March 27, 2024

Bank of Japan

Economic Activity, Prices, and Monetary Policy in Japan

Speech at a Meeting with Local Leaders in Aomori

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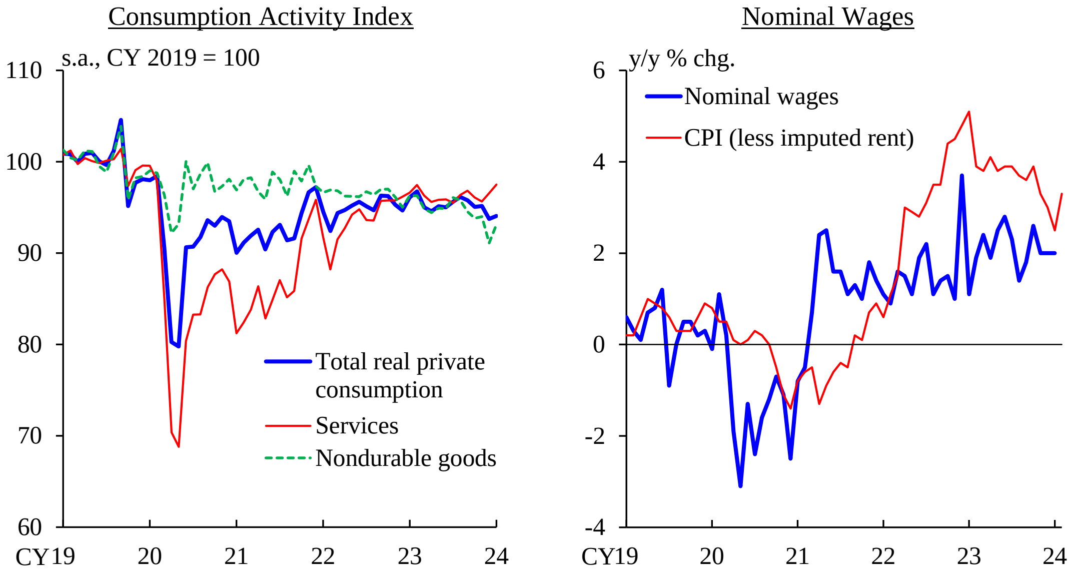
(English translation based on the Japanese original)

I. Economic Activity and Prices

A. Economic Activity

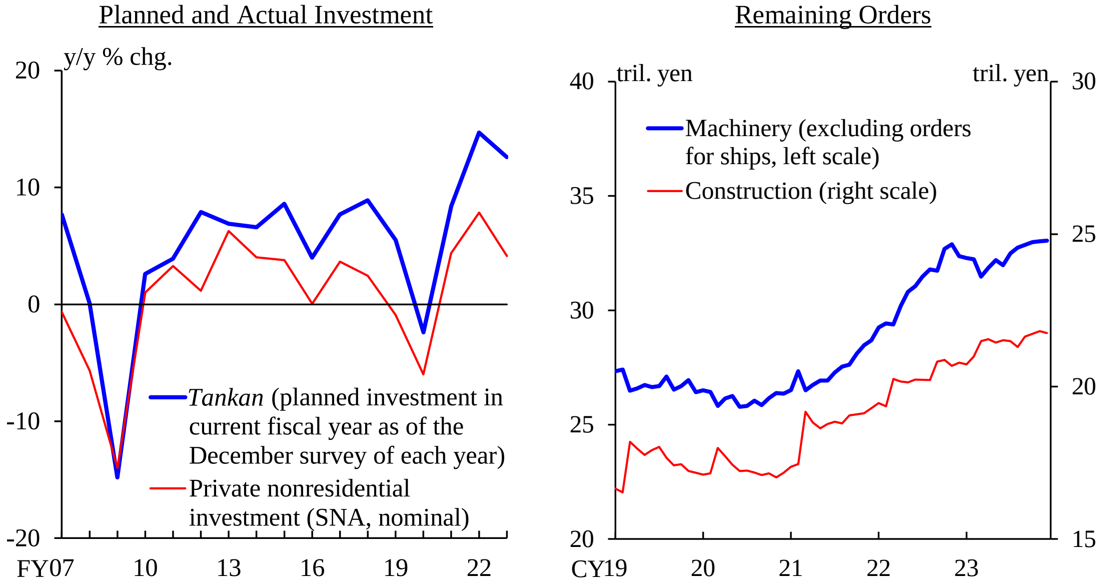
I will begin my speech by talking about recent developments in economic activity in Japan. The Bank of Japan assesses that the economy has recovered moderately, although some weakness has been seen in part. I would like to raise two points that I am concerned about recently. The first is about developments in private consumption. Despite high prices, private consumption has continued to increase at a moderate pace, due in part to pent-up demand from the COVID-19 pandemic (Chart 1). However, consumption of nondurable goods, such as food and clothes, has followed a decreasing trend in real terms after excluding price rises, reflecting a recent shift toward inexpensive products. My understanding is that consumption has started to show signs of waning, owing to high prices, as an increase in wages has not been catching up with price rises. The second concern is about business fixed investment. On the back of corporate profits having been at high levels on the whole, the business fixed investment plans for fiscal 2023 in the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) indicate that investment is likely to increase clearly (Chart 2). Meanwhile, the actual data for fixed investment in the GDP statistics up to December 2023 somewhat lack strength, even taking into account that the normal assumption is that actual data decline from the projection. On the other hand, the remaining orders for machinery and construction have

Chart 1: Private Consumption



Notes: 1. In the left panel, figures for "total real private consumption" are for the real Consumption Activity Index and are based on Bank staff calculations. The figures exclude inbound tourism consumption and include outbound tourism consumption.
2. In the right panel, figures for "nominal wages" are based on continuing observations following the sample revisions.
Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications; Bank of Japan.

Chart 2: Business Fixed Investment



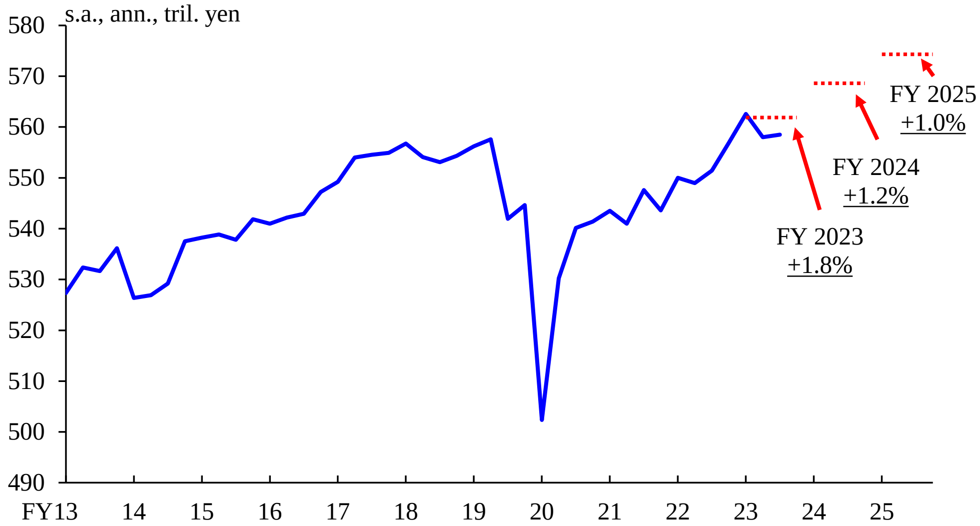
Notes: 1. In the left panel, the *Tankan* figures include software and R&D investments and exclude land purchasing expenses. Figures are for all industries including financial institutions.
2. In the left panel, the figure for private nonresidential investment for fiscal 2023 is the 2023/Q2-Q4 average.
3. In the right panel, figures for "construction" are based on the survey of 50 major construction companies.

Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism; Bank of Japan.

stayed on an increasing trend, and thus I consider that firms are faced with a lack of supply capacity, in that they receive orders but cannot manufacture, mainly due to labor shortages, although there is demand for business fixed investment.

In terms of the median of the Bank of Japan Policy Board members' forecasts -- as presented in the January 2024 *Outlook for Economic Activity and Prices* (Outlook Report) -- Japan's real GDP growth rate is expected to be at 1.8 percent for fiscal 2023, 1.2 percent for fiscal 2024, and 1.0 percent for fiscal 2025; the economy is projected to grow at a pace above its potential (Chart 3). Despite the recent concerns that I described earlier, when looking a little further ahead of Japan's economic development, private consumption is likely to be underpinned by an increase in wage growth coupled with the government's economic measures as inflation subsides. Business fixed investment is likely to follow its long-term uptrend despite some supply-side constraints. This is due to firm demand for fixed investment, such as investment to address labor shortages and digital-related investment, as well as investments associated with the green transformation and with strengthening supply chains. In addition, inbound tourism demand is expected to keep rising. Thus, there is little concern that the medium- to long-term outlook for Japan's economy will be undermined.

Chart 3: The Bank's Forecasts for Real GDP

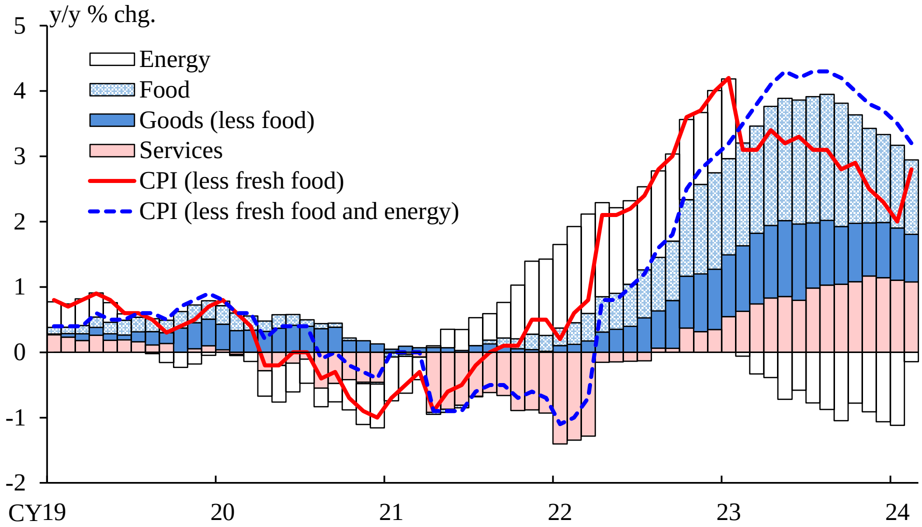


Note: The forecasts presented are the medians of the Policy Board members' forecasts in the January 2024 Outlook Report. The values of real GDP for fiscal 2023 onward are calculated by multiplying the actual figure for fiscal 2022 by all successive projected growth rates for each year.
Sources: Cabinet Office; Bank of Japan.

B. Price Developments

Turning to Japan's price developments, the year-on-year rate of increase in the consumer price index (CPI) for all items excluding fresh food has been in the range of 2.5-3.0 percent, albeit lower than before, and that for all items excluding fresh food and energy, for which prices fluctuate significantly, has been at around 3 percent (Chart 4). The contribution of goods prices to the rate of increase in the CPI has been declining due to the waning effects of the pass-through to consumer prices of cost increases led by the past rise in import prices. On the other hand, increases in services prices have been pushing up the CPI. At the beginning of the current inflationary phase, most firms reported that, although they were able to pass on raw material cost increases to selling prices, they could not go further to pass on a rise in personnel expenses. Thereafter, however, firms' moves to pass on the rise in personnel expenses to prices have been spreading gradually, and these have been reflected in the increases in services prices, for which personnel expenses account for a large proportion of costs. In my view, such developments indicate that firms' price-setting behavior has changed clearly in Japan.

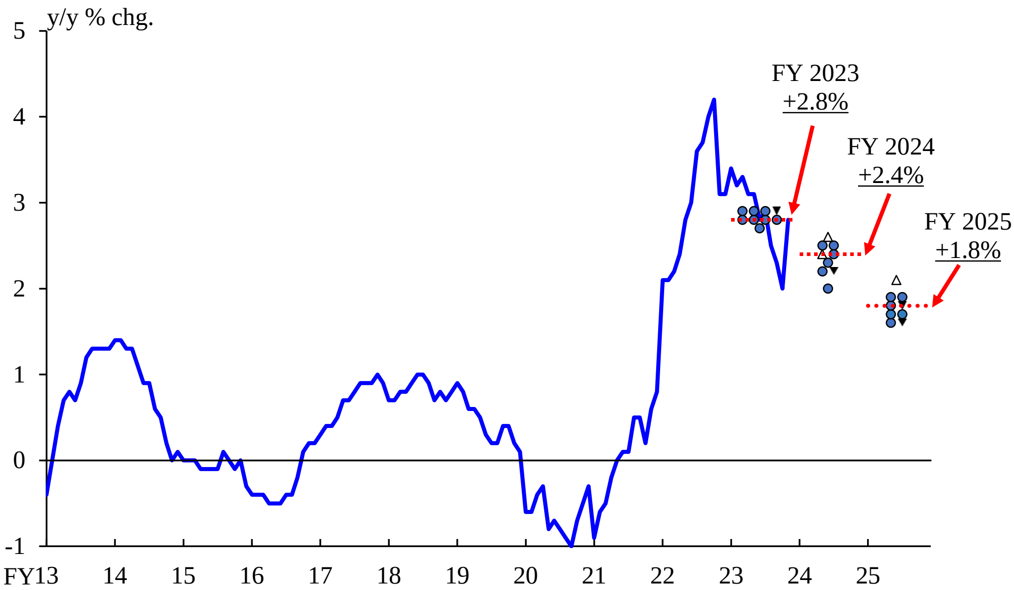
Chart 4: Consumer Prices



Source: Ministry of Internal Affairs and Communications.

In terms of the median of the Policy Board members' forecasts, the CPI (all items less fresh food) is projected to see a year-on-year rate of increase of 2.8 percent for fiscal 2023, 2.4 percent for fiscal 2024, and 1.8 percent for fiscal 2025 (Chart 5). In order to realize this outlook, it is important that a virtuous cycle between wages and prices be achieved, and that such cycle continue to operate.

Chart 5: The Bank's Forecasts for the CPI



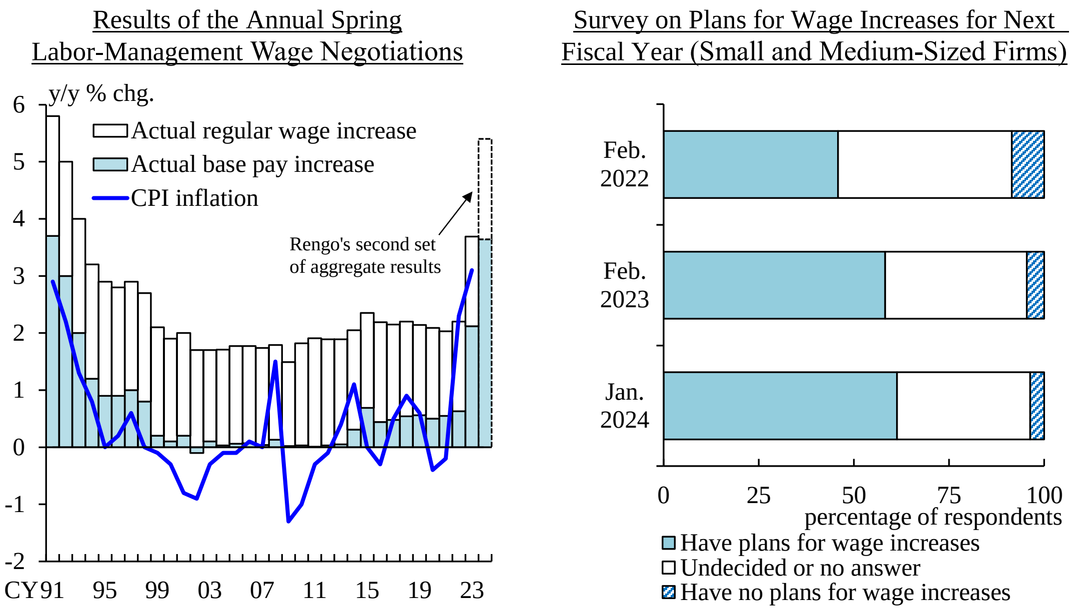
Notes: 1. Figures are the CPI for all items less fresh food, excluding the effects of the consumption tax hikes.

2. The locations of ●, △, and ▼ in the chart indicate the figures for each Policy Board member's forecasts. The risk balance assessed by each Policy Board member is shown by the following shapes: ● indicates that a member assesses "upside and downside risks as being generally balanced," △ indicates that a member assesses "risks are skewed to the upside," and ▼ indicates that a member assesses "risks are skewed to the downside." The dotted lines show the medians of the Policy Board members' forecasts presented in the January 2024 Outlook Report.

Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

I think that this year's wage growth is highly likely to surpass the previous year's substantial growth. The provisional aggregate results of the annual spring labor-management wage negotiations this year, which were released in late March, reveal that the wage growth rate is significantly higher than the results for the previous year, including among small and medium-sized firms (Chart 6). Likewise, a survey targeting small and medium-sized firms shows that the number of firms that are positive about raising wages has been increasing further. In addition, anecdotal information from firms -- which is gathered through the Bank's Head Office and branches -- suggests that a wider range of firms have actually been raising wages. I think that this is mainly because firms are feeling the need to retain and recruit human resources in response to labor shortages. Of course, it is also true that some firms claim that they do not have the resources for wage hikes or that it is difficult to pass on wage hikes to prices. However, taking into account recent data and anecdotal information, as well as the change in firms' price- and wage-setting behavior and ongoing labor shortages that I talked about earlier, I believe that there is a good chance of the virtuous cycle between wages and prices continuing to operate.

Chart 6: Developments in Wage Revisions



Notes: 1. In the left panel, figures for CPI inflation are for all items less fresh food, excluding the effects of the consumption tax hikes.
2. In the left panel, figures for "actual base pay increase" and "actual regular wage increase" from 1991 to 2014 are those published by the Central Labour Relations Commission, while those from 2015 to 2024 are figures released by the Japanese Trade Union Confederation (Rengo). Figures are based on the wage negotiation results of labor unions for which the base pay increase is clear. The figure for 2024 is from Rengo's second set of aggregate results.
3. In the right panel, figures are based on the survey by the Japan Chamber of Commerce and Industry and the Tokyo Chamber of Commerce and Industry. The time period indicated by the bars represents when the survey was conducted. In Japan, the fiscal year starts in April and ends in March of the following year.

Sources: Central Labour Relations Commission; Japan Chamber of Commerce and Industry; Ministry of Internal Affairs and Communications; Rengo.

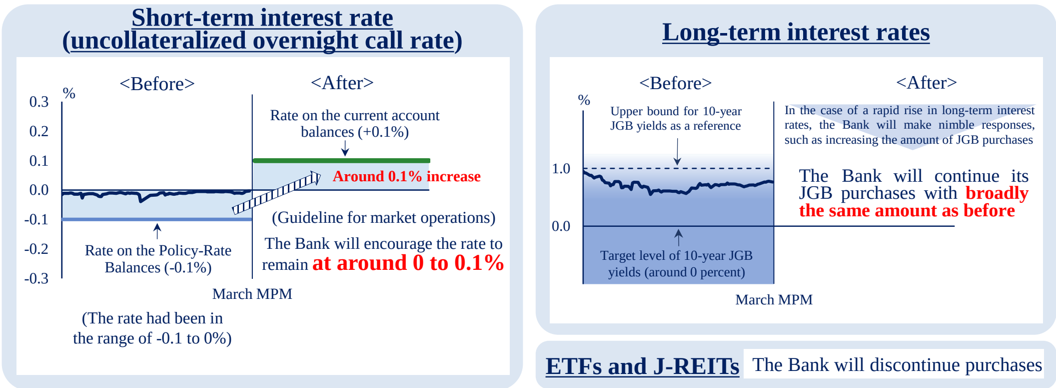
II. Conduct of Monetary Policy

A. Changes in the Monetary Policy Framework

Now, I would like to turn to the Bank's conduct of monetary policy. The Bank continued with large-scale monetary easing, aiming to achieve the price stability target of 2 percent in a sustainable and stable manner. At the Monetary Policy Meeting held on March 18 and 19, 2024, the Bank changed its monetary policy framework that had been in effect to date, given the confirmation that the virtuous cycle between wages and prices has become more solid, as I noted earlier, and also because it can be judged that it is now within sight that the price stability target of 2 percent will be achieved in a sustainable and stable manner toward the end of the projection period of the January 2024 Outlook Report, which covers from fiscal 2023 through fiscal 2025 (Chart 7).

Chart 7: Changes in the Monetary Policy Framework (March 2024)

- As recent data and anecdotal information have gradually shown that the virtuous cycle between wages and prices has become more solid, the Bank judged **it came in sight that the price stability target of 2 percent would be achieved in a sustainable and stable manner** toward the end of the projection period of the January 2024 Outlook Report. It considers that **its large-scale monetary easing measures have fulfilled their roles**, including the negative interest rate policy and the yield curve control.
- With the price stability target, the Bank will conduct monetary policy as appropriate, **guiding the short-term interest rate as a primary policy tool**, in response to developments in economic activity and prices as well as financial conditions from the perspective of sustainable and stable achievement of the target. Given the current outlook for economic activity and prices, it anticipates that **accommodative financial conditions will be maintained for the time being**.



Specifically, the Bank has set the uncollateralized overnight call rate as the policy interest rate and will encourage that rate to remain at around 0 to 0.1 percent by applying an interest rate of 0.1 percent to current account balances held by financial institutions at the Bank. This means that the interest rate level will increase by around 0.1 percentage point, given that the rate was in the range of minus 0.1 to 0 percent before the policy change.

The Bank has removed the target level of long-term yields and the upper bound for these yields as a reference on Japanese government bonds (JGBs), both of which were set to control interest rates. The Bank will continue its JGB purchases with broadly the same amount as before, and in the case of a rapid rise in long-term interest rates, it will nimbly respond by, for example, increasing the amount of JGB purchases. Such JGB purchases will be regarded as ways to avoid bringing about discontinuous changes, instead of as an active monetary policy tool.

Furthermore, the Bank has discontinued purchases of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs), which had been rarely made following the improvement in market environment.

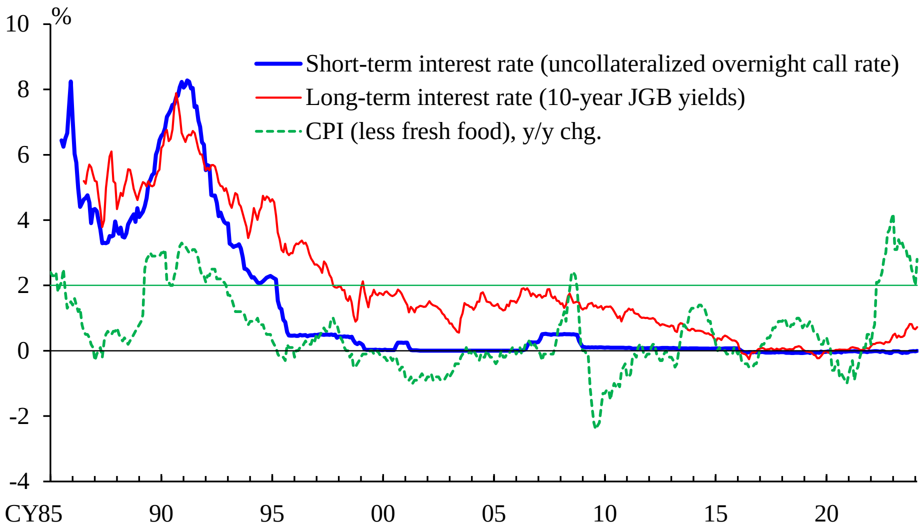
With these changes in the monetary policy framework, I believe that the Bank has exited from the so-called new phase of monetary policy implemented to date, which included the negative interest rate policy and yield curve control, and has taken its first step toward the normalization of monetary policy. It will continue to conduct monetary policy as appropriate in response to developments in economic activity and prices as well as financial conditions, from the perspective of sustainable and stable achievement of the 2 percent price stability target. Given the current outlook for economic activity and prices, the Bank anticipates that accommodative financial conditions will be maintained for the time being.

B. A Look Back at the Past 25 Years: A State without Meaningful Interest Rates

As the Bank has taken its first step toward the normalization of monetary policy, let me briefly look back at the Bank's monetary easing, which it has been carrying out over a long period, since the late 1990s, when Japan's economy fell into deflation. I would also like to consider the functions of interest rates -- the main vehicle of monetary policy -- while sharing what I perceived as a financial practitioner before becoming a member of the Bank's Policy Board.

Let me note developments in short-term interest rates, the conventional monetary policy tool. The uncollateralized overnight call rate hovered in the range of around 4-8 percent from the late 1980s to the early 1990s, a period before the collapse of the bubble economy (Chart 8). In the late 1990s, however, it fell to around 0.5 percent, ushering Japan into a state without meaningful interest rates. Subsequently, with the start of the Bank's zero interest rate policy and its introduction of the negative interest rate policy, the rate declined to 0 percent and then into negative territory. Meanwhile, the Bank also has kept long-term interest rates at low levels through unconventional measures, including its commitment aimed at generating policy duration effects, quantitative easing, and yield curve control.

Chart 8: Market Interest Rates and Consumer Prices



Note: Figures for the CPI (less fresh food) exclude the effects of the consumption tax hikes.
Sources: Ministry of Finance; Ministry of Internal Affairs and Communications; Bank of Japan.

Amid sluggish economic growth and mounting financial instability in the wake of the bubble's collapse, I think that monetary easing was effective to some extent in supporting the economy in the course of moving into the state without meaningful interest rates. Regarding the effects of further monetary easing once Japan reached that state, it is true that borrowing firms experienced a certain advantage in terms of lower funding costs, and that there were positive effects in terms of higher stock and real estate prices and a correction of the excessive appreciation of the yen. However, looking back, I had little sense that a marginal, few tenths of a percentage point decline in interest rates stimulated business fixed investment or otherwise invigorated corporate activity. My understanding is that the function of interest rates -- in terms of raising or lowering interest rates to adjust demand and affect prices -- was limited in the state without meaningful interest rates.

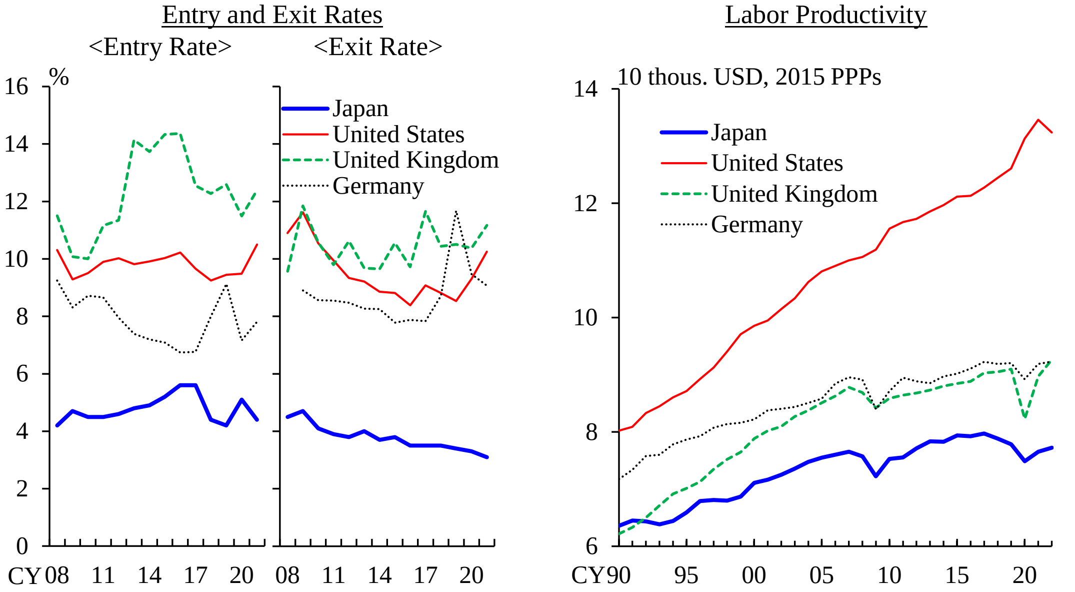
Various side effects have also been caused by unprecedented monetary easing carried out over such a long period of time. Side effects themselves are unavoidable, and policy decisions should be made based on the balance of positive effects against side effects. Having said that, I would like to note two side effects relating to interest rate functions that I find concerning (Chart 9).

Chart 9: Side Effects Relating to Interest Rate Functions in a State without Meaningful Interest Rates

(1) Weakening of the hurdle rate function of interest rates	The hurdle rate function acts to urge firms to concentrate their business resources to businesses with high added value that generate profitability that is higher than borrowing interest rates, thereby stimulating business metabolism. ⇒ In a state without meaningful interest rates, it is likely that the channeling of funds into businesses with relatively low productivity has impeded advances in business metabolism.
(2) Weakening of the signaling effects of interest rates	The level of long-term yields on JGBs and how it changes provide a signal for how the market sees factors such as the future state of economic activity and prices and the government's fiscal condition. ⇒ The signaling effects have not been fully exerted.

The first side effect is a weakening of the hurdle rate function of interest rates, which acts to stimulate business metabolism. If the borrowing interest rate for a firm is high, the firm, in order to survive, is pressured to concentrate its business resources in areas that earn enough profits to cover that interest cost; in other words, businesses with high added value. However, if the borrowing interest rate is low, the firm has the option of continuing with businesses with relatively low added value. In sum, in an environment where an interest rate functions effectively as a hurdle rate, funds will gravitate toward highly productive businesses, consequently stimulating business metabolism. This will make resource allocation more efficient from a macroeconomic perspective. Conversely, in an environment of the government's support measures and continued low interest rates, it is likely that the channeling of funds into businesses with relatively low productivity has impeded advances in business metabolism. In fact, entry and exit rates of firms in Japan have remained low compared to other major countries, and labor productivity growth also has remained lackluster (Chart 10).

Chart 10: Entry-Exit Rates and Productivity in Major Economies



Notes: 1. In the left panel, figures for Japan are on a fiscal-year basis. There is a discontinuity between the figures for Germany up to 2020 and those of 2021 due to changes to the definition.
2. In the right panel, figures represent GDP per person employed at constant prices.
Sources: Eurostat; OECD; Small and Medium Enterprise Agency; U.K. Office for National Statistics; U.S. Census Bureau.

The second side effect relating to interest rate functions is a weakening of the signaling effects of interest rates freely determined by the market. The level of long-term yields on JGBs and how it changes provide a signal for how the market sees factors such as the future state of economic activity and prices and the government's fiscal condition. However, with the Bank's large-scale JGB purchases, the signaling effects have not been fully exerted.

Of course, even if the hurdle rate function of interest rates is weakened, firms can nonetheless take action in pursuit of higher productivity. Likewise, even if the signaling effects are weakened, it is possible to make appropriate judgments on such factors as the future state of economic activity and prices and the government's fiscal condition, based on various information other than developments in long-term yields. Finance only plays a behind-the-scenes role in the economy, providing funds like a flow of blood -- firms, the government, and other economic entities are the economy's principle drivers. In a state without meaningful interest rates or no positive interest rates, however, the functions interest rates ought to fulfill have been weakened, and this should be fully recognized.

C. Toward the Normalization of Monetary Policy

I have said that the Bank has taken its first step toward the normalization of monetary policy. So, what does the normalization look like? In my view, the ultimate goal is, with the price stability target of 2 percent, to return interest rates to a level where they can perform their functions -- that is, where raising or lowering interest rates can act to adjust demand and affect prices -- and at the same time to recover the hurdle rate function and signaling effects I mentioned earlier.

Although the Bank has changed its monetary policy framework, the state without meaningful short-term interest rates I spoke about earlier has not changed, and long-term interest rates have not reached the point where they are entirely determined by market. Consequently, even though the Bank has taken its first step and the situation will be better than it has been, the kind of side effects I mentioned earlier seems to remain. I believe that it is crucial for the Bank to steer future policy conduct in order to proceed deliberately but steadily with monetary policy normalization and thereby successfully unwind the unprecedented large-scale monetary easing, with the fundamental premise that the Bank will do so in response to developments in economic activity and prices as well as financial conditions.

Thank you.