September 25, 2019

Bank of Japan

Economic Activity, Prices, and Monetary Policy in Japan

Speech at a Meeting with Business Leaders in Mie

Takako Masai

Member of the Policy Board

(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 July 29 and 30, 2019, 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 2021.

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 assesses that, although overseas economies have been growing moderately on the whole, slowdowns have continued to be observed.

Private consumption has been firm on the whole, mainly due to the favorable employment and income situation. However, the effects of trade friction are becoming evident in the form of deceleration in the pace of increase in the world trade volume, and it is confirmed that this, together with adjustments in the cycle for IT-related goods, has led to a deterioration in business sentiment and a decline in the propensity toward investment, particularly in the manufacturing sector. Indeed, the Global Purchasing Managers' Index (PMI) for manufacturing has been below the 50 mark and continued to decline since May 2019 -- that is, four consecutive months -- while the U.S. ISM Manufacturing Index also fell below 50 in August for the first time since August 2016 -- that is, about three years.

My view is that other central banks and international organizations have been sharing concerns about this situation. For instance, the G20 Osaka Leaders' Declaration adopted in June 2019 states that "[global economic] growth remains low and risks remain tilted to the downside." According to the *World Economic Outlook* (WEO) *Update* released in July 2019 by the International Monetary Fund (IMF), the growth rate of the global economy is projected to decelerate to 3.2 percent in 2019 but pick up to 3.5 percent -- about the same level as the past average -- in 2020; however, these projections were revised downward from the previous ones made in the April 2019 WEO, marking the fourth consecutive downward revision. Moreover, it was indicated by the IMF itself that the projections are "precarious" and presume that progress will be made toward resolving trade policy differences.

Looking at developments by major region, the U.S. economy has continued to be underpinned by the household sector against the backdrop of solid growth in employment and income. Although economic growth in some countries -- such as France -- is being underpinned by consumption, the European economy as a whole, in contrast, has seen moves to defer investment, partly against the backdrop of uncertainty over political developments, and there are no signs of the business sentiment of manufacturing firms -- especially those in Germany -- bottoming out. With regard to Germany in particular, the Deutsche Bundesbank assessed that the growth rate of the economy for the July-September quarter of 2019 could be negative for the second consecutive quarter, following the April-June quarter. The Chinese economy has continued to see stable growth on the whole, but weakness has been observed in manufacturing, as suggested by such indicators as industrial output -- for which growth for July was at its lowest level in about ten and a half years and decelerated further in August. In other emerging and commodity-exporting economies, such as the NIEs and ASEAN economies, effects of adjustments in IT-related goods, for example, have been observed.

In terms of the outlook for overseas economies, slowdowns are likely to continue for the time being; thereafter, however, such economies are expected to grow moderately on the whole, with the growth rates rising somewhat, partly due to the effects of each economy's stimulus measures and a pick-up in manufacturing, where relatively weak developments have been observed mainly in IT-related and capital goods. Nevertheless, there are concerns that, with the Brexit deadline approaching, global financial market conditions might suddenly change depending on the outcome of negotiations on the United Kingdom's exit from the European Union (EU), and I am of the view that downside risks to business activity remain significant, mainly for manufacturing, with trade issues becoming chronic, particularly between the United States and China. Accordingly, I am paying particular attention to the timing and the pace of the pick-up in overseas economies.

B. Japan's Economy

1. Current situation

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

The Bank assesses that Japan's economy has been on a moderate expanding trend, with a virtuous cycle from income to spending operating, although exports, production, and business sentiment have been affected by the slowdown in overseas economies. The assessment of the underlying trend as a whole is unchanged from the previous Outlook Report released in April 2019, but the slowdown in overseas economies seems to be affecting not only exports and production, as has been seen to date, but also the business sentiment of some firms as well as manufacturers' machinery investment, among others. In the meantime, domestic demand, such as business fixed investment, has maintained its firmness, mainly in nonmanufacturing, and private consumption has been increasing moderately, albeit with fluctuations; thus, the output gap has remained positive and the real GDP growth rate for the April-June quarter of 2019, which was released in August, was 1.3 percent on an annualized quarter-on-quarter basis, registering a positive figure for the third consecutive quarter.

Looking at developments by major expenditure item, with corporate profits staying at relatively high levels on the whole, the uptrend in business fixed investment has been maintained, mainly in investment intended for domestic capacity expansion, that aiming at saving labor in order to deal with labor shortage, and that in research and development for growth areas. Especially in nonmanufacturing, an increase has been observed in construction of logistics facilities, reflecting the expansion of e-commerce business, and of accommodation facilities to meet the demand of inbound visitors. Meanwhile, according to the *Financial Statements Statistics of Corporations by Industry, Quarterly*, business fixed investment by manufacturing firms for the April-June quarter of 2019 was minus 6.9 percent on a year-on-year basis, falling below the previous year's level for the first time in two years, due mainly to the effects of trade issues. Private consumption has maintained its moderate increasing trend with labor market conditions remaining tight and the income situation continuing to improve, albeit with fluctuations resulting from weather conditions. Exports have continued to show some weakness, mainly reflecting the effects of the slowdown in overseas economies. As a result of this situation, production mainly of export-related goods has exhibited some weak developments, but industrial production as a whole has been more or less flat. In these circumstances, business sentiment has been weakening somewhat, mainly in manufacturing.

2. Baseline scenario of the outlook for economic activity

Japan's economy is likely to continue on an expanding trend throughout the projection period, which covers from fiscal 2019 through fiscal 2021.

In fiscal 2019, exports are projected to continue showing some weakness for the time being, reflecting the slowdown in overseas economies, and business fixed investment also is likely to decelerate somewhat, mainly for manufacturing. Thereafter, exports are projected to return to their moderate increasing trend, with the growth rates of overseas economies rising gradually. The rate of increase in business fixed investment is expected to rise somewhat due to increases, for example, in labor-saving investment. Private consumption is likely to be pushed down for some time due to the effects of the scheduled consumption tax hike, but is expected to continue increasing as the employment and income situation continues to improve. Public investment also is likely to increase, reflecting Olympic Games-related demand and expansion in expenditure such as for national resilience.

In fiscal 2020, the pace of increase in exports is expected to accelerate, with the growth rates of overseas economies rising, and government spending accompanying the hosting of the Olympic Games is expected to underpin the economy. Business fixed investment is likely to maintain a moderate uptrend. Private consumption and housing investment are expected to head gradually toward a recovery from a decline after the scheduled consumption tax hike.

In fiscal 2021, private consumption and housing investment are projected to increase because the effects of the reactionary decline to the scheduled consumption tax hike are likely to dissipate, although Olympic Games-related expenditure -- which had been increasing -- will have been completed. Exports and business fixed investment are likely to maintain their moderate uptrend.

In terms of the medians of the Policy Board members' forecasts in the July Outlook Report, the real GDP growth rate is 0.7 percent for fiscal 2019, 0.9 percent for fiscal 2020, and 1.1 percent for fiscal 2021.

3. Uncertainties regarding the baseline scenario for economic activity

There are various uncertainties regarding the baseline scenario of the outlook for Japan's economic activity, and I would like to explain two points to which I currently pay particular attention.

First is the risk that the timing of the bottoming out of external demand will delay. Since the latter half of 2018, I have assessed that risks are tilted to the downside, particularly those regarding developments in overseas economies. Recently, due to political factors such as the strengthening of protectionist moves, downside risks seem to be increasing further. I am concerned that this could affect the timing of the bottoming out of external demand through various channels including disruptions in financial markets and a reduction in firms' incentive to invest caused by developments in trade.

Second is the effects of the consumption tax hike scheduled to take place in October 2019. The planned increase in the tax rate is smaller than that at the time of the previous hike in April 2014, and the government plans to implement measures such as a reduced tax rate, a point reward program when using cashless payments, and more flexibly passing on the rise in the consumption tax to sales prices. Taking these into consideration, the baseline scenario is that the negative impact of the tax hike on the growth rates will be smaller than that of the previous hike. Nevertheless, I am paying attention to future consumption, together with possible further heightening in the current geopolitical risks.

I would like to carefully examine the situation, including these two points, in the upcoming October Outlook Report.

C. Price Developments

1. Current situation

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 is currently at around 0.5 percent; it seems to have hit a lull somewhat in the uptrend, as the effects of energy price drops have started to appear. Nevertheless, the general public's gut feeling seems to be that prices are rising gradually. I believe that this is affected by the rise in prices of food products, which are staple purchases. Actually, the year-on-year rate of change in the CPI saw an acceleration in its growth for an increasing number of food products since early spring; in addition, the Unit Value Price Index released by Hitotsubashi University (SRI-Hitotsubashi Consumer Purchase Index) and the Nikkei CPINow-T Index, both of which are calculated based on point-of-sales (POS) data collected at supermarkets, for example, maintained their high growth.

As described in the *Comprehensive Assessment: Developments in Economic Activity and Prices as well as Policy Effects since the Introduction of Quantitative and Qualitative Monetary Easing (QQE)*, which was released by the Bank in September 2016, the adaptive component plays a considerably larger role in Japan than in other countries in the formation of inflation expectations, which means that inflation expectations tend to be influenced by past inflation rates. A similar trend has been confirmed by subsequent studies.[1] In other words, it is important to make cumulative efforts to raise inflation rates; as Gertler pointed out, for an economy that barely has a history of inflation being anchored at a targeted rate, "they [individuals] have to see it to believe it."[2] From this viewpoint, my understanding of

---

[1] See, for example, Toshitaka Maruyama and Kenji Suganuma, "Inflation Expectations Curve in Japan," Bank of Japan Working Paper Series, no.19-E-6, April 2019, http://www.boj.or.jp/en/research/wps_rev/wps_2019/data/wp19e06.pdf.

[2] Mark Gertler, "Rethinking the Power of Forward Guidance: Lessons from Japan," IMES Discussion Paper Series, No. 2017-E-8, Bank of Japan, Institute for Monetary and Economic Studies (IMES), October 2017, https://www.imes.boj.or.jp/research/papers/english/17-E-08.pdf.

the several signs of changes that recently have started to appear is that they are arising in a situation where we gradually are taking positive steps.

In fact, in contrast to the year-on-year rate of increase in the CPI for all items less fresh food that I mentioned earlier, that for all items less fresh food and energy has remained flat at a level around 0.5 percent since the beginning of this fiscal year. In addition, signs of changes -- albeit slight -- seem to have appeared in view of the fact that price rises by firms are beginning to spread to a broader range of products, and given other data, such as the trimmed-mean CPI, which excludes extreme relative price changes. Turning to inflation expectations, the expected inflation rate for the next five years surpassed 1 percent for the first time since 2013, according to an estimation by the Bank's staff based on the results of the *Opinion Survey on the General Public's Views and Behavior*.

The fact that the adaptive component is playing a considerably large role can be explained by people's mindset and behavior based on the assumption that wages and prices will not increase easily having been deeply entrenched. I assume that households are gaining cumulative experiences through rises in base pay for six consecutive years and in the year-on-year rate of increase in employee income on a quarterly basis for 26 quarters in a row, although the rates of increase are modest. As a matter of fact, households' tolerance of price rises, which the Bank's staff calculated, seems to have been on an improving trend, and I am of the view that these also are signs of positive changes.

As I have explained so far, I have the sense that, although we still have some distance to go to achieve the price stability target of 2 percent, there are some signs that the momentum toward achieving the target could strengthen again. In other words, I feel that we are approaching an important phase where firms' and households' tolerance of price rises could

---

Based on empirical analysis, the following paper concludes that individuals' expectations of future inflation rates are influenced by the inflation rates that they actually have experienced. Jess Diamond, Kota Watanabe, and Tsutomu Watanabe, "The Formation of Consumer Inflation Expectations: New Evidence From Japan's Deflation Experience," Bank of Japan Working Paper Series, no.19-E-13, August 2019, http://www.boj.or.jp/en/research/wps_rev/wps_2019/data/wp19e13.pdf.

improve, and expected inflation rates could rise further. Therefore, I believe that it is extremely important to encourage this development.

2. Baseline scenario of the outlook for prices

With regard to the outlook for prices, the year-on-year rate of change in the CPI for all items less fresh food is likely to increase gradually toward 2 percent, mainly on the back of the output gap remaining positive and medium- to long-term inflation expectations rising. The medians of the Policy Board members' forecasts of the year-on-year rate of change in the CPI for all items less fresh food presented in the July Outlook Report was 1.0 percent for fiscal 2019, 1.3 percent for fiscal 2020, and 1.6 percent for fiscal 2021.

3. Risks to prices

Specific risk factors to prices are developments in firms' and households' medium- to long-term inflation expectations, the fact that the responsiveness of prices of some items to the output gap is low, and developments in foreign exchange rates and international commodity prices going forward. My recent concern is that, amid significant downside risks concerning overseas economies, negative effects would be exerted on prices through the third risk factor in the case of disruptions in global financial markets.

II. The Bank's Monetary Policy

Next, I will talk about the Bank's monetary policy.

A. Current Monetary Policy Framework

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 is conducting monetary policy to achieve this target at the earliest possible time. Specifically, under the framework of QQE with Yield Curve Control, it has supported the economic activity of firms and households by maintaining highly accommodative financial conditions.

This framework mainly consists of four components: yield curve control, purchases of risky assets, an inflation-overshooting commitment, and forward guidance for policy rates. The first component, yield curve control, is a policy under which the Bank aims to keep shortand long-term interest rates stable 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 second component is purchases of risky assets; with a view to lowering risk premia of asset prices, the Bank purchases exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their amounts outstanding will increase at annual paces of about 6 trillion yen and about 90 billion yen, respectively. The third component, 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. The fourth component, forward guidance for policy rates, presents the Bank's stance of maintaining 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.

B. Persistently Continuing with Powerful Monetary Easing

The Bank introduced QQE in April 2013 and has continued with powerful monetary easing. However, as it gradually became clear that it likely would still take time to achieve the price stability target of 2 percent, it decided to strengthen the framework for QQE with Yield Curve Control in July 2018. Specifically, it decided to enhance the sustainability of powerful monetary easing by (1) strengthening its commitment to achieving the price stability target by introducing forward guidance for policy rates and (2) conducting market operations and asset purchases in a more flexible manner. To elaborate on the second point, the Bank announced that, in purchasing JGBs, the yields might move upward and downward to some extent, mainly depending on developments in economic activity and prices. It also decided to conduct such purchases in a flexible manner so that their amount outstanding would increase at an annual pace of about 80 trillion yen. Furthermore, it decided to purchase ETFs and J-REITs so that their amounts outstanding would increase at annual paces of about 6 trillion yen and about 90 billion yen, respectively. At the same time, with a view to lowering risk premia of asset prices in an appropriate manner, the Bank announced that it might increase or decrease the amount of purchases depending on market conditions. By allowing for some elasticity in the monetary policy framework, the Bank can respond flexibly to some extent to developments in financial markets.

Moreover, in April 2019, the Bank made clearer its policy stance to persistently continue with powerful monetary easing. Specifically, regarding its forward guidance for policy rates, the Bank added developments in overseas economies as a factor to consider when judging whether it would maintain the current extremely low levels of short- and long-term interest rates; in addition, it clearly presented a point of reference for the expression "for an extended period of time" as at least through around spring 2020. Furthermore, in order to contribute to smooth implementation of fund-provisioning and asset purchases as well as secure market functioning, the Bank decided to take the following measures and initiative: (1) expand eligible collateral for the Bank's provision of credit; (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 Securities Lending Facility (SLF); and (4) consider introducing an ETF lending facility.

The Bank will persistently continue with powerful monetary easing in a sustainable manner under the framework of QQE with Yield Curve Control by devising measures considered necessary at the time and strengthening the framework.

C. Coping with Current Uncertainties

My understanding is that global financial markets as a whole remain risk averse, and this development seems to be strengthening recently amid rapid alternation between pessimism and optimism due to factors of a very strong political nature. For example, in Germany, interest rates on all instruments from overnight loans to 30-year government bonds temporarily became negative, and in Switzerland, interest rates on all instruments up to 50-year government bonds were negative at one point. In the United States, yields on 10-year Treasuries have fallen close to the lowest levels marked after the global financial crisis; market participants seem to have various interpretations of the implication of an inverted yield curve, which has been observed since mid-August, with yields on 10-year Treasuries declining below those on 2-year Treasuries. In the meantime, major economies' central banks, such as the Federal Reserve and the European Central Bank (ECB), have shifted to a more accommodative policy stance so as to prevent uncertainties over the global economy from affecting domestic and regional economic activity and prices. In this respect, the Bank considers it important to thoroughly examine risks to overseas economies and carefully assess how those risks could affect Japan's economic activity and prices. Based on such examination, the Bank, like other central banks, will not hesitate to take additional easing measures if there is a greater possibility that the momentum toward achieving the price stability target will be lost.

To clarify its intention, in the July 2019 Statement on Monetary Policy, the Bank presented its stance that it "will not hesitate to take additional easing measures if there is a greater possibility that the momentum toward achieving the price stability target will be lost." Moreover, in the statement released on September 19, the Bank judged that it was becoming necessary to pay closer attention to the possibility that the momentum toward achieving the price stability target would be lost. Based on this judgment, it added an expression that, taking this situation into account, it would reexamine economic and price developments at the next MPM, when it will discuss the October Outlook Report.

Actual economic conditions faced by central banks are extremely complex and change dynamically in the course of time. On this point, at the Jackson Hole symposium in 2018, there was discussion about implications for monetary policy arising from various structural changes that have occurred in recent years, including digital innovation and an increase in types of non-tangible assets such as software, intellectual property, and brand equity. Moreover, at the Jackson Hole symposium held this year, Federal Reserve Chairman Jerome Powell pointed to recent uncertainties as a new challenge for monetary policy management.[3] In fact, a strengthening of protectionist moves recently appears to be one of the factors that makes the situation even more complicated.

---

[3] This economic symposium, held annually at Jackson Hole, Wyoming, in August, is hosted by the Federal Reserve Bank of Kansas City. Prominent central bankers, finance ministers, and academics from around the world convene to discuss topics such as on the global economy and monetary policy.

I intend to continue to conduct monetary policy appropriately toward achieving the price stability target while considering all conceivable adverse effects and positive effects from every angle as well as taking full consideration of these notable changes in the environment and risks on which to place emphasis.

See Jerome H. Powell, "Challenges for Monetary Policy: Remarks at a symposium hosted by the Federal Reserve Bank of Kansas City," Federal Reserve Bank of Kansas City, August 2019, https://www.federalreserve.gov/newsevents/speech/files/powell20190823a.pdf.