

Yukitoshi Funo: Economic activity and prices in Japan, and monetary policy in Japan

Speech by Mr Yukitoshi Funo, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Miyagi, 21 June 2018.

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I. Recent Economic and Price Developments

A. Overseas Developments

I would like to begin my speech by talking about overseas economies. The business sentiment of manufacturing firms on a global basis has maintained its improving trend, and the world trade volume has continued to recover. In this situation, overseas economies have continued to grow firmly on the whole.

In terms of the outlook, overseas economies are expected to continue growing firmly. According to the *World Economic Outlook*, released in April 2018 by the International Monetary Fund (IMF), the global growth rate is projected to be 3.9 percent in both 2018 and 2019.

Looking at developments by major region, the U.S. economy has been expanding and the European economy has continued to recover. The Chinese economy has continued to see stable growth on the whole. Other emerging economies and commodity-exporting economies have been recovering moderately on the whole, reflecting in particular an increase in exports and the effects of those economies' stimulus measures.

As for the outlook, the U.S. economy is expected to keep expanding and the European economy is projected to continue recovering. The Chinese economy is likely to broadly follow a stable growth path as authorities conduct fiscal and monetary policy in a timely manner. Other emerging economies and commodity-exporting economies are likely to continue their moderate recovery on the whole.

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 European Union (EU) and their effects, and (4) geopolitical risks. In addition, uncertainty is high regarding future developments in trade policies worldwide, and therefore these developments warrant attention. I hold the view that it is important to stay vigilant regarding these risk factors, especially now that overseas economies are continuing to grow firmly.

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 continued to represent positive growth for eight consecutive quarters on a quarter-on-quarter basis through the October-December quarter of 2017, and thereafter registered minus 0.6 percent for the January-March quarter of 2018 on an annualized quarter-on-quarter basis. While the contribution of net exports on real GDP growth has remained slightly positive, that of domestic private demand has been relatively weak.

With regard to the outlook, Japan's economy is likely to continue its moderate expansion. In fiscal 2018, the economy will probably continue growing at a pace above its potential.¹ Namely,

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, mainly against the background of highly accommodative financial conditions and the underpinnings through government spending. Meanwhile, exports are expected to continue their moderate increasing trend on the back of the firm growth in overseas economies. In terms of Miyagi Prefecture, given that there has been an increase in regularly scheduled domestic and international flights at Sendai International Airport, the number of passengers using the airport in fiscal 2017 registered a record high, and this is expected to contribute to the regional economy through tourism. In fiscal 2019 and 2020, Japan's economy is expected to continue on an expanding trend supported by external demand, although the growth pace is projected to decelerate due to a cyclical slowdown in business fixed investment and the effects of the scheduled consumption tax hike.² According to the April 2018 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) released by the Bank of Japan, the medians of the Policy Board members' forecasts of the economic growth rate are 1.6 percent for fiscal 2018, and 0.8 percent each for fiscal 2019 and 2020.

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. Policies concerning the provision of free education are also factored into the forecasts, based on information available as of April 2018.

2. Prices

Let me now explain price developments. Although 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, it has continued to show relatively weak developments compared to the economic expansion and the labor market tightening, remaining at around 0.5 percent excluding the effects of energy prices.

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 and increase toward 2 percent, mainly on the back of the improvement in the output gap and the rise in medium- to long-term inflation expectations. 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 April 2018 Outlook Report are 1.3 percent for fiscal 2018 and — on a basis excluding the direct effects of the scheduled consumption tax hike — 1.8 percent each for fiscal 2019 and 2020.³

1. Assuming that the rise in the consumption tax will be fully passed on to prices of taxable items, excluding those to which a reduced tax rate will be applied, the effect of the October 2019 consumption tax hike on the year-on-year rate of change in the CPI (all items less fresh food) for October 2019 onward is estimated to be 1.0 percentage point; the effect for fiscal 2019 and 2020 is estimated to be 0.5 percentage point for each year. It also is assumed that the effects of policies concerning the provision of free education will not be reflected in the CPI, as statistical treatment of these effects is not yet decided.

II. Keys to Assessing the Outlook for Economic Activity and Prices

In what follows, I would like to discuss several points that I think deserve particular attention in terms of realizing the outlook for economic activity and prices that I mentioned earlier.

A. Supply-Demand Conditions in the Labor Market and the Income Situation

Let me first talk about supply-demand conditions in the labor market and the income situation. As

the economy has continued its moderate expansion, the output gap has continued to improve; the figure for the October-December quarter of 2017 — the most recent data available — was in positive territory of around 1.5 percent. Furthermore, supply-demand conditions in the labor market have continued to tighten steadily. The year-on-year rate of increase in the *Labour Force Survey*-based number of employees accelerated to the range of 2.0-3.0 percent, and against this backdrop, the active job openings-to-applicants ratio has risen steadily. Moreover, a perception of labor shortage suggested by the employment conditions diffusion index (DI) in the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) has heightened, and the unemployment rate has been around 2.5 percent recently, which is slightly below the structural unemployment rate. These indicators of supply-demand conditions in the labor market show that the degree of labor market tightness has been at around the level last seen in the first half of the 1990s or in the first half of the 1970s. In terms of the outlook, as Japan's economy is likely to continue on a growing trend at a pace above its potential, it is expected that the number of employees will keep increasing and that the supply-demand conditions in the labor market will continue to tighten steadily.

Amid such supply-demand conditions in the labor market, 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, has exhibited relatively high growth recently of around 2.0 percent on average. On the other hand, the increase in overall employees' hourly cash earnings in nominal terms has remained moderate, and total cash earnings per employee also have risen moderately, albeit with some fluctuations. Going forward, the rate of increase in overall employees' hourly cash earnings is expected to accelerate as that in base pay has started to do so as well. However, there is a risk that firms will remain cautious with their decisions on wage setting, and in this context, I am paying attention to their stance regarding wages going forward.

B. Prices

Next, I will turn to price developments, taking into account supply-demand conditions in the labor market and the income situation. The year-on-year rate of change in the CPI (all items less fresh food and energy) has been at around 0.5 percent. While the fact that the pace of increase in the CPI has been moderate compared to the economic expansion and the labor market tightening is partly attributable to the sectoral shock of such factors as price declines at major supermarket chains mainly resulting from intensifying competition with other types of retail businesses, this reflects the fact that the mindset and behavior based on the assumption that wages and prices will not increase easily have been deeply entrenched among firms and households. There have been moves by firms to make efforts to absorb a rise in labor costs by increasing labor-saving investment and streamlining their business process, while limiting wage increases — which correspond to the labor shortage — mainly to part-time employees.

In the outlook for prices, the main factors that determine inflation rates — the output gap and inflation expectations — are assessed as follows. First, the output gap has improved steadily, and it is projected to continue expanding moderately within positive territory in fiscal 2018, both on the labor and capital sides, reflecting the increase in demand at home and abroad. Going forward, although such expansion is likely to pause, mainly 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 been more or less unchanged recently. As for the outlook, such expectations are likely to follow an increasing trend and gradually converge to around 2 percent on the back of the following: (1) in terms of the adaptive component, with the improvement in the output gap, firms' stance is likely to gradually shift toward raising wages and prices, and (2) in terms of the forward-looking component, the Bank will pursue monetary easing through its strong commitment to achieving the price stability target.

Nevertheless, if competition among firms — which provide goods and services that are difficult to differentiate — intensifies further, prices of these goods and services may not rise even if the

output gap widens within positive territory. Also, there is a risk that a rise in firms' and households' inflation expectations will lag behind if it takes time for firms' stance to shift toward raising wages and prices and inflation consequently remains relatively sluggish. Therefore, I believe that it is necessary to carefully examine developments in this regard.

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. What is important here is that it 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. In other words, the Bank is not simply trying to achieve a rise in prices by setting a specific deadline by which the target will be achieved. On this point, let me note that the April 2018 Outlook Report ceased to provide a description on the projected timing of achieving the 2 percent price stability target, so as to clarify that the timing is not a deadline by which the target will be 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 for an economy with a virtuous cycle from income to spending operating as the price stability target of 2 percent is achieved.

With a view to achieving this target, the Bank has been pursuing powerful monetary easing, considering developments in economic activity and prices, as well as financial conditions, under Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control introduced by the Bank in September 2016.

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. 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.

I would like to summarize economic and price developments in Japan. The economy has continued its moderate expansion, but prices have continued to show relatively weak developments, mainly against the background that firms' wage- and price-setting stance has remained cautious. Regarding the outlook for prices, risks are skewed to the downside, especially concerning developments in medium- to long-term inflation expectations, and this warrants attention. Financial conditions are highly accommodative. There is no sign so far of excessively bullish expectations in asset markets or in the activities of financial institutions. Furthermore, prolonged downward pressure on financial institutions' profits under the continued low interest rate environment could create risks of a gradual pullback in financial intermediation and of destabilizing the financial system. However, at this point, these risks are considered not significant, mainly because financial institutions have sufficient capital bases.

Given this situation, the momentum toward achieving the price stability target of 2 percent is being maintained. Nevertheless, there is still a long way to go to achieve the target. I believe that it is necessary 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 Japan's growth potential has been sluggish, mainly reflecting the population decline and low productivity growth. Yet, when looking at the economy in detail, we see that initiatives toward structural reforms and growth strategy have proceeded among a wide range of entities, in a situation where the output gap has widened within positive territory and further tightening has been seen in terms of both labor and capital. I expect that such initiatives will lead to raising the growth potential of Japan's economy. Let me point to some examples.

On the labor front, an increase in employment has been seen not only for non-regular employees, but also regular employees. At the same time, there has been progress in terms of making extensive use of diverse human resources, including women, the elderly, and foreigners. In addition, changes have begun to be observed in the seniority-based wage system. These developments can be perceived as one type of changes occurring in Japan's labor market, which previously had been rigid. My view is that bringing out the potential labor capacity that has not been utilized will likely boost Japan's labor productivity, which is low compared with that of the U.S. and European economies.

On the capital front, an increasing number of firms have been taking measures to establish new factories and expand production capacity against the background of such factors as supply-side constraints. Furthermore, in response to the tight labor market conditions, firms are making labor-saving investments not only at production sites but in various workplaces. At the same time, they are proceeding with streamlining and sophistication of business process. For example, the financial industry is moving ahead with advancing financial technology as well as making efforts to improve business efficiency. In the retail industry, while progress is being made with saving labor at stores, integration of sales at brick-and-mortar stores and online sales is also taking place.

If such initiatives toward structural reforms and growth strategy proceed, Japan's growth potential will likely rise. However, attention needs to be paid to the point that these initiatives are diverse and their pace of progress is not uniform. For example, the situation of labor shortages varies depending on types of job and industry. For this reason, it is necessary to keep a close watch on whether any imbalances arise amid increasing work demand across Japan. Let me note that raising growth potential is a time-consuming task. Therefore, while the Bank's conduct of monetary policy stimulates aggregate demand and suitably tight supply-demand conditions are being maintained, a virtuous cycle in which active demand encourages progress in various initiatives should remain intact for a long period of time. I believe that, with a view to achieving its price stability target and realizing sustainable economic growth in a coordinated manner, the Bank should continue with its monetary easing policy and firmly support the various initiatives taken by a wide range of entities.