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Bank of Japan

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

Speech at a Meeting with Business Leaders in Hyogo

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(English translation based on the Japanese original)

I. Developments in Economic Activity and Prices

I would like to start my speech with a look at developments in economic activity and prices.

At the Monetary Policy Meeting held on October 30 and 31, 2017, the Bank of Japan published the *Outlook for Economic Activity and Prices*, or the Outlook Report. In this report, the Bank presented its projections for Japan's economic activity and prices through fiscal 2019.

I will explain developments in economic activity and prices by presenting the main content of the Outlook Report.

A. Overseas Economies

Let me first touch on developments in overseas economies. The Bank's assessment is that overseas economies have continued to grow at a moderate pace on the whole.

In terms of the outlook, advanced economies are projected to continue growing steadily, and a recovery in emerging economies is likely to take hold on the back of the steady growth in advanced economies and the effects of policy measures taken by emerging economies. A similar view was presented in the *World Economic Outlook* (WEO) released in October 2017 by the International Monetary Fund (IMF). In recent years, the IMF has often revised downward the projections for global growth, but from early fiscal 2017, it has revised them upward.

Looking at developments by major region, the U.S. economy has continued to recover, 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 and it will likely follow a moderate recovery trend.

The Chinese economy will likely continue to broadly follow a stable growth path as the authorities conduct fiscal and monetary policy in a timely manner.

Other emerging economies and commodity-exporting economies have picked up on the whole, particularly reflecting an increase in exports, the past bottoming out of commodity prices, and the effects of economic stimulus measures in those economies. The growth rates of these economies are likely to increase gradually, due mainly to the spread of the effects of steady growth in advanced economies.

In my view, the downside risks to the global economy have been diminishing on the whole, partly because concerns over the financial sector in Europe have abated. In this situation, I am paying particular attention to firm international commodity prices; namely, crude oil prices. While uncertainties regarding the global economic outlook have been easing, it is likely that commodity-related fixed investment, which has been curtailed over the last few years, will start increasing. I expect there to be a strong possibility of the global economy continuing its steady growth through fiscal 2018.

B. Japan's Economy and Price Developments

1. Current situation

Now I would like to discuss developments in economic activity and prices in Japan.

The Bank's assessment is that Japan's economy is expanding moderately, with a virtuous cycle from income to spending operating. In fiscal 2017 to date, the Bank has revised up its economic assessment twice. Industrial production has been on an increasing trend, reflecting the increases in demand both at home and abroad, and labor market conditions have continued to tighten steadily. As a result, the output gap -- which captures the utilization of labor and capital -- has improved steadily.

On the domestic demand side, business fixed investment has been on a moderate increasing trend with corporate profits and business sentiment improving. According to the September 2017 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), business fixed investment plans for fiscal 2017, especially those of large enterprises, showed firms' solid

stance. This is evidenced by, for example, the fact that fixed investment on a basis close to GDP definition saw a year-on-year increase of 6.9 percent -- a level clearly exceeding the past average of 4.9 percent for the September *Tankan* surveys during the period of fiscal 2004-2016. Private consumption has increased its resilience against the background of steady improvement in the employment and income situation, and housing investment has been more or less flat. Exports have been on an increasing trend on the back of the growth in overseas economies that I mentioned earlier.

One of the features of the ongoing expansionary phase is that the economy has been growing across a wide range of regions, firm sizes, and industries in comparison with past expansions. In the latest September 2017 *Tankan*, the diffusion index for business conditions in small firms reached its highest level in almost 26 years. In the *Regional Economic Report*, many regions have revised their economic assessments upward in 2017. Indeed, the Kinki region, which includes Hyogo Prefecture, has revised up its assessment in the two previous reports released in July and October.

On the price front, the year-on-year rate of change in the consumer price index (CPI) for all items less fresh food is in the range of 0.5-1.0 percent.

2. Outlook

I will now look at the outlook for Japan's economy during the projection period, which covers from fiscal 2017 through fiscal 2019. The economy is likely to continue its moderate expansion. Domestic demand is likely to follow an uptrend on the back of highly accommodative financial conditions and fiscal spending through the government's large-scale stimulus measures. Exports are expected to continue their moderate increasing trend along with the growth in overseas economies. Reflecting this outlook, Japan's economy is likely to maintain growth during this projection period at a pace above its potential, mainly through fiscal 2018. In fiscal 2019, it is expected to continue expanding, although the growth pace is projected to decelerate due to a cyclical slowdown in business fixed investment and the effects of the consumption tax hike scheduled in October 2019. Looking at the medians of the Policy Board members' forecasts in the October 2017 Outlook Report, the real GDP growth rate is projected to be 1.9 percent for fiscal 2017, 1.4

percent for fiscal 2018, and 0.7 percent for fiscal 2019.

Let me explain the outlook in detail by major component. First, business fixed investment is likely to continue increasing moderately. This is because, in a situation where extremely stimulative financial conditions are maintained, fixed investment will be positively affected by (1) an improvement in corporate profits, (2) the materialization of the effects of projects conducted under the Fiscal Investment and Loan Program, and (3) moderate improvement in growth expectations. Specifically, an increase is likely to be seen in investment, particularly (1) that related to the 2020 Olympic Games and urban redevelopment projects, (2) that aiming at improving efficiency and saving labor in order to deal with the labor shortage, and (3) in research and development for growth areas. Private consumption is expected to follow a moderate increasing trend, due mainly to an increase in employee income as well as replacement demand for durable goods, and housing investment is expected to remain more or less flat. Exports are likely to be firm as a trend for the time being, underpinned by those of IT-related goods and capital goods, in which Japan has a comparative advantage. Thereafter, they are expected to continue their moderate increasing trend, due mainly to the improvement in overseas economies. Industrial production will likely continue to increase firmly for the time being, and thereafter is projected to continue on a moderate increasing trend.

The year-on-year rate of change in the CPI (all items less fresh food) is likely to increase toward around 2 percent. This is because, although upward pressure of energy prices is likely to wane gradually, firms are likely to gradually shift their stance toward raising wages and prices with an improvement in the output gap, and inflation expectations are expected to accelerate moderately. In the short run, the rate of increase in prices of food products and goods related to daily necessities in particular is expected to accelerate gradually with a moderate increase in private consumption, and moves to pass on the increase in labor costs to prices of general services, including dining-out and housework-related services, are likely to prevail. Looking at the medians of the Policy Board members' forecasts in the October 2017 Outlook Report, the year-on-year rate of change in the CPI (all items less fresh food) is projected to be 0.8 percent for fiscal 2017, 1.4 percent for fiscal 2018, and -- on a basis excluding the effects of the scheduled consumption tax hike -- 1.8 percent for fiscal 2019.

I believe that there are the following upside and downside risks to the outlook. Risks to Japan's economic activity are developments in overseas economies, such as the U.S. economic policies and geopolitical risks, firms' and households' medium- to long-term growth expectations, as well as fiscal sustainability in the medium to long term. Risks to prices are developments in firms' and households' medium- to long-term inflation expectations, the fact that there are items for which prices are not particularly responsive to the output gap, as well as developments in foreign exchange rates and international commodity prices going forward. I hold the view that, while downside risks to Japan's economic activity are limited, those to prices are fairly significant. This is particularly so because of the considerable uncertainty as to how far firms will adopt a shared attitude toward raising prices.

II. The Bank's Monetary Policy

Next, I will talk about the Bank's monetary policy. With a view to achieving the price stability target of 2 percent, the Bank has been maintaining highly accommodative financial conditions by pursuing strong monetary easing.

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

The framework of QQE with Yield Curve Control the Bank has adopted consists of two major components.

The first is an "inflation-overshooting commitment" in which the Bank commits itself to continuing to expand the monetary base until the year-on-year rate of increase in the observed CPI exceeds the price stability target of 2 percent and stays above the target in a stable manner. It aims at raising inflation expectations by demonstrating the Bank's unwavering determination. I will come back to this point again later.

The second component is "yield curve control," in which the Bank controls short-term and long-term interest rates. In the current framework, it sets the short-term policy interest rate and the target level of the 10-year Japanese government bond (JGB) yields as its operating targets. At present, in the guideline for market operations, the Bank sets the short-term rate at minus 0.1 percent and the target level at around 0 percent, and conducts JGB purchases

so as to achieve this target level.

B. The Aim of Strong Monetary Easing

Since the introduction of QQE in April 2013, the basic mechanism of monetary easing itself has not changed; that is, (1) pushing down the entire yield curve through the Bank's large-scale purchases of JGBs and (2) raising inflation expectations through the Bank's strong commitment to the 2 percent price stability target. These factors lead to a reduction in real interest rates.

Now, why does the Bank think that it is necessary to reduce interest rates to extremely low levels? The basic mechanism of monetary easing consists of driving real interest rates below the interest rate neutral to economic activity and prices; that is, the natural rate of interest. Japan's natural rate of interest has followed a downward trend, mainly reflecting the deceleration in the potential growth rate.¹ The estimation results obtained by the Bank's staff suggest that the natural rate of interest has been at around 0 percent recently. Given that estimates of the rate differ depending on the methodologies employed, they should be regarded as being subject to a considerable margin of error; however, the results show that the rate has been at an extremely low level. Therefore, in order to realize accommodative financial conditions with such a low level of the natural rate of interest, it is necessary to bring interest rates down further. I consider that the current highly accommodative financial conditions -- created by the yield curve control in this way -- have strongly supported Japan's economic activity from the financial side.

C. Toward Changing the Norm for Prices

Japan's economy has suffered from deflation for more than 15 years, since the late 1990s, with the year-on-year rate of change in the CPI being about zero or slightly negative. One likely reason why it has been taking time for the deflationary mindset to be dispelled in Japan is that households and firms have been adaptive to the deflationary environment. Despite the strong monetary easing being pursued for almost five years, the 2 percent price stability target has not been achieved. This confirms that the deflationary mindset was more

¹ Such a downward trend in the natural rate of interest is not unique to Japan, but rather is a global phenomenon. This is one element behind the fact that, since the global financial crisis, interest rates in Japan, the United States, and Europe have declined to lower levels than ever before.

persistent than initially had been assumed, although there were external factors such as the substantial decline in crude oil prices. Having said that, it is still necessary to pursue strong monetary easing; that is, to drive real interest rates sufficiently below the natural rate of interest. Meanwhile, almost five years have passed since the Bank introduced QQE, and I believe that the positive effects and side effects of QQE continue to warrant careful examination.

Recently, price increases around the world have been relatively weak, and many have been pointing out that the factors behind this are the deepening of globalization and digitalization. As research on these factors is still in progress, the empirical evidence has not yet yielded conclusive results.² I consider it important to fully take into account the effects of such changes in the economic structure on prices. However, even if the effects stemming from globalization and digitalization have been pushing down prices in advanced economies to some extent, I think price developments in Japan are quite different from those in the United States and Europe. This is because inflation expectations seem to be anchored at around 2 percent in the United States and Europe, with the price indexes showing that the underlying trend has been at around 1.5 percent, despite the past experience of the substantial decline in crude oil prices. On this point, in Japan, the year-on-year rate of change in the CPI (all items less fresh food) remains in the range of 0.5-1.0 percent -- as I mentioned earlier -- and that in the CPI (less fresh food and energy) is still in the range of 0.0-0.5 percent.

In order to achieve the 2 percent price stability target in Japan, it is necessary that (1) the deflationary mindset be dispelled, and (2) the perception that prices of goods and services as well as wages are supposed to go up every year by around 2 percent becomes firmly entrenched in society as a whole -- or, in other words, the 2 percent inflation takes hold as a

² The well-known argument that a global approach should be taken into account in the basic determinants of inflation is one made by Claudio Borio, Head of the Monetary and Economic Department of the Bank for International Settlements (BIS). For the recent empirical analysis, see the following: Auer, Raphael, Claudio Borio, and Andrew Filardo. "The globalisation of inflation: the growing importance of global value chains." *BIS Working Papers* no. 602 (January 2017). <https://www.bis.org/publ/work602.pdf>. Meanwhile, there has been no confirmation of any noticeable, direct influence of global slack on domestic inflation, according to the analysis conducted by economists from the Federal Reserve Board. For details, see the following: Ihrig, Jane, Steven B. Kamin, Deborah Lindner, and Jaime Marquez. "Some Simple Tests of the Globalization and Inflation Hypothesis." *International Finance* vol. 13, issue 3 (December 2010): 343-375. Federal Reserve Board staff have updated the latter analysis using data through early 2017, and have confirmed that their argument remains valid.

norm for prices. In this regard, it is essential that the Bank be committed in its conduct of monetary policy so as to achieve the price stability target, as I mentioned earlier. In the meantime, maintaining effective communication between the Bank and the government is crucial. Furthermore, nationwide changes are needed in the overall behavior and awareness toward prices. Of firms that have raised prices of their products and services recently, many have done so for the first time in more than two decades, and at present, firms themselves have limited experience in terms of raising prices. Moreover, consumers are not yet accustomed to an environment where both wages and prices increase at a certain pace. Thus, a change in the norm does indeed mean changes in various aspects of society. Financial literacy -- the next topic I will touch upon -- may seem unrelated to economic activity and prices or monetary policy at first, but I believe it does in fact have a connection with changing the norm I just described.

III. Initiatives to Improve Financial Literacy

A. Global Awareness of the Importance of Financial Education

The importance of financial education has been reaffirmed worldwide in the wake of the global financial crisis. In 2012, the Organisation for Economic Co-operation and Development (OECD) developed the High-Level Principles on National Strategies for Financial Education, which was then endorsed by the G-20 at their summit in Los Cabos later that year. According to the OECD, financial education is not merely the dissemination of financial knowledge, but "the process by which financial consumers/investors improve their understanding of financial products, concepts and risks and, through information, instruction and/or objective advice, develop the skills and confidence to become more aware of financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being."³ There has been widespread progress in initiatives to improve financial education, based on the principles endorsed by the G-20 leaders. It has been reported that the number of governments that have adopted national strategies for financial education has increased to almost 60.

³ OECD, "Recommendation on Principles and Good Practices for Financial Education and Awareness" (2005). <http://www.oecd.org/finance/financial-education/35108560.pdf>.

B. Importance of Improving Financial Literacy in Japan

As part of this global movement, Japan's Financial Services Agency (FSA) and Central Council for Financial Services Information (CCFSI) established the Committee for the Promotion of Financial Education in 2013, and have been strengthening their initiatives to promote financial and economic education.^{4,5} Let me also mention the government's growth strategy, the Investments for the Future Strategy 2017, approved by the Cabinet in June 2017. The strategy refers to the Nippon Individual Savings Account (NISA), a tax-free small-lot investment program introduced in 2014. It states that, in order to promote households' stable formation of assets, the government will further disseminate and promote the NISA system, including the introduction in January 2018 of the installment-type NISA, and enhance the financial and investment education that leads to improved practical knowledge of investment among households. I believe that it is crucial to improve financial literacy given the situation where many people feel somewhat uncertain about the future. Moreover, as I mentioned earlier, the Bank of Japan aims to achieve the 2 percent price stability target, and in a society where wages and prices rise in a stable manner, financial literacy becomes even more important. Therefore, I believe that the promotion of financial education in Japan is now particularly significant.

A number of surveys on financial literacy have been conducted in Japan, with their results revealing many challenges. One such survey is the *Financial Literacy Survey* conducted in 2016 by the CCFSI. In international comparisons, Japan ranked 24th out of 31 countries and economies in terms of the percentage of correct answers given to common financial questions.⁶ According to another survey, the percentage of correct answers given to a

⁴ Since 1950, efforts to encourage voluntary and proactive savings, with the aim of realizing economic autonomy, were led by the Local Councils for Savings Promotion. The Central Council for Savings Promotion was established in 1952 as the focus for private organizations related to this movement. This was then reorganized as the Central Council for Savings Information to concentrate on public relations activities providing accurate knowledge and information regarding the economy, finance, and currency. The council was then renamed as the CCFSI (Secretariat: Public Relations Department, Bank of Japan) in 2001.

⁵ As suggested by the April 2013 report of the Study Group on Financial Education under the FSA, the Committee for the Promotion of Financial Education (Secretariat: CCFSI) was established to address challenges facing the promotion of financial and economic education.

⁶ The *Financial Literacy Survey* is Japan's first large-scale survey covering 25,000 individuals chosen in proportion to Japan's demographic structure. The comparison with overseas was done in

question about the meaning of deflation was slightly above 20 percent.⁷ Obviously, it is no wonder that we face many challenges in financial education, as is the case with education in general. My concern, however, is the possibility that there is not sufficient recognition in Japan of the necessity for financial education in the first place. For example, in a survey of adults conducted in 2016 by the FSA, about 70 percent of respondents answered that they "have not participated in investment education," and about two-thirds of these respondents stated that they "do not wish to acquire financial or investment knowledge." This means that nearly half of all respondents in the survey indicated such unwillingness. My impression is that investment, in particular, is still perceived as something that wealthy people do.⁸ While this may be partly due to the prolonged period of deflation, I believe it is important that the necessity of financial education gain more recognition in Japanese society. I feel that an increase in such awareness is similar to a rise in public acceptance of a certain degree of increase in prices. It seems to me that both are indicative of a social norm where it is taken for granted that wages and prices rise in a stable manner.

terms of the simple average for the percentage of correct answers given to six common questions in the OECD survey, which was conducted in 30 countries and economies in 2016.

⁷ The multiple-choice question asked: "Which of the statements is correct in times of deflation, where prices continue to decline?" There were three answer choices: (1) "Borrowing is profitable because the value of money increases"; (2) "Borrowing is unprofitable because the value of money increases"; or (3) "Borrowing is unprofitable because the value of money decreases." The survey covered men and women living in Japan, aged from 20 to 69, with 1,000 people providing valid responses to the questions. The results were published in *The Nikkei* on September 2, 2017.

⁸ According to the *National Survey on Securities Investment* conducted in 2015 by the Japan Securities Dealers Association, about 30 percent of respondents answered that securities investment was "something that wealthy people do." The survey was conducted on 7,000 men and women living in Japan who were at least 20 years of age.