February 19, 2025

Bank of Japan

Economic Activity, Prices, and Monetary Policy in Japan

Speech at a Meeting with Local Leaders in Miyagi

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(English translation based on the Japanese original)

I. Economic Activity and Prices

I will begin by talking about developments in economic activity and prices. Overseas economies have grown moderately on the whole (Chart 1). Having faced concerns of an economic slowdown around summer 2024, the U.S. economy has since grown firmly, mainly led by private consumption. The projected growth in the U.S. economy for 2025 was revised upward to 2.7 percent in the January 2025 *World Economic Outlook* (WEO) *Update* released by the International Monetary Fund (IMF). Recent economic indicators suggest a solid U.S. economy, especially the possibility that the labor market, which triggered the concerns of an economic slowdown, has bottomed out. The Federal Reserve kept its policy interest rate unchanged at the January 2025 Federal Open Market Committee (FOMC) meeting, following three consecutive rate cuts at the previous meetings in the latter half of 2024 (Chart 2). The Summary of Economic Projections of the December 2024 FOMC meeting indicates future rate cuts. Some market participants, however, anticipate a pause in the reductions, partly because of firmness of the U.S. economy and speculation over the new administration. Based on the resilience of the economy, I believe it is more likely that the economy will accelerate again in the near future, making a "touch-and-go landing," so to speak, rather than a soft landing, although attention continues to be warranted on uncertainties surrounding policy conduct under the new administration. What is more, the U.S. economy has continued to grow for four years at a pace close to 3 percent, a pace above its potential growth rate of around 2 percent, and a relatively high growth rate is also projected for 2025. In this situation, it is necessary to bear in mind the possibility that growth in employment and inflation in the country will accelerate further and to consider how such developments will affect global financial markets.

Japan's economy has recovered moderately, although some weakness has been seen in part (Chart 3). With regard to the outlook, the economy is likely to keep growing at a pace above its potential growth rate, with overseas economies continuing to grow moderately and as a virtuous cycle from income to spending gradually intensifies against the background of factors such as accommodative financial conditions. Furthermore, I think that momentum for economic recovery could strengthen if overseas economies, particularly the U.S. economy, turn out better than expected.

With regard to the corporate sector, although firms may suffer a delay in fixed investment due to labor supply constraints, they have maintained an active investment stance, as seen by the relatively high levels of investment plans in the December 2024 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) (Chart 4). Private consumption has been on a moderate increasing trend despite the impact of price rises and other factors. While prices have risen ahead of wages, the year-on-year rate of change in real wages is recently heading toward an upturn because nominal wages have increased clearly, reflecting the 2024 annual spring labor-management wage negotiations (Chart 5). However, wage hikes have not yet caught up with the pre-pandemic levels of price rises. Private consumption is also projected to continue increasing moderately, with the gap between prices and wages closing. This is because of a rise in wage growth, in addition to downward pressure on inflation exerted by, for example, the continuation of the government's measures to reduce the household burden of higher gasoline and other prices, despite these measures being scaled back.

As for prices, in terms of the median of the Bank of Japan Policy Board members' forecasts in the January 2025 *Outlook for Economic Activity and Prices* (Outlook Report), the year-on-year rate of increase in the consumer price index (CPI) for all items excluding fresh food is projected to be in the range of 2.5-3.0 percent for fiscal 2024 and at around 2.5 percent for fiscal 2025, and then be at around 2 percent for fiscal 2026 (Chart 3). Thus, in the second half of the projection period, the rate of increase in the CPI is likely to be at a level that is generally consistent with the price stability target. Looking at medium- to long-term inflation expectations of various economic entities to assess underlying inflation, they have been rising steadily (Chart 6). In addition, firms' price- and wage-setting behavior has been active. With firms facing supply-side constraints due to labor shortages -- in other words, a shift to a "labor shortage economy," I am also paying attention to the fact that firms' price pass-through of sustained higher costs, such as increased personnel expenses and distribution costs, has been more widespread (Chart 7). As services prices recently have more frequently revised upward than before in every month including April and October, when prices are often changed in Japan, it can be assessed that price hikes have taken root. Against this background, the growth in the GDP deflator, which indicates domestic inflationary pressure, was mainly led by unit profits in 2023, as firms increasingly passed on cost increases. In 2024, on the other hand, the contribution of unit labor costs intensified, reflecting wage increases. Anecdotal information

reported at the meeting of the general managers of the Bank's branches, as well as media reports, suggests that a growing number of firms are indicating a positive stance toward wage hikes. Taking account of this and other information, I expect that base pay increases to be agreed in the 2025 annual spring labor-management wage negotiations will remain solid, as in 2024. As for the outlook, with solid levels of base pay increases in 2025, the growth rates of unit profits and unit labor costs are likely to become balanced due to a form of inflationary pressure stemming from domestic factors, as a virtuous cycle between wages and prices intensifies. This will likely bring inflation closer to the price stability target, which it has not been possible to achieve in a stable manner for many years.

In terms of overseas factors, import prices have recently become subdued, and thus their rise is not strong enough to bring about a price pass-through as significant as that which occurred from 2022 onward. That said, it has now become easier for firms to pass on cost increases to prices, partly because the norm that wages and prices do not rise has been shifting, with the relatively high inflation rate continuing for three years.

Given the possibility, as I mentioned earlier, that the U.S. economy will turn out better than expected, this could lead to a rise in U.S. interest rates and a further depreciation of the yen, thereby causing market volatility. These factors, combined with significant increases in base pay expected to be achieved in 2025, could pose an upside risk to prices, and this requires attention. In particular, as it is still early days since the launch of the new U.S. administration, I would also like to closely monitor the risk that markets will become highly volatile due to expectations regarding the economic measures to be taken by the administration.

Having said that, developments in wages and prices can be explained by the following three phases (Chart 8). In the first phase, looking back on the recent changes in firms' price- and wage-setting behavior, the starting point was the rise in imported raw material prices in 2022, or the first big push. In the second phase, relatively high wage increases have been achieved in the annual spring labor-management wage negotiations since 2023, this being the second big push. In the third phase, it is expected that there will be progress, especially from fiscal 2025 onward, toward achieving the price stability target, as inflationary pressure stemming

from domestic factors is exerted on the back of solid base pay increases and as inflation expectations rise.

II. Recent Conduct of Monetary Policy

Let me now present my views on the Bank's conduct of monetary policy.

Monetary policy in Japan reached a major turning point in 2024. The Bank changed its large-scale monetary easing framework in March 2024, discontinuing the negative interest rate policy and yield curve control. Then, in July, the Bank decided on a plan for the reduction of its purchase amount of Japanese government bonds (JGBs) and raised the target level of the short-term interest rate to around 0.25 percent.

Given that Japan's economic activity and prices have been developing generally in line with the Bank's outlook and that the likelihood of realizing the outlook has been rising, the Bank, in January 2025, judged it appropriate to adjust the degree of monetary accommodation from the perspective of sustainable and stable achievement of the price stability target of 2 percent. The Bank therefore decided to raise the target level of the short-term interest rate to around 0.5 percent (Chart 9). However, real interest rates are expected to remain significantly negative after the change in the policy interest rate, and accommodative financial conditions will be maintained (Chart 10).

As I have explained thus far, I consider it necessary for the Bank to shift gears as appropriate, that is, proceed with further adjustment of the degree of monetary accommodation if it is confirmed that prices are developing generally in line with the Bank's outlook and that positive corporate behavior -- such as solid business fixed investment, sustained wage hikes, and a continued price pass-through of cost increases -- is being maintained. In this regard, it can be said that, since 2024, firms have been taking an active stance toward fixed investment and have increasingly been passing on cost increases to prices and raising wages. On the other hand, I have also put emphasis on the risk that differences in monetary policy stance could bring about high volatility in financial markets, particularly foreign exchange markets. On this point, monetary policy stances differ due to the difference between economic cycles in Japan and those abroad, although the monetary policy stances of advanced economies and

their corresponding economic cycles were once largely in sync, following the shift to a floating exchange rate system in the 1970s. In fact, looking back on its previous five cycles of policy interest rate hikes since the 1970s, excluding the most recent cycle, the Bank turned to rate cuts after the Federal Reserve cut its rate. Although there is a difference in monetary policy stance between Japan and the United States in the most recent cycle, it can be said that the difference has actually grown smaller, given that there is no pressure on balance sheet adjustments in the financial, corporate, and household sectors in either country and that the firmness of the U.S. economy was reconfirmed through January 2025. In my opinion, these circumstances signal a decline in the risk of high market volatility -- in other words, I believe that the flexibility of the Bank's monetary policy has increased.

With regard to the outlook, if the sustainability of positive corporate behavior continues to be confirmed and the Bank's outlook is realized amid accommodative financial conditions, I think that it will then be appropriate timing for the Bank to make a further gear shift in monetary policy. In doing so, it will be important to monitor whether wage hikes and the price pass-through of cost increases spread to small and medium-sized firms and to regional firms. Meanwhile, prices could deviate upward from the Bank's baseline scenario due to (1) the virtuous cycle between wages and prices intensifying; (2) inflationary pressure stemming from domestic factors exerted especially toward fiscal 2025; and (3) possible market volatility, mainly in foreign exchange markets, caused by an increased likelihood of the U.S. economy returning to a recovery path. Furthermore, it can also be said that investors' expectations have increased, following a rise in asset prices, including real estate. From this perspective, while I recognize that inflation is approaching the 2 percent price stability target, with positive corporate behavior already being observed, I believe it will be important for the Bank to consider continuing to implement gear shifts gradually, even after the additional rate hike decided in January 2025, in order to avoid creating excessively high expectations of continued monetary easing, which would lead to a materialization of the upside risks to prices and the risk of overheating of financial activity.

However, as uncertainties still remain surrounding the U.S. economy and it is difficult to identify the neutral interest rate, I think that the Bank is expected to take a vigilant approach, such as by examining at each Monetary Policy Meeting (MPM) how policy interest rate hikes

may affect developments in economic activity, prices, and financial conditions. It is especially difficult to estimate Japan's neutral interest rate, because Japan's policy interest rates remained at low levels from the 1990s and did not change in the way they did in the United States and Europe. Furthermore, given these limitations in identifying the neutral interest rate, I think it would be problematic in terms of policy flexibility for a central bank to announce a certain level for the neutral interest rate, as the market could interpret this as forward guidance.

III. Looking Back on the Post-Bubble Period based on the *Review of Monetary Policy from a Broad Perspective*

Developments in Japan's economy that have not been seen for more than three decades were a topic of discussion in 2024; specifically, stock prices reaching a record high for the first time in about 35 years, and wage growth exceeding 5 percent for the first time in 33 years. I believe that these developments indicate a historic shift in Japan's post-bubble economy, and that the Bank's recent move away from large-scale monetary easing is an extension of this shift.

It took longer than expected for Japan to see this historic shift. In December 2024, the Bank compiled and released the findings of the *Review of Monetary Policy from a Broad Perspective* (hereafter "the Review"), which it had been conducting over a period of around a year and a half. Among the main reasons for the prolonged moderate deflation in Japan, the Review points to chronic demand shortages with a decline in the natural rate of interest and the entrenchment of behavior and a mindset based on the assumption that wages and prices will not increase easily (Chart 11). In what follows, I would like to look back on the changes in Japan's economy after the collapse of the bubble. I will also present my view on the significance of the Review, in terms of two topics in global financial history, and on the remaining issues.

First Significance: Unprecedented Situation Even on a Global Scale

The first significance of the Review is in highlighting the fact that Japan's economy, among post-war advanced economies, can be said to have faced an unprecedented situation in terms of, for example, its macroeconomic environment. That is, the Review's analysis focuses on an extremely rare situation, namely, a prolonged environment, including asset deflation and

the yen's appreciation, in which it was difficult to depend on external demand. On this point, I will now look back, from a historical perspective, on why Japan's economy fell into such a situation.

Japan's economy continued to experience low growth from the 1990s, with the collapse of the bubble. Although a variety of factors contributed to the slowdown in growth, including demographic changes, I believe that the major cause was the change in corporate behavior in response to post-bubble changes in the economic environment. Specifically, as Chart 12 shows, in the context of significant asset deflation, an increasing number of firms sought to pursue management with minimum assets by paring down assets on their balance sheets and reining in investment, while also engaging in business restructuring to cope with mounting international competition by reducing costs in their income statements. These moves were rational for individual firms as a response to the changing business conditions. From a macroeconomic perspective, however, this approach caused Japan to fall into a shrinking equilibrium due to the "fallacy of composition" -- assuming that what is true of one member of a group is true for the group as a whole. Firms' pursuit of both management with minimum assets and business restructuring not only reined in business fixed investment but also suppressed investment in human capital. These factors together are considered to have brought down Japan's potential growth rate (Chart 13). Combined with prolonged stagnation in corporate demand for funds and developments including globalization and demographic changes, this contributed to pushing down the natural rate of interest.

What was unprecedented is the asset deflation. At its peak in the 1980s, Japan accounted for nearly half of global market capitalization. However, from the 1990s, stock prices in Japan fell sharply and real estate prices stagnated (Chart 14). Turning to national wealth, when comparing the peak recorded during the bubble period with the lowest point recorded after the bubble's collapse, the difference was about 900 trillion yen, nearly double the GDP of Japan. The extent of the impact of the bubble's collapse bears comparison even with the loss of national wealth during World War II.[1] Also during the post-bubble period, a significant

[1] According to a report on damage and casualties of World War II compiled by the Economic Stabilization Board of Japan, the damage to national wealth reached 64.3 billion yen. This amounts to 86 percent of Japan's GNP for fiscal 1944.

decline in capital bases in real terms drove firms to curtail investment and reduce interest-bearing debt. In addition, firms' concerns over funding stemming from post-bubble financial system instability led to hoarding cash and deposits. Furthermore, from the second half of the 1990s, following the bubble's collapse, there were some cases where firms' liquidity concerns grew because they perceived that financial institutions' lending attitudes became more severe, which likely resulted in scarring effects for corporate management. The multiplied impact on the real economy of such changes in financial factors is referred to as the financial accelerator effect, and it has been argued that accelerator effects had a serious negative influence on Japan's post-bubble economy.[2]

What can also be considered unprecedented is the situation in which Japan's economy could not depend on external demand -- or, the competitive environment vis-à-vis overseas economies that led to business restructuring among Japanese firms. In the aftermath of World War II, Japan benefited from the tailwind of global trade, for many years serving as the manufacturing hub for the Western bloc. However, the geopolitical environment shifted after the fall of the Berlin Wall in 1989, and Japan was seen to pose a growing economic threat, which led to mounting trade friction with the United States, followed by the rapid appreciation of the yen from the 1990s (Chart 15). Under these circumstances, Japanese firms were forced to curtail their share of production in the semiconductor sector. In addition, firms across a wide range of sectors, including those in the automobile industry, were called on to shift their production sites overseas, leading to a hollowing out of domestic industries. Moreover, despite the yen's appreciation, firms left their export prices unchanged to maintain price competitiveness. The upshot is that it became the established practice for firms in Japan to pursue management aimed at business restructuring and to hold down margins while not raising employee wages. Firms grew accustomed to the norm of absorbing increases in the cost of raw materials by cutting costs rather than by passing the higher costs on to selling prices.

[2] For the feedback mechanisms of the financial accelerator, see the Bank's research paper on monetary policy under credit-market imperfections (available only in Japanese): Fukunaga, I., *Bank of Japan Review*, no. 2006-J-13 (July 2006).

Historical examples of asset deflation include Europe and the United States during the Great Depression in the 1930s, and some Scandinavian countries in the early 1990s. It has been pointed out that it was the expansion in external demand arising from currency depreciation that contributed to recovery in these economies. For example, expansion in external demand at the time of the Great Depression was brought about by currency depreciation partly due to the departure from the gold standard. In some Scandinavian countries in the early 1990s, the boost to demand arising from German reunification, in addition to currency depreciation, contributed to higher external demand. In light of these precedents, my view is that, in the case of Japan, the yen's appreciation and the difficulty of relying on external demand posed major constraints on economic recovery following the 1990s. These unprecedented conditions likely led to the entrenchment of the norm in which firms took for granted the practice of leaving wages and prices unchanged.

Second Significance: Introduction of World's First Monetary Policy Tools

The second significance of the Review is that its analysis focuses on the world's first unconventional monetary policy measures, implemented by the Bank of Japan (Chart 16). Let us look back on the transition of the Bank's monetary policy: I believe the Bank adopted the world's first zero interest rate policy, quantitative easing policy, and yield curve control to address the unprecedented conditions mentioned earlier (Chart 17).

Among these unconventional monetary policy measures, regarding the positive effects and side effects of large-scale monetary easing, the Review assesses that, "although there have been certain side effects on financial markets and financial institutions' profits, the overall effect on the Japanese economy so far appears to have been positive." It also assesses that, "if it becomes necessary to implement unconventional monetary policy measures, it will be important to weigh the benefits and costs of unconventional measures, while taking account of the developments in economic activity and prices as well as financial conditions at that point in time." In addition, the Bank assumed that one of the primary channels through which large-scale monetary easing would affect prices would be higher inflation expectations brought about by the Bank influencing people's expectations. The Review then summarizes as follows. First, "[although] the large-scale monetary easing appears to have had an impact to some degree on inflation expectations . . . adaptive expectations formation has had a larger

impact on the formation of inflation expectations in Japan, and such expectations also have been strongly influenced by past experience." Second, "it was not easy to change the behavior and mindset based on the assumption that wages and prices will not increase easily, and influencing expectations alone was not sufficiently effective to anchor inflation at 2 percent."

The results of the Review's analyses likely have implications for economies other than Japan as well. For instance, China has commonality with post-bubble Japan in terms of the drop in real estate prices in recent years. I therefore hope the series of releases related to the Review will also be useful in the context of many other economies.

Improvement in the Macroeconomic Environment

The unprecedented asset deflation and excessive appreciation of the yen reached a turning point around 2012 (Chart 14). On the other hand, it has taken a long time to shift the persistent norm that wages and prices do not rise. I said in my previous speeches that this shift could take longer than expected. To show the persistence of this norm, which took hold after the collapse of the bubble economy, I would like to present again, in this speech, one estimate as an example of Japan's negative experience, or the economic scarring effects.

Chart 18 shows the cumulative returns on investment by age of investors, assuming that they made a fixed monthly investment in the Nikkei 225 Stock Average starting from age 22, when many people are likely to begin working. With the ongoing rise in stock prices over the past decade or so, although people in their 20s and 30s have experienced hardly any negative returns, those in their 40s and 50s have had negative returns for nearly half of their working life, due to the prolonged post-bubble sluggishness in stock prices. While this is merely an estimate using stock prices as an example, it shows that those in their 40s and 50s in particular, the generation that currently makes up the core of firms and other economic entities, have suffered a long-term negative and traumatic experience. This is likely one of the factors that led to the deeply-entrenched cautiousness in corporate behavior after the collapse of the bubble economy. In addition, it also suggests that a shift in the corporate behavior mired in such a norm could take longer than expected, perhaps the decade it takes to form the next generation. In terms of the adaptive formation mechanism of inflation expectations, one interpretation is that, since the norm that wages and prices do not rise was entrenched for such

a long period, the shift from cautious inflation expectations and the subsequent rise in expectations took far longer than initially anticipated.

On this point, the Review also shows that, in addition to the lower funding costs transmission channel, the financial and capital markets channel (stock prices and foreign exchange rates) was also significantly effective in translating the benefits of lower interest rates into an improvement in the output gap (Chart 19). These findings suggest that the Bank's monetary easing contributed to the shift away from the asset deflation and the so-called six headwinds -- including the headwind of the yen's appreciation -- both of which prompted the changes in corporate behavior in the post-bubble economy. Considering, as I mentioned, that it may take as long as a decade for the norm to change, I believe that the Bank's patient continuation of monetary easing, and the resulting support for rises in asset prices and for the reversal in the excessive appreciation of the yen, laid the groundwork for reaching the inflection point of the norm shift, marking a historic change since the collapse of the bubble economy. With this groundwork, it can be assumed that, as shown in Chart 8, the big push observed since 2022 that originated abroad and stemmed from higher import prices finally led to the symbolic change in the norm in 2024 -- the historic shift observed for the first time in more than three decades -- and this shift has progressed to date.

Looking at Chart 12, the asset deflation that led firms to pursue management with minimum assets on their balance sheets has improved significantly as asset prices have risen, mainly in the stock and real estate markets. Firms have also managed to shift away from business restructuring since the 2010s, with the dissipation of the continued excessive appreciation of the yen, which had driven severe international competition in terms of firms' income statements. Moreover, with Japan finding itself in a very different geopolitical position compared with the period around 1990, there were historic moves to bring production sites back home out of concern over economic security, as seen in, for example, the shoring up of domestic production of semiconductors in Kumamoto and Hokkaido prefectures. From a macroeconomic perspective, these developments suggest a significant historic shift away from the unprecedented post-bubble economic environment.

Remaining Microeconomic Issues

In light of this shift in economic conditions, I would like to consider some remaining issues. As I just mentioned, the key to a further gear shift in monetary policy is the sustainability of positive corporate behavior. Given that corporate behavior in Japan after the bubble's collapse was typified by firms' pursuit of management with minimum assets and of business restructuring, I think it is also necessary to examine the issues from these standpoints.

From the standpoint of management with minimum assets, an important criterion is whether solid business fixed investment will be maintained. On this point, firms have continued to take an active stance toward such investment. From the standpoint of business restructuring, the key criteria include increases in wages and selling prices as well as steps to secure margins. In this regard, corporate managers are aware of mounting social expectations for wage hikes and investment in human capital, and there has also been a change in their mindset that took for granted the core practice of keeping wages and selling prices unchanged. Around 70 percent of firms have reported that they thought it preferable in terms of business activities for prices and wages to rise moderately (Chart 20). Forces are beginning to work to stimulate a certain degree of innovation, including among small and medium-sized firms and regional firms, as seen in the recent ongoing increase in business succession and merger and acquisition (M&A) activities, which may suggest that these firms have started to raise selling prices. Similarly, in the household sector, many households have reported that a state in which both prices and income rise moderately is preferable to a state in which prices and income both remain almost the same. As Chart 18 shows, Japan's economy is seeing the rise of a new generation that never experienced the negative economic environment and shrinking equilibrium of the post-bubble period. I believe that this new generation has the potential to drive a rethinking of the core practice and the norm that have to date been widespread in Japan.

Notwithstanding such positive changes, the shrinking equilibrium that continued over a number of years has left many firms and households with a cautious mindset. From a microeconomic perspective, some firms have remained cautious toward business fixed investment, and improvements in corporate profits have not easily been trickling down to small and medium-sized firms and regional firms -- the downstream firms in the economy --

through price pass-throughs and wage hikes. I think this situation could be said to reflect challenges resulting from the norm.

In this context, I have been paying attention to the annual spring labor-management wage negotiations every year and firms' passing on of costs to prices, believing that progress in addressing microeconomic challenges is critical to creating a virtuous cycle between wages and prices and thereby achieving the price stability target. With regard to price pass-through in particular, the government has historically taken the initiative in implementing measures in the form of incomes policy to contain wage hikes and thereby curb inflation. However, the opposite aim is currently being pursued. The Japan Fair Trade Commission (JFTC) and the Small and Medium Enterprise Agency (SMEA) are taking the lead in promoting price pass-through, and representatives from the government, labor, and management have held joint meetings on wage increases -- a kind of reverse incomes policy. I will therefore be paying attention to these developments and their impact. In this regard, it can be assumed that these initiatives have been partly driven by restrained wage growth and a downtrend in the labor share despite extremely high growth in corporate profits (Chart 21).

Please take a look at Chart 22, which is a conceptual diagram of how expansion in corporate profits is spreading across the economy. From a macroeconomic perspective, corporate profits have expanded significantly due to factors such as the efforts of firms and more robust competition in international markets. However, from a microeconomic perspective, the use of corporate profits as a source for wage hikes and price pass-through to subcontractors has been limited due to the norm that wages and prices do not rise. Firms have channeled most of their profits into dividends and foreign investment, and have also limited their domestic fixed investment. This situation is gradually improving owing to various initiatives, and it is expected that this improvement will benefit households, small and medium-sized firms, and regional firms equally, thereby achieving a virtuous cycle.

These efforts toward the correction of microeconomic challenges, including wage hikes and price pass-throughs, are important to achieving the price stability target, and I think therefore that the Bank should conduct monetary policy while examining their developments. I am paying attention to changes in wages and in firms' price-setting behavior because, as I said

earlier, the macroeconomic environment in Japan faced an unprecedented severe situation for a long time, and consequently it became the norm for wages and firms' price-setting behavior not to change. I think that the need to focus on these changes could be considered one of the distinctive features of the Bank's current monetary policy, compared with other central banks.

Changes in Financial Intermediation and Summary

Lastly, I would like to highlight that significant structural changes have been unfolding in the field of financial intermediation in Japan over the quarter century covered by the Review, especially as a secondary effect of the quantitative and qualitative monetary easing (QQE) that had been in place since the 2010s.

One of the Expert's Commentaries in the Review states that, while there was weakness in the transmission channel through which growth in lending is assumed by conventional monetary policy to have a positive impact on economic activity and prices, the capital markets channel -- that is, the stock and foreign exchange markets -- had a great impact. Indeed, real estate and housing loans were the drivers of the limited growth in bank lending over the past 25 years (Chart 23).[3] On the other hand, invested assets of asset management firms (investment advisors and investment trusts) have increased substantially over the past decade, due in part to the role of large-scale monetary easing in helping to improve the financial and capital markets. In 2024, the so-called first year of asset management in Japan, domestic and overseas investment assets outstanding approached 1,000 trillion yen, a scale that is above the domestic bank lending market. As the role of the transmission channel through financial and capital markets grows in importance, questions arise such as how central banks ought to carry out monitoring and respond appropriately to the structural changes. At the same time, I believe these changes also raise issues regarding the way in which the Bank communicates with the markets. The Review's initiative should prove invaluable in highlighting issues to be addressed.

Similarly, looking at changes over the past 25 years from the standpoint of firms, there has been a major change in the environment surrounding corporate finance. As Chart 21 shows,

[3] The rise in housing loans is partly attributable to the Government Housing Loan Corporation, which had a substantial lending share, scaling down its loan business in the 2000s.

corporate profits expanded more than eightfold in fiscal 2023 over the second half of the 1990s, reaching the highest level on record of around 80 trillion yen, and a further expansion is expected for fiscal 2024. The current situation of corporate profits remaining at high levels differs from the economic recovery phase in the 2000s, and this has also led to an increase in the overall level of corporate value. Turning to the returns of corporate profits to suppliers of funds, while interest paid to banks and other financial institutions has remained at around 10 trillion yen, dividends paid out to shareholders have expanded to a level just below 40 trillion yen, around eight times that of the second half of the 1990s. Since the bubble's collapse, firms have improved their financial positions by reducing excessive interest-bearing debt -- their interest burden falling to the extent that interest income exceeds interest expenses (Chart 24). On the other hand, amid asset deflation, firms' capital bases in real terms have been impaired and they have raised dividends to increasingly scarce suppliers of funds. It also appears that more corporate managers are conscious of capital costs. In terms of the savings-investment balance, the post-war structure of financial intermediation in Japan centered on commercial banks, which provided funds mainly in the form of loans to firms, which faced a shortage of funds (net borrowers). Since the bubble's collapse, however, as firms came to have excessive funds (net savers), the focus has shifted to suppliers of risk capital, including domestic and overseas investment funds. Therefore, equity governance has been strengthening, as opposed to debt governance.

Reflecting once again on the post-bubble period, the Bank had been implementing unconventional monetary measures ahead of other central banks to address a downturn in the real economy under the historically unprecedented situation of asset deflation and international competition. However, with the recent improvement in corporate profits and the solid rise in asset prices such as real estate and stocks, it could be said that now is the time for the direction of the financial accelerator to be changed, from its prolonged negative effect on the economy. In this case, it seems possible for the Bank to shift gears away from the substantial degree of monetary accommodation that has continued for many years. While microeconomic challenges remain, including wage hikes and price pass-throughs, the economy has moved out of the previous unprecedented situation. Given these developments, I believe that the Bank will need to conduct monetary policy based on the recognition that it

has finally reached the point of returning from the implementation of unconventional monetary measures to policy conduct that is in line with what is seen in normal times.

Thank you.

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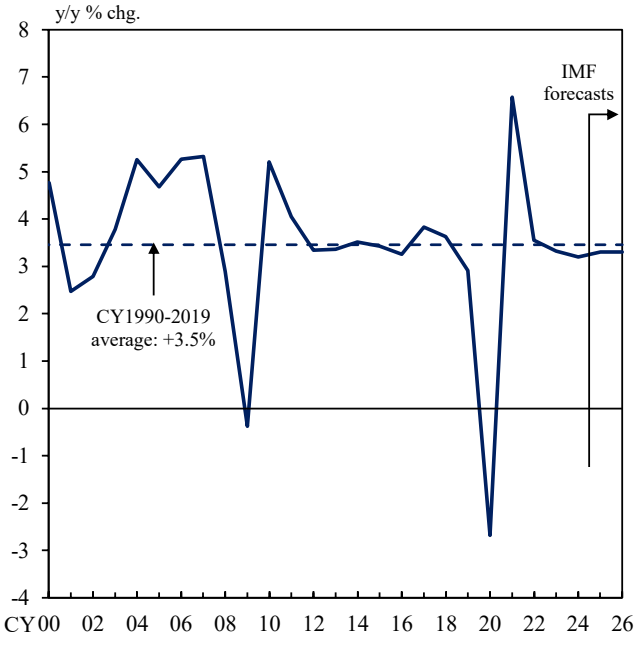
February 19, 2025

TAKATA Hajime
Member of the Policy Board
Bank of Japan

Chart 1

Developments in Overseas Economies (IMF's January 2025 WEO *Update*)

Global Growth Rate

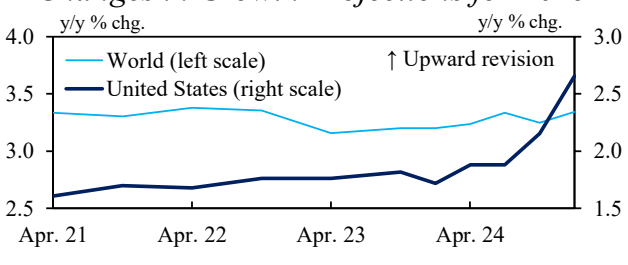


Major Economies' Growth Rates

y/y % chg., % points

	CY 2023	CY 2024	CY 2025 [Forecast]	CY 2026 [Forecast]
World	3.3	3.2	3.3 (0.1)	3.3 (0.0)
Advanced economies	1.7	1.7	1.9 (0.1)	1.8 (0.0)
United States	2.9	2.8	2.7 (0.5)	2.1 (0.1)
Euro area	0.4	0.8	1.0 (-0.2)	1.4 (-0.1)
Emerging market and developing economies	4.4	4.2	4.2 (0.0)	4.3 (0.1)
China	5.2	4.8	4.6 (0.1)	4.5 (0.4)

Changes in Growth Projections for 2025

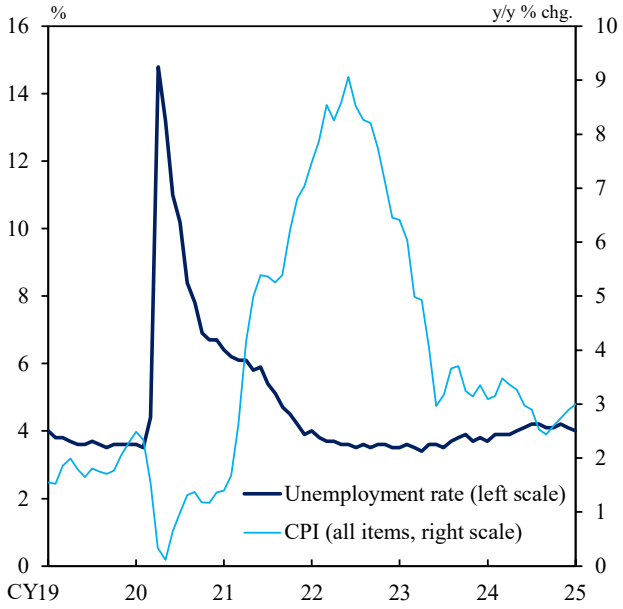


Note: In the table, figures in brackets are the differences from the forecasts in the October 2024 *World Economic Outlook* (WEO).
Source: IMF.

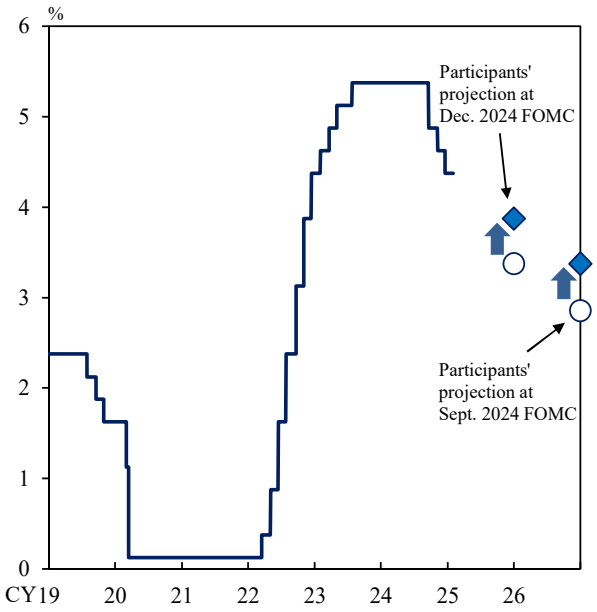
Chart 2

The U.S. Economy

Employment and Prices



Policy Interest Rate



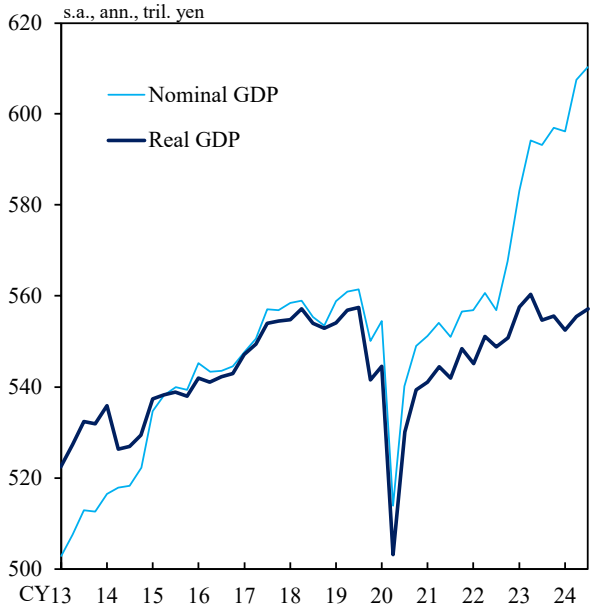
Note: In the right panel, figures are the medians of the target ranges for the federal funds rate. Figures for participants' projections are the medians of all participants' projections at the FOMC meetings.

Sources: Bloomberg; BLS; FRB.

Chart 3

GDP and Outlook for Economic Activity and Prices

GDP



Outlook for Economic Activity and Prices (January 2025 Outlook Report)

y/y % chg.

	Real GDP	CPI (less fresh food)	CPI (less fresh food and energy)
Fiscal 2024	+0.5	+2.7	+2.2
As of October 2024	+0.6	+2.5	+2.0
Fiscal 2025	+1.1	+2.4	+2.1
As of October 2024	+1.1	+1.9	+1.9
Fiscal 2026	+1.0	+2.0	+2.1
As of October 2024	+1.0	+1.9	+2.1

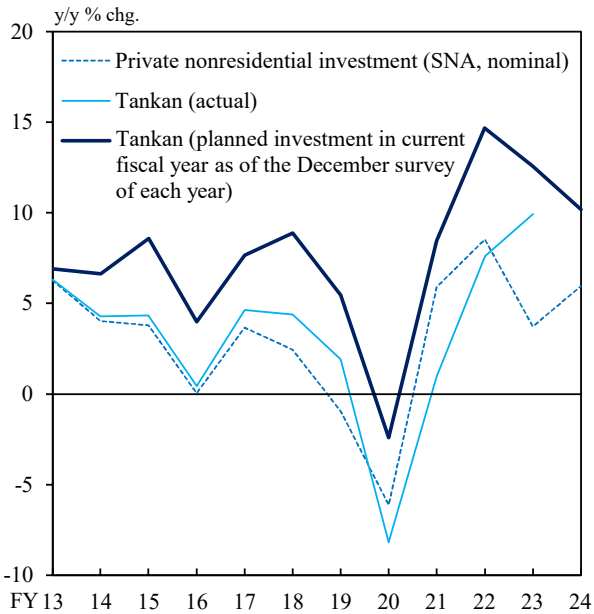
Note: In the right table, figures indicate the medians of the Policy Board members' forecasts (point estimates).

Sources: Cabinet Office; Bank of Japan.

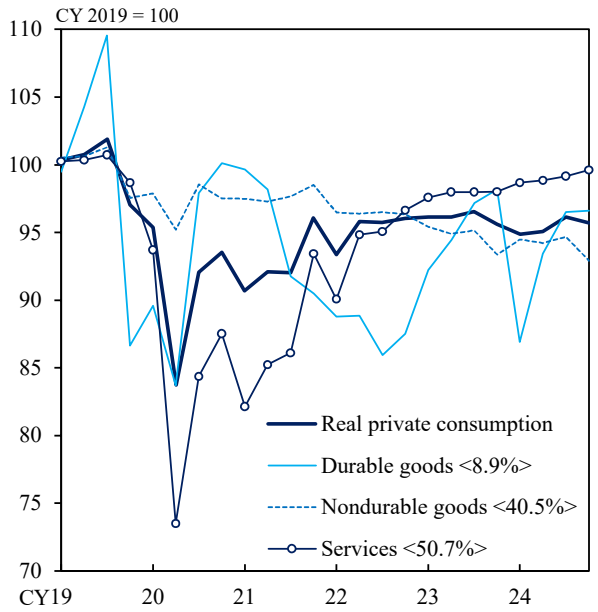
Chart 4

Corporate Sector and Private Consumption

Planned and Actual Business Fixed Investment



Real Private Consumption



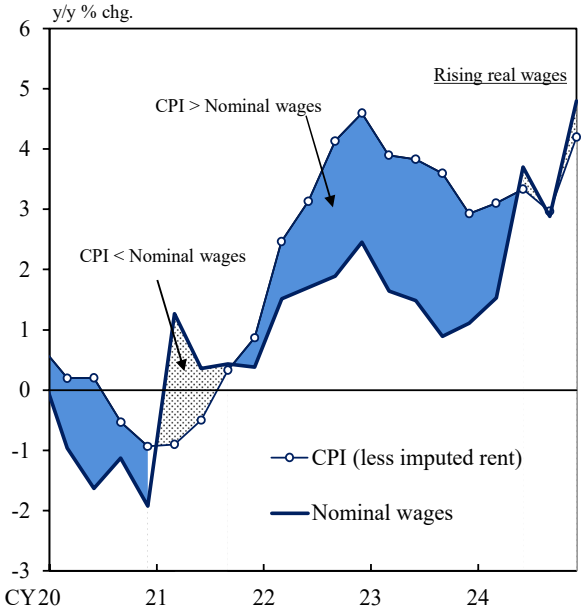
Notes: 1. In the left panel, the *Tankan* figures are for all industries including financial institutions. The figures include software and R&D investments and exclude land purchasing expenses. R&D investment is not included before the March 2017 survey. The figure for private nonresidential investment for fiscal 2024 is the 2024/Q2-Q3 average.
2. In the right panel, figures for real private consumption are the real Consumption Activity Index (travel balance adjusted) based on Bank staff calculations, which exclude inbound tourism consumption and include outbound tourism consumption. Figures in angle brackets show the weights in the index.

Sources: Cabinet Office; Bank of Japan.

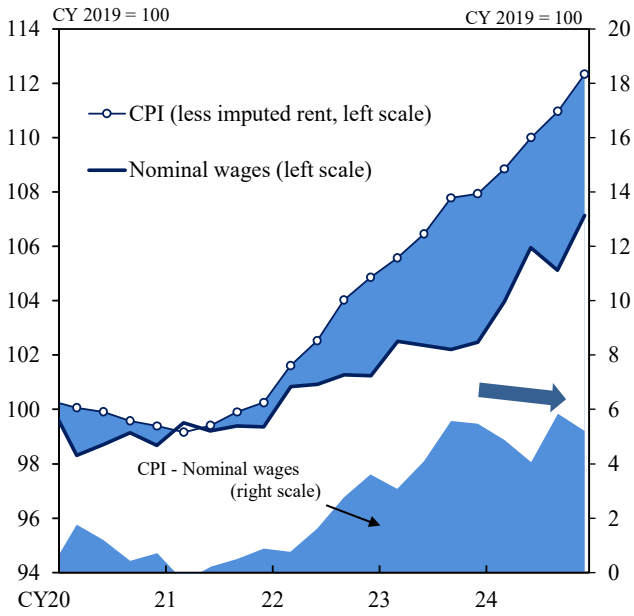
Chart 5

Nominal Wages and Prices

Yearly Change



Estimated Level



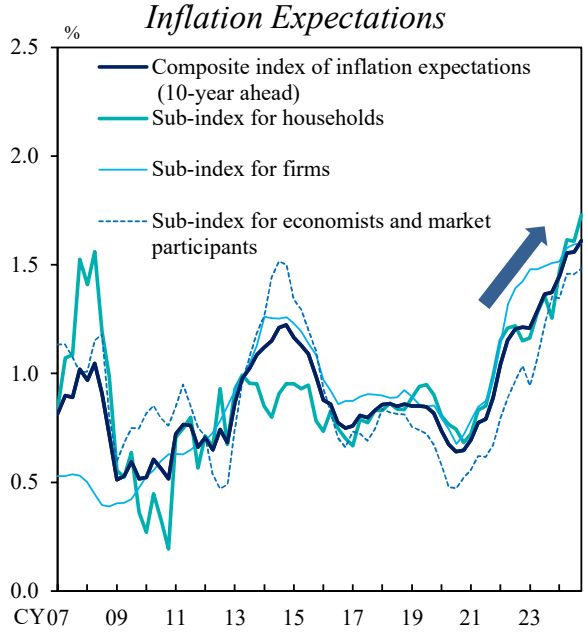
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. Figures for 2024/Q4 are those for December.
2. In the right panel, figures for nominal wages are seasonally adjusted.

Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

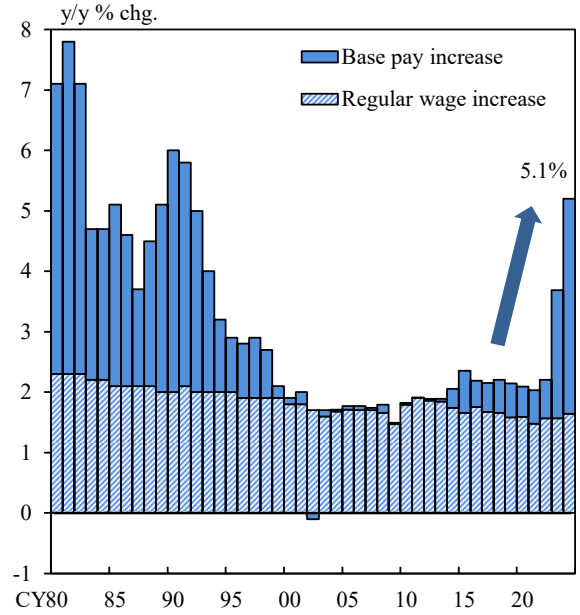
Chart 6

Inflation Expectations and Wage Growth Rate

Composite Index of Inflation Expectations



Wage Growth Rate



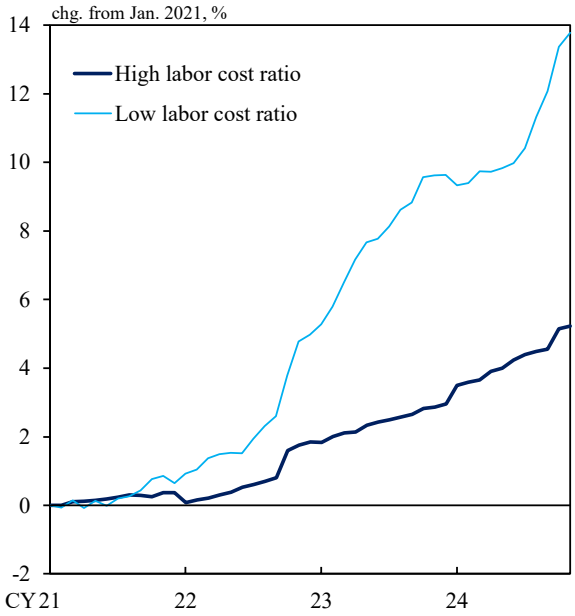
Notes: 1. In the left panel, the composite index is calculated by extracting the common components, based on the first principal component, of the inflation expectations of firms, households, and economists and market participants. For details of the calculation method, see Box 4 in the April 2024 Outlook Report.
2. In the right panel, figures from 1980 to 2014 are those published by the Central Labour Relations Commission, while those from 2015 to 2024 are figures released by Rengo.

Sources: Bloomberg; Central Labour Relations Commission; Consensus Economics Inc., *Consensus Forecasts*; Japanese Trade Union Confederation (Rengo); QUICK, *QUICK Monthly Market Survey <Bonds>*; Bank of Japan.

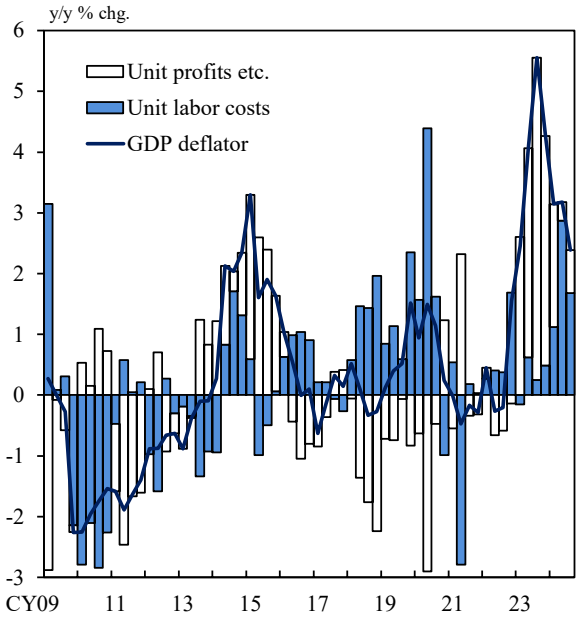
Chart 7

Higher Labor Costs and Prices

CPI by Labor Cost Ratio



GDP Deflator



Notes: 1. In the left panel, figures are based on Bank staff calculations using the CPI excluding fresh food, energy, imputed rent, and the effects of temporary factors. For details of the calculation method, see Box 5 in the January 2025 Outlook Report.
2. In the right panel, unit labor costs = nominal compensation of employees / real GDP.

Sources: Cabinet Office; Ministry of Internal Affairs and Communications.

Chart 8

Wage and Price Developments from Fiscal 2022 (From the Perspective of Three Phases)

1st phase — Rise in imported raw material prices around 2022

1st big push

Price pass-through of higher imported prices

2nd phase — Relatively high wage hikes in the annual spring labor-management wage negotiations in 2023 and 2024, and expected in 2025

2nd big push

Price pass-through of wage increases

3rd phase — From fiscal 2025:
Further spread to services prices
Rise in inflation expectations

Inflationary pressure due to domestic factors

→ *Toward achieving the price stability target*

Chart 9

Decision at the January 2025 MPM

Japan's economic activity and prices have been **developing generally in line with the Bank's outlook**, and **the likelihood of realizing the outlook has been rising**.

Medians of the Policy Board Members' Forecasts (y/y % chg.)

	Fiscal 2024	Fiscal 2025	Fiscal 2026
Real GDP	0.5 (-0.1)	1.1 (—)	1.0 (—)
CPI (all items less fresh food)	2.7 (+0.2)	2.4 (+0.5)	2.0 (+0.1)
CPI (all items less fresh food and energy)	2.2 (+0.2)	2.1 (+0.2)	2.1 (—)

Note: Figures in parentheses indicate changes from the October 2024 Outlook Report.

Wages

- Firms have expressed the view that they will **continue to raise wages steadily**, following the solid wage increases last year.

Prices

- With wages continuing to rise, **underlying CPI inflation has been increasing gradually toward 2 percent**.
- CPI inflation is likely to be at around 2.5 percent for fiscal 2025, due to the higher import prices stemming from the yen's depreciation etc.

Overseas economies

- Global financial and capital markets have been **stable on the whole**, while attention has been drawn to various uncertainties.

Adjusting the degree of monetary accommodation from the perspective of sustainable and stable achievement of the price stability target of 2 percent

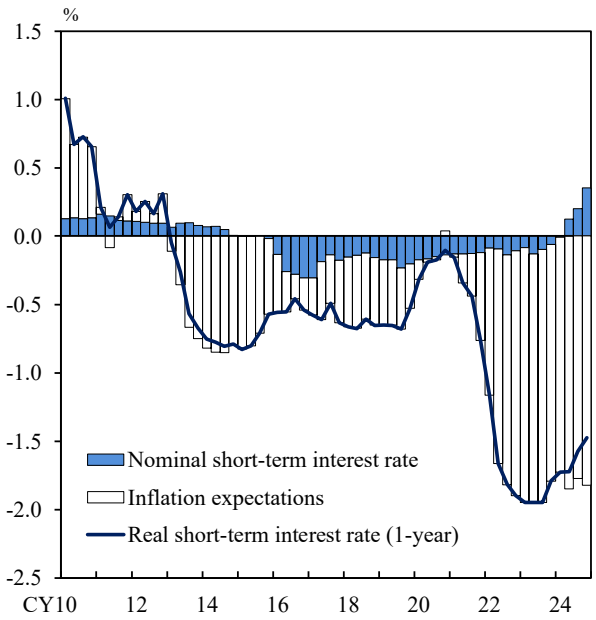
Short-term interest rate : raised to "around 0.5%"
(uncollateralized overnight call rate) (previously "around 0.25%")

- Real interest rates are expected to remain significantly negative, and accommodative financial conditions will continue to **firmly support economic activity**.
- If the outlook presented in the January Outlook Report will be realized, the Bank will accordingly continue to raise the policy interest rate and adjust the degree of monetary accommodation.

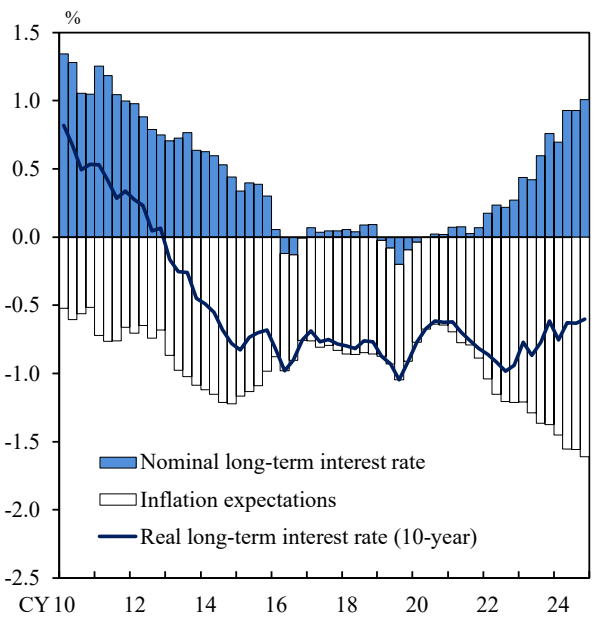
Chart 10

Real Interest Rate

Real Short-Term Interest Rate (1-Year)



Real Long-Term Interest Rate (10-Year)



Note: Figures for real interest rates are calculated by deducting inflation expectations from JGB yields for each maturity. Figures for inflation expectations are based on Bank staff calculations using the expectations of various economic entities (firms, households, and experts) at different horizons. Specifically, the data used in the calculations are as follows: for firms, the *Tankan*; for households, the *Opinion Survey on the General Public's Views and Behavior*; for experts, the *QUICK Survey*, the *Consensus Forecasts*, and inflation swap rates.

Sources: Bloomberg; Consensus Economics Inc., *Consensus Forecasts*; QUICK, *QUICK Monthly Market Survey <Bonds>*; Bank of Japan.

Chart 11

Review of Monetary Policy from a Broad Perspective: Developments in Economic Activity, Prices, and Financial Conditions

Since the latter half of 1990s: prolonged moderate deflation

- **Chronic demand shortages** with **a decline in the natural rate of interest**
  - Conventional monetary policy measures were unable to sufficiently stimulate the economy due to the effective lower bound on nominal interest rates.
  - The decline in the natural rate of interest was attributable to factors such as asset prices falling and growth expectations taking a downward turn after the burst of the bubble economy; firms becoming more cautious in their risk-taking, particularly due to the Global Financial Crisis; and demographic changes.
- Downward pressure on prices due to globalization and IT innovations
- **Entrenchment of behavior and a mindset based on the assumption that wages and prices will not increase easily**

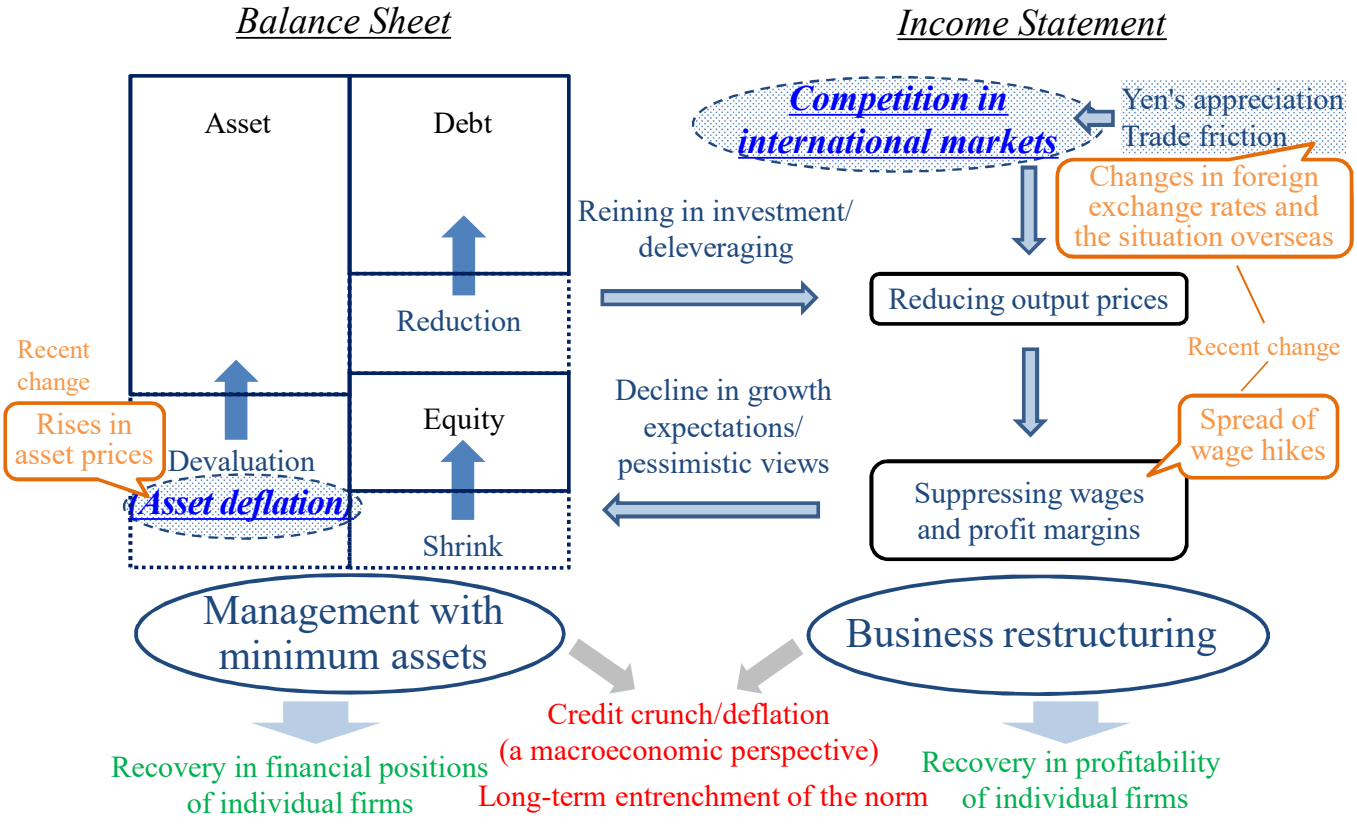
Since 2013: moved out of the state of deflation

- The chronic shortage of demand abated, mainly due to large-scale monetary easing and fiscal stimulus packages, as well as changes in the external environment
- Inflation expectations rose somewhat, and **the rate of change in prices turned positive but remained below 2 percent**
  - There remained room for increases in the labor supply, such as from women and seniors.
  - It took time for the behavior and mindset based on the assumption that wages and prices will not increase easily to change.

In the 2020s: changes since the COVID-19 pandemic

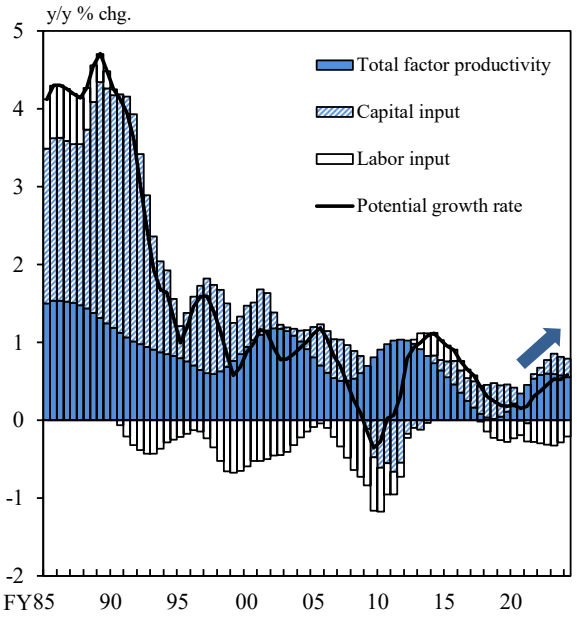
- Firms' **behavior has shifted more toward raising wages and prices**
  - Labor shortages became more pronounced (shrinkage of the room for additional labor supply and increased number of employed persons due to monetary easing and other factors).
  - Import prices rose significantly and government measures were taken to support firms to pass on higher input prices to their selling prices and raise wages.

My View on Corporate Behavior in the Post-Bubble Period

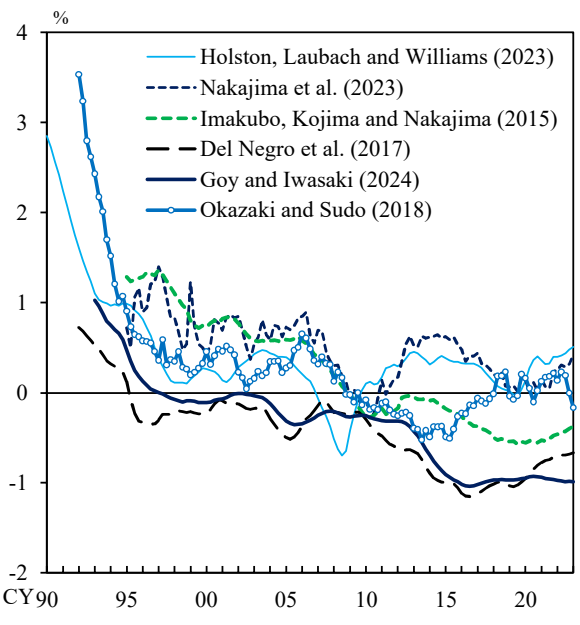


Potential Growth Rate and Natural Rate of Interest

Potential Growth Rate



Natural Rate of Interest

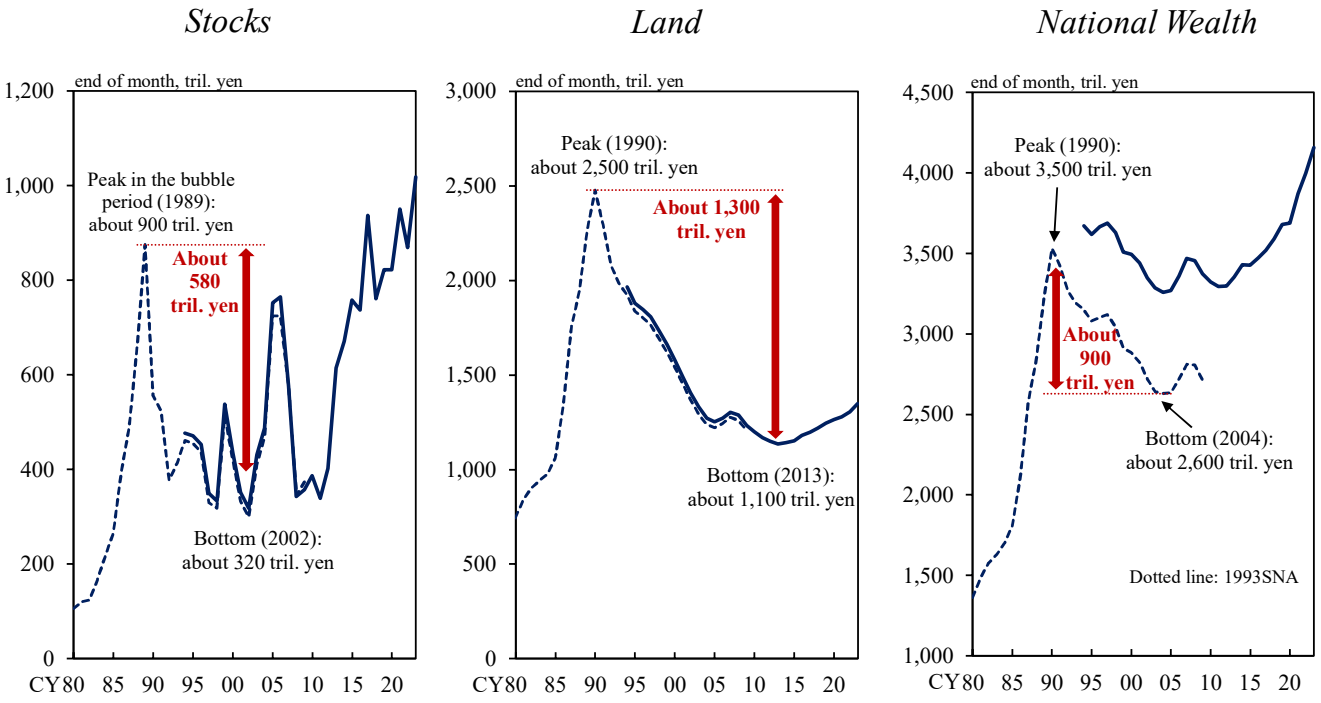


Notes: 1. In the left panel, figures are Bank staff estimates.
2. In the right panel, the estimates are based on Bank staff calculations using the models proposed in the respective papers.

Sources: Bloomberg; Cabinet Office; Consensus Economics Inc., *Consensus Forecasts*; Ministry of Finance; Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications; Bank of Japan.

Chart 14

Asset Prices and National Wealth



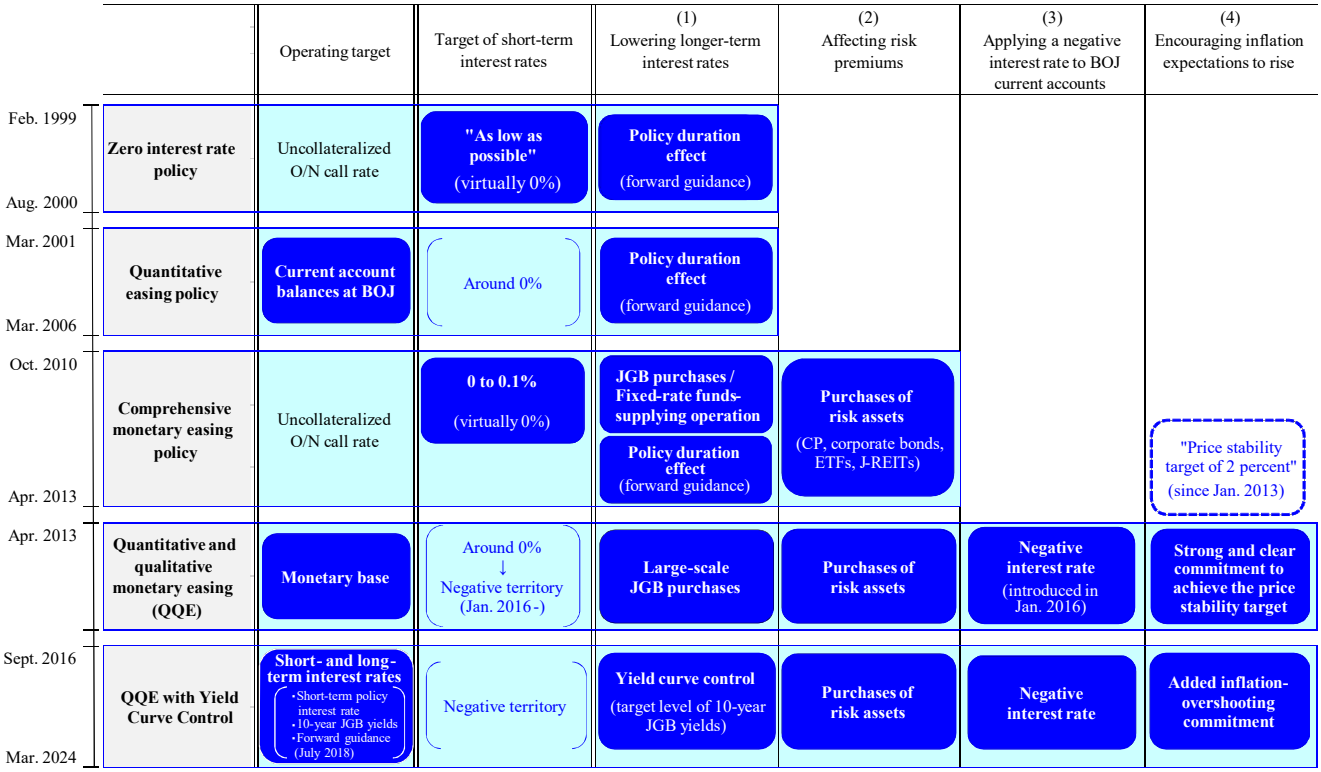
Note: Figures are based on the SNA. Dotted lines are based on the 1993SNA (benchmark year: 2000).
Source: Cabinet Office.

Chart 15

U.S. Dollar/Yen

Source: Bank of Japan.

Transition of the Bank of Japan's Monetary Policy



Source: Bank of Japan.

Introduction of Unconventional Monetary Policies

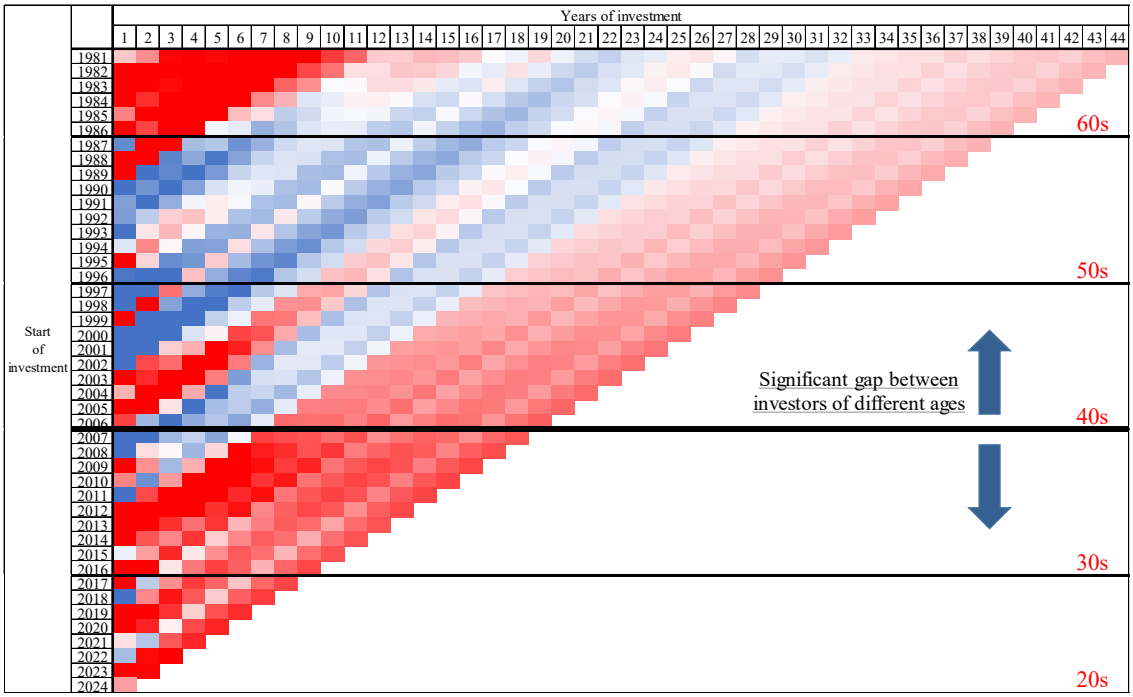
	BOJ	FRB	ECB
Zero interest rate policy	February 1999	December 2008	July 2012
Quantitative easing policy	March 2001	November 2008	May 2009
Negative interest rate policy	January 2016	—	June 2014
Yield curve control (target level of 10-year JGB yields)	September 2016	—	—

Notes: 1. The underlined dates indicate that the Bank of Japan was the first to introduce the policies.
2. The date of the introduction of the ECB's zero interest rate policy is when the deposit facility rate was set at 0 percent. The dates for the FRB's and the ECB's quantitative easing policies are when they announced their decisions to purchase mortgage-backed securities (MBS) and covered bonds, respectively.

Sources: ECB; FRB; Bank of Japan.

Chart 18

Cumulative Returns from Investment in Japanese Stocks by Age of Investors



Period with negative cumulative returns (percentage)

60s average: 38%

50s average: 50%

40s average: 32%

30s average: 9%

20s average: 11%

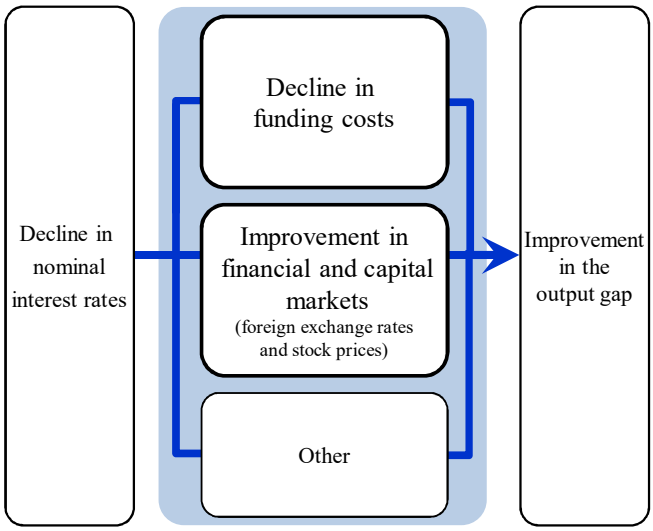
Note: Cumulative returns are estimated as of the end of 2024 by age of investors, based on the assumption that a fixed amount of the Nikkei 225 Stock Average is purchased every month from the beginning of the year. Red shows positive returns and blue shows negative returns. Darker shadows show larger positive or negative returns. Percentages for the period with negative cumulative returns are calculated by dividing "years with negative cumulative returns as of the year end" by "total years of investment."

Source: Bloomberg.

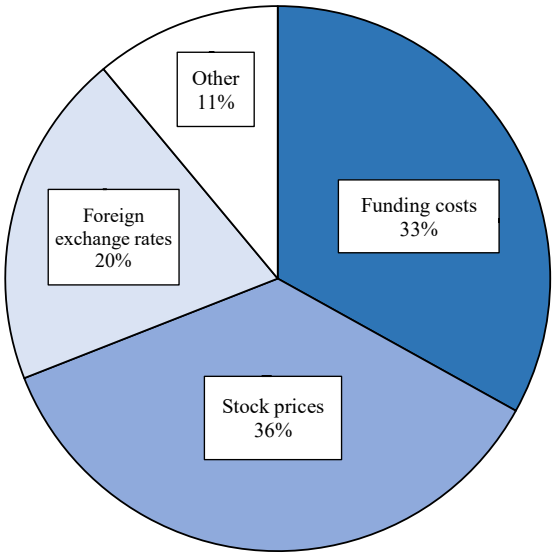
Chart 19

Transmission Channels of Lower Interest Rates

Overview



Improvement in the Output Gap (Breakdown by Channel)



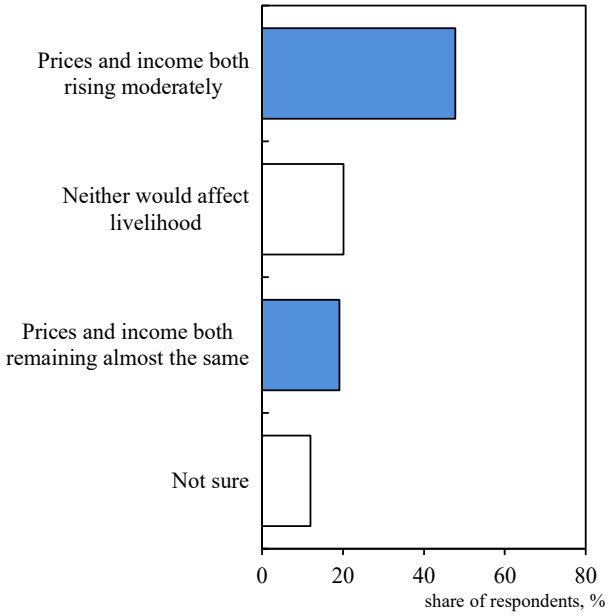
Notes: 1. Figures are based on a VAR model with coefficient restrictions using eight variables: output gap, interest rates (3-month), interest rate spreads (2-year minus 3-month, 5-year minus 2-year, 10-year minus 5-year), aggregate funding costs, nominal effective exchange rates of the yen, and stock prices.
2. Aggregate funding costs are the weighted average of bank lending rates and issuance yields for CP and corporate bonds.
3. In the right pie graph, figures show the 5-year cumulative effects.

Sources: Bloomberg; Bank of Japan; etc.

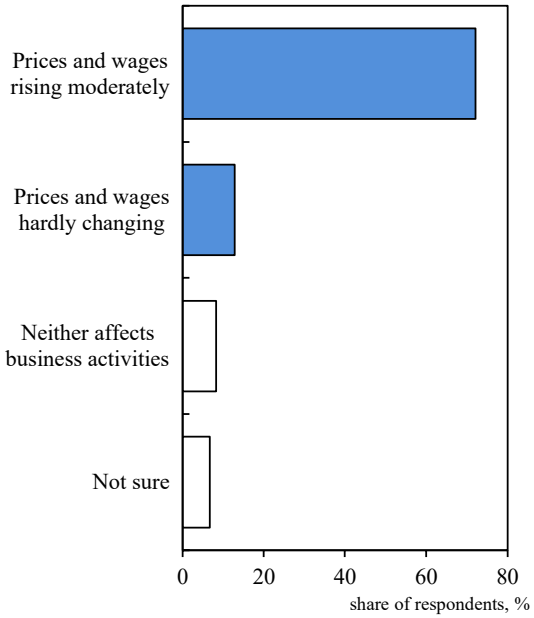
Chart 20

Preferable State of Prices, Income, and Wages

Households (Opinion Survey)



Firms (Large-Scale Corporate Survey)



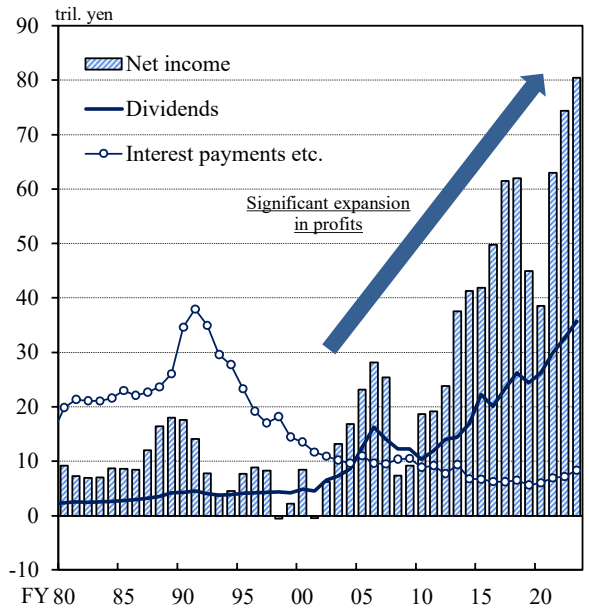
Note: For details of the left and right panels, see the *Opinion Survey on the General Public's Views and Behavior* (September 2024 Survey) and the *Survey regarding Corporate Behavior since the Mid-1990s*, respectively.

Source: Bank of Japan.

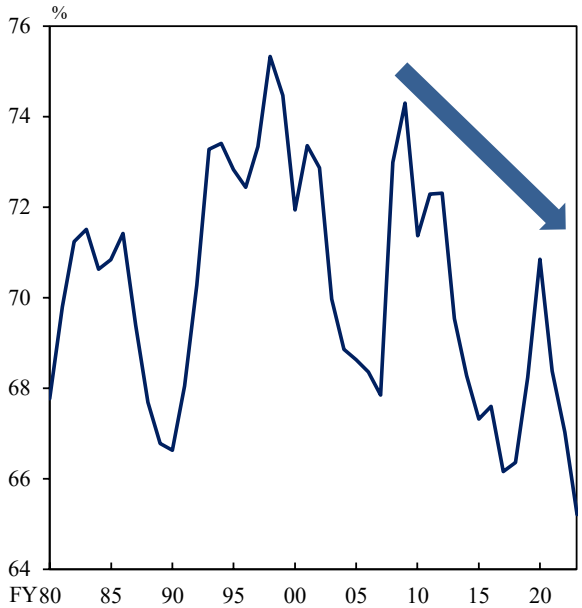
Chart 21

Corporate Profits

Corporate Profits and Returns to Investors



Labor Share



Notes: 1. Figures are based on the *Financial Statements Statistics of Corporations by Industry, Annually*, and exclude the finance and insurance industries.
2. Labor share = personnel expenses / value-added. Value-added = operating profits + personnel expenses + depreciation expenses.

Source: Ministry of Finance.

Chart 22

My View on Mechanism of Expanding Corporate Profits and Ensuing Challenges

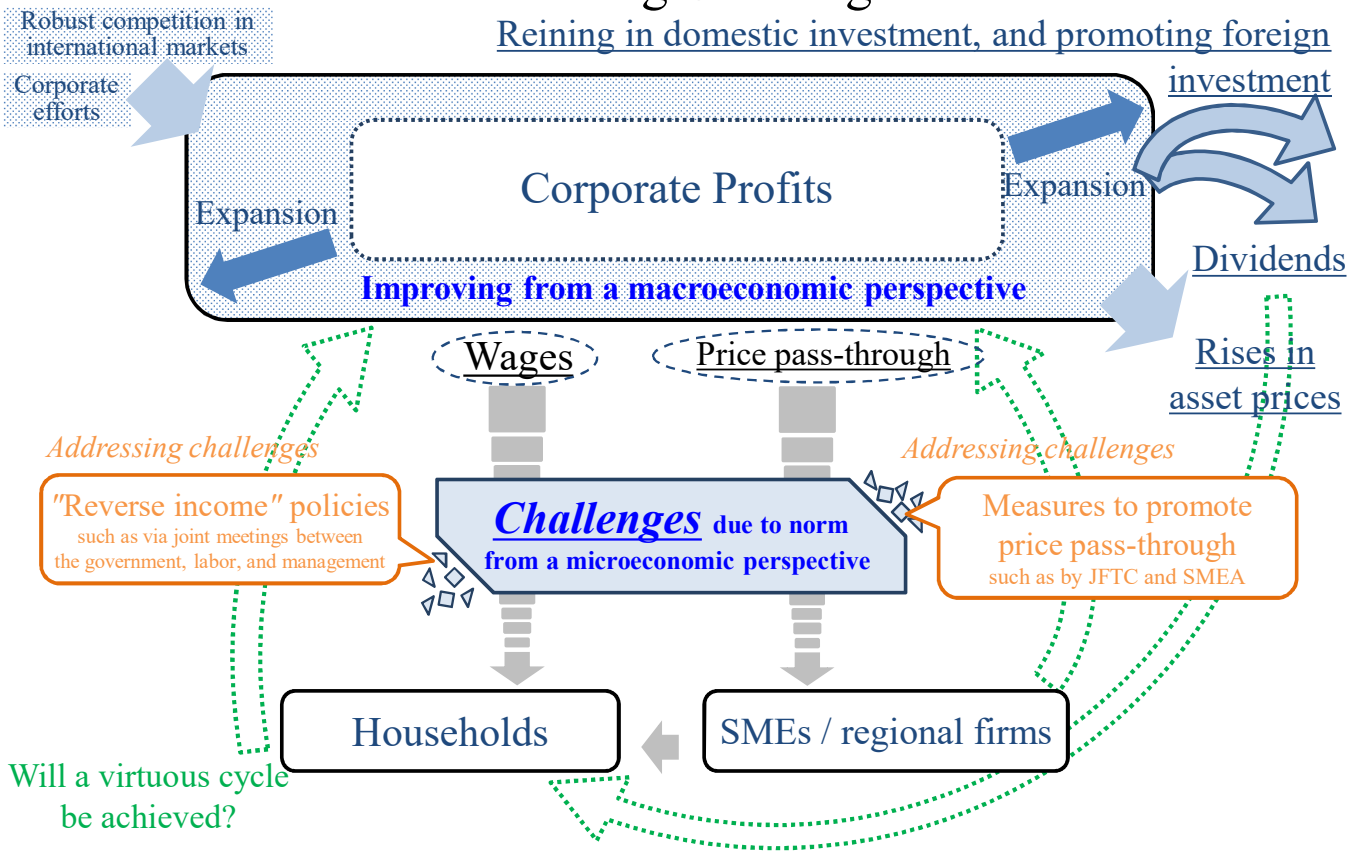
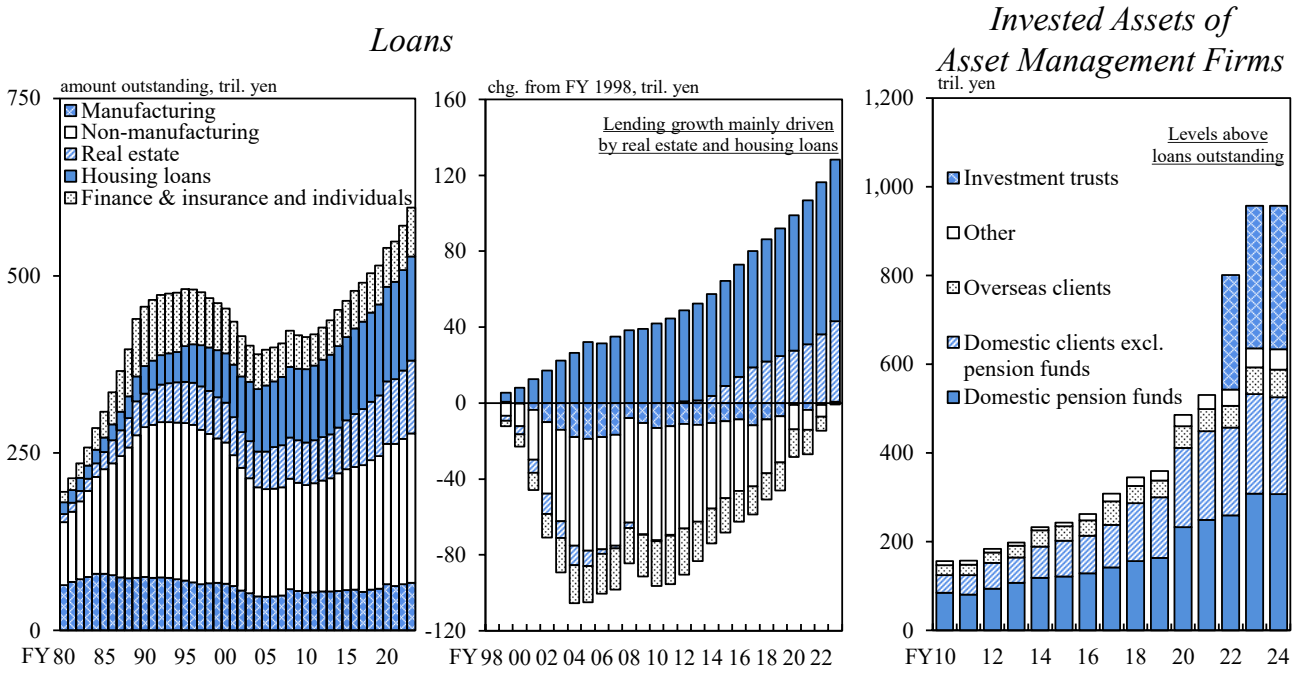


Chart 23

Changes in Financial Intermediation



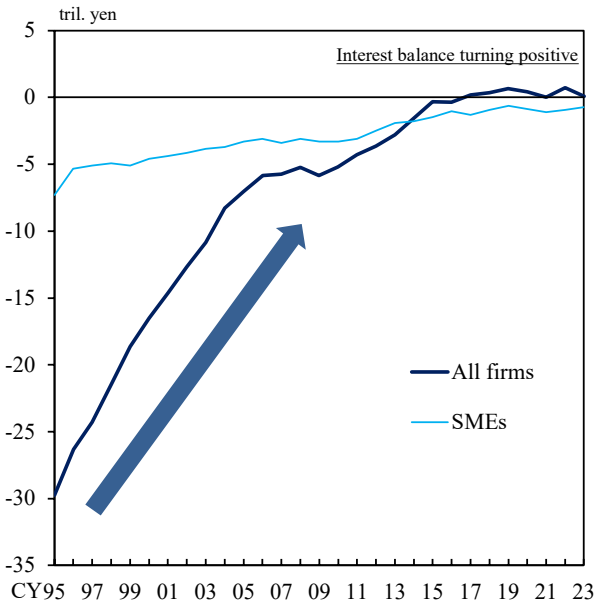
Notes: 1. In the left and center panels, figures cover domestically licensed banks (banking accounts of domestic branches). Figures for "non-manufacturing" exclude real estate and finance and insurance, and figures for "finance & insurance and individuals" exclude housing loans.

2. In the right panel, figures for "overseas clients," "domestic clients excl. pension funds," and "domestic pension funds" are assets for discretionary businesses. Figures for fiscal 2024 are those for the end of September 2024. Figures for "investment trusts" are from fiscal 2022 onward due to data constraints.

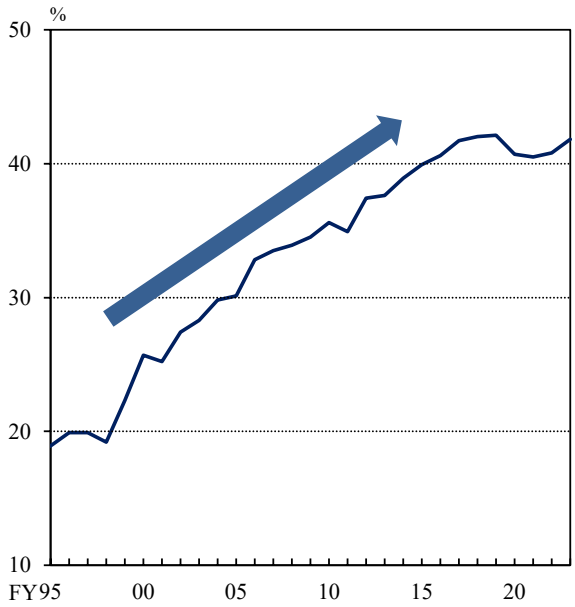
Sources: Japan Investment Advisers Association; Bank of Japan.

Improvement in Corporate Finance

Interest Balance



Capital Adequacy Ratio



Note: Interest balance for small and medium-sized enterprises (SMEs) in the left panel includes dividend income.
Sources: Cabinet Office; Ministry of Finance.