Yukitoshi Funo: Economic activity, prices, 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, Hiroshima, 3 July 2019.

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I. Recent Economic and Price Developments

A. Overseas Developments

I would like to begin by talking about overseas economies, which have been growing moderately on the whole, although slowdowns have been observed. Uncertainty regarding the outlook has been heightening, due in part to protectionist moves, but private consumption has been firm on the whole, partly supported by a favorable employment and income situation. In terms of the outlook, slowdowns are likely to continue for the time being; thereafter, however, overseas economies are expected to grow moderately on the whole with their growth rates rising somewhat.

Looking at developments by major region, the U.S. economy has been expanding moderately, whereas the European economy has been decelerating. The Chinese economy has continued to see stable growth on the whole, but some weakness has been observed in the manufacturing sector. Other emerging and commodity-exporting economies have been recovering moderately on the whole, mainly on the back of the effects of those economies' stimulus measures. As for the outlook, the U.S. economy is expected to maintain its moderate expansion and the European economy is projected to gradually move out of its deceleration phase. The Chinese economy is likely to broadly follow a stable growth path as authorities conduct fiscal and monetary policies in a timely manner. Other emerging and commodity-exporting economies are likely to continue to see moderate recovery on the whole.

Risk factors to the overseas economic outlook are wide ranging and likely to be significant, as exemplified by (1) the U.S. macroeconomic policies and their impact on global financial markets, (2) the consequences of protectionist moves, including those observed in U.S.-China trade negotiations and their effects, (3) developments in emerging and commodity-exporting economies, (4) the progress in global adjustments in IT-related goods, (5) negotiations on the United Kingdom's exit from the European Union (EU) and their effects, and (6) geopolitical risks. As it can be said that there is uncertainty surrounding overseas economies, it is necessary to stay vigilant regarding these risk factors, including their impact on firms' and households' sentiment in Japan.

B. Japan's Economy and Prices

1. Economic activity

I will now discuss the economic situation in Japan. The economy has been on a moderate expanding trend, with a virtuous cycle from income to spending operating, although exports and production have been affected by the slowdown in overseas economies. It has continued to grow at a pace above its potential growth rate.[1] This is evidenced by the real GDP growth rate having registered 1.8 percent for the October-December quarter of 2018 on an annualized quarter-on-quarter basis, and 2.2 percent for the January-March quarter of 2019. According to the Bank of Japan's June 2019 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) released at the beginning of July, the diffusion index (DI) for business conditions for all industries and enterprises has remained positive despite being affected by the slowdown in overseas economies and other factors.

Meanwhile, after enduring the severe damage caused by the heavy rain, which mainly affected western Japan in July 2018, Hiroshima Prefecture has seen steady progress in its restoration and reconstruction, owing to the efforts of those involved. To give an example, although firms' production activities had become stagnant due to damage to production facilities, a water cutoff, and disruptions to traffic infrastructure, these effects have more or less dissipated. Moreover, such inviting locations as the two World Heritage Sites of Hiroshima — the Atomic Bomb Dome and the Itsukushima Shrine — as well as the beauty of the archipelago in the Setouchi region are attracting tourists from home and abroad once again, making up for the past slowdown.

With regard to the outlook, Japan's economy is likely to continue growing at about the same pace as its potential on average and continue on an expanding trend, despite being affected by the slowdown in overseas economies for the time being.[2] Specifically, for now, exports are projected to show some weakness and business fixed investment also is likely to decelerate somewhat, reflecting the effects of the slowdown in overseas economies. Meanwhile, private consumption is expected to continue increasing as the employment and income situation continues to improve. Thereafter, Japan's exports are projected to return to their moderate increasing trend, with overseas economies expected to grow moderately on the whole. 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, despite being affected by such factors as the scheduled consumption tax hike. In terms of specific figures for the economic growth rate, as provided in the April 2019 *Outlook for Economic Activity and Prices* (Outlook Report) released by the Bank, the medians of the Policy Board members' forecasts are 0.8 percent for fiscal 2019, 0.9 percent for fiscal 2020, and 1.2 percent for fiscal 2021.

1. Under a specific methodology, Japan's potential growth rate is estimated to be in the range of 0.5-1.0 percent recently. 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.

2. Prices

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

With regard to the outlook, medium- to long-term inflation expectations are projected to rise gradually as firms' stance is likely to gradually shift toward further raising wages and prices with the output gap remaining positive. As a result, the year-on-year rate of change in the CPI (all items less fresh food) is likely to increase gradually over time. In terms of specific figures, the medians of the Policy Board members' forecasts of the year-on-year rate of change presented in the April 2019 Outlook Report are 1.1 percent for fiscal 2019, 1.4 percent for fiscal 2020, and 1.6 percent for fiscal 2021.[3]

1. 3The forecasts assume the following: (1) the consumption tax will be raised to 10 percent in October 2019 and a reduced tax rate will be applied to food and beverages — excluding alcohol and dining out — and newspapers, and (2) with regard to policies concerning the provision of free education, measures for free early childhood education as well as other measures including free higher education will be introduced in October 2019 and April 2020, respectively.

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. Employment and Income Situation

Let me first talk about the employment and income situation. As the economy has continued its moderate expansion, the output gap has remained clearly positive, and supply-demand conditions in the labor market have continued to tighten steadily. The *Labour Force Survey*-based number of employees has continued to increase firmly when smoothing out fluctuations, and the active job openings-to-applicants ratio has been at a high level that exceeds the peak marked during the bubble period. In addition, the unemployment rate has remained at a low level. These indicators of supply-demand conditions in the labor market show that the degree of labor market tightness has been at the level last seen in the first half of the 1990s or in the first half of the 1970s.

Amid such supply-demand conditions in the labor market, the latest rate of base pay increase for fiscal 2019 is about the same as the actual rate for fiscal 2018. The year-on-year rate of increase in scheduled cash earnings of full-time employees is in the range of 0.5-1.0 percent. In addition, that in hourly scheduled cash earnings of part-time employees, which are responsive to supply-demand conditions in the labor market, has registered relatively high growth at around 2 percent. As a result, although total cash earnings per employee have been increasing moderately, albeit with fluctuations, the increases have remained relatively weak compared to the labor market tightening, partly due to the high wage elasticity of labor supply in recent years, mainly among women and seniors.

As Japan's economy is likely to continue on an expanding trend, it is expected that the number of employees will keep increasing and supply-demand conditions in the labor market will continue to tighten steadily. I therefore expect the rate of increase in total cash earnings per employee to gradually accelerate.

B. Prices

Next, I will turn to price developments, taking into account the employment and income situation. The year-on-year rate of change in the CPI (all items less fresh food and energy) has remained at around 0.5 percent. The relatively weak developments compared to such factors as the labor market tightening are attributable to the mindset and behavior based on the assumption that wages and prices will not increase easily, which have been deeply entrenched among firms and households, due mainly to the experience of prolonged low growth and deflation. In addition, room for raising productivity and progress in information technology in recent years, for example, have allowed firms to absorb an increase in costs and thereby maintain their cautious stance toward raising prices.

While affected by various factors, I view the underlying trend in prices as being determined by the aggregate supply-demand balance. In other words, a positive output gap leads to a rise in the inflation rate through a virtuous cycle from income to spending. In the case of households, for example, a tightening of labor market conditions encourages an increase in private consumption through a rise in wages, thereby leading to an increase in the year-on-year rate of change in the CPI.

In this regard, looking at annual price changes across all CPI items less fresh food, the share of price-increasing items minus the share of price-decreasing items has been rising on average recently. In this situation, I believe various changes are spreading throughout the economy. For example, in terms of private consumption, firms have developed and supplied new products to tap potential demand in view of the increasing variation in consumer needs. My impression is that consumers, in response, are tolerant of the prices set for products and services that are not necessarily inexpensive, as long as they are unique and have high value-added, like travel packages that offer a new life experience in return.

As for the outlook, it is projected that, with the output gap remaining positive, firms' stance gradually will shift toward further raising wages and households' tolerance of price rises will increase. In this situation, further price rises are likely to be observed widely and medium- to long-term inflation expectations are projected to rise gradually. As a consequence, it can be said that the year-on-year rate of change in the CPI is likely to increase gradually. Conversely, attention should be paid to the fact that a change in the mindset and behavior of firms and households does not occur overnight and may in fact take a considerable amount of time.

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. To this end, the Bank has been pursuing powerful monetary easing, considering developments in economic activity and prices, as well as financial conditions, under the framework of Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control. The Bank, under this framework, has been conducting yield curve control, in which it controls short- and long-term interest rates. Specifically, 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. By conducting this operation, short- and long-term interest rates have been stable at low levels, and I consider that the highly accommodative financial conditions, brought about by yield curve control, have stimulated firms' and households' spending activities.

Meanwhile, prices have continued to show relatively weak developments compared to the economic expansion and labor market tightening, with Policy Board members' forecasts presented in the April 2019 Outlook Report indicating that it likely would still take time to achieve the price stability target. As part of its efforts to do so, at the Monetary Policy Meeting (MPM) held on April 24 and 25, the Bank decided to clarify forward guidance for policy rates. Specifically, the description of the existing guidance was partially revised, thereby making clear that the Bank would "maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, at least through around spring 2020, taking into account uncertainties regarding economic activity and prices including developments in overseas economies and the effects of the scheduled consumption tax hike." By doing so, the Bank clarified its unchanged policy stance to persistently continue with the current powerful monetary easing. What I would like to call attention to here is that the current extremely low levels of short- and long-term interest rates will be maintained "for an extended period of time" and that the inclusion of "at least" in the description regarding the time frame of the guidance indicates a fair possibility that the current low interest rates will be maintained beyond "around spring 2020." In other words, "for an extended period of time" does not denote "through around spring 2020"; rather, it implies an open-ended period even beyond that.

The Bank also decided at the April MPM to implement measures contributing to the continuation of powerful monetary easing. Specifically, the Bank decided to (1) expand the scope of eligible collateral for its provision of credit for such purposes as the Bank's lending to financial institutions, (2) improve the use of the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth, (3) relax the terms and conditions for the facility of temporarily lending Japanese government securities (JGSs) held by the Bank, and (4) consider introducing an exchange-traded fund (ETF) lending facility, which would make it possible to lend its ETFs to market participants. These measures are aimed at strengthening policy durability in order for the Bank to continue with powerful monetary easing through its smooth fund-provisioning and securing of market functioning.

Given the current situation, where prices and inflation expectations have not risen easily, it is necessary to maintain a positive output gap for as long as possible by keeping interest rates at sufficiently low levels for a prolonged time, in order to achieve the price stability target. I believe that the clarification of forward guidance and the aforementioned four measures will bolster confidence in the Bank's continuation of powerful monetary easing and further ensure achievement of the price stability target. With a view to achieving the target, the Bank will continue conducting monetary policy in an appropriate manner, taking account of developments in economic activity and prices as well as financial conditions.

IV. Challenges for Japan's Economy

I now would 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 has been in the range of 0.5-1.0 percent recently. Although the rate has risen compared to around 2010, it can be said that Japan's growth potential has been sluggish. This is also an indication of the various challenges that Japan faces in achieving a rise in productivity. With regard to corporate activities, for example, firms' utilization of resources to achieve the intended goals should be minimized, and the achievement process needs to be managed by means of effective corporate governance. Unless this way of thinking is widely accepted by firms, however, excessive resources — including labor — tend to be allocated in order to produce results that are more impressive than necessary, regardless of the marginal benefit. This tendency, prevalent across professions and industries, seemingly is encouraged by Japan's employment practices and bottom-up approach to management.

In spite of these trends, going forward, I see the potential growth rate rising through an improvement in productivity as a wide range of entities continue with initiatives concerning structural reforms and growth strategies. Take recent developments for instance; namely, the output gap being positive and labor market conditions remaining considerably tight, as evidenced by the existing labor shortage. Such underlying developments seem to have given rise to changes in employment practices, including increased mobility in the labor market brought about by the efficient allocation of excess labor resources from sectors with low productivity to those with high productivity. Alongside this, progress in working-style reforms and other initiatives suggests a deepening awareness among both workers and managers of the need to raise productivity. Pursuing structural reforms and growth strategies is not an easy task and a fairly extensive process. Nonetheless, it is safe to say that the necessary conditions for a rise in productivity, which will bring about a boost in Japan's growth potential, gradually are being fulfilled.

I believe these developments will play a role in underpinning the virtuous cycle from income to spending. Specifically, a rise in productivity will act as a starting point of such cycle, stimulating price rises through increases in wages and private consumption. Effects of monetary policy are not directly transmitted to economic entities — namely, individual firms and households — and thus may take time to materialize in the form of backing up their efforts. However, they should be able to support various initiatives as the Bank's conduct of monetary policy stimulates aggregate demand and suitably tight supply-demand conditions are maintained. Therefore, with a view to achieving its price stability target and realizing sustainable economic growth in a coordinated manner, the Bank needs to persistently continue with its powerful monetary easing and consistently provide support for the initiatives of a wide range of economic entities.