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Bank of Japan

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

*Speech at a Meeting with Business Leaders in Gunma*

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(English translation based on the Japanese original)

## **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 firmly on the whole. Trade activity was sluggish globally following the financial crisis of 2008, but it has been recovering markedly recently. Under these circumstances, as favorable effects spill over from advanced to emerging economies, the momentum toward recovery is spreading to broader regions. Global financial markets, which became somewhat unstable from February, have been regaining calmness of late.

Looking at developments in detail, the U.S. economy has been expanding. As exports have been on an increasing trend, business and household sentiment is improving as well. Expansionary fiscal measures taken by the U.S. government are also expected to push domestic demand upward in the short term. The European economy also has continued to recover firmly as a trend. Although several economic indicators have showed signs of a slowdown recently, this is considered to be due to temporary factors such as a reaction to the high growth that continued until the end of 2017, unfavorable weather conditions, and industrial strikes.

Among emerging economies, the Chinese economy has continued to see stable growth on the whole. Exports have been increasing, and domestic demand has continued to be firm, underpinned by growth in public investment. In the NIEs and the ASEAN countries, exports have been following an uptrend, and domestic demand has been resilient on the back of the improvement in business and household sentiment and economic stimulus measures taken by their authorities. Commodity-exporting economies such as Brazil, Russia, and South Africa have been recovering moderately as their central banks have been engaging in monetary easing following the declines in their inflation rates.

Since February 2018, global financial markets, mainly in the United States, have exhibited unstable movements. However, this is considered to represent a strong reaction to the steep stock price rise from the latter half of 2017, which was partly caused by expectations for

fiscal expansion in the United States, and to the overheated speculative trading in some countries of financial products, betting on a decline in financial market volatility. Recently, as these developments have subsided, global financial markets seem to be regaining calmness.

As for the outlook, overseas economies are expected to continue growing firmly. As trade activity in the manufacturing sector has stayed firm globally, advanced and emerging economies are expected to grow in a well-balanced manner. According to the April 2018 *World Economic Outlook* (WEO) released by the International Monetary Fund (IMF), the global growth rate was projected at 3.9 percent in each of 2018 and 2019, up slightly from 3.8 percent in 2017.

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

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

Japan's economy is expanding moderately, with steady growth in overseas economies as well as highly accommodative financial conditions and government spending. A virtuous cycle operating from income to spending has become stronger in both the corporate and household sectors, and the economy is in the process of shifting from growth led by external demand to more self-sustaining growth accompanied by a recovery in domestic demand. The economy recorded positive growth for the eighth consecutive quarter until the end of 2017. Although it marked small negative growth in the January-March quarter of 2018, this was due to temporary factors such as unfavorable weather conditions. As relatively high economic growth has continued as a trend, the positive output gap -- an indicator of the utilization of capital and labor -- has been widening steadily. Amid the growing supply-side constraints in some sectors of the economy, firms are taking measures to enhance supply capacity, such as increasing their labor force, making business fixed investment that is intended to promote labor saving and expand production capacity, and streamlining their business processes. As a result, Japan's economy has maintained well-balanced growth on both the demand and supply sides.

Looking at developments in more detail, in the corporate sector, exports have been on an increasing trend on the back of the firm growth in overseas economies. For example, here in Gunma Prefecture, exports, particularly of transportation machinery, showed strength. A factor contributing to the strength in overall exports is the growth in inbound demand led by the increasing number of visitors to the World Heritage site Tomioka Silk Mill and to popular hot springs. As Japan's economy has continued to grow moderately, corporate profits and business sentiment also have maintained their improving trend. While labor shortages have continued and supply-side constraints gradually have become apparent, as evidenced by delays in procurement of some components in the manufacturing sector and an increase in front-loaded orders placed in anticipation of future delays, firms are becoming more active in making business fixed investment intended to promote labor saving and expand production capacity. According to the Bank's March 2018 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the diffusion index for business conditions for all industries and enterprises improved for the seventh consecutive quarter, reaching the highest level since 1991.<sup>1</sup> Business fixed investment plans for all industries and enterprises, including financial institutions, showed a relatively strong year-on-year increase of 4.3 percent for fiscal 2017 and 2.0 percent for fiscal 2018.

Let us turn to the household sector. Labor market conditions have tightened steadily as the number of employees has increased. The active job openings-to-applicants ratio has surpassed the peak level observed during the bubble period. The unemployment rate is 2.5 percent, a level that essentially represents a situation close to full employment. Firms are making active efforts to secure their labor force while expanding the scope of workers who may be employed and are promoting a shift from non-regular to regular employment. Wages of part-time employees, which are responsive to labor market conditions, have risen markedly. Although wages of regular employees -- the majority of employees -- have continued to increase only moderately, there are signs of gradual yet stronger improvement in wages. For example, the growth in base pay in fiscal 2018 is projected to exceed the actual growth of a year earlier, as in the previous year, and the share of firms raising wages

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<sup>1</sup> The diffusion index for business conditions is calculated as the proportion of firms responding that business conditions were "favorable" minus the proportion of those responding that they were "unfavorable."

of regular employees is growing. With the employment and income situation improving, as I have mentioned, private consumption also has been increasing moderately.

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

As for the outlook, Japan's economy is likely to continue its moderate expansion, supported by the highly accommodative financial conditions and stimulative fiscal measures. In line with the firm growth in overseas economies, exports are likely to maintain their increasing trend. As a virtuous cycle operating from income to spending is being maintained in both the corporate and household sectors, business fixed investment and private consumption are also likely to follow an uptrend. I believe that the impact of the consumption tax hike scheduled for 2019 is highly uncertain, yet most likely to be smaller than the impact of the tax hike in 2014. At the time of the previous consumption tax hike, the last-minute rise in demand before the hike and the ensuing fallback in demand turned out to be strong, particularly with respect to high-priced products, not only because the margin of the hike was large but also because a second tax hike was expected down the road. Application of a reduced tax rate on some products and policies concerning the provision of free education will also contribute to lightening the burden on households.

According to the April 2018 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) released by the Bank, the median of the Policy Board members' forecasts of the real GDP growth rate in fiscal 2018 was 1.6 percent. This represents a slight upward revision of the forecast made three months ago. In fiscal 2019 and 2020, the growth rate is expected to decline to around 0.8 percent, a level close to the potential growth rate, because of such factors as a cyclical slowdown in business fixed investment and a fallback in Olympic Games-related demand.

Needless to say, the outlook is not free from uncertainty. Among the main risks, we must keep a watchful eye on overseas factors. In particular, I am concerned about a possible spread of protectionist measures in trade policy. In the past, trade and investment liberalization, coupled with the advances in technological innovation, has driven global economic growth. As new technologies have been disseminated through trade and investment activities, productivity improvement and further technological development

have been promoted across the regions. If the protectionist mood gains traction and constrains trade and investment, the global economy could be deprived of its main growth engine. Moreover, uncertainty over the U.S. economic policy management is growing. If the inflation rate accelerates or concerns over the deterioration of the fiscal balance grow while favorable economic conditions continue and the government implements expansionary fiscal measures, there is a risk that interest rates will shoot up, triggering a stock price plunge and changes in the global flow of funds. In addition, we must keep a watchful eye on the negotiations on the United Kingdom's exit from the European Union (EU) and geopolitical risks related to North Korea and the Middle East. All these risk factors could significantly affect Japan; therefore, while continuing to pay due attention to them, the Bank will closely examine developments at home and abroad.

## **II. Prices**

### **A. Current Situation**

Next, I will turn to price developments. The year-on-year rate of change in the consumer price index (CPI) for all items less fresh food for April, which was released on May 18, 2018, was 0.7 percent. The rise in energy prices has contributed considerably to the increase in the CPI. Meanwhile, the increase in the CPI for all items less fresh food and energy for April remained only moderate, with the year-on-year rate of change standing at 0.4 percent.

Despite the continued improvement in economic conditions, the growth in wages and prices has been sluggish, and various factors have been pointed out as the causes. I am paying particular attention to the changes in the economy's supply capacity. For example, while the tightness in labor market conditions has been highlighted by the media, the labor force participation rate, which had been trending downward, has started to rise, partly as a result of various initiatives conducted by the government and firms. In addition, the number of employees who have reluctantly accepted non-regular employment -- due to a lack of opportunities to work as regular employees -- is declining. This is because firms are promoting a shift from non-regular to regular employment in order to retain their labor force. Firms also have made progress with such activities as making business fixed

investment intended to promote labor saving and streamlining their business processes.<sup>2</sup> All of these changes lead to an expansion of the economy's supply capacity in terms of labor input and labor productivity. I believe that such expansion appears to be easing the upward pressure on wages and prices associated with an increase in demand.

## **B. Outlook**

That being said, I do not believe that the sluggish growth in wages and prices will continue forever. There are certain limits to the extent of such activities as raising the labor force participation rate, promoting a shift from non-regular to regular employment, and streamlining business processes. In the longer term, the effects of the expansion of supply capacity in curbing growth in wages and prices are expected to decline in due course.

Meanwhile, the expansion of the economy's supply capacity will strengthen the economy's growth potential. If expectations for growth increase on the back of the continued expansion of supply capacity, thereby increasing expectations of households regarding permanent income and of firms about future earnings, this may push up wages and prices through active consumption and business fixed investment.

As I explained so far, although the recent expansion of the economy's supply capacity may delay growth in wages and prices in the short term, it is unlikely to become a factor that will keep wages and prices at low levels in the long term. As wages and prices start increasing, the public's inflation expectations are likely to rise through the adaptive formation mechanism. Therefore, my judgment is that the momentum toward achieving the Bank's 2 percent price stability target is being maintained. According to the April 2018 Outlook Report, the medians of the Policy Board members' forecasts of the year-on-year rate of change in the CPI for all items less fresh food were 1.3 percent for fiscal 2018 and 1.8 percent for fiscal 2019 and 2020, excluding the effects of the consumption tax hike.

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<sup>2</sup> The annex to the *Regional Economic Report* (available only in Japanese) released in December 2017 presents some cases of firms' initiatives taken toward improving productivity.

### **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. This framework consists of two main components.

One of the two is yield curve control, whereby 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. This is intended to support proactive economic activities by Japanese firms and households through maintaining highly accommodative financial conditions.

The other main component is the inflation-overshooting commitment. This represents the Bank's strong commitment 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. In Japan, the inflation rate has remained stable at low levels over a long period of time. For Japanese firms and households, the low inflation rate has become a quite natural condition that serves as a premise for conducting economic activities. Going forward, in order to raise prices in a stable manner, it is necessary to encourage firms and households to change their behavior patterns by making them actually experience an inflation rate higher than 2 percent.

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

In light of the recent relative weakness of prices, I believe that it is appropriate for the Bank, for the time being, to maintain the accommodative financial conditions with persistence under the current policy framework. While doing so, the Bank needs to keep in mind the following two factors.

First, it is necessary to keep a careful watch on preventing a significant supply-demand imbalance. As I mentioned earlier, the pace of the expansion of the economy's supply



capacity eventually may slow in the longer term. Meanwhile, yield curve control contains a mechanism of amplifying its own easing effect as inflation expectations rise and the economy's growth potential increases. In this respect, it is possible that changes in the supply-demand balance will occur in line with the slowdown in the pace of expansion of the supply capacity and the strengthening of the effects of demand-stimulating measures taken on the monetary front. If a significant deterioration in the supply-demand balance is left unattended for a long time, this may unnecessarily cause sharp economic swings. I will discuss this point later in more detail.

Second, it is necessary to pay due attention to not making the financial system unstable by maintaining accommodative financial conditions over a long period of time. According to the Bank's assessment presented in the April 2018 *Financial System Report*, although Japan's financial system as a whole is not showing any sign of overheating, some indicators, such as the lending attitudes of financial institutions, are very close to a state of overheating. Furthermore, if the low interest rate environment continues and downward pressure on financial institutions' profits becomes prolonged, the functioning of financial intermediation may be undermined.

I believe that the Bank will need to review these points at each Monetary Policy Meeting and, as necessary, consider in earnest the most appropriate monetary policy.

#### **IV. Changes in the Economy's Supply Capacity and Conduct of Monetary Policy**

So far, I have mentioned several factors associated with the expansion of the economy's supply capacity as the causes of the delay in growth in wages and prices. From now, although there will be a degree of overlap with some of the points I have touched upon earlier, I will discuss somewhat longer-term changes in the supply capacity of Japan's economy and how monetary policy should be conducted in response to the changes.

##### **A. Changes in the Economy's Supply Capacity**

In Japan, various changes have taken place in the economy's supply capacity since the 1990s due to deficient demand and deflation that have lasted for a protracted period. Based on the experience of struggling to overcome excessive employment, firms tightened their

employment stance and promoted a shift to non-regular employment. Consequently, an increasing number of people gave up on seeking jobs or reluctantly accepted non-regular employment as they could not obtain their ideal jobs. In addition, because firms reined in new business fixed investment in order to reduce excess production capacity, their capital stock became obsolete and new technologies were not necessarily introduced actively. Moreover, excessive competition among firms to provide extravagant services or excessively cut the prices of their services or products was seen everywhere, and this may have led in part to the decline in labor productivity. The mechanism by which an economic downturn, which fundamentally is a cyclical phenomenon, exerts downward pressure on the economy's long-term growth potential by affecting the supply capacity is called "hysteresis." In Japan, the hysteresis has indeed occurred under the successive and serious economic downturns.

On the other hand, recently, the economy's supply capacity appears to be expanding rapidly with the waning effects of hysteresis that occurred in the past. For example, there are increasing opportunities for those who potentially have the willingness to work to participate in the labor market and for those who have reluctantly accepted non-regular employment to obtain regular employment. Firms are also starting to undertake postponed business fixed investment, and are proceeding with efforts to streamline their business processes through suspending the provision of extravagant services and reassigning employees to new positions. As labor input has increased and labor productivity has risen through these changes, the long-term growth potential of Japan's economy, which declined substantially in the past, is gradually strengthening again. Currently, Japan's economy may be referred to as being in a rehabilitation process to regain its fundamental strength.

The effects of hysteresis have been pointed out in overseas economies as well. These effects have attracted increased attention, especially as the economic growth trend has shifted downward globally since the financial crisis in the latter half of the 2000s. Since the early 1990s, however, the growth trend in Japan's economy has marked falls ahead of those in other economies following each successive and serious economic downturn. In this respect, there is a possibility that the effects of hysteresis remain relatively strong in Japan. For example, Japan's low labor productivity is well known as being lower than that of other

advanced economies. If we take a look at this situation from another perspective, it can be said that there is ample room for Japan to expand its economy's supply capacity as the effects of hysteresis dissipate. Indeed, Japan's labor productivity recently has been improving at a relatively fast pace to catch up with other economies.

The expansion of the economy's supply capacity, in the short term, has been working in the direction of easing the upward pressure on wages and prices associated with an increase in demand. However, there is no need to be unduly pessimistic about the current situation. As I mentioned earlier, the momentum toward achieving the price stability target is being maintained. In addition, we should not focus solely on raising prices. It is desirable that prices rise moderately as the quality of people's lives improves. Recently, an increasing number of people are participating in the labor market in ways that meet their wishes, and firms are promoting a shift to more efficient and adequate work practices. As a result, the economy's long-term growth potential is also beginning to be raised. I believe that these changes will indeed enrich people's lives.

## **B. Framework of Monetary Policy**

Based on what I have presented, I would now like to reconsider the framework of monetary policy. My view is that monetary policy should aim at maintaining somewhat tight supply-demand conditions, which are currently in place, for as long as possible.

As I have explained, I believe that Japan's economy at present, except for sluggish inflation, is in a very favorable condition. Driven by an increase in demand, various benefits stemming from the expansion of the supply capacity have been brought about. It is possible that these benefits are relatively large as the adverse effects of hysteresis that occurred in the past have remained strong in Japan.

Of course, this does not mean that a rise in prices is unwelcome. The Bank should achieve the price stability target at the earliest possible time. Note, however, that we should not misunderstand the meaning of "at the earliest possible time." This does not mean that the Bank should try to achieve the target at whatever cost. Its mission, as stipulated in the Bank of Japan Act, is "achieving price stability, thereby contributing to the sound development of

the national economy." If sound development of the economy is hindered as a consequence of a rise in prices, this will confuse the essential with the unessential.

For example, because of the relatively slow pace of change in the supply capacity, if the pace of increase in demand accelerates, prices might rise significantly due to increased supply-side constraints. However, if economic swings amplify in this way, there is concern that various harmful effects, such as a decline in the efficiency of resource allocation, might arise. The Bank will then be rushed into tightening its monetary policy, possibly resulting in the reversal of hysteresis left undone. Most of all, price rises attained in this way will not be stable over the long term, and nobody will want such a circumstance.

With the understanding just described, it is essential to aim at achieving the price stability target while benefiting from the waning effects of hysteresis brought about by maintaining somewhat tight supply-demand conditions. I should add that there is no universal monetary policy measure that should be taken to this end. As I mentioned earlier, from a somewhat longer-term perspective, the room for expanding the economy's supply capacity will narrow in due course as the effects of hysteresis dissipate further. On the other hand, if inflation expectations rise or the economy's long-term growth potential increases, the demand-stimulating effects of yield curve control will strengthen. On this point, when conducting monetary policy in the future, I believe that the Bank, as necessary, should consider without prejudgment the most appropriate policy while paying close attention to preventing a significant supply-demand imbalance that might be caused by the described changes in the external environment.

### **C. Uncertainty and Communication**

Lastly, I would like to point out that there is a certain degree of uncertainty over how the economy's supply capacity will change in the future. There are various arguments concerning the extent to which the adverse effects of past hysteresis can be reversed; apparently, no consensus has been reached in academic or other circles. Moreover, as a matter of course, changes in the supply capacity of Japan's economy are attributable not only to hysteresis but also to more structural factors, such as demographics. Therefore, it is difficult to accurately make a forecast on the extent to which the expansion of the supply

capacity of the economy will be maintained and how long this expansion will constrain price rises.

In relation to this, the fact that the Bank deleted the description on the projected timing of reaching around 2 percent inflation in the April 2018 Outlook Report became an issue for the public. I believe that indicating the projected timing itself is meaningful, but this "projection" tended to be perceived by some market participants as a "deadline," thereby creating unnecessary speculation about the Bank's policy conduct. As I have explained, monetary policy should be conducted by taking into consideration various uncertainties, and therefore it is undesirable to attract excessive attention merely to specific timing or a numerical value. Based on these points, I have judged that deleting the description of the projection in the Outlook Report is unavoidable. I believe that providing a detailed and articulate explanation on the mechanism of price rises and on the assessment of risks will lead to more appropriate communication with market participants.

Today, I have expressed my views on changes in the supply capacity of Japan's economy and how monetary policy should be conducted in response to these changes. The Bank will persistently pursue monetary easing measures and provide its utmost support for the sound development of the national economy by ensuring price stability. Under such circumstances, I hope to see continued proactive initiatives and efforts by firms and the government.