September 24, 2019

Bank of Japan

Japan's Economy and Monetary Policy

Speech at a Meeting with Business Leaders in Osaka

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(English translation based on the Japanese original)

Introduction

It is my great pleasure to have the opportunity today to exchange views with a distinguished gathering of business leaders in the Kansai region. I would like to take this opportunity to express my sincerest gratitude for your cooperation with the various activities of the Bank of Japan's branches in Osaka, Kobe, and Kyoto.

At the Monetary Policy Meeting (MPM) held last week, the Bank, regarding the price developments in Japan, judged that it was becoming necessary to pay closer attention to the possibility that the momentum toward achieving the price stability target of 2 percent will be lost. The Bank also made clear in its policy statement that, while taking this situation into account, it will reexamine economic and price developments at the next MPM, when it compiles the *Outlook for Economic Activity and Prices* (Outlook Report). Today, I would like to talk about the Bank's view regarding the economic and price developments on which its judgment was based and then explain the basic thinking behind the conduct of monetary policy.

I. Economic Developments at Home and Abroad

Let me start by talking about developments in overseas economies. Overseas economies have been growing moderately on the whole, but the pace has continued to decelerate since the start of the year (Chart 1). According to the *World Economic Outlook* (WEO) *Update* released by the International Monetary Fund (IMF) in July, growth is forecast at 3.2 percent in 2019 on a year-on-year basis, marking a decline from the previous year's figure of 3.6 percent. Growth in the world trade volume has been decelerating clearly, mainly against the background of the increasing and prolonged U.S.-China trade friction and adjustments in IT-related goods. The diffusion indexes (DIs) for business sentiment of manufacturing firms on a global basis have remained below 50 since May, which is the borderline between improvement and deterioration of business conditions perceived by firms. Looking at developments in major regions, the U.S. economy has continued to expand moderately, supported primarily by an increase in private consumption. On the other hand, the Chinese and European economies have continued to be somewhat weak. Specifically, the manufacturing sector in China has remained weak, mainly due to the effects of additional tariffs imposed by the United States and the authorities' measures to push forward with deleveraging. As for Europe, production has declined since the second half of last year, mainly in Germany, partly reflecting the tightening of gas emission regulations on automobiles within the European Union (EU), and weaker exports to China also have been exerting downward pressure on the European economy.

Looking at Japan's economy, exports -- mainly those of capital goods related to business fixed investment to China as well as the NIEs and the ASEAN economies -- have been relatively weak since the turn of the year, affected by the slowdown in overseas economies (Chart 2). In addition, weakness in exports and related production is leading manufacturing firms to have cautious sentiment. On this point, since the Kansai region, in particular, has a strong economic relationship with the Asian economies, such as China, you may feel such developments.

That said, domestic demand has remained firm. Thus far, the effects of the slowdown in overseas economies do not seem to be exerting on domestic demand (Chart 3). Business fixed investment has continued on an increasing trend, with corporate profits staying at high levels on the whole. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly* (FSSC), the ratio of current profits to sales for all industries and enterprises has remained at a historically high level. In this situation, business fixed investment on a GDP basis has maintained its uptrend, being positive for the April-June quarter on a quarter-on-quarter basis. Turning to the household sector, private consumption has increased moderately, albeit with fluctuations. This is mainly attributable to the continued improvement in the employment and income situation (Chart 4). The active job openings-to-applicants ratio has been at a high level that exceeds the peak marked during the bubble period, and the unemployment rate has been in the range of 2.0-2.5 percent, remaining at around a low level that was observed during the bubble period. While labor market conditions have remained tight, employee income has been increasing. Japan's economy thus has been on a moderate expanding trend, with a virtuous cycle from income to spending continuing to operate in both the corporate and household sectors, although exports have shown some weakness.

With regard to the outlook, Japan's economy is likely to continue on a moderate expanding trend, despite being affected by the slowdown in overseas economies for the time being. The keys to this outlook are the following: (1) the timing of a pick-up in overseas economies and (2) whether the firmness in domestic demand will be sustained until that happens.

I now would like to talk about the sustainability of domestic demand. Private consumption is expected to continue increasing moderately as the employment and income situation continues to improve. Although the impact of the scheduled consumption tax hike warrants attention, it is likely to be marginal compared to that of the previous tax hike in 2014, mainly because an increase in household burden will be smaller and various measures to smooth out demand prior to and after the tax hike will be implemented. In addition, government spending is expected to underpin the economic activity going forward, mainly on the back of an increase in public investment accompanied by policy measures for national resilience and of spending on hosting the Olympic and Paralympic Games. The sustainability of domestic demand depends on business fixed investment. Business fixed investment has been steady despite the slowdown in overseas economies, and this likely is attributable to an increase in investment that is relatively less susceptible to changes in overseas demand and the business cycle, including that aimed at improving efficiency and saving labor in order to deal with labor shortage, that in research and development (R&D) for growth areas, and that related to urban redevelopment projects. In fact, in the Kansai region, an increase is seen in a wide range of medium- to long-term strategic investment, such as R&D investment in life science, which is the theme of the World Expo to be held in Osaka, Kansai, and investment related to the digitalization of automobiles and use of 5G network. Also, the redevelopment projects in Osaka are getting underway in such areas as Kita (or "the North") and Minami (or "the South"). With regard to the outlook, business fixed investment is expected to increase moderately on the back of high levels of corporate profits and highly stimulative financial conditions. Thus, it can be said that the sustainability of domestic demand in Japan is substantially high. However, business and household sentiment could be affected, depending on developments in overseas economies and financial markets. In particular, if the slowdown in overseas economies lasts longer than expected, it is necessary to pay attention to the possibility that firms' investment stance will become cautious, mainly in the manufacturing sector.

Next, I would like to explain the other key point, which is the outlook for overseas economies. Although it is likely that slowdowns will continue to be observed for the time being, the growth rates are projected to rise somewhat thereafter, partly backed by the materialization of the effects of fiscal and monetary policies in each economy and the progress in global adjustments in IT-related goods. Thus, overseas economies are expected to grow moderately on the whole. As for now, overseas economies are projected to pick up in the second half of 2019 and into 2020, which is in line with the projections made by such as the IMF. On this point, adjustments in IT-related goods seem to be moving out of the phase of continued deterioration, but there is no clear sign that the global economy will turn to a pick-up. Under these circumstances, downside risks concerning overseas economies seem to be increasing (Chart 5). Since both the United States and China have been increasing incrementally the number of goods subject to additional tariffs, the trade friction between these economies appears to be increasing and becoming more prolonged. They are exhibiting a stance of continuing with the negotiations, but future developments continue to warrant attention. In addition to the trade friction, uncertainties concerning overseas economies include various factors such as the consequences of the negotiations on the United Kingdom's exit from the EU, the effects of stimulus measures in China, and geopolitical risks in the Middle East. Uncertainties surrounding developments in emerging economies also are of concern. Thus, in a situation where downside risks concerning overseas economies seem to be increasing, it is necessary to bear in mind the possibility that the pick-up will lag behind by longer than expected. The Bank judges that it is becoming necessary to closely examine whether overseas economies will pick up while the aforementioned firmness in domestic demand is being maintained.

II. Price Developments in Japan

Let me move on to price developments. The year-on-year rate of change in the consumer price index (CPI) has been at around 0.5 percent (Chart 6). It has been relatively weak compared to the economic expansion and tight labor market conditions. While there are various reasons for this, it seems to be affected largely by the fact that the mindset and behavior based on the assumption that wages and prices will not increase easily have been deeply entrenched in Japan, due to the experience of prolonged low growth and deflation. Thus, it is taking time for firms' cautious wage- and price-setting stance, as well as households' cautiousness toward price rises, to change.

However, the basic mechanism has continued to operate in which a positive output gap -- a rise in the level of economic activity -- results in moderate increases in wages and prices. Let me elaborate on this point. As I mentioned earlier, in a situation where the economy has been expanding moderately and labor market conditions have remained tight, wages of employees have continued to rise and base pay increases have been achieved for a sixth consecutive year. On the other hand, firms have faced upward pressure such as of personnel expenses and distribution costs on prices resulting from an increase in economic activity. In this situation, moves to raise selling prices have been spreading gradually among firms (Chart 7). Regarding the output prices DI in the *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the situation has continued for seven consecutive quarters in which the proportion of enterprises answering that the output prices have risen has exceeded the proportion of those answering that such prices have fallen. This already has lasted for a longer period than that observed during the bubble period. Firms' stance steadily has shifted toward further raising prices. In addition, looking at annual price changes across all CPI items, the share of price-increasing items minus the share of price-decreasing items recently has been increasing moderately. Of course, the reason why firms can raise selling prices is that households' tolerance of price rises has been increasing, albeit moderately, on the back of improvement in the employment and income situation. Such improvement has been achieved especially because the economy has been expanding moderately and the positive output gap has been maintained.

As for the outlook, it is likely that Japan's economy will continue on an expanding trend and the output gap will remain positive. With the level of economic activity remaining high, firms' stance is expected to gradually shift toward further raising wages and prices and medium- to long-term inflation expectations of firms and households, which have been more or less unchanged recently, are projected to rise gradually. Under these circumstances, the year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent, although this will take time.

Regarding this baseline scenario of the outlook for prices, however, risks are skewed to the downside. In particular, recently, slowdowns in overseas economies have continued to be observed and their downside risks seem to be increasing. Thus, it is necessary to pay closer attention to the risk that the economic slowdown stemming from overseas economies will spread to prices. I will elaborate on this point later when I talk about the Bank's thinking behind the conduct of monetary policy.

III. The Bank's Conduct of Monetary Policy

Now, I would like to talk about the Bank's conduct of monetary policy.

The Bank has been pursuing powerful monetary easing under the framework of "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control," aiming to achieve the price stability target of 2 percent (Chart 8). The main transmission mechanism of monetary easing that the Bank assumes is to lower real interest rates, which are calculated by subtracting inflation expectations from nominal interest rates. Real interest rates currently are well below the natural rate of interest, which is neutral to economic conditions, and are stimulating a wide range of economic activities. In this situation, the inflation mechanism driven by the positive output gap has been operating, as I mentioned earlier. In order to achieve the price stability target, the Bank considers it important to ensure that the inflation mechanism continues to operate and thereby maintain the momentum toward achieving the target.

This stance of monetary policy conduct by the Bank basically has not changed from a year ago, when I spoke at this meeting last time. On the other hand, monetary policy conduct of major central banks abroad has changed significantly from last year's moves toward normalization. This month, the European Central Bank (ECB) decided to lower one of its policy rates and restart its asset purchases, and the Federal Reserve also decided to lower its policy rate, following the rate cut in July. Factors that lie behind these decisions are the prolonged slowdown in the global economy and heightening uncertainties, which Japan is also facing. At the press conference after the decision to take monetary easing measures, President Draghi of the ECB underlined that, in an environment of prolonged uncertainties related to, for example, geopolitical factors and the rising threat of protectionism, international trade had been weakening and downside risks surrounding the euro area economy were significant.

The Bank of Japan has the same policy stance, in that preventing and insuring against risks are taken into consideration when conducting monetary policy. In doing so, what is essential for the Bank is assessment of the momentum toward achieving the price stability target of 2 percent. If there is a greater possibility that such momentum will be lost, the Bank will not hesitate to take additional easing measures. While various factors are considered when examining the momentum toward achieving the price stability target, the following two points are particularly important. First is whether the positive output gap, or the high level of economic activity, will be maintained, and whether firms' stance will shift toward further raising wages and prices under such situation. Second is developments in medium- to long-term inflation expectations of firms and households. Based on these points, the Bank deems that the momentum toward achieving the price stability target has been maintained so far. With the output gap remaining positive, moves to raise selling prices reflecting cost increases have been observed recently in a wide range of firms. As for the outlook, inflation expectations are projected to rise as many of the factors that have been delaying inflation will be resolved gradually and moves to raise prices will spread widely. Under these circumstances, the year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent. Thus, the Bank judges it appropriate to continue with the current monetary policy.

However, given that slowdowns in overseas economies have continued to be observed and their downside risks seem to be increasing, it is becoming necessary to pay closer attention to the possibility that the momentum toward achieving the price stability target will be lost. Developments in the output gap warrant particular attention. If downside risks to overseas economies materialize, there is a possibility that the growth rate of Japan's economy will decelerate substantially through, for example, the prolonged weak exports and firms' investment stance becoming cautious. If this happens, the momentum toward achieving the price stability target could be affected through shrinkage of the output gap. Attention also should be paid to the fact that the impact of the so-called adaptive formation mechanism is large in Japan, in which the actual inflation rate affects inflation expectations. Although crude oil prices temporarily rose somewhat due to increased geopolitical risks, they have declined to some extent from a somewhat longer-term perspective, mainly against the background of the slowdown in overseas economies. If crude oil prices decline further and the actual inflation rate decreases clearly, inflation expectations also may be affected.

Considering that it is becoming necessary to pay closer attention to the possibility that the momentum toward achieving the price stability target will be lost, the Bank will thoroughly reexamine economic and price developments at the next MPM, when it releases the Outlook Report. It will examine economic and price developments from a broad perspective at the next MPM, based on observations that will be available by the time of the meeting, such as various economic indicators, the reports at the meeting of general managers of the Bank's branches, and developments in financial markets. Recently, the situation has been changing rapidly, with investors' risk aversion abating somewhat due to expectations for progress in U.S.-China trade negotiations. Let me also add that the Bank does not have any preconception at this point regarding the outcome of its examination.

Before closing my speech, I would like to elaborate on the Bank's basic thinking on the current conduct of monetary policy. There are three points.

First, the Bank's conduct of monetary policy will continue to be based on the current framework of "QQE with Yield Curve Control," which is highly sustainable and enables the Bank to make flexible adjustments according to developments in economic activity and prices as well as financial conditions. Possible measures for monetary easing include cutting the short-term policy interest rate, lowering the target level of 10-year Japanese government bond (JGB) yields, expanding asset purchases, and accelerating the expansion of the monetary base. Combinations or applications of these various measures would also be an option. The Bank will take appropriate measures depending on the situation, but in any event, the policy effects will be exerted basically through real interest rates and risk premia of asset prices.

Second, the Bank considers that the conclusion reached in the Comprehensive Assessment released in September 2016, in which it assessed the policy effects and their transmission mechanism since the introduction of QQE, is still valid even in the present situation. For example, there is no change in our recognition regarding the impact on economic activity and prices of the term structure of interest rates, in that short- and medium-term interest rates have a larger impact than longer-term rates. On the other hand, the Bank continues to take the view that an excessive decline in super-long-term interest rates could lower the rates of return such as on insurance and pension products, and this may exert a negative impact on economic activity through a deterioration in people's sentiment.

And third, it is important to consider appropriate monetary policy measures while thoroughly weighing their benefits and costs. As I mentioned earlier, "QQE with Yield Curve Control" has been exerting its effects firmly by stimulating a broad range of economic activities through the decline in real interest rates. That said, if the low interest rate environment is prolonged further, it will become necessary to pay closer attention to the costs of policy measures, including the impact on the functioning of financial intermediation and market functioning. Thus, the Bank recognizes that there remains an important challenge to consider what is required to further enhance the sustainability of policy measures.

The Bank will continue to pursue policy conduct in an appropriate manner without preconception, taking account of developments in economic activity and prices as well as financial conditions, while carefully examining various risks. It also will continue to make its utmost efforts as a central bank and strongly support firms' activity in Japan.

Thank you very much for your attention.

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Haruhiko Kuroda
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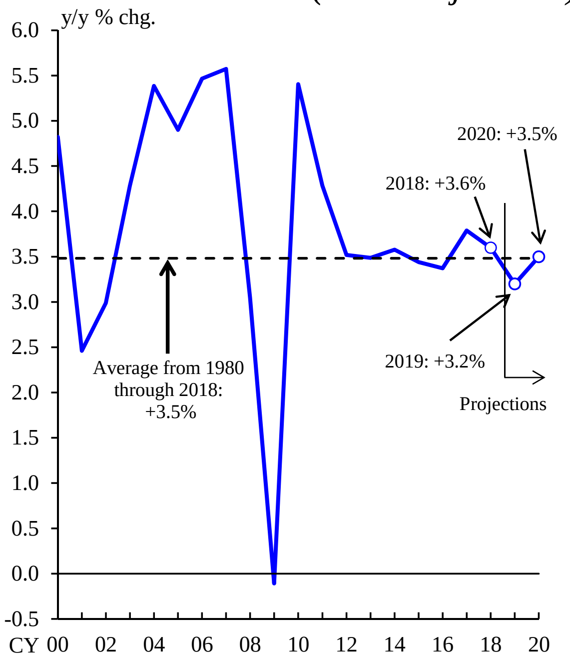
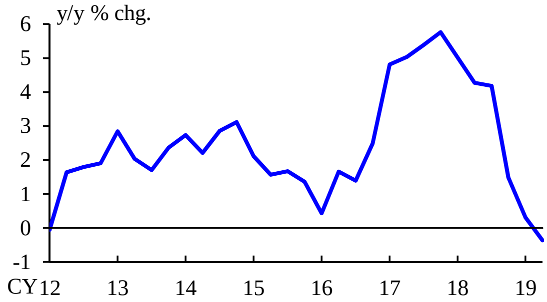
Global Economy

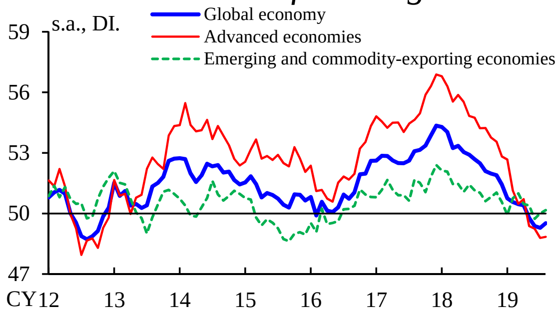
Global Growth Rate (IMF Projections)



World Trade Volume



Global Manufacturing PMI

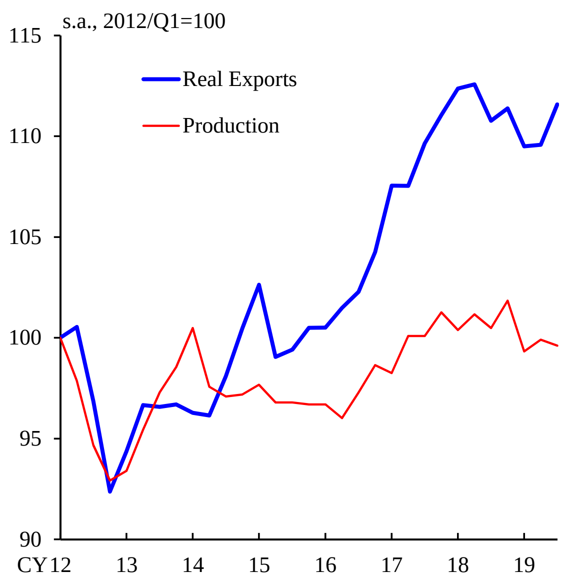


Notes: 1. In the left chart, figures for 2019 and 2020 are IMF's projections as of July 2019.
2. In the upper right chart, figures are those for real imports.
3. In the lower right chart, figures for the global economy are the "J.P. Morgan Global Manufacturing PMI." Figures for advanced economies as well as emerging and commodity-exporting economies are calculated as the weighted averages of the Manufacturing PMI using GDP shares of world total GDP from the IMF as weights. Advanced economies consist of the United States, the euro area, the United Kingdom, and Japan. Emerging and commodity-exporting economies consist of 17 countries and regions, such as China, South Korea, Taiwan, Russia, and Brazil.

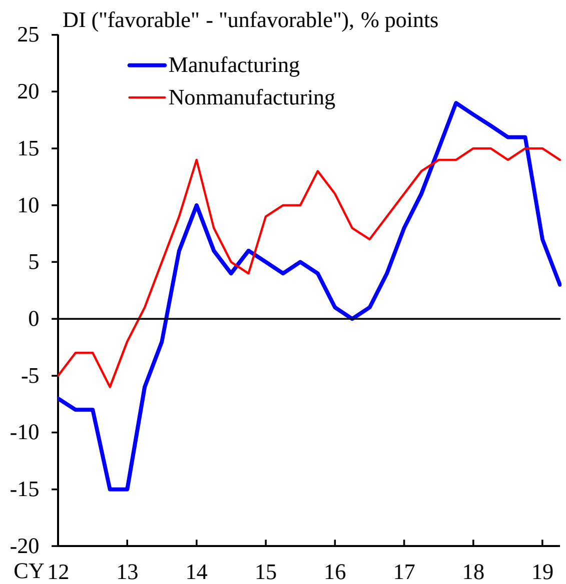
Sources: CPB Netherlands Bureau for Economic Policy Analysis; IHS Markit (© and database right IHS Markit Ltd 2019. All rights reserved.); IMF, etc.

Exports, Production, and Business Sentiment

Exports and Production



Business Conditions DI (Tankan)

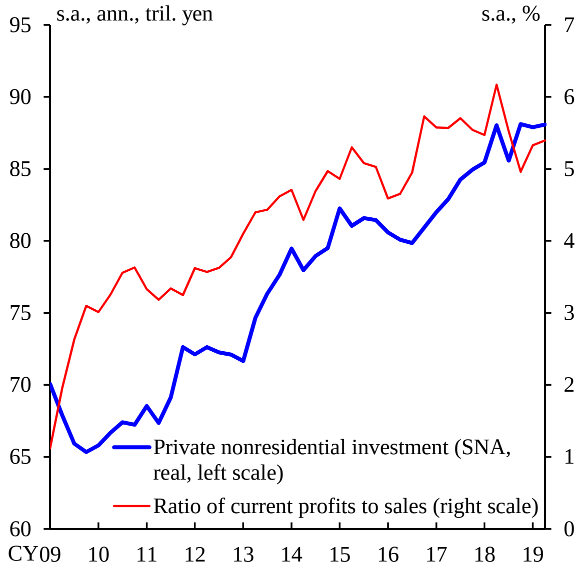


Sources: Ministry of Finance; Ministry of Economy, Trade and Industry; Bank of Japan.

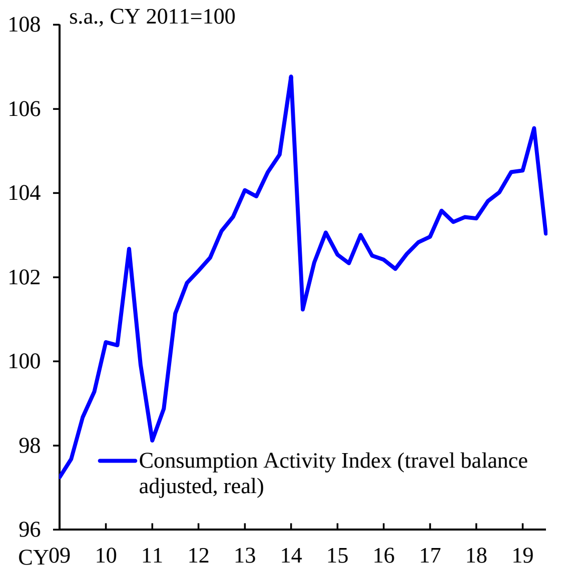
Chart 3

Domestic Demand

Business Fixed Investment and Corporate Profits



Private Consumption

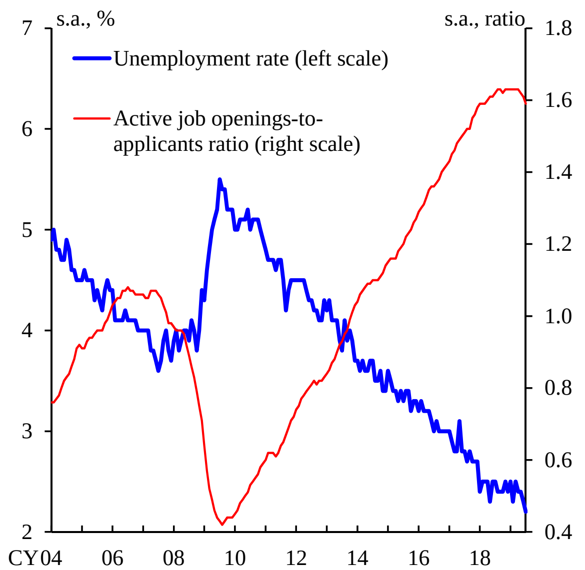


Notes: 1. In the left chart, figures for the ratio of current profits to sales are based on the "Financial Statements Statistics of Corporations by Industry, Quarterly." Excluding "finance and insurance." Figures from 2009/Q2 exclude "pure holding companies."
2. In the right chart, figures for the Consumption Activity Index exclude inbound tourism consumption and include outbound tourism consumption.
Sources: Ministry of Finance; Cabinet Office; Bank of Japan, etc.

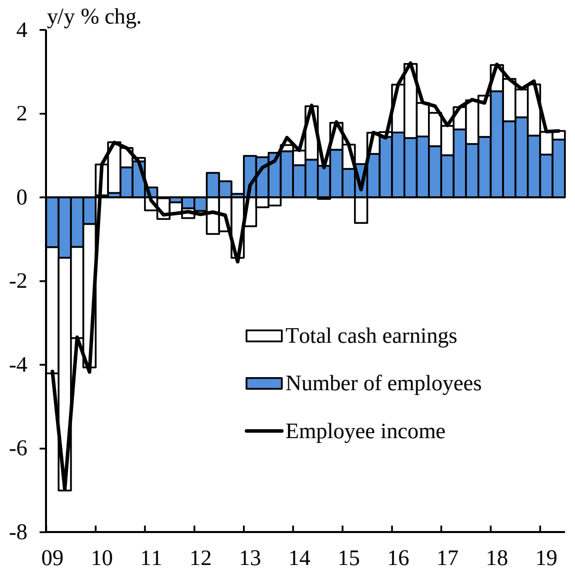
Chart 4

Employment and Income Situation

Labor Market Conditions



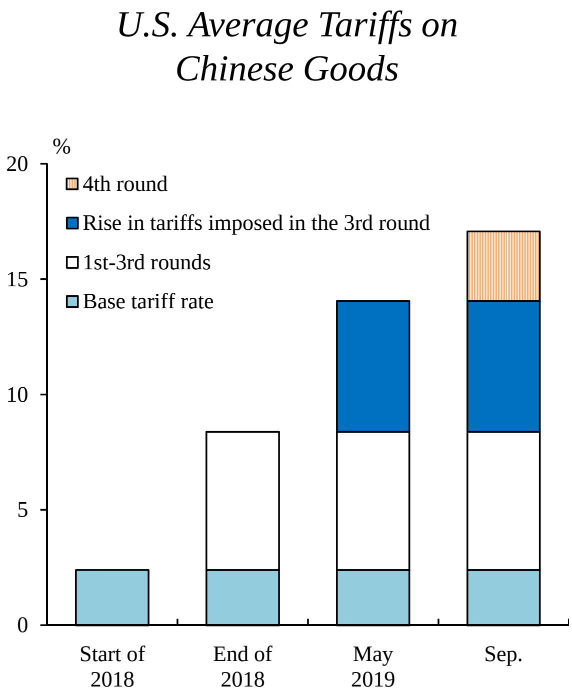
Employee Income

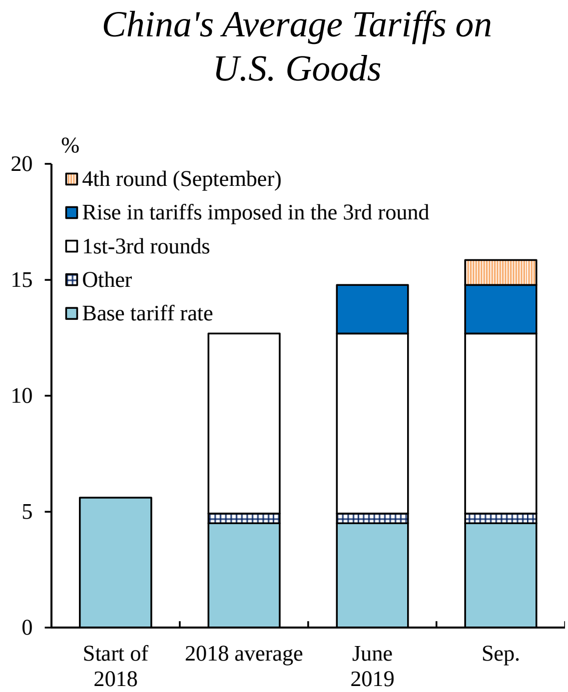


Note: In the right chart, figures for the employee income, Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. Employee income = total cash earnings ("Monthly Labour Survey") × number of employees ("Labour Force Survey"). Figures for the "Monthly Labour Survey" from 2013/Q1 are based on corrected figures adjusted for establishments in Tokyo with 500 or more employees. Figures from 2016/Q1 are based on continuing observations following the sample revisions of the "Monthly Labour Survey."
Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

I. Economic Developments

U.S.-China Trade Friction

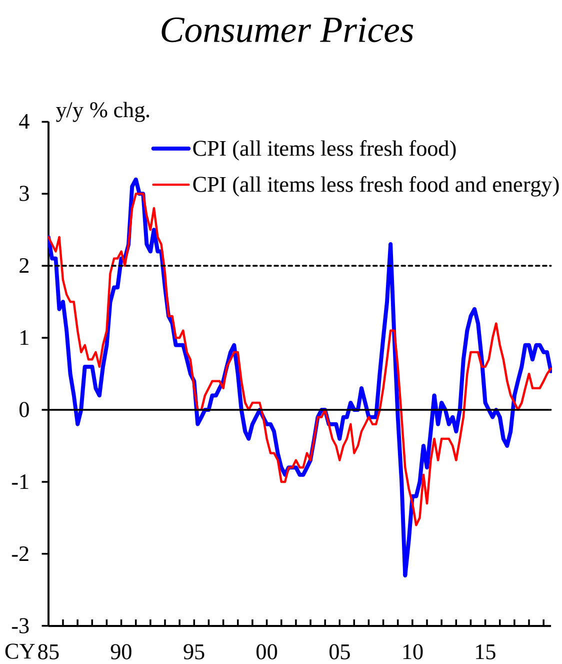


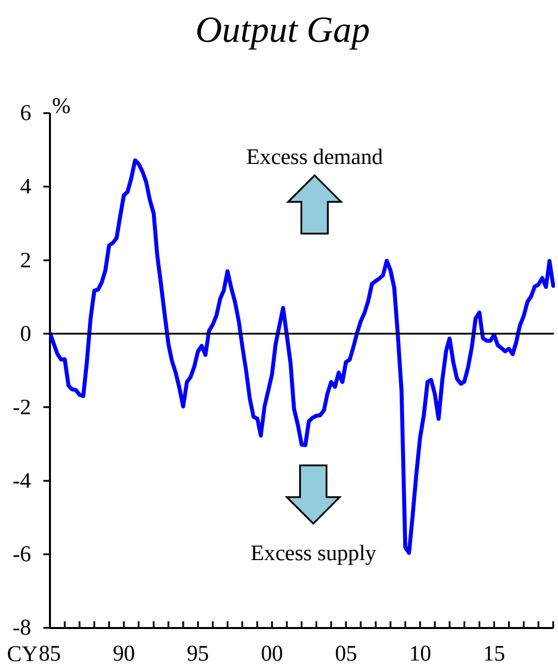


Note: Average tariffs are BOJ staff estimates based on such factors as the tariff rates under most-favored-nation treatment at the start of 2018, additional tariffs by goods, and the trade value between the U.S. and China in 2017.
Sources: Census Bureau; U.S. government; WTO; UN Comtrade; Chinese government; Bown, Chad P. 2019. US-China Trade War: The Guns of August. *PIIE Trade and Investment Policy Watch blog, Peterson Institute for International Economics (August 26).*

II. Price Developments

Consumer Prices and Output Gap

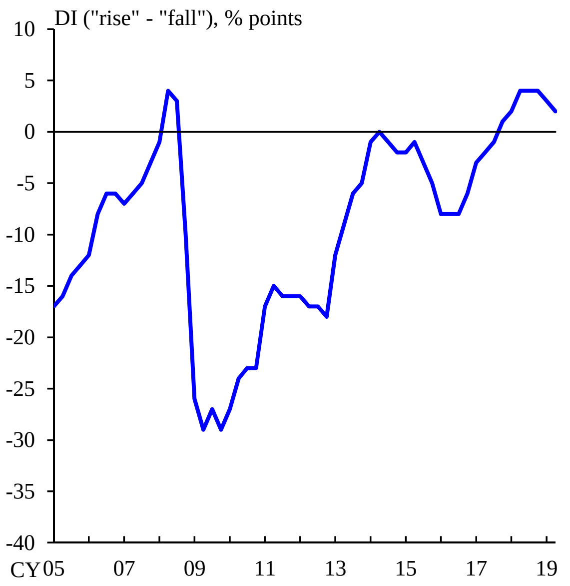




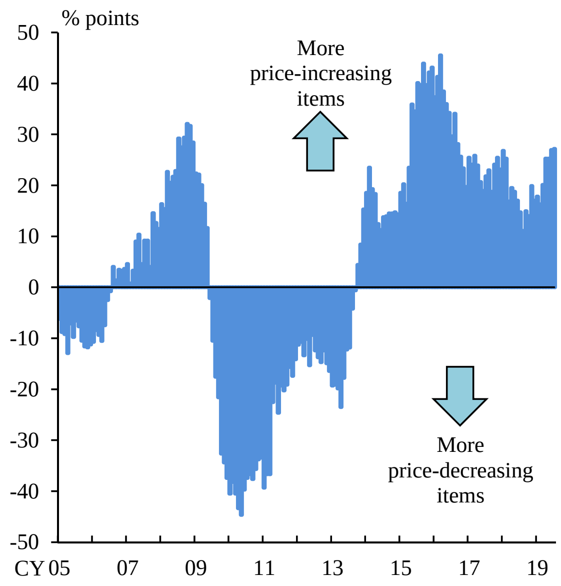
Notes: 1. In the left chart, figures are adjusted for changes in the consumption tax rate.
2. In the right chart, figures are based on BOJ staff estimations.
Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

Situation Surrounding Consumer Prices

Changes in Output Prices (Tankan)

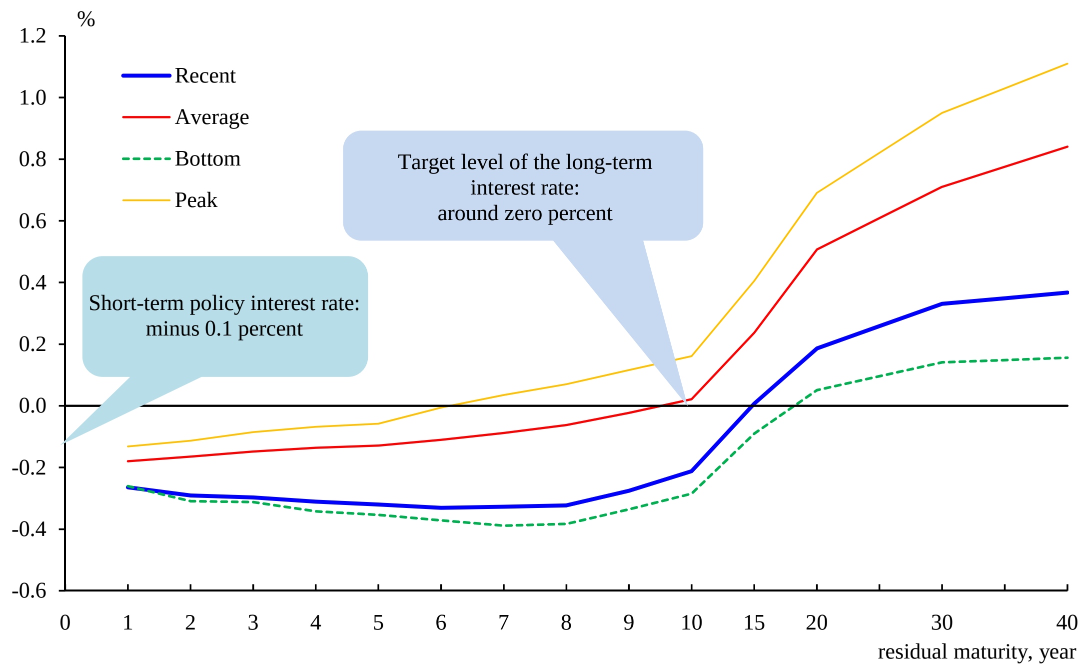


Diffusion Index of Price Changes



Note: In the right chart, the diffusion index is defined as the share of price-increasing items minus the share of price-decreasing items. The share of price-increasing/decreasing items is the share of items in the CPI (less fresh food, consumption tax adjusted) for which price indices increased/decreased from a year earlier.
Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

Yield Curve Control



Note: Figures for average, bottom, and peak are of JGB yields since the introduction of yield curve control (Sep. 21, 2016). Those for bottom and peak are of 10-year JGB yields.
Source: Bloomberg.