overseas economies.

Overseas economies have continued to grow at a moderate pace. Trade activity was sluggish globally following the financial crisis of 2008, but has recovered since the second half of 2016, providing support for the recent growth in the global economy. In many countries, business fixed investment has been increasing, accompanied by an improvement in corporate profits. Private consumption has also been solid against the background of an improvement in the employment and income situation. Global financial markets have responded temporarily to the increasing seriousness of the situation regarding North Korea, but so far, there have been only limited signs of investors' risk aversion.

Let me elaborate on developments by region. The U.S. and European economies have continued to recover firmly. Exports have been increasing moderately as global trade activity has recovered. Private consumption has been on a trend increase against the background of an improvement in the employment and income situation. Meanwhile, an upturn in business fixed investment has continued, accompanied by an improvement in corporate profits. Although economic activity in the United States is likely to be temporarily slowed by the effects of the recent powerful hurricanes, experience suggests that the economy will maintain its momentum toward recovery, underpinned in part by demand for reconstruction. The European economy has been experiencing a further increase recently in its cyclical momentum toward recovery, in a situation where uncertainties have been easing following events such as elections in major countries in the region.

Let me turn to emerging economies. The Chinese economy has continued to see stable growth on the whole. The momentum for growth in fixed asset investment in the private sector has slowed, due in part to the cumulative effects of monetary tightening, but public investment has maintained high growth under fiscal policy conducted in a timely manner. Exports have been on a pick-up trend, and private consumption has been resilient against the backdrop of a favorable employment and income situation. In the NIEs and ASEAN countries, with an uptrend in exports, domestic demand has been resilient, on the back of an improvement in business and household sentiment and the effects of economic stimulus measures in these countries. A recovery trend in commodity-exporting economies has been apparent recently, partly reflecting a bottoming out of commodity prices.

In terms of the outlook, moderate growth in overseas economies as a whole is projected to continue. Advanced economies are likely to continue growing steadily, and a recovery in emerging economies is expected to take hold on the back of the steady growth in advanced economies and the effects of policy measures taken by emerging economies. According to the October 2017 *World Economic Outlook* (WEO) released by the International Monetary Fund (IMF), the global growth projection represents an upward revision from the previous estimate made in July 2017; global growth is now expected to rise from 3.2 percent in 2016 to 3.6 percent in 2017 and 3.7 percent in 2018, picking up pace.

Needless to say, the outlook is not free from uncertainty. For example, particular uncertainty seems to remain in the United States over economic policy management, including tax reform. In a situation where further normalization of monetary policy by the Federal Reserve is in sight, the impact of U.S. interest rate hikes on the global flow of funds is an issue which also calls for close attention. As massive capital inflows have been observed in some emerging economies since 2016, there is the risk of an increasing impact should there be a reversal of funds. Moreover, geopolitical risks have been heightening, including with regard to North Korea. Negotiations on the United Kingdom's exit from the European Union (EU) and the effects they will have are also risks to the outlook. In the longer run, I believe that particular attention must continue to be paid to the growing protectionist mood of recent years. The establishment of supply chains through trade and direct investment has long been driving global economic growth. If the protectionist mood gains traction, this will limit trade and direct investment, making it necessary to rebuild existing supply chains. This could cause significant disruption to the global economy and deprive it of its main growth engine. Keeping a watchful eye on these uncertainties, I will continue to carefully monitor overseas developments.

## ***B. Recent Developments in Japan's Economy***

Next, I will discuss developments in Japan's economy.

The economy is expanding moderately. Exports have continued on an increasing trend, reflecting moderate growth in overseas economies. The implementation of the government's large-scale economic stimulus measures has made progress, and the synergy effects between monetary and fiscal policies have become profound. A virtuous cycle operating from income to spending has become stronger in both the corporate and household sectors, and economic growth is in the process of shifting from one led by external demand, to a more self-sustaining one accompanying a recovery in domestic demand. Improvements have been seen in wider sections of the economy; from urban areas to regional areas, and from large firms to small firms. In this way, I feel that the robustness of the economy has been further enhanced. The GDP growth rate has increased for six consecutive quarters for the first time since 2006; the annualized rate of average quarterly growth during this period marked relatively high growth of 1.7 percent, thereby maintaining a significantly higher figure than the potential growth rate, which is estimated to be in the range of 0.5-1.0 percent. This shows that the output gap — an indicator of the utilization of capital and labor — has clearly improved. This consecutive growth for several quarters also seems to have steadily exerted a positive influence on household and business sentiment.

Looking at developments in detail, in the corporate sector, exports have followed an increasing trend, particularly in automobile-related and capital goods. Corporate profits have been improving markedly since the second half of 2016. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly* (FSSC), the seasonally-adjusted ratio of current profits to sales for all industries and enterprises reached the historically high level of 6.16 percent in the April-June quarter of 2017. Business sentiment has also been improving. In the Bank's September 2017 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) released on October 2, the diffusion index for business conditions for all industries and enterprises — the proportion of firms responding that business conditions were "favorable" minus the proportion of those responding that they were "unfavorable" — reached its highest level since 1991, when the economy was experiencing an asset bubble. Improvements in economic activity have been observed in many regions and firm sizes, making it possible to conclude that the recovery has been spreading across wider economic entities. I believe this is one of the salient characteristics of the current economic expansion phase. In this situation, business fixed investment has been on a moderate increasing trend, mainly in investment related to the Olympic Games and the redevelopment of urban areas, and labor-saving and efficiency-improving investment to address labor shortages. Firms planned to substantially increase their business fixed investment for fiscal 2017 compared with the plans they made in the previous fiscal year. The rate of increase was up 6.9 percent for all industries, including the financial industry, according to the September *Tankan*,

and up 11.2 percent for major firms in all industries, according to a survey conducted by the Development Bank of Japan.

Let us turn to the household sector. Labor market conditions have tightened steadily, as the number of employees has continued to increase. The active job openings-to-applicants ratio registered 1.52, exceeding the peak level observed during the bubble period, and reaching the even higher level seen in the first half of the 1970s. The unemployment rate is currently 2.8 percent, which essentially represents a situation close to full employment. Wages of part-time employees, which are responsive to labor market conditions, have risen markedly, but wages of regular employees — the majority of employees — have only increased moderately. Private consumption has increased its resilience against the background of improvement in the employment and income situation. This resilience seems to have been underpinned by, for example, the replacement of durable goods, which consumers were encouraged to purchase by a number of demand-boosting measures implemented following the financial crisis, including the eco-point system for energy-efficient household electrical appliances. Private consumption has also been supported by large-scale economic stimulus measures carried out last year to support households, such as lowering employee insurance premiums. As seen also in Hakodate, consumption by foreign visitors to Japan — which has been on an uptrend in recent years — is contributing to sales at retail stores and in the services sector, not only in urban areas but across wider regions in Japan.

On this basis, from an overall perspective, despite the steady improvement evident in economic activity as a whole, wages have been slow to recover. Some people suggest that this is due to Japan's employment practice, which places importance on securing jobs. Firms are cautious about raising regular employees' wages because they are difficult to cut even during periods of recession, and labor unions seem to be reluctant in general to demand sharp wage hikes, since they prioritize stability of their employment in the long run. Moreover, an increase in the labor supply in recent years — resulting in part from the government's initiatives to promote the empowerment of women and the elderly — has been another factor in easing any upward pressure on wages. Especially, in practice, considering that wages paid to women and the elderly tend to be low, my view is that firms facing a labor shortage have consequently been able to obtain low-cost labor.

### ***C. Outlook for Japan's Economy***

As for the outlook, Japan's economy is likely to continue its moderate expansion, mainly supported by the growth in overseas economies and the synergy effects between monetary easing measures and stimulative fiscal measures.

In the corporate sector, profits are projected to follow an increasing trend due to growth in demand at home and abroad. Exports are likely to maintain their increasing trend as global trade activity continues to recover. Business fixed investment is expected to continue to see a moderate increase on the back of the improvement in corporate profits and accommodative financial conditions.

As for the household sector, upward pressure on wages is likely to strengthen further with the increase in demand for labor. Private consumption is expected to follow a moderate increasing trend as there will continue to be replacement demand for durable goods, and the employment and income situation will continue to improve.

In the light of these developments, the positive output gap is also expected to widen further, as the economy is likely to continue growing at a relatively high pace above its potential.

## **II. Prices**

### ***A. The Current Situation of Prices***

Next, I will turn to price developments, an issue of much interest in Japan recently.

The year-on-year rate of change in the consumer price index (CPI) for all items less fresh food has increased to 0.7 percent. The rise in energy prices has contributed to the increase in the CPI, against the background of a pick-up in crude oil prices since the spring of 2016. It must be noted, however, that developments in the CPI for all items less fresh food and energy remain relatively weak, with the year-on-year rate of change standing at 0.2 percent.

In a situation where wages are increasing, albeit moderately, firms are facing higher labor costs. However, instead of directly passing on the cost increases to sales prices, most firms are trying to absorb these increases by improving productivity. Among the initiatives they have adopted are: (1) streamlining of excessive services and inefficient business procedures, including discontinuation of late-night business and reduction of parcel delivery time slots; (2) more efficient reallocation of human resources, including sending staff temporarily to different departments when necessary, for example, from an administrative to an operational section; and (3) investment in labor-saving and efficiency-improving machinery and equipment, including installment of self-checkout machines, full automation of distribution facilities, and adoption of online booking systems.

Behind firms' reluctance to pass on cost increases to sales prices is the fear of losing customers. While this is not surprising given the highly competitive business environment they are in, I believe that the following factors are responsible for further heightening this fear. First, given that the inflation rate has remained stable at an extremely low level for the past few decades, I believe firms have become increasingly afraid to raise prices because consumers are not accustomed to price hikes, or because firms anticipate a negative reaction to price rises from those consumers. And second, the widespread use of smartphones and the expansion of e-commerce may have had an impact. Consumers can now easily refer to and compare a wide range of information on prices at the press of a button, and purchase goods and services as necessary, even from a distance. I believe these changes have increased convenience for consumers while, at the same time, increasing their responsiveness to prices, consequently somewhat accelerating price competition among firms.

## ***B. Outlook for Prices***

That being said, I do not believe that firms will be able to avoid price hikes forever. Cost cutting efforts such as streamlining of business processes and efficient reallocation of human resources have their limitations. It will gradually become difficult for firms to absorb increases in labor costs even if they are reluctant to raise prices. In this situation, competing firms in the same environment are likely to be faced with similar limitations. Therefore, I believe there will be cases of a price hike starting at an individual firm, followed by hikes at competing firms. Once price hikes actually start to become common, consumers are, to some extent, likely to accept increases in prices as a matter of course. Subsequently, there will be even greater room for firms to raise prices. Employees will then start to demand a raise in wages to reflect these price increases. Under such a cyclical mechanism, the uptrend in the inflation rate is likely to gradually strengthen toward the 2 percent price stability target.

It is difficult to predict precisely when such a cyclical mechanism will start to operate. Having said that, however, I would like to point out that some firms, in the transportation and food service industries for example, have begun to raise prices due to increasing labor costs. There are also frequent news reports that more firms are considering raising prices in the near future. While the situation may differ largely by industry, my view is that, in general, the momentum toward price hikes is starting to increase. Moreover, I feel that the perception of the general public toward price hikes has gradually become more positive recently, as reflected in major rises in the price of stocks of firms that have announced price hikes. In other words, given the evidence of successful cases of price increases, more people have begun to think that firms do not always



lose customers by raising the price of the goods and services they offer. Consumers might be gradually showing their understanding of the situation firms are placed in, hearing more frequent news reports of labor shortages.

In sum, despite the relatively weak price developments at present, a cyclical mechanism toward price increases is likely to operate going forward, as labor market conditions tighten further with improvements in economic activity. There are signs of such a mechanism working, and in my judgment, a process toward price increases has been evolving steadily.

### **III. Monetary Policy**

#### ***A. Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control***

In September 2016, the Bank introduced QQE with Yield Curve Control as a new framework for strengthening monetary easing. The framework consists of the two components of an inflation-overshooting commitment and yield curve control.

Under the inflation-overshooting commitment, the Bank commits itself to continuing to expand the monetary base until the observed year-on-year rate of increase in the CPI, for all items less fresh food, exceeds the price stability target of 2 percent and stays above the target in a stable manner. For people to regard a rise in prices of around 2 percent every year as a matter of course, I believe it is important that the Bank shows such strong commitment and that people actually experience an inflation rate of above 2 percent.

Under yield curve control, the Bank facilitates the formation of short- and long-term interest rates that are considered most appropriate in light of the 2 percent price stability target. In the Bank's current guideline for market operations, the short-term policy interest rate is set at minus 0.1 percent and the target level for yields on 10-year Japanese government bonds (JGBs) is set at around 0 percent. Since the introduction of yield curve control a year ago, short- and long-term interest rates have thus far been maintained at levels consistent with the guideline for market operations. Meanwhile, with the shift in the Bank's main operating target from quantity to interest rates, I believe that the following points have been confirmed. First, the amount of the Bank's JGB purchases varies according to financial market conditions at the time and the progress in its cumulative purchases of JGBs. And second, as a result of this, the sustainability of the Bank's policy framework has increased.

#### ***B. Future Conduct of Monetary Policy***

At present, price developments are relatively weak, and the inflation rate is fairly distant from the 2 percent price stability target. The Bank should face this fact with sincerity. Nevertheless, as I discussed earlier, Japan's economy has been improving solidly and the process toward price increases has been evolving steadily. When long-term economic growth potential is increasing and people's views on prices are changing, the real interest rate level that is considered to be neutral to economic activity — the natural rate of interest — will rise and the observed real interest rates will decrease. This, in turn, is expected to further enhance the effects of monetary easing. Taking these points into account, I believe that it is important that the Bank, for the time being, continues to firmly pursue powerful monetary easing under the current policy framework.

Recently, some have come to believe that the price stability target of 2 percent is too high, due in part to improvements in economic activity. I, however, am of the opinion that the Bank should not readily change the 2 percent price stability target, because this target was set after giving due consideration to domestic and overseas circumstances. Let me elaborate on this point. First, the CPI has a statistical tendency to assert a higher inflation rate than the inflation that people actually experience. Therefore, in order to ensure that people actually experience price stability, the rate of change in the CPI should be sufficiently positive. Second, the room for monetary policy responses is not symmetrical on the upside and downside, and there is relatively limited

scope for responding to deflation, compared with inflation, because it is difficult for the Bank to lower interest rates to a level substantially below zero. That is why it is considered desirable, under normal circumstances, to ensure that the inflation rate be positive, to a certain extent. And third, targeting inflation at 2 percent is a global standard shared by major advanced economies. Pursuing the same rate of inflation at 2 percent will contribute to the stability of foreign exchange rates in the long run, as well as price stability.

#### **IV. Expansion of the Economy's Supply Capacity**

I have pointed out various factors behind the delay in improvements in wages and prices. To summarize, I consider one of the major reasons behind the delay to be the expansion of the economy's supply capacity caused by an increase in the labor supply and by firms' efforts toward increasing productivity. I would like to elaborate on this, because it is particularly important in considering the outlook for economic activity and prices in Japan.

Starting with labor supply, the labor force participation rate in Japan rose by 1.8 percentage points over the five years to August 2017. Over the same period, the size of the labor force increased by 1.92 million, and this accounts for nearly 70 percent of the 2.82 million increase in the number of employed persons. The trend in the labor force participation rate started to rise markedly from around 2012. Indeed, the growth in labor force participation was remarkably rapid, considering the downward pressure on the participation rate stemming from an increasingly aging population. This reflects various structural changes in the economy resulting from, for example, measures to promote the empowerment of women and the elderly, including the provision of child-rearing and nursing care facilities, as well as extending the retirement age or abolishing traditional retirement systems amid the increase in life expectancy. I believe that these structural changes have eased the upward pressure on wages and prices by providing additional labor force to firms facing labor shortages.

Japan's productivity has shown relatively high growth in recent years, compared with other major advanced countries, as reported for example by a U.S. private institute, although productivity figures should be regarded as being subject to a considerable margin of error because of their large measurement bias. It has been said that Japan's productivity is low, but this could also be taken to mean merely that there is large room for improvement. As I have already mentioned, most firms are currently trying to improve productivity, and my assessment of the current situation in Japan is that, due to labor shortages, productivity is growing sharply to catch up with other countries.

Naturally, such an expansion in supply capacity raises the economy's long-term growth potential. Enhancing growth potential is an extremely important issue for Japan, which is facing a decline in population. A fall in growth potential can lead, for example, to concerns about fiscal sustainability and to restraints in firms' and households' spending due to anxiety about their long-term economic outlook. In this regard, although recent developments in supply capacity may exert downward pressure on wages and prices in the short run, they will definitely bring positive effects to the economy as a whole. I believe that the recent GDP growth — which was positive for six consecutive quarters — is attributable not merely to cyclical factors but also to these structural changes in the economy. The Bank, for its part, does not focus solely on raising prices. I believe that it is essential to achieve price stability while the virtuous cycle in the economy continues to operate and the quality of people's lives improves. A joint statement released by the government and the Bank in 2013 stated that they aim “to overcome deflation early and achieve sustainable economic growth with price stability.” My assessment of recent developments in the economy is that they are in line with such an objective.

Even if we focus on how wages and prices are affected by the increase in supply capacity, I do not think that it necessarily exerts a negative effect in the long run. As I explained earlier, there is a natural limit to the rise in the labor force participation rate, the streamlining of firms' business

processes, and the efficient reallocation of human resources. Therefore, the downward pressure on wages and prices resulting from such efforts will dissipate eventually. Let me also note that, in the long run, there are mechanisms through which an expansion in supply capacity leads to an increase in wages and prices. First, firms' expectations of higher profits and a rise in households' permanent income stimulates the demand side of the economy, such as business fixed investment and private consumption. Second, when firms' long-term outlook for the business environment starts to improve, they are likely to shift their stance toward raising wages. Third, since the rate of growth in labor productivity corresponds to the rate of increase in real wages in the long run, a rise in productivity also exerts upward pressure on wages. And fourth, an increase in the economy's long-term growth potential leads to a rise in the natural rate of interest, enhancing the effects of accommodative monetary policy measures. Given these points, it is likely that, as time passes, the long-term positive effects of an increase in supply capacity will gradually outweigh the short-term negative effects on wages and prices. In other words, although an expansion of the economy's supply capacity may delay rises in wages and prices, I do not think that it will hold them back for any protracted period.

In my view, therefore, Japan's economy is currently experiencing adjustments arising from positive structural changes. There is no need to be unduly pessimistic simply on account of the current low growth rates in wages and prices. Rather, I personally find the current state of the economy to be very promising, since both demand and supply are improving in a balanced manner, and developments in wages and prices are steadily making progress toward increases. What is crucial in this situation is not to hinder these positive developments. To this end, I think that it is important that the Bank continues to pursue powerful monetary easing under the current framework for monetary policy. At the same time, I hope to see continued progress in the various initiatives and efforts by the government and firms toward strengthening the economy's growth potential, including structural reforms.