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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. Developments in Economic Activity and Prices

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

Following the discussion at the Monetary Policy Meeting (MPM) held on October 30 and 31, 2018, 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 2020.

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 firmly on the whole.

Looking at recent developments in overseas economies, their growth is losing momentum compared to a while ago, when the global economy was widely referred to as seeing synchronous growth. A virtuous cycle of overseas economic activity has been maintained, however, as seen in the fact that domestic demand in many economies has been firm.

According to the *World Economic Outlook* (WEO) released in October 2018 by the International Monetary Fund (IMF), the real GDP growth rate of the global economy is projected to be 3.7 percent on a year-on-year basis for both 2018 and 2019. The projections have been revised downward by 0.2 percentage point for each year from the previous ones released three months before, and differences in growth rates among regions have widened to some extent. Nonetheless, the growth rate of 3.7 percent is by no means low, as this figure represents a level exceeding its past average.

Let me outline the Bank's outlook for overseas economies by major region. The U.S. economy is expected to maintain its expansion, underpinned by expansionary fiscal measures. The European economy is projected to continue recovering, albeit at a gradually slowing pace. The Chinese economy is likely to broadly follow a stable growth path as authorities conduct fiscal and monetary policy in a timely manner, although it is expected to be affected to some extent by the United States having raised tariffs imposed on China.

B. Japan's Economy

1. Current situation

Now I would like to move on to developments in Japan's economy.

The Bank's assessment is that Japan's economy is expanding moderately, with a virtuous cycle from income to spending operating.

The output gap -- which shows the utilization of capital and labor -- widened within positive territory from late 2016, for seven consecutive quarters through the April-June quarter of 2018. Although the first preliminary estimate of the real GDP growth rate for the July-September quarter -- released on November 14 -- was minus 1.2 percent on an annualized quarter-on-quarter basis, this is considered to be largely attributable to the temporary effects of natural disasters that occurred successively this summer. In fact, exports and production decreased slightly following these disasters, but have been showing recovery thereafter. Corporate profits have continued to follow their uptrend at record high levels, and business fixed investment also has continued on an increasing trend. According to the September 2018 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), business fixed investment plans for fiscal 2018 registered a year-on-year increase of 8.7 percent -- a level clearly exceeding the past average for the September *Tankan* surveys. Meanwhile, labor market conditions have continued to tighten steadily and total cash earnings per employee have risen moderately. Under these circumstances, the consumption activity index (CAI) -- which is calculated by combining various sales and supply-side statistics -- increased for the April-June quarter on a quarter-on-quarter basis and continued to do so for the July-September quarter relative to the previous quarter.

2. Outlook

I will now look at the outlook for Japan's economy during the projection period, which covers from fiscal 2018 through fiscal 2020. The economy is likely to continue its moderate expansion.

In fiscal 2018, Japan's economy is likely to continue growing at a pace above its potential growth rate, which is estimated to be in the range of 0.5-1.0 percent, mainly against the background of highly accommodative financial conditions and the underpinnings through government spending, with overseas economies continuing to grow firmly on the whole. From fiscal 2019 through fiscal 2020, the economy is expected to continue on an expanding trend, partly 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 in October 2019. In terms of the median of the Policy Board members' forecasts in the October 2018 Outlook Report, the real GDP growth rate is 1.4 percent for fiscal 2018, and 0.8 percent each for fiscal 2019 and 2020.

I also hold the view that the Bank's baseline scenario has been maintained, in which Japan's economy is likely to continue its moderate expansion. As the reason for this, I would like to highlight two positive factors for the economic outlook.

The first is the strength in business fixed investment, which I mentioned earlier. In addition to the high growth in the investment amount itself, I am reassured by the fact that firms in a wide range of industries have been planning a variety of investments, such as (1) that intended for domestic capacity expansion, (2) that in research and development, (3) that aiming at improving efficiency and saving labor, and (4) that aiming at enhancing business continuity arrangements in preparation for times of disaster or other emergency.

The second positive factor is that, fortunately, the effects of this summer's natural disasters on Japan's economic activity are likely to be only temporary. According to information we obtained from, for example, interviews with firms conducted by the Bank's branches, many of the firms for which production and distribution were undermined already have accelerated their production to offset the impact of the disasters. Moreover, public investment toward restoration and rebuilding is projected to take hold going forward. Although the extent to which the disasters affect inbound demand was a matter of concern at first, such demand has been showing faster recovery than expected, partly reflecting successful results of the government's and the private sector's provision of relevant information to the public. I believe that efforts that take advantage of lessons learned in the past have been playing a role in post-disaster restoration and rebuilding this time as well.

3. Uncertainties regarding economic activity

Meanwhile, there are various uncertainties regarding the baseline scenario of the outlook for Japan's economic activity. On this point, risks recently appear to be tilted to the downside, particularly regarding developments in overseas economies.

Specifically, risks to overseas economic developments include the following: the U.S. macroeconomic policies and their impact on global financial markets; the consequences of protectionist moves and their effects; developments in emerging and commodity-exporting economies including the effects of the two aforementioned factors; negotiations on the United Kingdom's exit from the European Union (EU) and their effects; the fiscal problem in Italy; and geopolitical risks.

Of these risks, I remain especially concerned about protectionist moves; in particular, the trade friction between the United States and China. In fact, the deterioration in Chinese firms' sentiment toward business conditions, particularly those related to exports and imports, has been distinct. Although no significant changes have been evidenced, for example, by Chinese statistics on exports and imports, some have pointed out the possibility that China's trade activity has been buoyed temporarily by the front-loading of exports to the United States prior to a looming rise in tariffs.

Thus far, the effects of the U.S.-China trade friction on Japan's economy have been limited. There is an argument, however, that if it takes time to ease this tension, this may result in a direct negative impact on Japan's economy through trade activity, and may adversely affect the economy to a greater extent through such channels as the deterioration in business sentiment and the destabilization of global financial markets. The IMF and other international organizations have released similar results in their simulation analyses on the effects of the U.S.-China trade friction on the global economy. According to these analyses, the extent to which this trade friction directly impacts the economy through trade activity is likely to be limited, but the effects of this issue would be larger when involving such channels as the deterioration in business sentiment and the destabilization of global financial markets. I believe that we should not be inclined toward extremely pessimistic views in this regard, mainly because an agreement has been reached in the renegotiation of the North American Free Trade Agreement (NAFTA) and there has been ongoing dialogue between the United States and China toward easing the tension. However, I will continue to closely monitor the effects of protectionist moves on economic activity overseas and in Japan.

C. Price Developments

Next, I will turn to price developments in Japan.

The year-on-year rate of increase in the consumer price index (CPI) for all items less fresh food slowed temporarily in early spring 2018, but it has been accelerating again since summer, having risen to around 1 percent recently. Nevertheless, the year-on-year rate of change in the CPI excluding energy in addition to fresh food has been at around 0.5 percent of late, and the underlying trend in prices in Japan has continued to show relatively weak developments compared to the economic expansion and the labor market tightening.

This is likely to be attributable to two main factors. The first is the deeply entrenched mindset and behavior based on the assumption that wages and prices will not increase easily. For this reason, firms' wage- and price-setting stance, as well as households' views toward price rises, have remained cautious, and there has not yet been a clear change in this situation. Behind such entrenched mindset and behavior lie Japan's fairly recent 15-year experience of low growth and a mild but persistent decline in prices. In this sense, this first factor can be regarded as people's price perception inherent in Japan, or a kind of social norm in the country.

The second factor behind the relatively weak price developments is changes on the supply side of the economy, including active labor-saving investment and intensifying competition among firms, which have been brought about by the progress in digital technology, as well as an increase in labor participation by women and seniors. For example, it has been pointed out that retailers such as supermarkets maintaining their cautious price-setting stance is partly due to the expansion of online shopping. Unlike the first factor, such intensifying competition brought about by technological progress can be described as a structural change observed globally, rather than only in Japan.

As I have explained, Japan has continued to see a situation where the underlying trend in inflation does not rise easily. Nonetheless, with the output gap remaining positive and operating firmly as a driver for a rise in inflation, the year-on-year rate of change in the CPI is likely to increase gradually toward the price stability target of 2 percent. In terms of the median of the Policy Board members' forecasts in the October 2018 Outlook Report, the year-on-year rate of change in the CPI (all items less fresh food) is 0.9 percent for fiscal 2018 and -- on a basis excluding the effects of the scheduled consumption tax hike -- 1.4 percent and 1.5 percent for fiscal 2019 and 2020, respectively.

II. The Bank's Monetary Policy

A. The Basic Thinking behind the Bank's Policy

1. Continuing powerful monetary easing

Thus far, I have talked about Japan's economic activity and prices. Next, I will explain the Bank's monetary policy.

In order to overcome prolonged deflation, the Bank introduced in April 2013 an unprecedented and highly accommodative monetary policy, quantitative and qualitative monetary easing (QQE). Since then, the Bank has supported firms' and households' economic activity by maintaining highly accommodative financial conditions and contributed to an improvement in the output gap. At present, Japan's economy has improved significantly, and in terms of prices, it is no longer in deflation, in the sense of a sustained decline in prices.

As I touched on earlier, the underlying trend in prices in Japan has continued to show relatively weak developments compared to the economic expansion. Nevertheless, the mechanism whereby an improvement in the output gap leads to a rise in inflation has continued to operate and the momentum toward 2 percent inflation has not been lost. Therefore, I consider it appropriate to persistently maintain the current highly accommodative financial conditions so as to keep the output gap within positive territory for as long as possible, thereby sustaining the positive momentum I just mentioned. Specifically, I believe that it is necessary that the Bank persistently continue with powerful monetary easing under the framework of QQE with Yield Curve Control, introduced in September 2016.

This framework consists of two components: yield curve control and an inflation-overshooting commitment. Yield curve control is a policy under which the Bank aims to keep short- and long-term interest rates stably at low levels. Namely, in the guideline for market operations, the Bank sets the short-term policy interest rate at minus 0.1 percent and the target level of 10-year Japanese government bond (JGB) yields at around 0 percent, and conducts JGB purchases so as to achieve this target level. The inflation-overshooting commitment is a policy under which the Bank commits itself to continuing to expand the monetary base -- the total amount of money the Bank directly supplies to the economy -- until the year-on-year rate of increase in the observed CPI exceeds 2 percent and stays above that level in a stable manner. Through this commitment, the Bank aims at increasing people's confidence in the achievement of the 2 percent price stability target.

2. Policy effects and side effects

While monetary easing stimulates the economy, keeping interest rates low across the entire yield curve for a prolonged period could exert adverse effects on the functioning of the JGB market and profits of financial institutions. Therefore, the Bank deems it necessary to proceed with policy conduct while examining policy effects and the possible side effects from every angle, as well as carefully assessing their costs and benefits to the economy.

Based on this thinking, the Bank has pursued strong monetary easing by taking into account the situation at the time. Moreover, at the MPM held on July 30 and 31, 2018, it decided to further strengthen the framework of QQE with Yield Curve Control: the Bank introduced forward guidance for policy rates and decided to conduct market operations as well as asset purchases in a more flexible manner. As for the long-term interest rate, for example, the Bank made clear that, while it would maintain the target level of "around zero percent," the observed yields might move upward and downward to some extent mainly depending on developments in economic activity and prices. As for exchange-traded fund (ETF) purchases, it was announced that the Bank might increase or decrease the amount of purchases depending on market conditions, while maintaining the annual target of increase at about 6 trillion yen. I believe that conducting these flexible measures will lead to maintaining market functioning.

The Bank intends to continue paying careful attention to the risks considered most relevant to the conduct of monetary policy. With a view to achieving the price stability target, it will conduct monetary policy in an appropriate manner, taking account of developments in economic activity and prices as well as financial conditions.

B. Addressing Changes in the Economic Structure

So far, I have explained the Bank's monetary policy measures. In what follows, I would like to talk about the points I keep in mind regarding the basic thinking behind monetary policy.

At each MPM, the Bank discusses the current situation of and outlook for developments in economic activity and prices as well as financial conditions, and decides on the conduct of monetary policy that is considered most appropriate for achieving the price stability target. In such policy conduct, I consider it important to make a comprehensive assessment, giving due consideration to various changes in the environment surrounding Japan's economy, such as digital innovation.

Digital innovation in recent years has dramatically increased the quality and quantity of information people can obtain in their daily lives. Although it has been only about a decade since smartphones became prevalent among the public, they have disseminated explosively worldwide. In Japan, more than 60 percent of Japanese people own them today. Men and women of all ages carry in their pockets devices that are equivalent to the supercomputers of the past, and can access worldwide information instantly. People's lifestyles are changing significantly with smartphones: they enjoy listening to music and watching videos through digital distribution; do shopping and make travel reservations; look up information more quickly using their devices' search function; and spend leisure time communicating with friends through social media and other digital tools. And it seems that such changes are becoming more rapid.

Besides lifestyles, structural changes have been taking place in various aspects. In this regard, let me mention the Federal Reserve Bank of Kansas City's Jackson Hole Economic Policy Symposium held annually in August -- which may not be well known among the public but draws significant attention of central bankers, academics, and economists. At this year's symposium entitled "Changing Market Structure and Implications for Monetary Policy," prominent academics presented interesting papers on the theme of recent shifts in the market structure.[1] The topics included increasing differences between firms, the rising importance of intangible assets, and intensifying competition in the banking industry. Of these, I would like to touch on the paper on intangibles.[2] This posits that, in recent years, intangible assets -- including software, intellectual property, and brand -- account for an increasingly large share of total capital compared to traditional physical assets such as equipment. The paper then points out that, in the existing data, which do not sufficiently cover the increase in intangible assets, the amount of investment appears to be smaller than the theoretically optimal level. I will not go into more detail, but the paper also refers to the possibility that such an increase in intangible assets may weaken the effectiveness of monetary policy.

A similar point of view has been presented from the business sector. Mr. Bill Gates, a well-known co-founder of Microsoft Corporation, claims that, given the ever-increasing importance of software and data in economic activity, policy authorities in each country should debate more actively the important question of the best way to stimulate economic activity.[3]

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[1] These papers are available at the following: https://www.kansascityfed.org/publications/research/escp/symposiums/escp-2018.

[2] Nicolas Crouzet and Janice Eberly, "Understanding Weak Capital Investment: the Role of Market Concentration and Intangibles," paper prepared for the Jackson Hole Economic Policy Symposium, August 2018.

[3] See https://www.gatesnotes.com/Books/Capitalism-Without-Capital.

I think that it is by no means a coincidence that the same issue was raised within academia and the business sector around the same time. This is probably evidence of how significant these changes are and that they are rapidly occurring worldwide. Intangible assets literally are difficult to measure. However, taking just one example -- namely, the importance of these assets being discussed both within academia and the business sector -- reveals that it is becoming hard to assess firms' investment activities and the effects of monetary policy without considering the impact of these assets. Therefore, I believe that it is necessary to adequately address these changes in the economic structure.

The actual economy that central banks face is very complex and changing dynamically. It is of course very important to learn economic theories in textbooks and analyze past experiences. However, when authorities and economic entities make decisions, it is my view that they should pay due attention to various factors, such as these structural changes that may not necessarily be evident from economic models, and continue to examine what needs to be done at the time.