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Bank of Japan

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

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(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 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.

In terms of the outlook, overseas economies are expected to continue growing at a moderate pace. According to the *World Economic Outlook*, released in October 2017 by the International Monetary Fund, the global growth rate is projected to be 3.6 percent in 2017 and 3.7 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 also has continued to recover steadily. As for the outlook, the economy will likely follow a moderate recovery trend, while uncertainty -- associated, for example, with political issues such as those regarding negotiations on the United Kingdom's exit from the European Union (EU) -- is expected to be a burden.

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, 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 moderately.

B. Japan's Economy and Prices

1. Economic activity

I will now discuss the economic situation in Japan. Japan's economy is expanding moderately, with a virtuous cycle from income to spending operating. The real GDP growth rate for the April-June quarter of 2017 was 0.6 percent on a quarter-on-quarter basis, representing positive growth for six consecutive quarters for the first time in about 11 years. The growth rate was above the potential growth rate, 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 on the back of growth in overseas economies. 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 domestic demand.² According to the October 2017 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), released by the Bank of Japan, the medians of the Policy Board members'

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.

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.

forecasts of the economic growth rate are 1.9 percent for fiscal 2017, 1.4 percent for fiscal 2018, and 0.7 percent for fiscal 2019.

2. Prices

Let me now explain price developments. The year-on-year rate of increase in the consumer price index (CPI) for all items less fresh food has been accelerating and is in the range of 0.5-1.0 percent, while the rate of change for all items less fresh food and energy has remained slightly positive.

With regard to the outlook, the year-on-year rate of change in the CPI (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 (all items less fresh food) presented in the October 2017 Outlook Report are 0.8 percent for fiscal 2017, 1.4 percent for fiscal 2018, and, excluding the direct effects of the scheduled consumption tax hike, 1.8 percent for fiscal 2019.³

II. Characteristics of Japan's Economy and Keys to Assessing the Outlook for Economic Activity and Prices

In what follows, I would like to outline my understanding of the characteristics of the recent developments in Japan's economy and then discuss several points that I think deserve particular attention in terms of realizing the outlook for economic activity and prices that I mentioned earlier.

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.

A. Characteristics of the Recent Developments in Japan's Economy

One of the characteristics of the recent developments in Japan's economy is how the economic growth has been led by various components in a well-balanced manner. In terms of external demand, exports have been on an increasing trend, with overseas economies continuing to grow at a moderate pace. For domestic private demand, business fixed investment has been on a moderate increasing trend, with corporate profits and business sentiment improving, and private consumption has increased its resilience against the background of steady improvement in the employment and income situation. Regarding public demand, public investment also has been increasing as the positive effects resulting from the set of stimulus measures formulated in fiscal 2016 became evident.

The recent environment in which multiple components of the economy are contributing to its overall expansion in a well-balanced manner is necessary for Japan's economy to continue expanding moderately. I consider that such environment is especially important in the operation of the virtuous cycle from income to spending and the functioning of the mechanism in which inflation rises moderately accompanied by wage increases.

B. Employment and Income Situation

Let me now talk about the employment and income situation as one of the factors to consider in assessing the outlook for economic activity and prices. Supply-demand conditions in the labor market have continued to tighten steadily. The active job openings-to-applicants ratio -- which has followed a steady uptrend -- has been at a high level last seen in the first half of the 1970s, as the rate of increase in the number of employees has continued to show growth of around 1.5 percent. Moreover, the unemployment rate has been in the range of 2.5-3.0 percent recently and a perception of labor shortage has heightened. It is expected that the number of employees will keep increasing and that the supply-demand conditions in the labor market will tighten further.

On the wage side, total cash earnings per employee have risen moderately, albeit with some fluctuations. The year-on-year rate of increase in hourly scheduled cash earnings of part-time employees, which are responsive to supply-demand conditions in the labor market, recently registered relatively high growth of around 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 such employment and wage conditions, employee income has increased moderately, albeit with fluctuations. Going forward, it is likely to increase at a moderate pace, but with differences in wage-setting mechanisms between full-time and part-time employees, there is a risk that firms will remain cautious with their decisions on wage setting. In this context, I am paying attention to firms' stance regarding wages going forward.

C. Prices

Next, I will discuss the output gap and inflation expectations, which are the main factors that determine inflation rates. First, the output gap has improved steadily, being in the range of 1.0-1.5 percent in the April-June quarter of 2017. Considering the improvements seen in various indexes, the output gap likely will have expanded somewhat within positive territory in the July-September quarter. 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. As for the outlook, they 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.

I would note that attention needs to be paid to the possibility that, depending on the

developments in firms' price-setting stance, there might be items for which prices are not particularly responsive to the output gap and the rise in inflation expectations might be delayed.

III. Conduct of Monetary Policy

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

The Bank has set the price stability target at 2 percent in terms of the year-on-year rate of change in the CPI and has been conducting monetary policy to achieve this target at the earliest possible time.

There are three reasons why the Bank is aiming at 2 percent inflation. The first is a bias in price statistics. Since the CPI has a statistical tendency of demonstrating a higher inflation rate than the actual one, a sufficiently high inflation rate is necessary in order to ensure price stability. The second reason is with regard to securing policy room for the future. The level of nominal interest rates is usually determined in accordance with that of inflation rates. With a high level of nominal interest rates, the Bank will have more room for a monetary policy response by being able to push down the policy interest rates to stimulate the economy at times of economic downturns. The third reason is that the 2 percent target is a global standard. Central banks in major economies are currently conducting monetary policy with the aim of achieving around 2 percent inflation. For this reason, it is considered that the Bank's aim of achieving 2 percent inflation will lead to stable foreign exchange rates in the long run and also contribute to the stability of corporate activities.

What is important here is that the Bank conducts monetary policy based on the principle that the policy shall aim at "achieving price stability, thereby contributing to the sound development of the national economy," as stipulated in the Bank of Japan Act. The Bank is not simply trying to achieve a rise in prices, but it is aiming for an economy with a virtuous cycle in which the incomes of people increase firmly as the price stability target of 2 percent is achieved. If prices rise in a stable manner and firms and households start to behave based on this assumption, prices of goods and services will rise, which in turn will increase firms' sales and profits. With such increases, wages would rise accordingly, leading to more active

consumption. The Bank is aiming to achieve a sustainable price stability in which such an economic virtuous cycle operates.

With a view to achieving the price stability target, the Bank introduced Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control in September 2016, and has been implementing powerful monetary easing policy under this framework.

This policy framework 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.

Currently, the momentum toward achieving the price stability target of 2 percent is being maintained firmly, and the year-on-year rate of change in the CPI is expected to increase toward 2 percent. Nevertheless, there is still a long way to go to achieve the 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 persistently 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 for Japan's economy from a longer-term perspective.

According to the Bank's estimates, the potential growth rate, which was about 4 percent in the latter half of the 1980s, has been in the range of 0.5-1.0 percent recently. It can be said that the rate -- although it has been on an increasing trend in recent years -- has been trending downward over the long term, mainly reflecting the population decline and low productivity growth. This has led to a decline in growth expectations in Japan, engendering some pessimistic views on the prospects for the economy.

Although it is true that the population decline has a large impact on the economy and that productivity improvement takes time, I consider it unnecessary to underestimate the potential of Japan's economy; my view is that it is possible to boost the potential growth rate. Let me add that raising the potential growth rate is also important as the Bank aims for sustainable price stability, and efforts by a wide range of entities are necessary to this end.

To raise the potential growth rate of the economy, from the viewpoint of the management of firms, they not only need to streamline or upgrade their supply systems, but also explore new demand and arrange their supply systems in a way that would match such demand, given that we are in a time when consumers' demand varies and constantly changes. In other words, it is necessary for firms to tap potential demand and work on product innovation -- which aims to develop and provide new products that are unique and have high value-added -- over the long term in a sustainable manner.

To this end, I believe that two factors are especially important: personnel who can develop new products, and an environment in which such products are desired. Needless to say, it is necessary to acquire personnel who are capable of producing and implementing new ideas to generate innovations, regardless of their scale -- that is, innovations ranging from paradigm-shifting developments to refinements to existing products. Let me also highlight the importance of an environment in which new products are desired. In order for a number of innovations to be created in Japan, it is essential to maintain the virtuous cycle between demand and innovation by appropriately stimulating demand. It is said that necessity is the mother of invention. In other words, innovation is unlikely to occur when not many consumers seek products that outperform existing ones. Having said that, the current situation, in which the Bank's accommodative monetary policy is appropriately stimulating

demand, is likely having a positive impact in terms of bringing about innovation. Of course, it takes time to tap potential demand and transform this into actual demand. Therefore, I believe it is important to persistently maintain accommodative financial conditions with a view to accelerating innovation.

Thank you for your attention.