



November 5, 2019

Bank of Japan

Japan's Economy and Monetary Policy

Speech at a Meeting with Business Leaders in Nagoya

Haruhiko Kuroda

Governor of the Bank of Japan

(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 Chubu region. I would like to take this chance to express my sincerest gratitude for your cooperation with various activities of the Bank of Japan's Nagoya Branch.

At the Monetary Policy Meeting (MPM) held last week, the Bank updated its projections for Japan's economic activity and prices through fiscal 2021. In particular, it examined economic and price developments while paying closer attention to the fact that slowdowns in overseas economies have continued and their downside risks seem to be increasing. Today, while outlining this examination, I would like to explain the Bank's view on Japan's economic activity and prices as well as its thinking behind the recent conduct of monetary policy.

I. Economic Developments

Let me start by talking about economic developments. At the MPM held last week, the Bank assessed that Japan's economy was likely to continue on an expanding trend throughout the projection period -- that is, through fiscal 2021. There has been no change to this overall assessment. While the recovery in external demand is expected to slow due to the delay in the timing of a pick-up in overseas economies, domestic demand is likely to be firm as the impact of the delay is expected to be limited. I will elaborate on this mechanism in what follows.

First, I would like to explain developments in overseas economies (Chart 1). Since the turn of this year, the diffusion indexes (DIs) for business sentiment of manufacturing firms on a global basis have remained below 50, which is the borderline between improvement and deterioration of business conditions perceived by firms. The U.S.-China trade friction has exerted a negative impact on the global trade activity as there had been incremental rises in additional tariffs until a partial agreement was reached in mid-October. In addition, slowdowns have continued to be observed in emerging economies, partly because it has been taking time for the effects of China's economic policy to materialize. Against the background of these developments, a pick-up in overseas economies has been delayed and

its timing is expected to lag behind by about half a year compared to the previous projection. The *World Economic Outlook* (WEO) released by the International Monetary Fund (IMF), which has been revised somewhat downward from the July projections, presents a similar view.

However, the Bank's projection for overseas economies does not assume further deceleration. The IMF also maintains the outlook that the global economy will accelerate its growth pace next year. The reason is as follows. Since the turn of this year, monetary easing has been pursued by the Federal Reserve and the European Central Bank (ECB), in addition to central banks in many emerging economies. While the household and nonmanufacturing sectors have been steady thus far despite the weak manufacturing sector, accommodative financial conditions are expected to support domestic demand in these economies. In addition, there has been gradual progress in adjustments in IT-related goods, which had been one of the factors behind the weakness in the global manufacturing sector (Chart 2). The world semiconductor shipments had continued to register negative growth on a quarterly basis, but have been flat recently. Thus, downward pressure stemming from adjustments in IT-related goods is expected to diminish. Under these circumstances, overseas economies are expected to raise their growth rates and grow moderately on the whole. However, this outlook is based on the assumption that the trade friction will not intensify further. As I will explain later, there is no change in the situation that downside risks concerning overseas economies warrant vigilance.

Although the timing of a pick-up in overseas economies has been delayed, the Bank expects that Japan's economy will not decelerate substantially, as I mentioned earlier. This is because, while external demand is expected to decrease, reflecting developments in overseas economies, domestic demand is likely to remain firm. Japan's economy has experienced many business cycle episodes where the initial drivers were fluctuations in external demand. However, in the current phase, weakness in external demand has not affected domestic demand, at least thus far, mainly due to steady business fixed investment. In addition, the Bank had paid careful attention to the impact of the consumption tax hike in October based on past experience, and this has remained small compared to that of the previous tax hike in 2014 as far as available data suggest. In the next part of my speech, I

will elaborate on developments in economic activity in Japan in terms of external demand and domestic demand.

First, external demand has continued to show some weakness, mainly in capital goods, as signs of a further deceleration in business fixed investment have been observed, such as in China (Chart 3). Business sentiment in the manufacturing sector in the September *Tankan* (Short-Term Economic Survey of Enterprises in Japan) has become clearly cautious, reflecting weakness in external demand and related production. As for the outlook, external demand is likely to continue to show some weakness for the time being due to the delay in the timing of a pick-up in overseas economies.

On the other hand, domestic demand has remained firm. In the September *Tankan*, business sentiment of the nonmanufacturing sector has maintained a relatively high level. Among components of domestic demand, business fixed investment has continued on an uptrend (Chart 4). Business fixed investment plans in the September *Tankan* were steady, exceeding the average of past September surveys. Specifically, while machinery investment has been somewhat weak in the manufacturing sector due to the effects of the slowdown in overseas economies, it has remained steady in the nonmanufacturing sector. In the nonmanufacturing sector, not only machinery investment but also software investment has seen an acceleration in its growth pace, reflecting strong demand for saving labor and improving efficiency. Research and development (R&D) investment has maintained its pace of increase in a wide range of industries, including those related to exports. Construction investment also has continued on an uptrend, mainly on the back of urban development projects and the construction of logistics facilities accompanying the spread of e-commerce. With regard to the outlook, business fixed investment is projected to see a temporary deceleration in its pace of increase, mainly in the manufacturing sector, reflecting the effects of the slowdown in overseas economies. However, amid accommodative financial conditions, it is expected to continue increasing moderately thereafter, mainly for investments that are relatively less susceptible to the effects of changes in overseas demand, such as investment for urban development projects, labor-saving investment, and R&D investment for growth areas. Such steady business fixed investment seems to be attributable to changes in firms' behavior, which has become positive in terms of taking future business opportunities and addressing

long-term challenges because the moderate expanding trend in Japan's economy has continued for a few years and a sustained decline in prices is no longer observed.

Private consumption has increased moderately (Chart 5). The impact of the consumption tax hike is likely to be smaller than that of the previous tax hike in 2014, mainly because the net burden on households is small and various measures to smooth out demand have been implemented. The moderate increase in private consumption is mainly attributable to the improvement in the employment and income situation (Chart 6). Labor market conditions have been tight, in a situation where the active job openings-to-applicants ratio has stayed at a level that exceeds the peak marked during the bubble period and the unemployment rate has declined to the range of 2.0-2.5 percent. Employee income has continued to increase. Regarding the outlook, with the employment and income situation continuing to improve, private consumption is expected to follow a moderate increasing trend, although it is likely to be pushed down temporarily due to the effects of the tax hike. Meanwhile, government spending is likely to underpin economic activity going forward, mainly on the back of an increase in disaster-related restoration and reconstruction, Olympic Games-related expenditure, and public investment associated with national resilience.

Thus, Japan's economy is likely to continue on an expanding trend throughout the projection period -- that is, through fiscal 2021 -- as the impact of the slowdown in overseas economies on domestic demand is expected to be limited, although the economy is likely to continue to be affected by the slowdown for the time being (Chart 7). In the latest *Outlook for Economic Activity and Prices* (Outlook Report), the medians of the forecasts for the growth rate are 0.6 percent for fiscal 2019, 0.7 percent for fiscal 2020, and 1.0 percent for fiscal 2021.

So far, I have talked about the outlook for economic activity. There is no change in the situation that downside risks are significant, mainly regarding developments in overseas economies. As for the U.S.-China trade friction, although the partial agreement reached last month can be viewed as a positive move, future developments remain uncertain. With regard to the United Kingdom's exit from the European Union (EU), a situation where the United Kingdom leaves the EU without a deal at end-October was avoided, but there remain

uncertainties given that the general election is scheduled to take place in December. There also are uncertainties such as over developments in emerging economies and geopolitical risks. Moreover, attention should be paid to the fact that global financial markets have become more reactive to these risks. If such downside risks materialize, positive behavior by firms could become cautious. Besides risks concerning overseas economies, the impact of the consumption tax hike continues to warrant attention. As I have explained, although the degree appears to be small for now, the Bank will continue to conduct a careful examination of the impact, including that on consumer sentiment.

II. Price Developments

Let me move on to price developments. At the September MPM, the Bank 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 would be lost, given that slowdowns in overseas economies had continued to be observed and that their downside risks seemed to be increasing. Taking this situation into account, it examined price developments and assessed the momentum toward achieving the price stability target at last week's MPM. In assessing the momentum, the Bank considers it particularly important to examine developments in (1) the output gap, which indicates the strength of economic activity, and (2) inflation expectations, which show people's perception of prices.

First, I would like to explain developments in the output gap (Chart 8). The output gap is expected to narrow temporarily within positive territory, but remain at around the current level on average. In other words, aggregate demand is likely to continue exceeding average supply capacity. As I explained earlier, Japan's economy is expected to grow temporarily at a somewhat slower pace than its potential, reflecting the effects of the slowdown in overseas economies and the consumption tax hike, and the positive output gap is projected to narrow. However, throughout the projection period, domestic demand is likely to continue on an uptrend as the impact of the slowdown in overseas economies is expected to remain limited. In addition, since overseas economies are expected to pick up eventually, Japan's economy is likely to maintain an expanding trend. Under these circumstances, the output gap is expected to remain at around the current positive level on average.

Next, let me talk about developments in inflation expectations (Chart 9). Measures of inflation expectations based on surveys, for example, have shown somewhat mixed signals, in that some have indicated relatively weak developments while others have shown an increase; on the whole, however, inflation expectations have been more or less unchanged. In order to grasp developments in people's inflation expectations, it also is important to monitor changes in households' perception of prices as well as firms' price-setting stance. When "comments on the rise in prices" from the *Opinion Survey on the General Public's Views and Behavior* are regarded as a measure for households' tolerance of price rises, households' tolerance since 2017 has remained at a level that exceeds the past average. As for the price-setting stance of firms that are closely related to consumption, the output prices DI for consumption-related industries shows that the proportion of enterprises answering that output prices have risen has continued to exceed the proportion of those answering that such prices have fallen, and the gap has been expanding, albeit at a moderate pace. Regarding the outlook, it is expected that households' tolerance of price rises will increase steadily and firms' stance gradually will shift toward further raising prices as the employment and income situation is likely to continue improving with the output gap remaining positive. Accordingly, households' and firms' inflation expectations are likely to increase gradually.

Moreover, developments in crude oil prices and global financial markets affect prices. Crude oil prices have been more or less flat -- albeit with fluctuations -- since around this summer, although they have been lower compared to the level seen around spring. In global financial markets, investors' risk aversion had continued to be observed, but the markets recently have been calm compared to a while ago.

Given these observations, the Bank judged at last week's MPM that there had been no further increase in the possibility that the momentum toward achieving the price stability target would be lost. On this basis, it expects that the year-on-year rate of change in the consumer price index (CPI) is likely to increase gradually toward 2 percent, mainly on the back of the output gap remaining positive and inflation expectations rising, despite the CPI inflation rate being affected by such factors as the decline in crude oil prices for the time being (Chart 10). In the latest Outlook Report, it is projected that the year-on-year rates of

change in the CPI excluding fresh food will be 0.7 percent for fiscal 2019, 1.1 percent for fiscal 2020, and 1.5 percent for fiscal 2021.

That said, risks to the outlook for prices are skewed to the downside, and thus close attention should continue to be paid to the possibility that the momentum toward achieving the price stability target will be lost. In particular, it is necessary to take into account the possibility that, if downside risks to economic activity materialize, they will affect prices, mainly through downward pressure on the output gap. Therefore, the Bank will continue to carefully examine economic and price developments and closely monitor whether there will be no increase in the possibility that the momentum toward achieving the price stability target will be lost.

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 conducting monetary policy while examining economic and price developments from two perspectives: the baseline scenario for the outlook and risk analysis. In the current situation where downside risks to economic activity and prices are significant, the examination of risks is becoming increasingly important (Chart 11). In order to make this thinking clearer, the Bank clarified in the July policy statement that it would not hesitate to take additional easing measures if there was a greater possibility that the momentum toward achieving the price stability target would be lost, and emphasized in the September statement that it would reexamine economic and price developments at the October MPM, when it releases the Outlook Report. At the same time, in a situation where downside risks to economic activity and prices have become significant, the aim of these descriptions in the statements was to indicate that the Bank's basic policy stance is further tilted toward monetary accommodation.

At last week's MPM, based on our examination results, the Bank judged that there had been no further increase in the possibility that the momentum toward achieving the price stability target would be lost, but that it was necessary to continue paying close attention to the possibility, given that downside risks concerning overseas economies seemed to be

increasing. With a view to clarifying the assessment of economic and price developments as well as the Bank's policy stance of being further tilted toward monetary accommodation, the Bank decided on a new forward guidance for the policy rates at that meeting (Chart 12). Specifically, the Bank expects short- and long-term policy interest rates to remain at their present or lower levels as long as it is necessary to pay close attention to the possibility that the momentum toward achieving the price stability target will be lost. There are two points here. First, the Bank clearly related the forward guidance to the momentum toward achieving the price stability target. Second, the Bank reflected its policy stance of being tilted toward monetary accommodation in the forward guidance for the policy rates as well. On this basis, it clarified that there would be a downward bias in the policy rates. However, I would like to add that this does not limit additional easing measures to lowering the policy rates. There is no change in our understanding that, besides lowering the policy rates, there are various possible measures for additional easing -- such as expanding asset purchases and accelerating the expansion of the monetary base -- depending on developments in economic activity and prices as well as financial conditions, and that combinations or applications of these various measures also would be an option.

The Bank will continue to conduct appropriate monetary policy without preconception, taking account of developments in economic activity and prices as well as financial conditions, while carefully examining various risks.

Conclusion

Before concluding my speech, I would like to touch on developments in the economy of the Tokai region. Since the turn of the year, the regional economy has remained steady despite the slowdown in overseas economies affecting exports and production across Japan. Labor market conditions in the region have remained tight; for more than a year, the active job openings-to-applicants ratio has been around 2 times and the unemployment rate has been 2 percent or below. In addition, growth in scheduled cash earnings has exceeded that for Japan as a whole. As for the corporate sector, business fixed investment has continued to increase on the back of high levels of corporate profits. With the slowdown in overseas economies continuing, there have been some postponements in nonessential and nonurgent investment intended for capacity expansion, but forward-looking investments -- that is,

R&D investment as well as labor-saving and efficiency-improving investment -- have increased. Such forward-looking investments that are relatively less susceptible to changes in overseas demand are underpinning the expanding trend in the economic activity across the country, and this tendency is notable particularly in this region.

The steady regional economy seems to be attributable not only to the high quality of manufacturing but also the high ability to analyze and grasp consumers' needs in detail. For example, in the automobile industry, a framework has been established in which firms monitor developments in demand worldwide through detailed analysis and provide instantaneous feedback on the outcome to their production process. Through such framework, they can completely manage the process in an integrated manner, starting from market analysis through the distribution of products to their customers, which enables them to run their business flexibly amid high uncertainties.

I would like to close my speech today by making a commitment that the Bank will persistently pursue powerful monetary easing, thereby providing its utmost support for your corporate activities.

Thank you very much for your attention.

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Introduction

I. Economic Developments

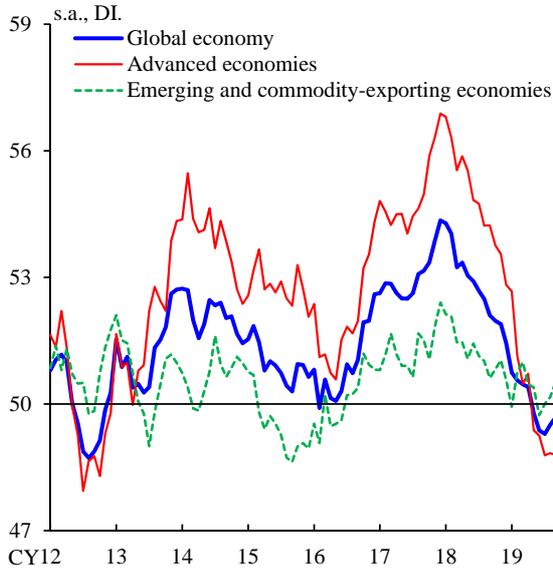
II. Price Developments

III. The Bank's Conduct of Monetary Policy

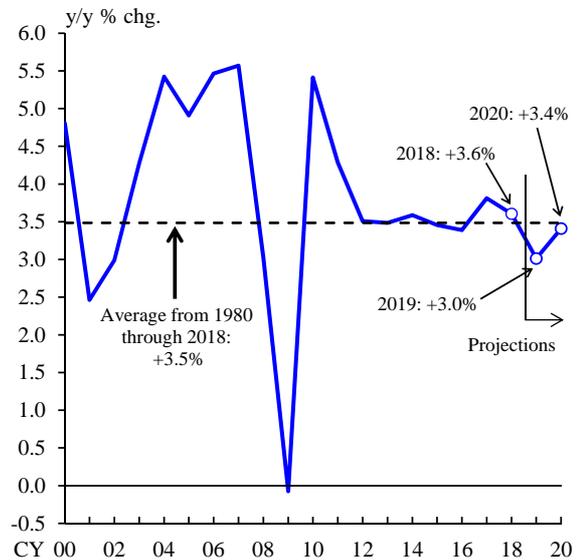
Conclusion

Global Economy

Global Manufacturing PMI

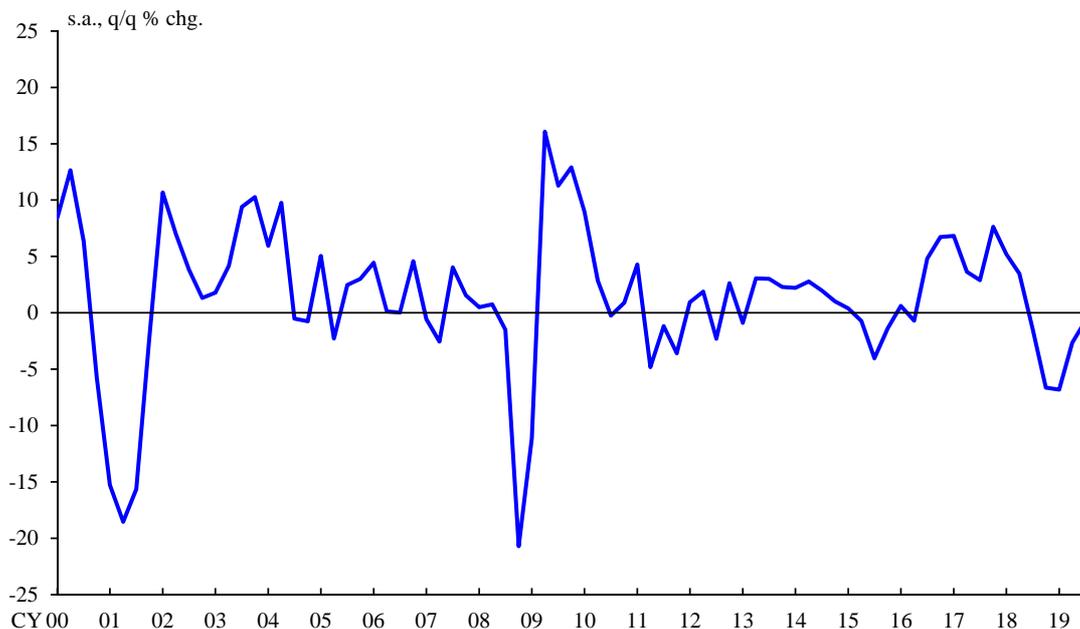


Global Growth Rate (IMF Projections)



Notes: 1. In the left 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.
 2. In the right chart, figures for 2019 and 2020 are the IMF's projections as of October 2019.
 Sources: IHS Markit (© and database right IHS Markit Ltd 2019. All rights reserved.); IMF, etc.

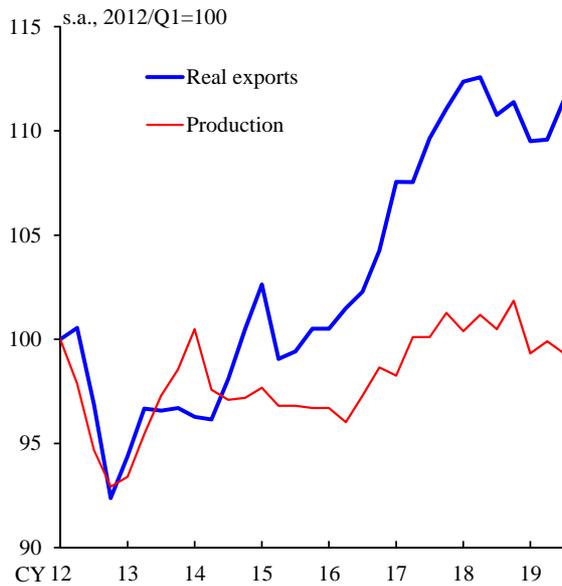
World Semiconductor Shipments



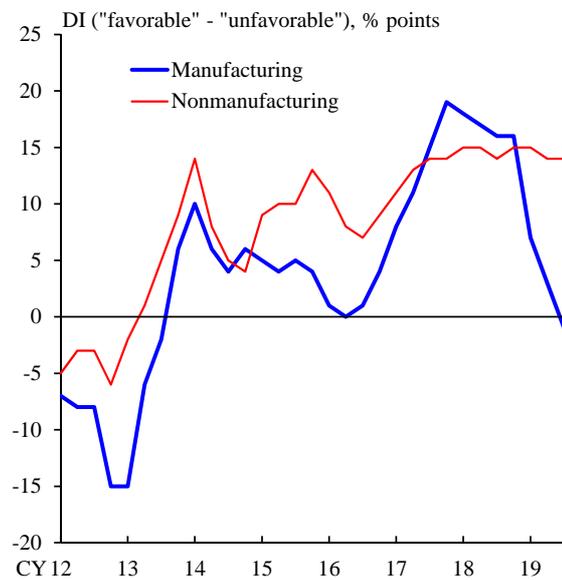
Note: Figures are based on staff estimates using WSTS data.

Exports, Production, and Business Sentiment

Exports and Production



Business Conditions DI (Tankan)

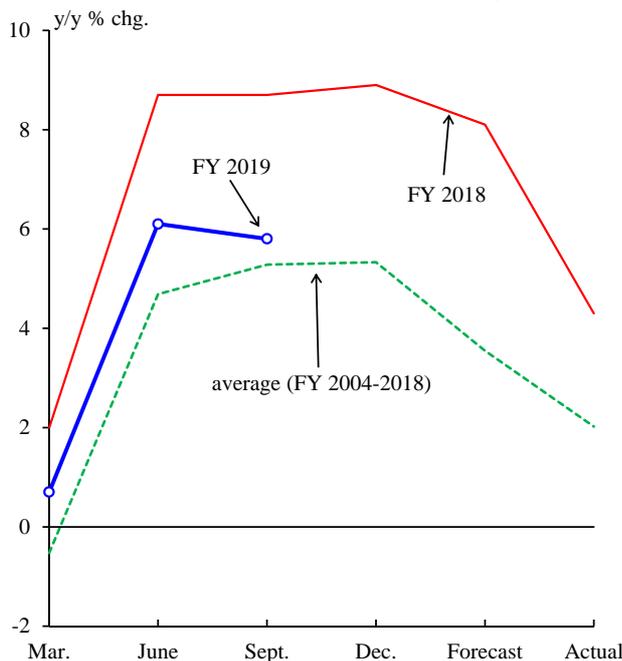


Sources: Ministry of Finance; Ministry of Economy, Trade and Industry; Bank of Japan.

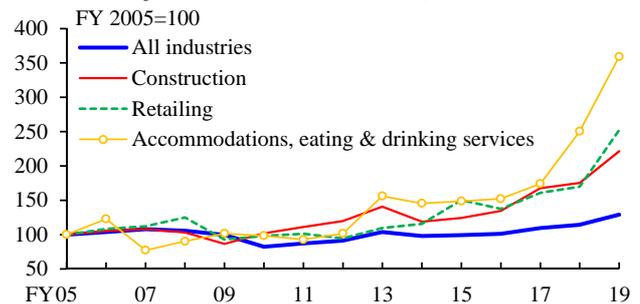
3

Business Fixed Investment

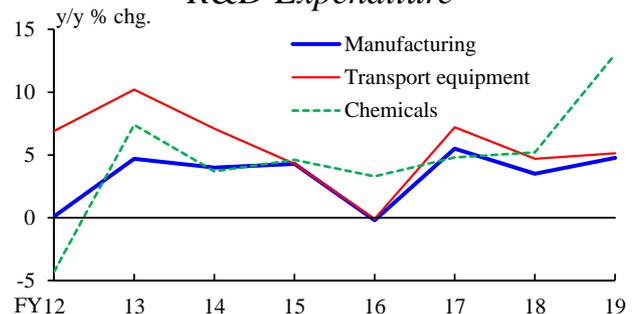
Business Fixed Investment Plans (Tankan)



Software Investment (Tankan)



R&D Expenditure



Notes: 1. In the left chart, figures are for all industries including financial institutions. Figures include software and R&D investment and exclude land purchasing expenses.

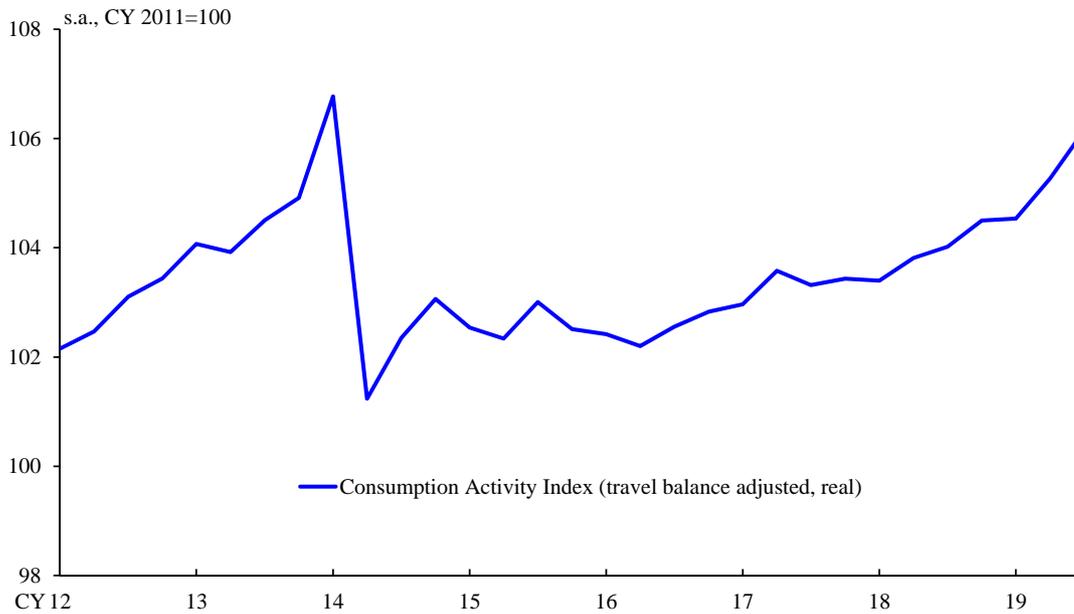
2. In the upper right chart, figures through fiscal 2018 are actual results. Figures for fiscal 2019 are forecasts from the September 2019 survey.

3. In the lower right chart, figures are those of firms with capital of 1 billion yen or more on a consolidated basis. Figures for fiscal 2019 are based on staff calculations using figures adjusted for the average of changes from planned to actual expenditure in fiscal 2012-2018.

Sources: Development Bank of Japan; Bank of Japan.

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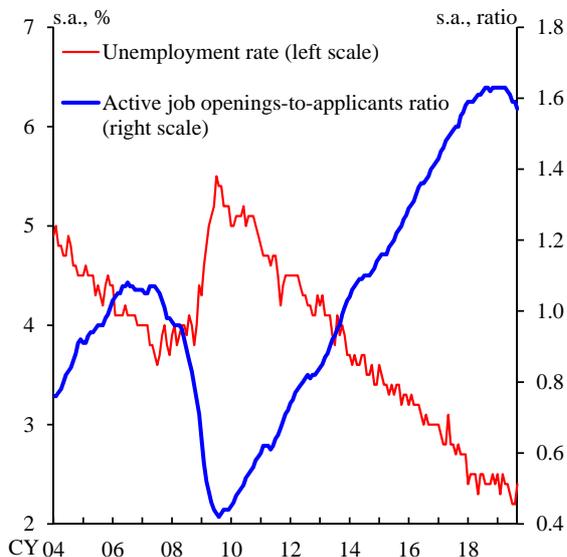
Private Consumption



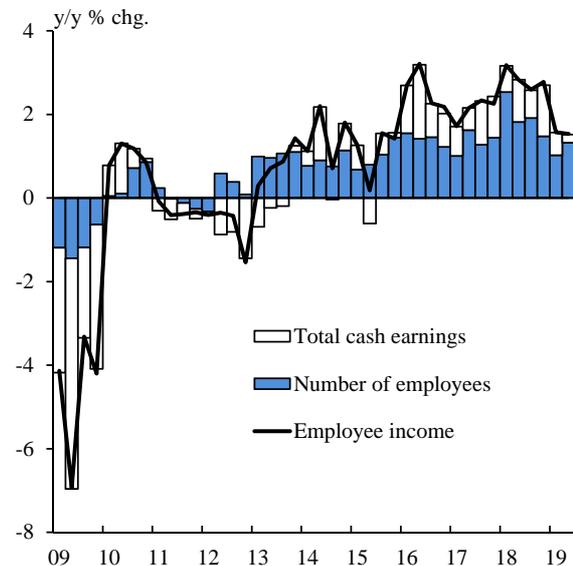
Note: Figures exclude inbound tourism consumption and include outbound tourism consumption.
Sources: Bank of Japan, etc.

Employment and Income Situation

Active Job Openings-to-Applicants Ratio and Unemployment Rate



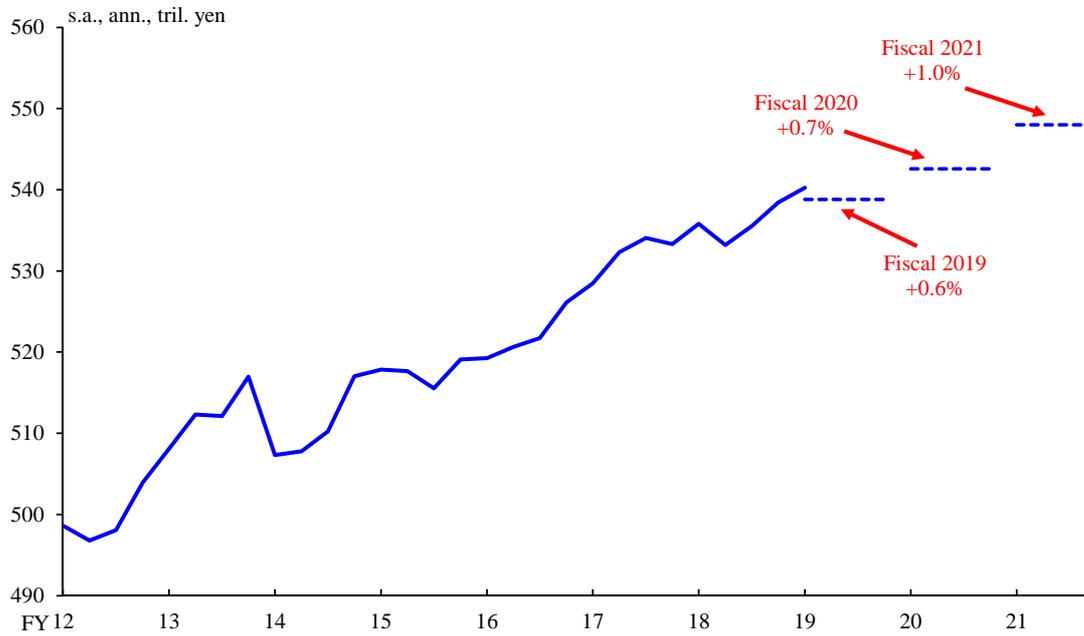
Employee Income



Note: In the right chart, 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").
Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

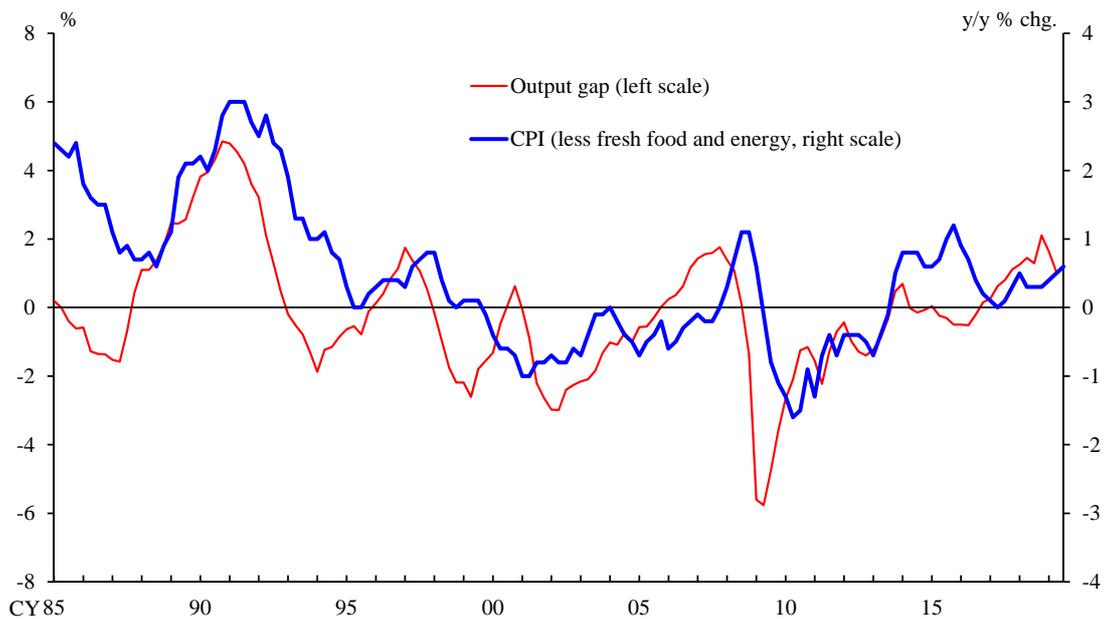
BOJ's Economic Forecasts

Real GDP
 <October 2019 Outlook Report>



Note: Forecasts are the medians of the Policy Board members' forecasts (point estimates).
 Sources: Cabinet Office; Bank of Japan.

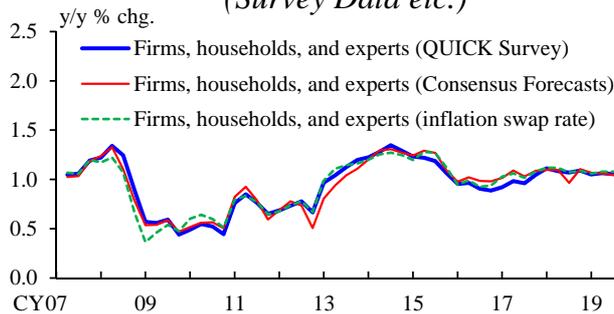
Consumer Prices and Output Gap



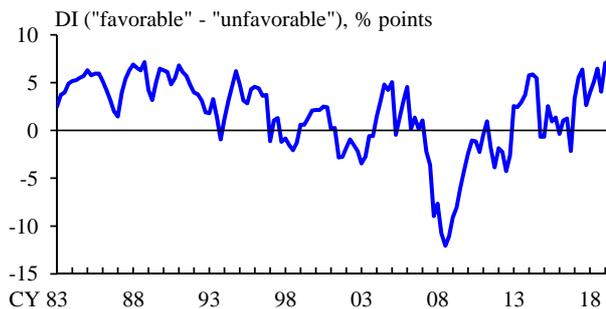
Note: Figures for the CPI are adjusted for changes in the consumption tax rate. Figures for the output gap are based on BOJ staff estimates.
 Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

Inflation Expectations

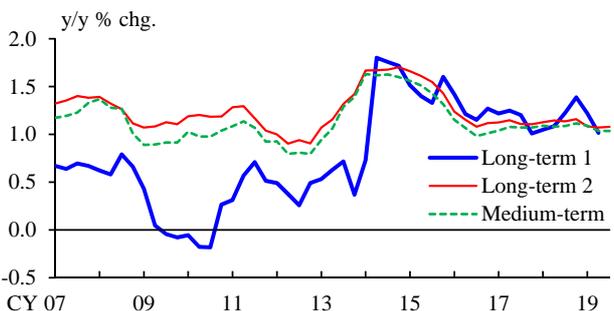
Synthesized Inflation Expectations Indicators (Survey Data etc.)



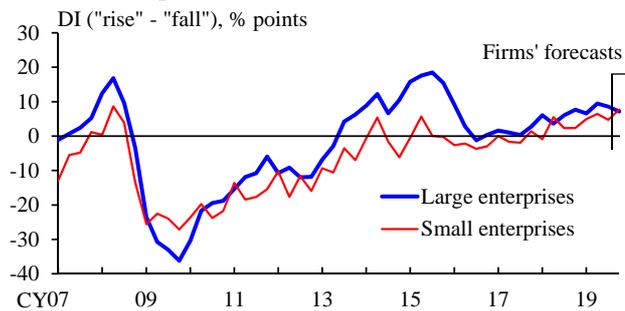
Households' Tolerance of Price Rises



Estimates of Inflation Expectations (Economic Models)



Output Prices DI for Consumption-Related Industries (Tankan)

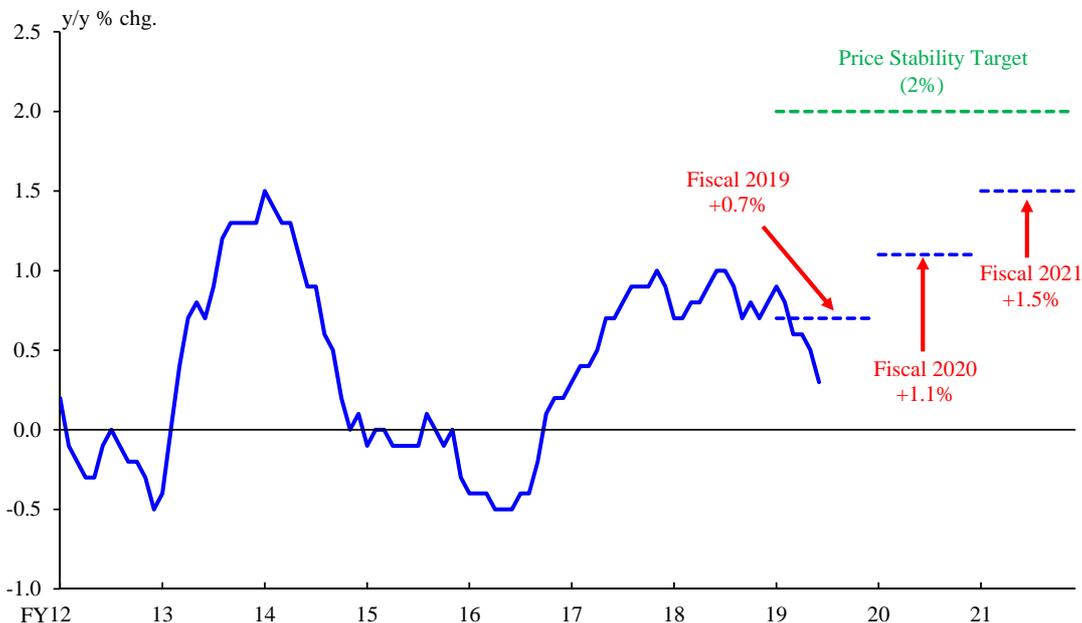


Note: For details, see BOX 7 in the October 2019 Outlook Report.

Sources: QUICK, "QUICK Monthly Market Survey (Bonds)," "QUICK Tankan"; JCER, "ESP Forecast"; Consensus Economics Inc., "Consensus Forecasts"; Wolters Kluwer, "Blue Chip Economic Indicators"; Bloomberg; Ministry of Finance; Ministry of Internal Affairs and Communications; Cabinet Office; Bank of Japan.

BOJ's Price Forecasts

CPI (All Items Less Fresh Food) <October 2019 Outlook Report>



Note: The actual figures exclude the direct effects of the consumption tax hike in April 2014. Forecasts are the medians of the Policy Board members' forecasts (point estimates). Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

BOJ's Conduct of Monetary Policy

Assessment of Economic Activity and Prices from Two Perspectives

Excerpt from September 2019 Statement on Monetary Policy

The first perspective

Examining the outlook for economic activity and prices deemed most likely by the Bank of Japan

The second perspective

Examining, in a longer term, various risks that are most relevant to the conduct of monetary policy

The Bank will continue with "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control," aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. . . . In particular, in a situation where downside risks to economic activity and prices, mainly regarding developments in overseas economies, are significant, the Bank 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.

Given that, recently, slowdowns in overseas economies have continued to be observed and their downside risks seem to be increasing, the Bank judges that it is becoming necessary to pay closer attention to the possibility that the momentum toward achieving the price stability target will be lost. Taking this situation into account, the Bank will reexamine economic and price developments at the next MPM, when it updates the outlook for economic activity and prices.

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BOJ's Forward Guidance

BOJ decided on a new forward guidance for the policy rates (Oct. 2019)

As for the policy rates, the Bank expects short- and long-term interest rates to remain at their present or lower levels as long as it is necessary to pay close attention to the possibility that the momentum toward achieving the price stability target will be lost.

First point: Clearly related to the momentum toward achieving the price stability target.

Second point: Clarified that there was "a downward bias" in the policy rates.

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