January 31, 2019
Bank of Japan

Japan's Economy and Monetary Policy

Speech at a Meeting with Business Leaders in Yamaguchi

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Deputy Governor of the Bank of Japan

(English translation based on the Japanese original)

Introduction

It is my pleasure to have the opportunity today to exchange views with administrative, financial, and business leaders in Yamaguchi Prefecture. I also would like to take this opportunity to express my sincere gratitude for your cooperation with the activities of the Bank of Japan's Shimonoseki Branch.

At the Monetary Policy Meeting (MPM) held last week, the Bank updated its projections for Japan's economic activity and prices through fiscal 2020 and released them in the January 2019 *Outlook for Economic Activity and Prices* (Outlook Report). Today, I would like to explain the Bank's outlook for Japan's economic activity and prices as well as the recent conduct of monetary policy, while outlining the Outlook Report.

I. Financial and Economic Developments

The stock and foreign exchange markets saw large fluctuations at the start of this year. The Nikkei 225 Stock Average marked the highest level seen for the first time in 27 years in October last year but thereafter decreased substantially in late December through the beginning of January. In the foreign exchange market, the U.S. dollar/yen rate continued to be relatively stable throughout the second half of last year, being in the range of 110-115 yen; however, it dipped briefly to the range of 104-105 yen in the early morning of January 3 amid the low trading volume in the market. Thereafter, although stock prices recovered to the 20,000 yen level and the U.S. dollar/yen rate returned to the range of 109-110 yen through mid-January, financial markets both at home and abroad have remained volatile (Chart 1). However, as I will explain later, the real economies of Japan as well as the United States and Europe have continued to recover steadily on the whole so far, and the outlook for corporate profits has remained firm. Therefore, developments in financial markets in the meantime may partly reflect market participants responding somewhat sensitively to heightening uncertainties regarding the outlook. At the same time, however, it is said that financial markets act as a mirror that reflects the real economy. Thus, it is important to carefully examine economic developments while also bearing in mind the signals emitted by financial markets. In what follows, I would first like to explain the current situation of and outlook for Japan's economy, and then examine the risks to the outlook, particularly regarding developments in overseas economies.

To begin with, I will talk about economic developments in Japan. The economy is expanding moderately, with a virtuous cycle from income to spending being maintained in both the corporate and household sectors. In order to grasp the overall picture of economic activity, let us first take a look at an indicator called the output gap, which represents the balance between demand and supply in the economy as a whole (Chart 2). While a positive output gap shows excess demand and a negative output gap indicates excess supply, the gap has been clearly positive over the past two years. Under these circumstances, the current economic recovery phase, which began in December 2012, has already lasted for a long period of about six years, almost reaching the longest post-war recovery on record.

Next, let me explain developments by economic entity. In the corporate sector, exports and production have maintained their increasing trend (Chart 3). Although they were pushed down by the successive natural disasters in the July-September quarter last year, such effects were only temporary, and exports and production have turned to an increase since October. In this situation, corporate profits have been at high levels and business fixed investment has continued on an increasing trend (Chart 4). Looking at fixed investment by sector, in manufacturing, there has been a notable increase in research and development investment in cutting-edge technologies such as self-driving systems and artificial intelligence (AI), in addition to investment intended for enhancing capacity. In nonmanufacturing, investment also has been increasing in a wide range of fields, such as that in office buildings accompanying urban redevelopment projects and in the construction of accommodation facilities to meet demand from inbound tourism. Investment aimed at improving efficiency and saving labor in order to deal with the recent labor shortage also has maintained its high growth nationwide. Such improvement in the corporate sector has had positive effects on the household sector. In the labor market, the active job openings-to-applicants ratio has been at a high level last seen during the period of high economic growth, and the unemployment rate has declined to around 2.5 percent, the level observed during the bubble period (Chart 5). Total cash earnings per employee have risen moderately but steadily. Against the background of improvement in the employment and income situation, private consumption also has been increasing moderately, albeit with fluctuations.

With regard to the outlook, Japan's economy will likely continue on an expanding trend. The Bank projects that the economy will continue growing at an annual pace of around 1 percent throughout the projection period -- that is, through fiscal 2020. The pace is about the same as the growth rate of Japan's economy that can be achieved in the long term, or the so-called potential growth rate, which the Bank estimates to be nearly 1 percent. Our main scenario is that Japan's economy will maintain its firm growth for the time being, at a pace consistent with its potential (Chart 6).

However, due attention should be paid to the fact that downside risks to this scenario have been heightening, particularly regarding developments in overseas economies. The baseline scenario of the outlook for overseas economies at this point is that these economies are expected to continue growing firmly on the whole. Meanwhile, there are differences in growth rates among regions compared to the synchronous growth of the global economy observed through the first half of last year, and uncertainties regarding the outlook have been heightening. Similar views have been presented by international organizations and major central banks. According to the latest forecasts released by the International Monetary Fund (IMF) this month, the global economy is projected to register relatively high annual growth of around 3.5 percent in 2019 and 2020. However, these forecasts have been somewhat revised downward from the previous ones released in October 2018 (Chart 7). In addition, the IMF also has pointed out that the global economy is faced with downside risks, mainly due to the effects of the trade friction between the United States and China.

With regard to this friction, negotiations have continued between the two countries since the turn of 2019, but it remains difficult to project developments. Going forward, the effects may spread, not only through a direct impact on trade activities in various economies, but also factors such as a deterioration in firms' fixed investment stance and risk sentiment in global financial markets. In addition, an increasing number of developments imply that the Chinese economy is decelerating recently, reflecting not only the effects of the trade friction but also of factors such as authorities' measures to prevent overheating on the credit side. Taking into account the timely conduct of fiscal and monetary policy by China, the risk that the growth pace of the Chinese economy will decelerate substantially is judged to be small. However, as Japan -- including Yamaguchi Prefecture -- has strong economic relations with

China, we will monitor developments in the Chinese economy carefully. In addition, there are various other risks originating from overseas economies. Although it is a positive factor that capital outflows from some emerging economies such as Turkey and Argentina -- which were a matter of concern a while ago -- have calmed recently, uncertainties remain concerning developments in negotiations on the United Kingdom's exit from the European Union (EU). Against the background of such heightening uncertainties regarding overseas economies, financial markets have remained unstable, as I mentioned at the outset. The Bank will continue to carefully monitor developments in the domestic and overseas markets, including the effects on firms' and households' sentiment.

II. Price Developments

Next, I will move on to price developments. The year-on-year rate of change in the consumer price index (CPI) in Japan remained in negative territory for 15 years from the late 1990s, with brief exceptions (Chart 8). In order to make a breakthrough in this situation, the Bank introduced quantitative and qualitative monetary easing (QQE) in April 2013, embarking on unprecedentedly powerful monetary easing. Since then, Japan's economy has improved significantly, and on the price front, the year-on-year rate of change in the CPI excluding energy and fresh food generally has been in positive territory for about five years. The economy is no longer in deflation, in the sense of a sustained decline in prices.

This trend can be observed in firms' price- and wage-setting stance. According to the Bank's *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the situation recently has come to take hold in which the proportion of enterprises answering that the output prices have risen exceeds the proportion of those answering that such prices have fallen. This occurred for the first time in about 30 years since the bubble period (Chart 9). Also, on the wage side, the practice of regular increases in base pay, which had disappeared under deflation, returned in 2014 and has taken hold again since then. Moves to increase wages have been spreading steadily, not only among large firms but also small and medium-sized firms in local areas. In relation to this point, the Bank compiled the results of interviews conducted by its branches in the annex paper to the *Regional Economic Report* released in December, in which it introduced comments by firms in this region as well, such that there was a notable number of firms that were proceeding with wage increases in order to secure employees. Thus, firms' stance has shifted toward further raising wages and prices, and as such developments continue, the year-on-year rate of change in the CPI is likely to increase toward the price stability target of 2 percent (Chart 6).

However, the pace of improvements in wages and prices has remained more moderate than expected. The year-on-year rate of change in the CPI has been positive but has stayed in the range of 0.5-1.0 percent, continuing to show relatively weak developments compared to the economic expansion and the labor market tightening. This is likely to be mainly due to two reasons (Chart 10).

The first is that prices have not responded smoothly to excess demand stemming from the economic expansion. Theoretically, when demand exceeds supply, there will be shortage of labor and products, leading to increases in wages and prices. As I explained earlier, such increases actually have been observed, mainly for wages, but the pace has been slow compared to that of economic improvement. In particular, the rate of increase in scheduled cash earnings of regular employees has been sluggish, and it has been taking time for a rise in their wages to fully take hold. The year-on-year rate of increase in hourly wages of part-time employees, which are sensitive to developments in labor market conditions, has continued to mark relatively high growth of around 2.5 percent. However, prices in the services sector, which is highly dependent on part-time employees, also have not risen clearly. Regarding the reason why firms can avoid price rises despite the increase in labor costs, it has been pointed out that, in mainly the nonmanufacturing sector in Japan, there is large room to absorb an increase in labor costs by raising labor productivity, primarily through labor-saving investment. Technological progress such as digitalization in recent years also has partly contributed to encouraging firms' efforts to raise productivity. Thus, even amid the economic expansion, there is a combination of various factors that makes it difficult for wages and prices to rise. It has been taking time to resolve these factors and such downward pressure on prices may last longer than expected.

The second reason why price rises have been sluggish is that inflation expectations have not risen easily. Inflation expectations refer to the outlook for prices that firms and households assume in carrying out economic activity, or in other words, people's mindset toward prices.

Inflation expectations and the actual inflation rate affect each other. For example, if current prices rise, firms expect that such a rise will continue in the future and consider raising prices of goods and services that they produce and sell. In addition, if households expect future inflation, they are likely to request wage increases in line with it. Thus, in order to achieve the price stability target of 2 percent, people's mindset based on the assumption that prices will not increase easily -- which became entrenched under prolonged deflation -- needs to change. However, inflation expectations have been more or less unchanged so far despite moderate inflation, and it has been taking time for people's mindset toward prices to change, or in other words, for the deflationary mindset to be dispelled.

I would like to add one point regarding prices. In terms of the outlook for prices from fiscal 2019 onward, some institutional factors that will have certain effects on the CPI are assumed, including the scheduled consumption tax hike in October 2019 and policies concerning the provision of free education. Moreover, a reduction in charges for mobile phone services that is expected in the future also is likely to influence the CPI. Regarding these issues, two points hold the key from the viewpoint of monetary policy conduct. First, what is important is not temporary price fluctuations but the underlying trend in prices. On this point, the factors that were raised earlier can be characterized as temporary shocks, and as long as this is the case, their impact on the underlying trend in prices as well as monetary policy conduct can be assessed as small. Second, having said that, these shocks may not just remain temporary depending on the situation. As I mentioned earlier, there is a possibility that people's inflation expectations will move upward and downward in line with price fluctuations, thereby affecting the underlying trend in prices. Giving due consideration to these points, the Bank will assess future price developments and communicate developments in such special factors to the public in an appropriate manner.

III. The Bank's Conduct of Monetary Policy

Now, I would like to explain the Bank's conduct of monetary policy. As I have talked about so far, prices have continued to show relatively weak developments compared to the economic expansion and it is also taking more time than expected for inflation expectations to rise. I feel that an extended period of time is needed for a change in people's mindset toward prices, which was formed under prolonged low growth and deflation. Moreover, we are in a situation where we also need to pay more attention to the accumulation of side effects accompanying monetary easing. In order to achieve the price stability target under such financial and economic developments, the Bank recognizes that it is important to persistently continue with the current powerful monetary easing and thereby maintain a positive output gap -- a driver for inflation -- for as long as possible.

Based on such thinking, the Bank made two main policy decisions at the July 2018 MPM. First, with a view to clarifying its stance to persistently continue with the current powerful monetary easing, the Bank introduced forward guidance for policy rates (Chart 11). This is a policy measure that strengthens market confidence and expectations regarding the continuation of monetary easing by making clear future policy rates in advance. Specifically, the Bank made clear that it would "maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices including the effects of the consumption tax hike." Second, the Bank implemented measures to enhance policy sustainability and durability. In order to persistently continue with the current powerful monetary easing, it is necessary to contain the accompanying negative effects, or the side effects. In the first half of last year, there was a growing concern that the functioning of the Japanese government bond (JGB) market had deteriorated under the Bank's large-scale JGB purchases, as seen, for example, in rigid interest rate formation. In view of this situation, at the July 2018 MPM, the Bank decided to conduct market operations and asset purchases in a more flexible manner. Regarding JGB purchases, while the target level of the long-term yields was maintained at around zero percent, the Bank made clear that the actual yields might move upward and downward to some extent mainly depending on developments in economic activity and prices. In addition, as for purchases of exchange-traded funds (ETFs), the Bank clarified that it might increase or decrease the amount of purchases depending on market conditions while maintaining the annual pace of increase in the amount outstanding of about 6 trillion yen.

Half a year has passed since the policy decision was made last July. It can be confirmed that the intended effects of alleviating the side effects have been achieved, and that the policy decision also has been effective to a certain extent in stabilizing financial markets. Before the introduction of forward guidance, quite a few market participants held the view that the Bank would raise policy rates in the near future, which led to market instability in some cases. Since the July MPM, such view has dissipated rapidly, and the Bank's stance of continuing with powerful monetary easing has prevailed further. Moreover, the degree of JGB market functioning has improved, as seen, for example, in transactions gradually having become more active and price movements having increased. 10-year JGB yields rose temporarily after the policy decision in July; however, they then fell into negative territory and recently have been stable at around the target level of around zero percent. The pace of ETF purchases on an annual basis was around 2 trillion yen in August last year, while such purchases marked a high pace of around 10 trillion yen in October and December, when the markets fluctuated significantly. Such flexible purchases likely have had the effect of alleviating market instability in the meantime.

Regarding the effects brought about by powerful monetary easing, its relation to financial institutions' profits and the functioning of financial intermediation is often discussed. The Bank is fully aware that prolonged downward pressure on financial institutions' profits, with the low interest rate environment and severe competition among financial institutions continuing, could create risks of a gradual pullback in financial intermediation and of destabilizing the financial system. Although these risks are judged as not significant at this point, mainly because financial institutions have sufficient capital bases, the Bank will continue to make efforts to grasp the latest situation through its on-site examinations and off-site monitoring of financial institutions and encourage them to take concrete actions as necessary.

As I have outlined so far, the Bank will pursue powerful monetary easing while thoroughly examining both the benefits and costs of its policy effects. In doing so, the Bank will make policy adjustments as appropriate, taking account of developments in economic activity and prices as well as financial conditions, with a view to maintaining the momentum toward achieving the price stability target.

Conclusion

To conclude, I would like to talk about the economy of Yamaguchi Prefecture.

Despite the temporary effects of disasters such as the heavy rain last year, which mainly affected western Japan, the Bank judges that the economy of Yamaguchi Prefecture thereafter has been recovering moderately but steadily. There is an accumulation of manufacturing industries in the prefecture, mainly along the coast of the Seto Inland Sea, and production and exports have been at high levels, led by chemicals and transport equipment, where there is favorable demand for high value-added products. Mainly against the background of these positive developments in production, business fixed investment also has increased. In addition, in terms of tourism, the number of domestic and foreign tourists has been on an uptrend, partly because tourist attractions have become more famous, mainly owing to the blessed natural landscape.

Under these circumstances, labor market conditions in the prefecture have tightened further, as evidenced by the active job openings-to-applicants ratio having been at around the levels seen during the bubble period. According to interviews conducted by the Bank's Shimonoseki Branch, labor shortage was pointed out by a wide range of firms, regardless of industry. In response to this, I heard that administrative bodies and economic organizations in the region were providing various support programs, such as for job seekers who live outside the prefecture. Firms also have been undertaking labor-saving investment and reviewing working conditions in line with the diversification of workers' needs. Such active efforts by the public and private sectors are essential in order for the prefecture's economy to overcome the challenge of labor shortage and achieve sustainable economic growth.

In the Edo era, *Kokudaka* -- land value expressed in terms of the estimated amount of rice production -- of the *Chōshū* clan in the former Yamaguchi Prefecture was about 369,000 *koku*, which was not necessarily top class. Despite that fact, the *Chōshū* clan played an important role in the great achievement of the Meiji Restoration. It is often said that this is because the prefecture turned out many prominent individuals and had strong economic power that substantially outweighed its *Kokudaka*. The *Chōshū* clan gathered all its force to powerfully promote industries and made efforts to boost production of local specialties such as rice, paper, salt, and wax -- the so-called *Bōchōyonpaku*. Furthermore, in Shimonoseki, which was an important place for maritime traffic, an institution called *Koshinikata* managed by the clan was established. Together with merchants in the prefecture, the clan actively developed businesses with those on the ships that passed by. These various leading efforts significantly enhanced the economic power of the *Chōshū* clan, and this became the driver for the Meiji Restoration. I heard that, since 2018, which marked the 150th anniversary of the Meiji Restoration, efforts have been made toward making Yamaguchi Prefecture full of vitality through meeting challenges to achieve restorations in three aspects: industry, interaction, and living. I would like to close my speech by expressing my hope that such positive joint efforts by the public and private sectors will lead to growth in existing firms and creation of new work places, and that the prefecture's economy thereby will grow further. Thank you very much for your attention.

Japan's Economy and Monetary Policy

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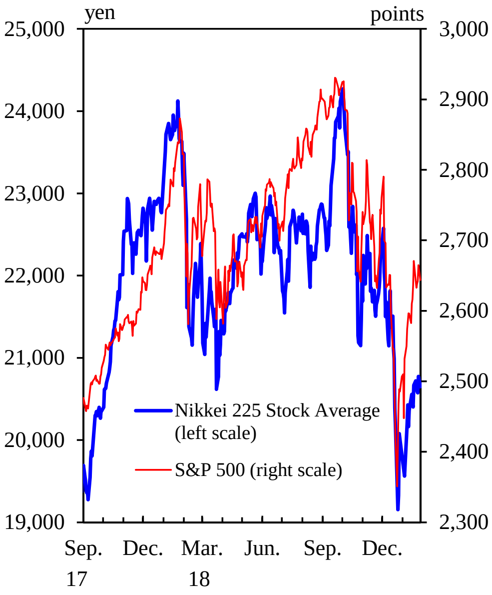
January 31, 2019

Masayoshi Amamiya
Deputy Governor of the Bank of Japan

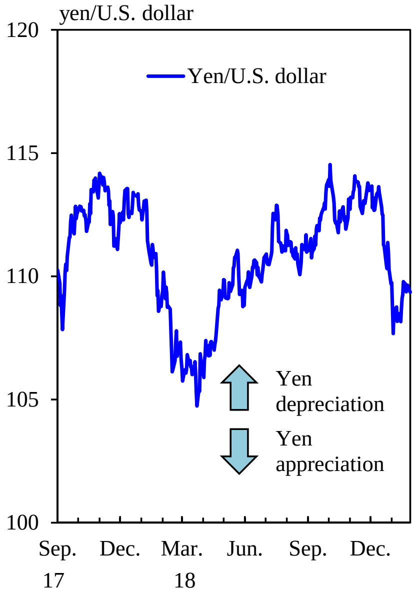
Chart 1

Developments in Financial Markets

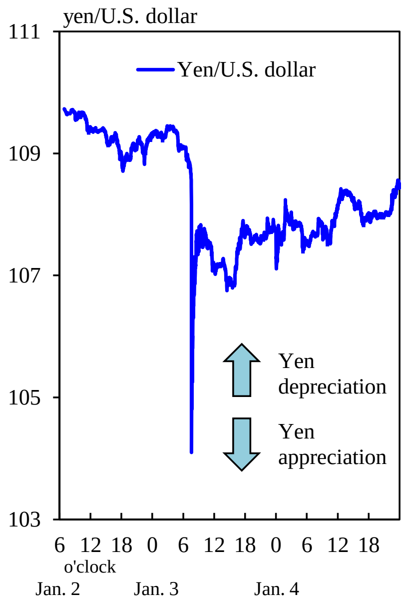
Stock Markets



Foreign Exchange Markets



Fluctuations in FX rate on January 3

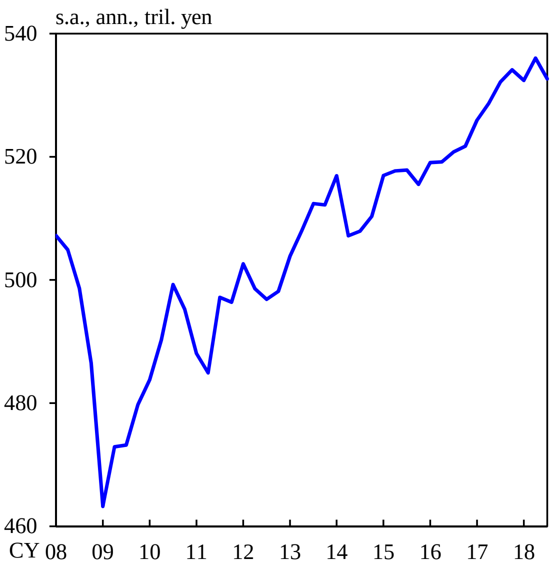


Sources: Bloomberg; Thomson Reuters.

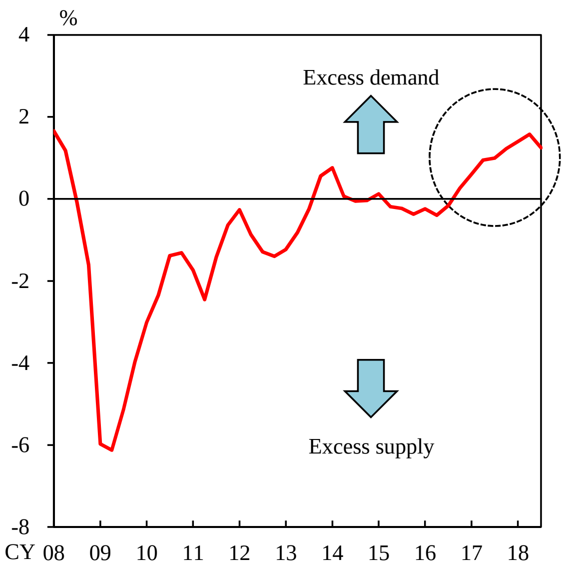
Chart 2

Japan's Economy

Real GDP



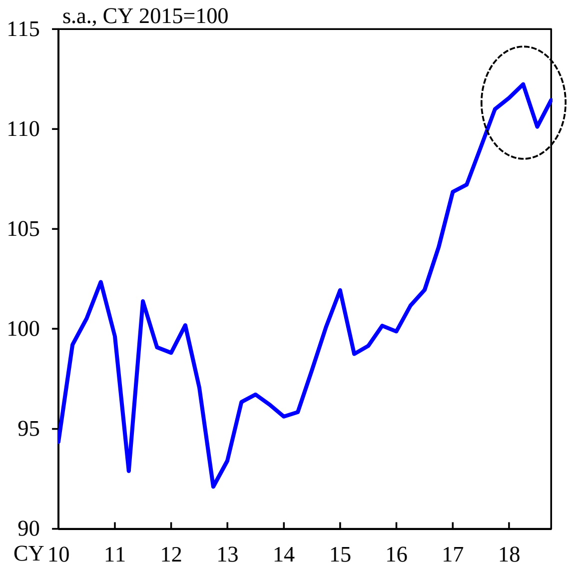
Output Gap



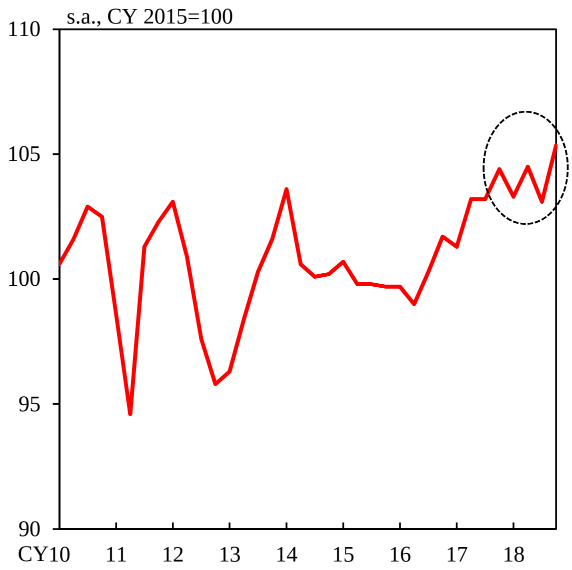
Note: The output gap is based on BOJ staff estimations.
Sources: Cabinet Office; Bank of Japan.

Exports and Production

Real Exports



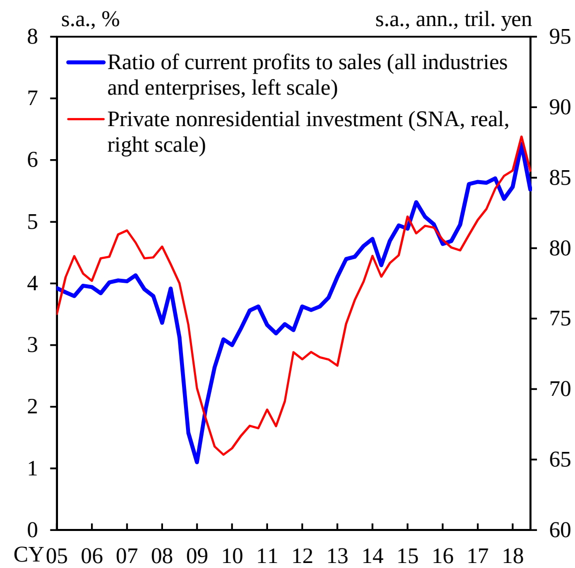
Industrial Production



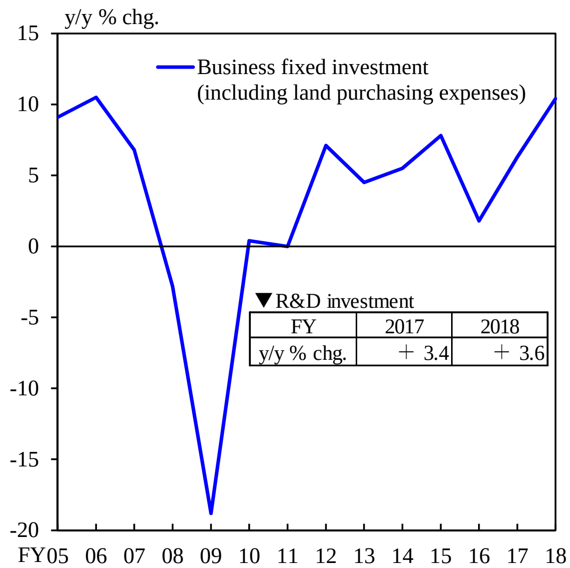
Note: The figure for industrial production for 2018/Q4 is the October-November average.
Sources: Ministry of Finance; Ministry of Economy, Trade and Industry; Bank of Japan.

Corporate Profits and Business Fixed Investment

Corporate Profits



Business Fixed Investment Plans (December Tankan)

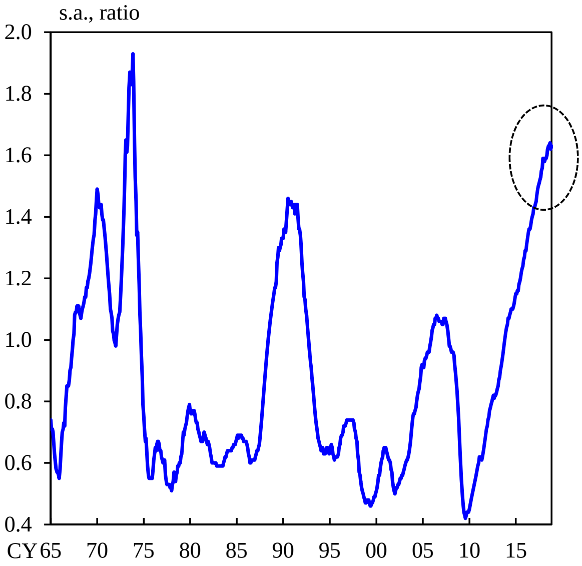


FY	2017	2018
y/y % chg.	＋ 3.4	＋ 3.6

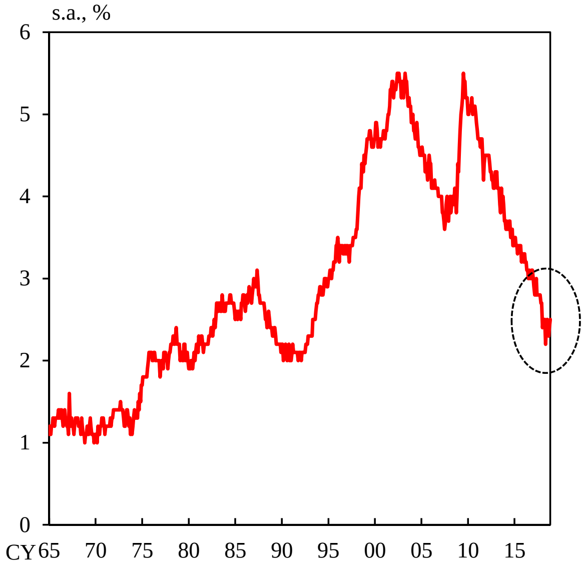
Notes: 1. Figures for ratio of current profits to sales are based on the *Financial Statements Statistics of Corporations by Industry, Quarterly* (from 2009/Q2 exclude "pure holding companies"). Excluding "finance and insurance."
2. Figures for business fixed investment (including land purchasing expenses) and R&D investment are based on the plans as of December *Tankan* in each fiscal year (all enterprises).
Sources: Ministry of Finance; Cabinet Office; Bank of Japan.

Employment Situation

Active Job Openings-to-Applicants Ratio



Unemployment Rate



Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

Outlook for Economic Activity and Prices
(January 2019 Outlook Report)

the medians of the Policy Board members' forecasts, y/y % chg.

	Real GDP	CPI (all items less fresh food)	(Reference) Excluding the effects of the consumption tax hike and policies concerning the provision of free education
Fiscal 2018	+0.9	+0.8	
Forecasts made in October 2018	+1.4	+0.9	
Fiscal 2019	+0.9	+1.1	+0.9
Forecasts made in October 2018	+0.8	+1.6	+1.4
Fiscal 2020	+1.0	+1.5	+1.4
Forecasts made in October 2018	+0.8	+1.6	+1.5

Note: The direct effect of the consumption tax hike on the CPI for fiscal 2019 and fiscal 2020 is estimated to be 0.5 percentage point for each year. The direct effects of policies concerning the provision of free education on the CPI for fiscal 2019 and fiscal 2020 are estimated to be minus 0.3 percentage point and minus 0.4 percentage point, respectively.
Source: Bank of Japan.

Overseas Economies

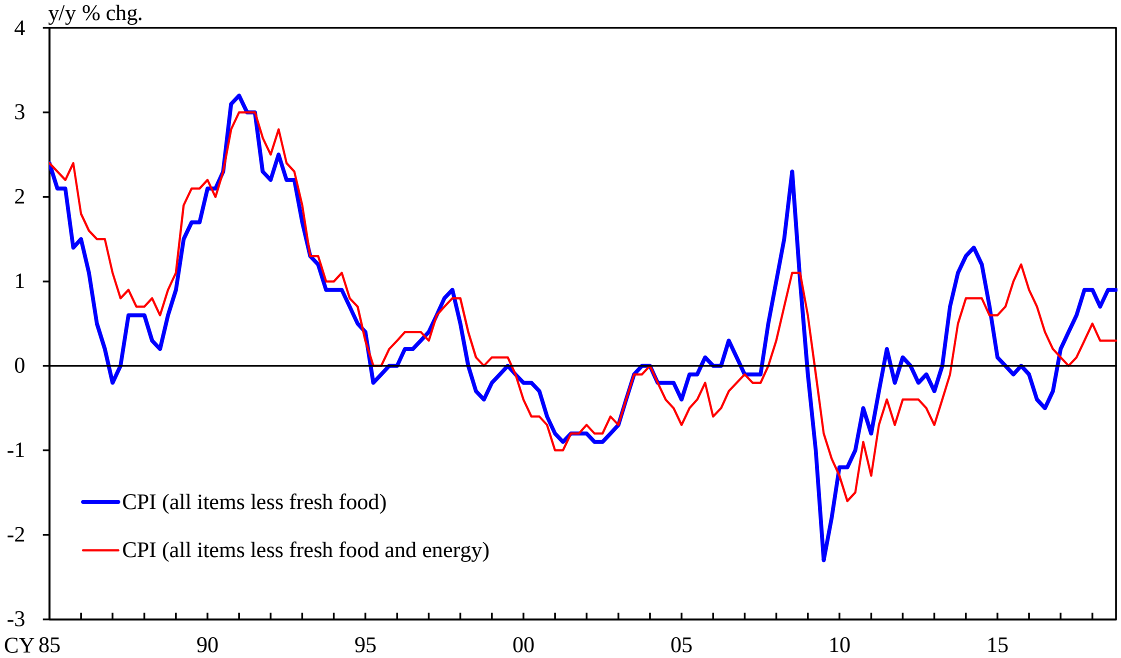
Projections for Major Economies (IMF)

y/y % chg., % points

	2017	2018	2019 Projection	2020 Projection
World	3.8	3.7	**3.5 (-0.2)**	**3.6 (-0.1)**
Advanced economies	2.4	2.3	2.0 (-0.1)	1.7 (0.0)
United States	2.2	2.9	2.5 (0.0)	1.8 (0.0)
Euro area	2.4	1.8	1.6 (-0.3)	1.7 (0.0)
Japan	1.9	0.9	1.1 (0.2)	0.5 (0.2)
Emerging market and developing economies	4.7	4.6	4.5 (-0.2)	4.9 (0.0)
China	6.9	6.6	6.2 (0.0)	6.2 (0.0)
ASEAN-5	5.3	5.2	5.1 (-0.1)	5.2 (0.0)
Latin America and the Caribbean	1.3	1.1	2.0 (-0.2)	2.5 (-0.2)

Note: The post-2019 figures are based on January 2019 WEO projections. Figures in parentheses show the differences from the October 2018 projections.
Source: IMF.

Consumer Prices



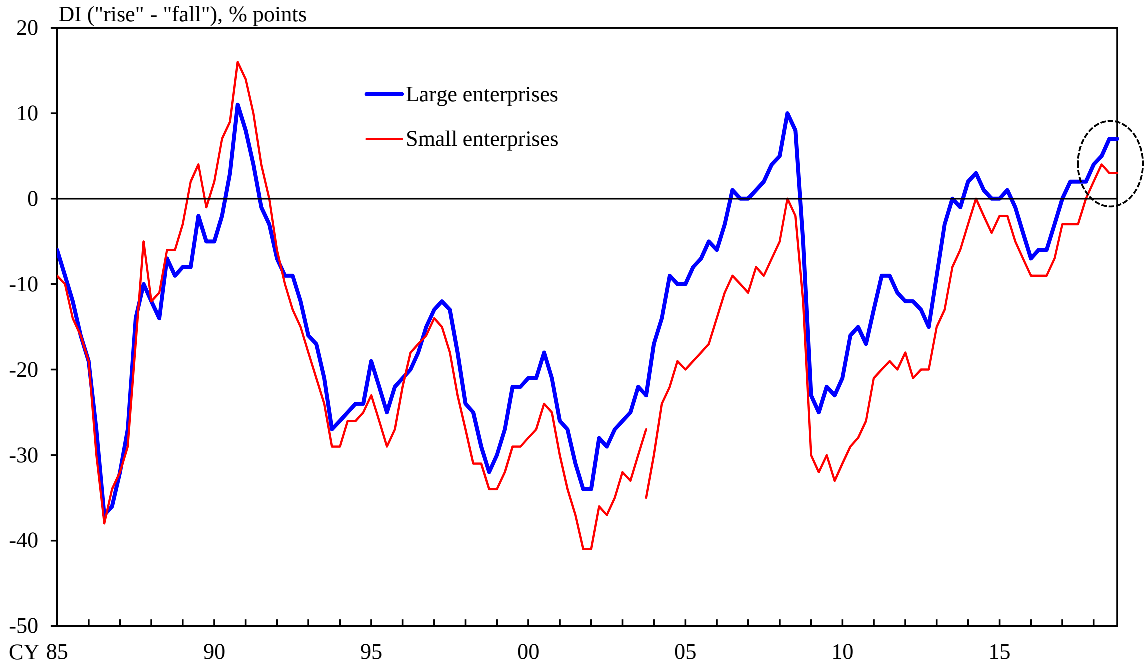
Note: Figures are adjusted for changes in the consumption tax rate.
Source: Ministry of Internal Affairs and Communications.

II. Price Developments

Chart 9

Environment Surrounding Prices

Output Prices DI (Tankan)



Note: There is a discontinuity in the data in December 2003 due to a change in the survey framework.
Source: Bank of Japan.

II. Price Developments

Chart 10

Reasons for a Rise in Inflation Taking Time

Supply Side

- ✓ Large room for firms to raise productivity
- ✓ Technological progress in recent years
- ✓ High wage elasticity of labor supply

Mindset

- ✓ Experience of prolonged low growth and deflation

The pace of improvement in prices and inflation expectations has remained slow compared to the improvement in the output gap.

1. Firms' cautious wage- and price-setting stance
2. Sluggish increase in households' tolerance of price rises
3. Intensifying competition

Strengthening the Framework for Continuous Powerful Monetary Easing

(Decided on 31 July, 2018)

Taking more time than expected to achieve the price stability target of 2 percent.
Maintaining the output gap as long as possible within positive territory is appropriate.

Persistently Continuing with Powerful Monetary Easing

Forward guidance for policy rates

"The Bank intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices including the effects of the consumption tax hike scheduled to take place in October 2019."

⇒ Strengthening the commitment to achieving the price stability target

Enhancing the sustainability of "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control"

Long-term interest rate: The Bank maintains the target level of around zero percent. While doing so, the yields may move upward and downward to some extent mainly depending on developments in economic activity and prices.

Purchases of ETFs: The Bank maintains the annual pace of increase in the amount outstanding of about 6 trillion yen. While doing so, the Bank may increase or decrease the amount of purchases depending on market conditions. etc.