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Bank of Japan

**Economic Activity, Prices,
and Monetary Policy in Japan**

Speech at a Meeting with Local Leaders in Okinawa

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(English translation based on the Japanese original)

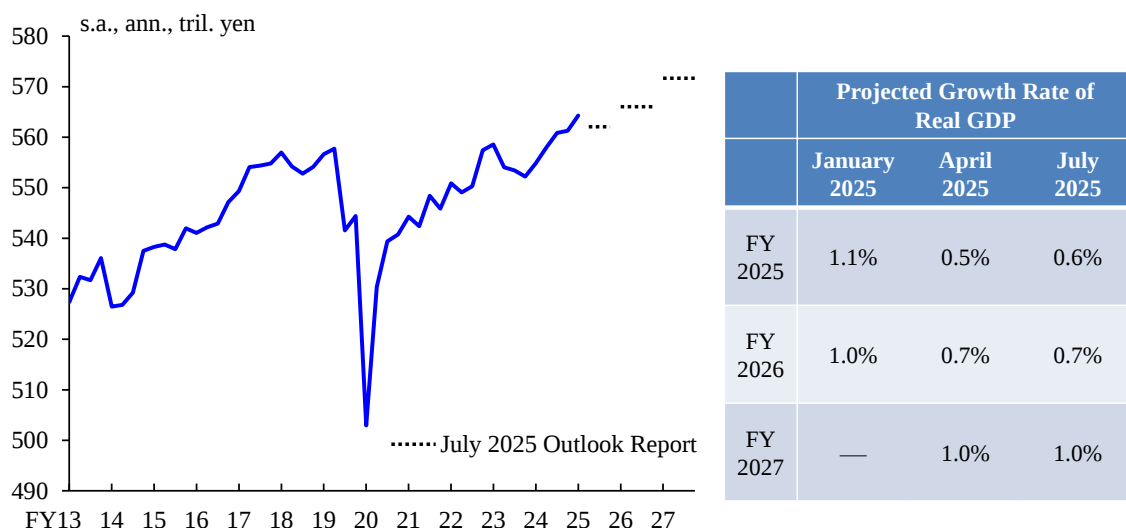
I. Economic Activity and Prices

A. Current Situation of and Outlook for Economic Activity in Japan

I will begin my speech by talking about developments in economic activity in Japan. The Bank of Japan assesses that the economy has grown moderately on the whole, although some weakness has been seen in part.

There was significant uncertainty regarding the future course of U.S. tariff policy and its impact on Japan's economy, and the Bank had to make revisions to its forecasts for real GDP in April and July 2025, as shown in Chart 1. In terms of the medians of the Policy Board members' forecasts -- as presented in the January 2025 *Outlook for Economic Activity and Prices* (Outlook Report) -- the forecast for Japan's real GDP growth rate was 1.1 percent for fiscal 2025 and 1.0 percent for fiscal 2026, indicating that Japan's economy was expected to see relatively firm growth. However, given the U.S. tariff policy announced in April 2025, the Bank's forecasts were revised substantially downward in the April Outlook Report, to 0.5 percent for fiscal 2025 and 0.7 percent for fiscal 2026. That said, how U.S. tariff policy would turn out and how firms would respond to the policy were both fluid at the time the Bank made its forecasts in April. The Bank's April forecasts were therefore likely to be revised considerably, either upward or downward, depending on future developments.

Chart 1: The Bank's Forecasts for Real GDP

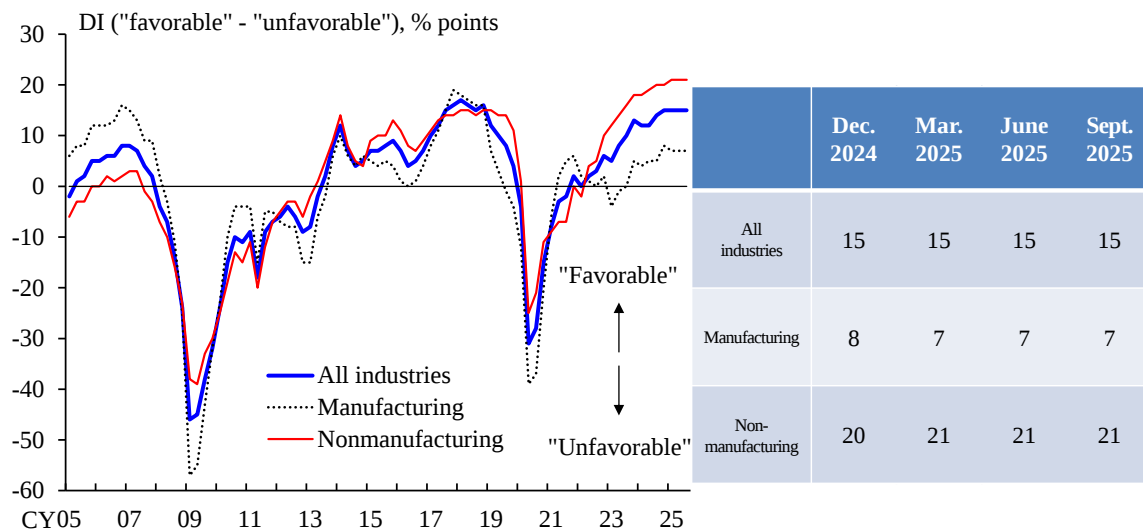


Note: Forecasts are the medians of the Policy Board members' forecasts. Real GDP values for 2025/Q3 onward are calculated by multiplying the actual figure for fiscal 2024 by all successive projected growth rates for each year.

Sources: Cabinet Office; Bank of Japan.

Judging from the results of the Bank's June 2025 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) and interviews with firms, it was surprising to me that firms maintained a proactive stance. Furthermore, Japan and the United States reached an agreement on tariffs, the terms of which were modest, especially for automobiles. In this context, I believed at the time that this would definitely reduce the uncertainty regarding U.S. tariff policy and give Japanese firms more leeway in making business decisions. My view was subsequently backed up by the diffusion index (DI) for business conditions in the September *Tankan* released this month, which showed that firms have indeed maintained their proactive stance, as illustrated by Chart 2.

Chart 2: Business Conditions DI



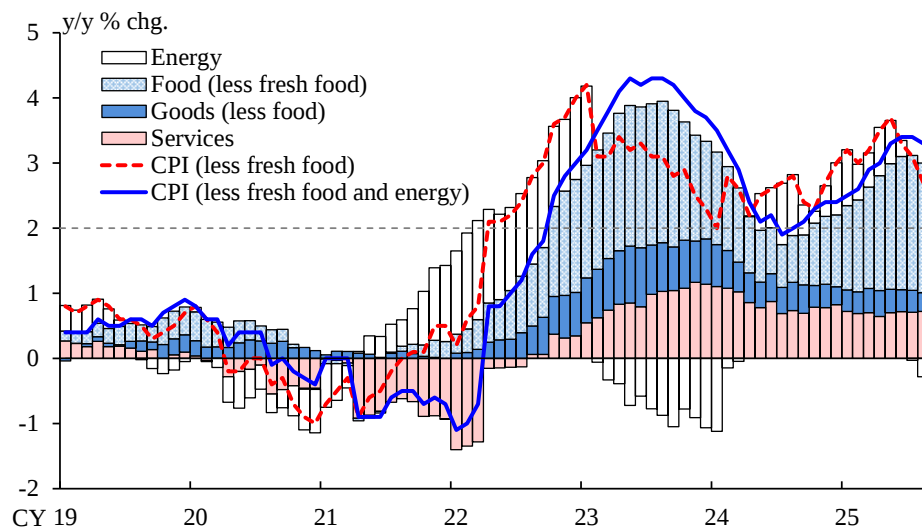
Note: Based on the *Tankan*. All enterprises.
Source: Bank of Japan.

Needless to say, the magnitude of the impact of U.S. tariff policy varies depending on the industry, and I believe that Japan's economy as a whole will not be able to remain completely unharmed by the effects of, for example, a slowdown in overseas economies induced by U.S. tariff policy. That said, I think that the growth rate of Japan's economy is likely to rise, with overseas economies returning to a moderate growth path. Although it is necessary to continue to carefully monitor incoming data and information, my view is that there is a strong possibility that the slowdown in overseas economies will not be as significant as initially expected.

B. Current Situation of and Outlook for Prices in Japan

I will now talk about prices in Japan. As shown in Chart 3, with moves to pass on wage increases to selling prices continuing, 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 recently, due to the effects of the rise in food prices, such as rice prices, and other factors.

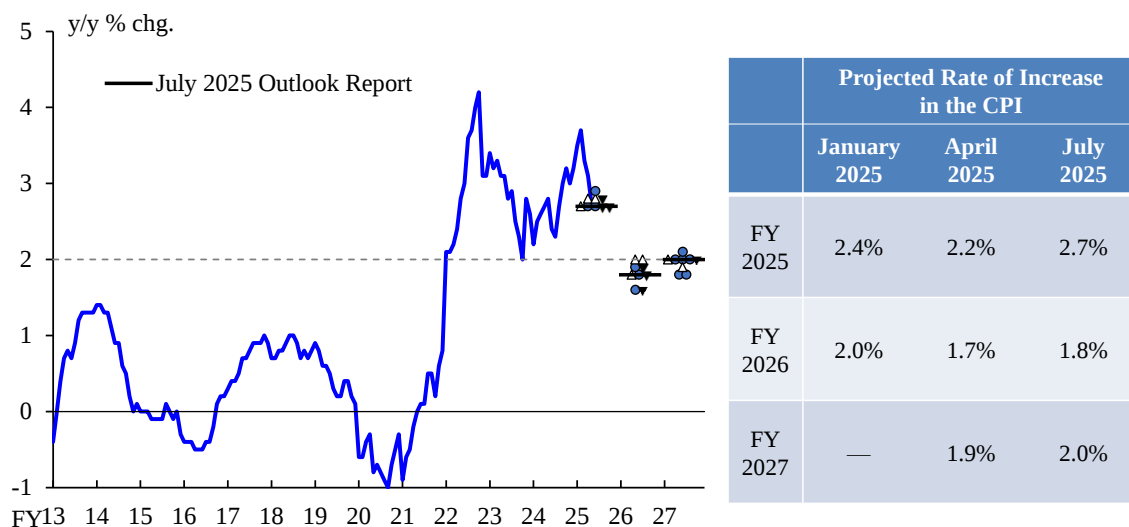
Chart 3: Consumer Prices



Source: Ministry of Internal Affairs and Communications.

As was the case with the forecasts for real GDP, the Bank had to make revisions to its forecasts for the CPI, taking account of the uncertainty caused by U.S. tariff policy. Chart 4 shows that the Bank's forecast presented in the January Outlook Report for the year-on-year rate of increase in the CPI for all items excluding fresh food was 2.4 percent for fiscal 2025 and 2.0 percent for fiscal 2026, indicating that the rate of increase in the CPI was expected to continue to exceed the 2 percent price stability target. However, the Bank revised its forecast for fiscal 2026 downward to 1.7 percent in the April Outlook Report. This was because the Bank had factored in, for example, the risk of wage increases for fiscal 2026 being pushed down to a certain extent by sluggish growth in corporate profits due to the impact of U.S. tariff policy. Meanwhile, the reason the Bank made a substantial upward revision to its forecast for the CPI for fiscal 2025 to 2.7 percent in the July Outlook Report was to take into account actual developments in prices, particularly in food prices, which have recently shown a significant upward deviation from the Bank's baseline scenario.

Chart 4: The Bank's Forecasts for the CPI

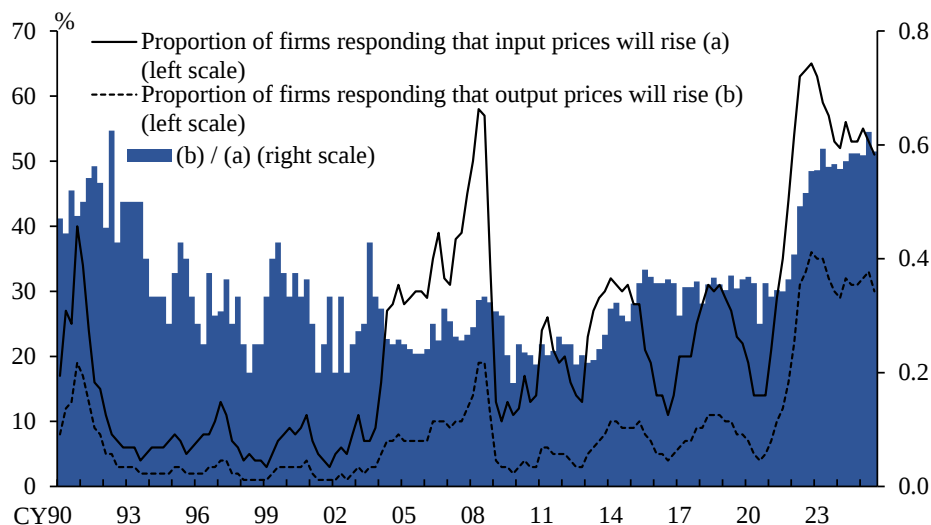


Notes: 1. Figures are the CPI for all items less fresh food, excluding the effects of consumption tax hikes.
 2. The locations of ●, △, and ▼ in the chart indicate the figures for each Policy Board member's forecasts. The risk balance assessed by each Policy Board member is shown by the following shapes: ● 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 black lines show the medians of the Policy Board members' forecasts.
 Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

The Bank's baseline scenario for prices is as follows. Underlying CPI inflation is likely to be sluggish for the time being, mainly due to the deceleration in the economy. Thereafter, however, it is expected to increase gradually, since it is projected that a sense of labor shortage will grow as the economic growth rate rises, and that medium- to long-term inflation expectations will rise. In the second half of the projection period presented in the July 2025 Outlook Report -- which covers the period through fiscal 2027 -- underlying CPI inflation is likely to be at a level that is generally consistent with the price stability target. Meanwhile, my view is that there is a good chance of the price stability target being achieved earlier than the second half of the projection period. The reasons why I believe inflation may deviate upward from the baseline scenario are as follows.

First, firms have maintained their proactive business stance. I was concerned that the adverse impact of U.S. tariff policy might lead firms' business stance to revert to the past stance observed during the deflationary period, when wages and prices did not increase easily. In fact, firms have maintained a price-setting behavior that is more proactive than was observed in the past. Chart 5 shows the percentage of firms responding in the *Tankan* that output prices

Chart 5: Changes in Firms' Price-Setting Behavior

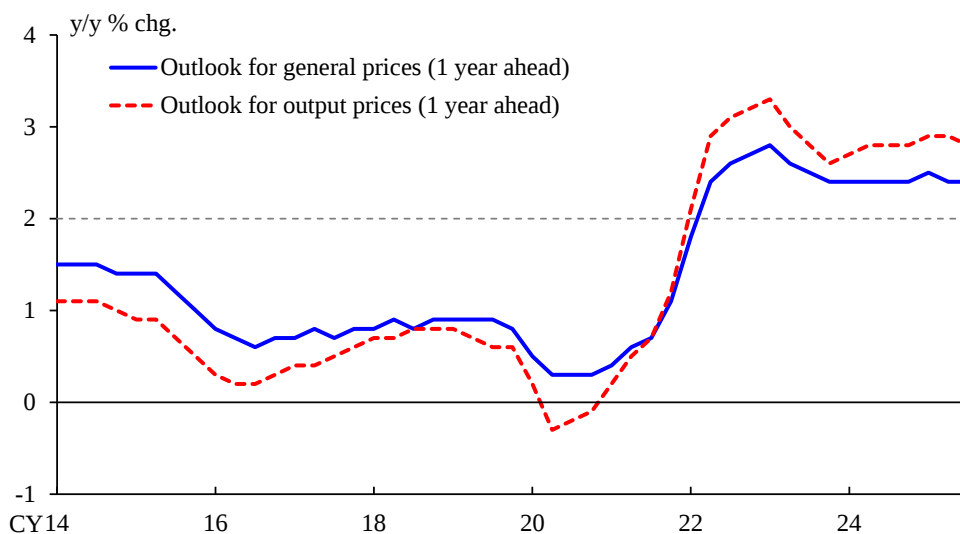


Note: Figures are based on the *Tankan*, and are for all industries and enterprises. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

Source: Bank of Japan.

would rise divided by the percentage of firms responding that input prices would rise -- a rough indicator of firms' willingness to raise prices. From 2022, this indicator recovered to the level last seen in the early 1990s, before the deflationary mindset took hold among firms, and has since remained at a relatively high level. Chart 6 presents developments in firms' one-year ahead inflation outlook for general prices and for output prices for their products, both of which remain at high levels exceeding 2 percent. I am attentive to the fact that, until 2022,

Chart 6: Firms' Inflation Outlook

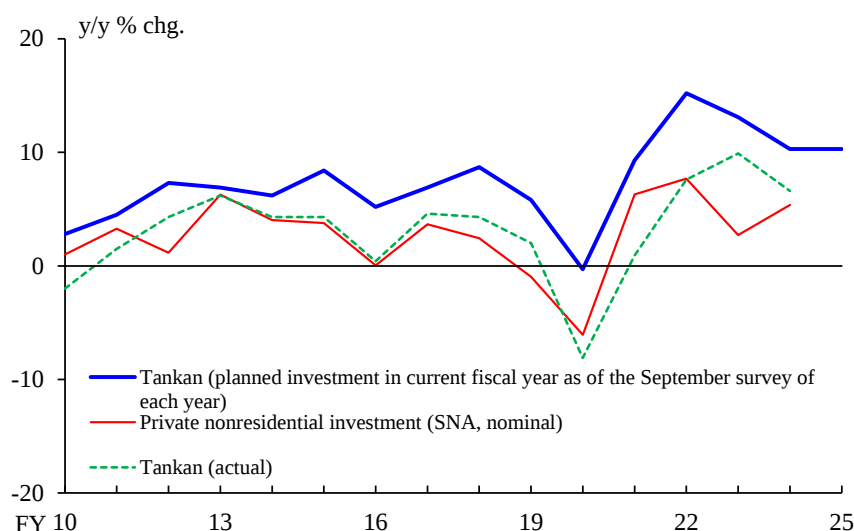


Note: Figures are based on the *Tankan*, and are averages of all industries and enterprises.

Source: Bank of Japan.

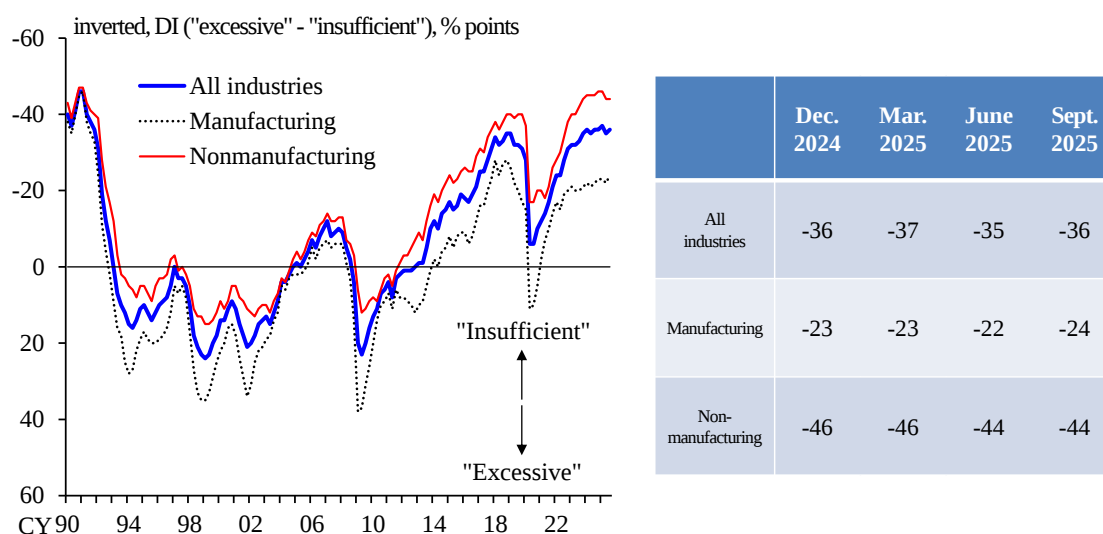
firms' stance was not to raise their product prices as much as the rise in general prices, but this stance has shifted since 2022 to raising their product prices more than the rise in general prices. I regard this shift as indicating more proactive price-setting behavior of firms. With regard to firms' fixed investment, while some firms showed a wait-and-see stance immediately after the announcement of U.S. tariff policy in April, investment plans in the September *Tankan* showed a high rate of increase like that observed in the previous fiscal year, as illustrated by Chart 7. Many firms appear to be maintaining a proactive fixed investment stance, continuing with investment to address labor shortages, digital-related investment, and investment associated with the green transformation. Furthermore, firms' wage-setting behavior can likewise be judged to have remained proactive. Reports at the meeting of the general managers of the Bank's branches held recently and the results of interviews with firms conducted by the Bank's staff at the Head Office and branches indicated that many firms were planning to continue raising wages, with a strong sense of labor shortage shown in Chart 8.

Chart 7: Business Fixed Investment



Note: The *Tankan* figures include software and R&D investments and exclude land purchasing expenses. R&D investment is not included before the March 2017 survey. The figures are for all industries, including financial institutions.
Sources: Cabinet Office; Bank of Japan.

Chart 8: Employment Conditions DI

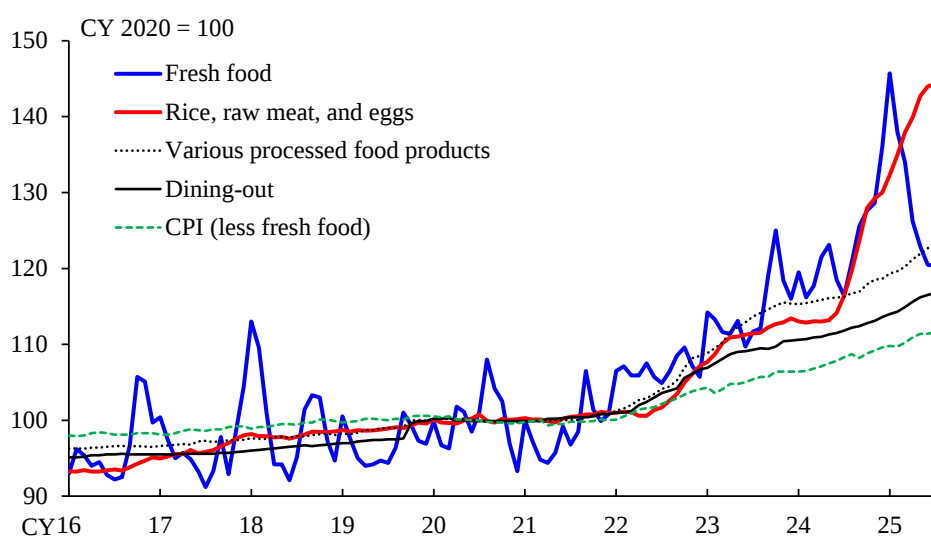


Note: Figures are based on the *Tankan*, and are for all enterprises. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

Source: Bank of Japan.

Second, food prices have seen sustained increases since 2022, as shown in Chart 9. Prices for fresh food, rice, eggs, and other food items have continued to rise, and this has led to higher prices for processed food and dining-out. While the price increases for fresh food, rice, eggs, and other food items may be temporary since they were induced by supply-side factors, inflation as a whole could remain relatively high, even with changes in those items for which prices rose. This is mainly attributable to the effects of (1) an increase in various costs,

Chart 9: Consumer Prices (Food)

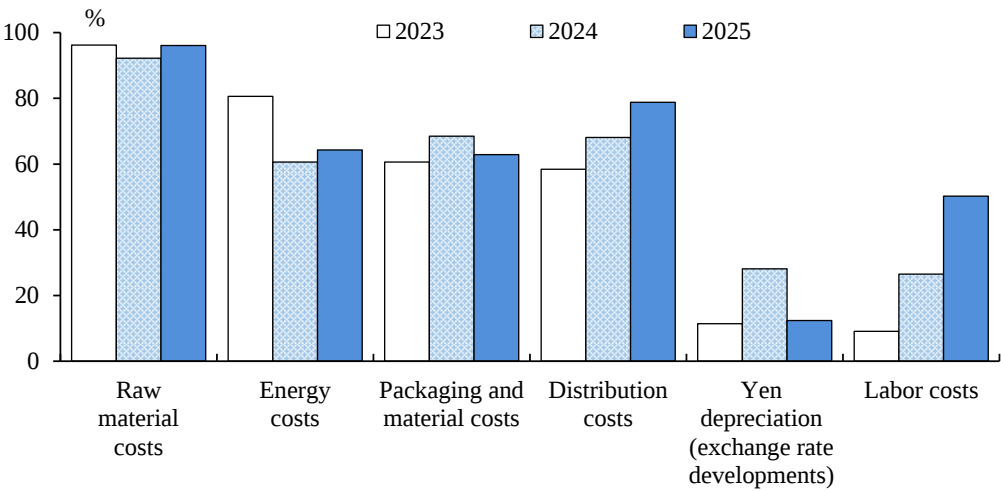


Note: "Various processed food products" consists of food excluding fresh food, rice, raw meat, eggs, and dining-out.

Source: Ministry of Internal Affairs and Communications.

including fertilizer, utility, and shipping costs; (2) higher labor costs at each stage from production to retail; (3) lower supply capacity due to labor shortages; and (4) adverse weather conditions caused by climate change. In addition, even if the price increases for fresh food, rice, eggs, and other food items are indeed temporary, I believe that the spillovers to the price of processed food and dining-out are unlikely to occur all at once since firms pass on higher costs to their prices gradually, and spillovers therefore usually take place over a certain period. Furthermore, as shown in Chart 10, a larger proportion of major food manufacturers have cited labor costs as a reason for their price increases, indicating that labor costs are becoming a structural factor pushing up prices. Given this, there is a strong possibility that food prices will continue to rise. Higher food prices have a significant impact on households' inflation expectations, and this could further push up prices. Higher food prices should therefore not be regarded as merely a temporary factor, and they require close monitoring.

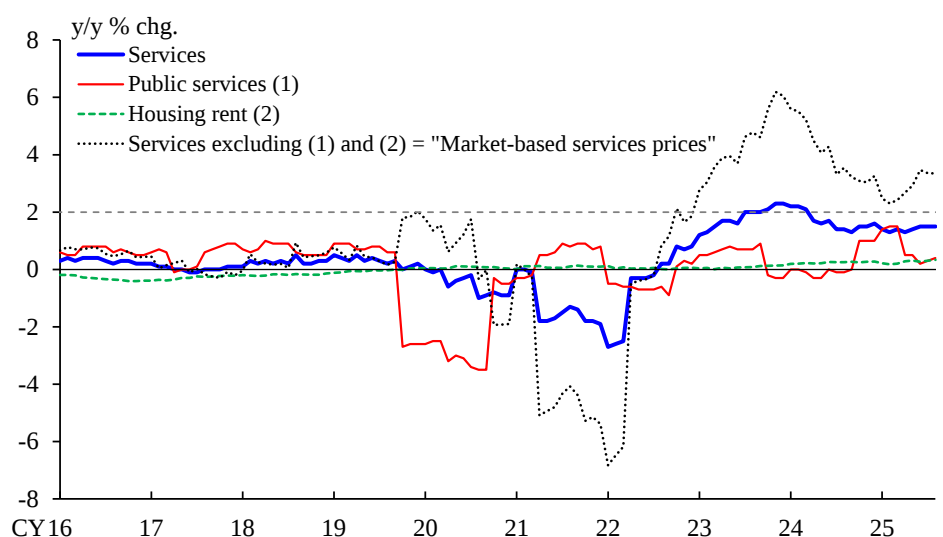
Chart 10: Reasons for Food Price Increases



Source: Teikoku Databank.

Third, the prices of items under services that are susceptible to developments in labor costs have continued to rise at a high rate of above 2 percent. As shown in Chart 11, services prices as a whole appear to have been rising at a rate of somewhat below 2 percent year on year, but

Chart 11: Consumer Prices (Services)



Notes: 1. "Public services" includes public housing rent, rent for Urban Renaissance Agency, and rent for public corporation.

2. "Housing rent" consists of private housing rent and imputed rent.

Source: Ministry of Internal Affairs and Communications.

this is because housing rent and public services are included, both of which are considered to structurally follow developments in general prices with a significant time lag.^{1,2,3} Services

¹ Housing rent refers to private housing rent and imputed rent in the CPI.

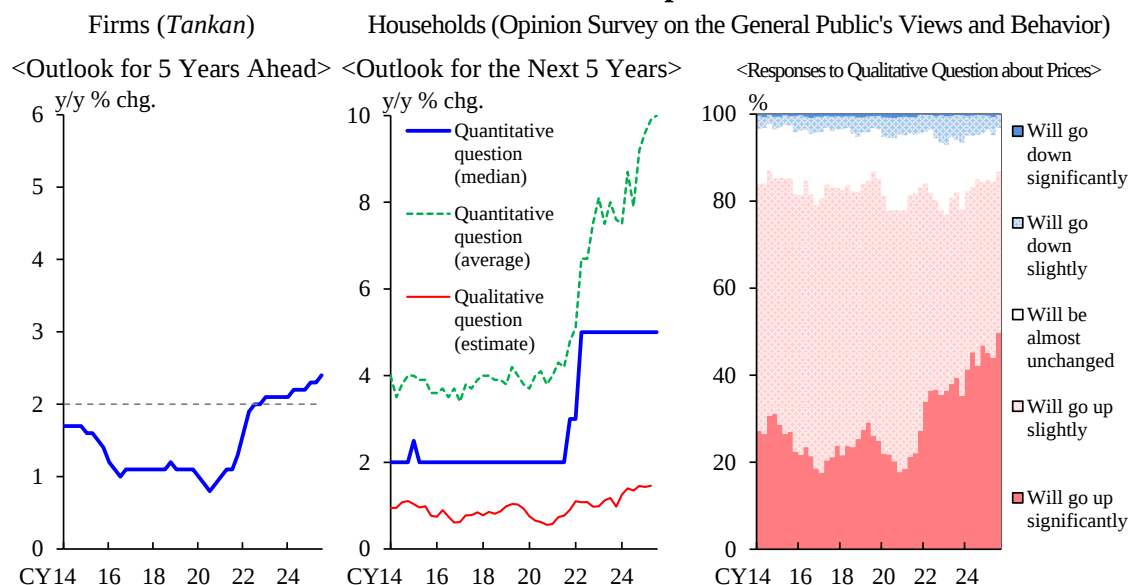
² The small rate of increase in terms of the year-on-year rate of change in Japan's CPI for housing rent has been attributed to the high institutional barriers against raising rent, and because surveys on housing rent include ongoing rents, the impact of increases in new contract rents made at the time of a change of resident is not fully accounted for. A downward bias in housing rent is also created by the fact that a quality adjustment to housing for rent in terms of deterioration from aging is not incorporated. It is important to note that these effects are reflected not only in private housing rent but also in imputed rent, which has a large weight in the CPI. The weight for private housing rent and imputed rent in services prices is 36 percent.

³ Public services in the CPI include not only items under legal prices and ordinance-based prices, regulated either by the central or local governments, but also items under licensed prices, which require the approval of the central government for price changes, and items under notified prices, whose changes are reported to the government. One of the reasons why the rise in such administered prices in Japan has been sluggish is that government subsidies for supplementing revenues are constantly injected to public firms, and administered prices do not sufficiently reflect operating expenses and depreciation costs of equipment (see Box 4 of the July 2016 Outlook Report). Although higher fire and earthquake insurance premiums and optional auto insurance premiums have recently pushed up

prices excluding these components -- which I refer to as "market-based services prices" -- have continued to see an increase of more than 2 percent, indicating that the mechanism by which wages and prices rise in interaction with each other has been operating. Furthermore, recently, the rate of increase in housing rent and public services prices has also been rising gradually. The rate of increase in public services prices in particular could accelerate further, mainly reflecting the government's announcement in June 2025 of a policy to raise government-set prices in areas such as healthcare, nursing care, and welfare for people with disabilities.

The fourth reason is developments in inflation expectations, shown in Chart 12. I believe that, when considering future price developments, the focus should be placed on the inflation expectations of firms and households, who are the actual drivers of economic activity. Firms' inflation outlook for general prices in the *Tankan* has continued to rise moderately, with their inflation outlook for five years ahead remaining above 2 percent. Regarding inflation

Chart 12: Inflation Expectations



Notes: 1. Figures for firms in the left panel are averages of all industries and enterprises.
2. Figures for the quantitative question in the middle panel are based on numerical values for expected inflation rates provided by respondents, and the average of those is calculated by excluding 0.5 percent of the highest and lowest figures, respectively, in order to avoid extremes. Figures for the qualitative question are estimated using the modified Carlson-Parkin method, quantifying the results of the 5-choice question, asking respondents their expectations for whether and to what degree prices will go up or down.
Source: Bank of Japan.

the price of public services, the rate of increase remains sluggish when these premiums are excluded. The weight for public services (including public housing rent, rent for Urban Renaissance Agency, and rent for public corporation) in services prices is 25 percent.

expectations of households, the results of the Bank's *Opinion Survey on the General Public's Views and Behavior* show that both the median and average of households' inflation outlook for five years ahead have remained significantly above 2 percent, although bias in expected price levels should be taken into account.⁴ Unlike the United States and Europe, where inflation expectations have been stable at around 2 percent, Japan has seen inflation expectations rise from a low level. In that sense, I have been paying attention to whether any further rise is more than expected, and it was confirmed in the September 2025 *Tankan* and the Opinion Survey released in October that inflation expectations of firms and households have risen further.

Based on the points that I have explained, I believe that there is a significant risk that domestic price developments will deviate upward from the outlook presented in the July 2025 Outlook Report.

II. Conduct of Monetary Policy

I would now like to turn to the Bank's conduct of monetary policy. The Bank conducts monetary policy with the aim of achieving the price stability target of 2 percent in a sustainable and stable manner. Since the changes in the monetary policy framework decided at the March 2024 Monetary Policy Meeting (MPM), the Bank has returned to conventional monetary policy, employing the guidance of the short-term interest rate as a primary policy tool. The Bank intends to adjust the degree of monetary accommodation in response to an increase in the likelihood of achieving the price stability target; after setting the target level of its short-term policy interest rate at around 0 to 0.1 percent at the March 2024 MPM, it

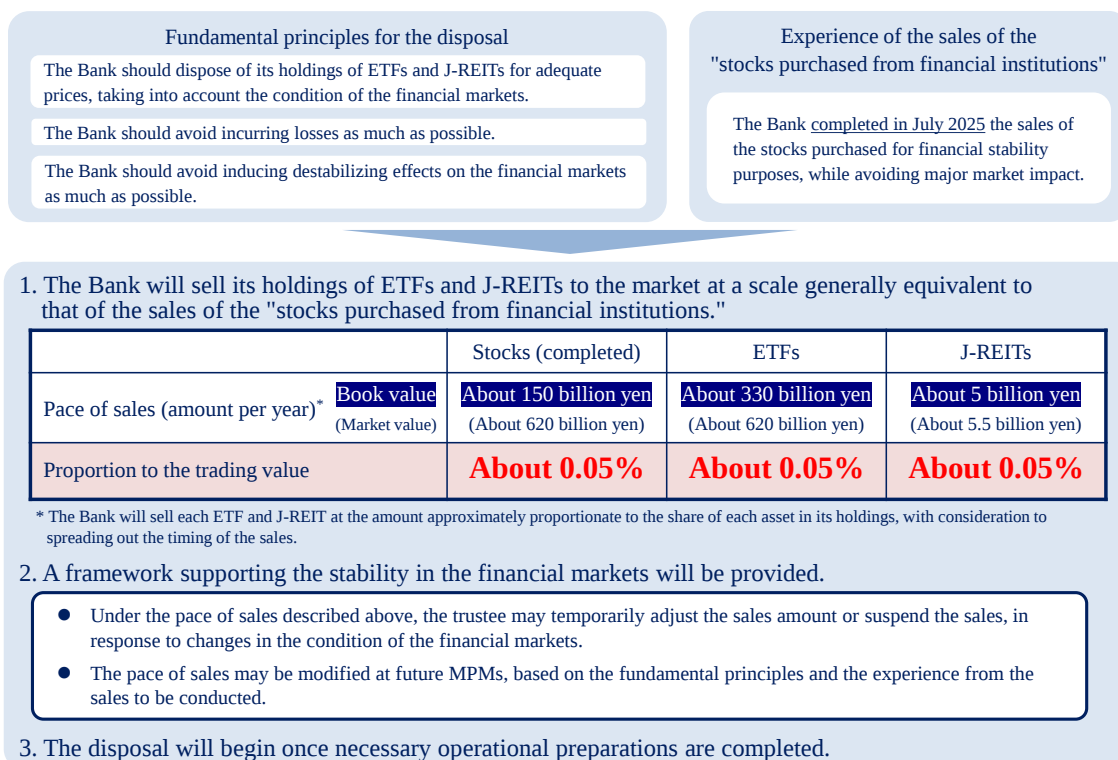
⁴ This survey included a qualitative question asking respondents to indicate their outlook for prices by choosing options such as prices "will go up slightly" or "will go up significantly." When inflation expectations are estimated using the responses to this question to adjust for bias in household expectations, the latest estimates suggest that inflation expectations have remained at a level of around 1.5 percent. Compared with the levels observed prior to 2023, this represents only a modest increase, whereas the median and average responses to quantitative questions have risen sharply. Given this, I feel that estimates based on qualitative responses may be underestimated. For example, even if people with high inflation expectations, like respondents saying that prices "will go up significantly," have increased their expectations further, they are only able to choose the same response, since there is no higher category than "will go up significantly," and this induces a downward bias.

raised the target level to around 0.25 percent at the July 2024 MPM, and further to around 0.5 percent at the January 2025 MPM.

At the most recent MPM held in September 2025, the Bank decided to maintain the target level of its short-term policy interest rate at around 0.5 percent. I voted against maintaining the target level and proposed that the Bank raise the target level to around 0.75 percent. This is because I considered that, with risks to prices being skewed to the upside, the Bank should set the policy interest rate a little closer to the neutral interest rate to prevent future shocks arising from possible rapid policy interest rate hikes, although it should not immediately raise the policy interest rate to a restrictive level, given that there are currently both upside and downside risks.

It should also be noted that, as shown in Chart 13, the Bank decided at the September MPM to sell its holdings of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) to the market in accordance with the fundamental principles for their disposal, which include the principle to avoid inducing destabilizing effects on the financial markets as much as possible. The scale of the sales will generally be equivalent to that for the stocks

Chart 13: Decisions on Disposal of ETFs and J-REITs (September 2025 MPM)

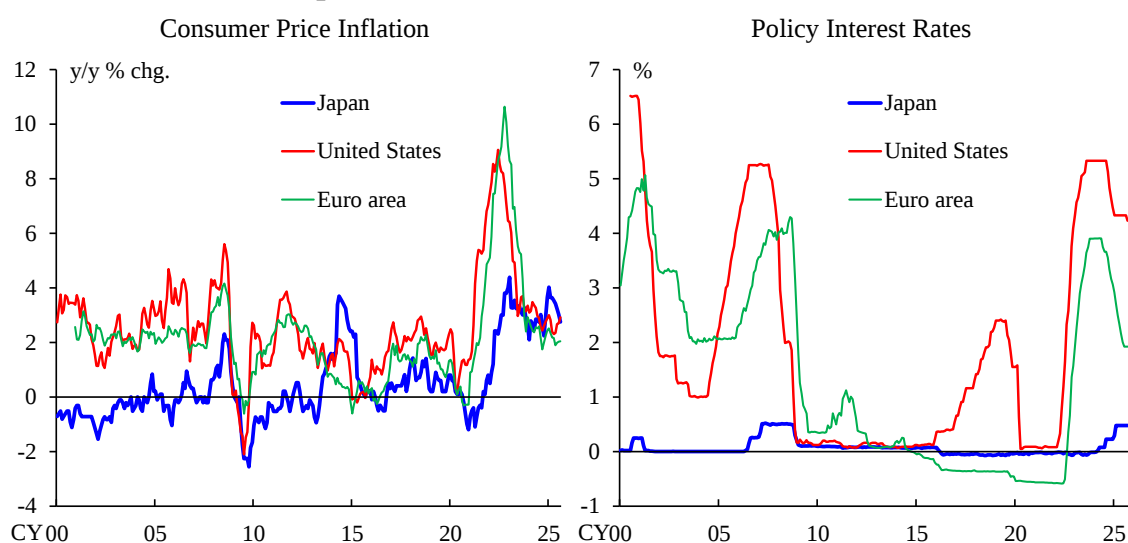


purchased from financial institutions. Since the sales amounts of ETFs and J-REITs will be limited to about 0.05 percent of the trading values in the markets, completion of the disposal is estimated to take more than 100 years. However, my view is that, as long as the Bank disposes of ETFs and J-REITs, which it purchased to have an impact on risk premiums in the markets, in a way that does not have a major market impact, it is inevitable that the completion of the disposal will take considerable time.

In what follows, I will elaborate a little further on my views regarding policy interest rates.

Chart 14 shows developments in consumer price inflation and policy interest rates in Japan, the United States, and the euro area. With consumer price inflation in the United States and

**Chart 14: Consumer Price Inflation and Policy Interest Rates
in Japan, the United States, and the Euro Area**



Notes: 1. In the left panel, figures for Japan are the CPI (all items, excluding the effects of consumption tax hikes). Those for the United States and the euro area are the CPI (all items) and the HICP (all items), respectively.

2. In the right panel, figures for each economy are as follows: for Japan, the uncollateralized overnight call rate; for the United States, the effective federal funds rate; for the euro area, EONIA before 2020, and €STR thereafter.

Sources: BLS; ECB; Eurostat; FRED; Ministry of Internal Affairs and Communications; Bank of Japan.

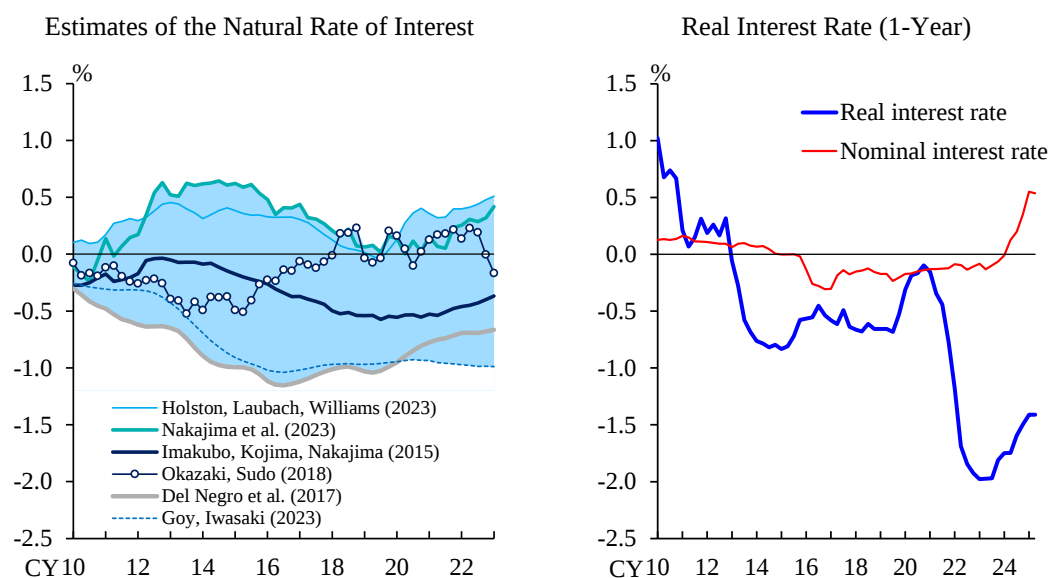
the euro area generally being in the range of 2-3 percent recently, the policy interest rate in the United States is slightly over 4 percent, and in the euro area the rates are at around 2 percent. While the levels differ reflecting developments in economic activity and prices in these economies, the policy interest rates are either close to or slightly above the respective neutral interest rates, and the central banks are navigating a highly uncertain situation where both upside and downside risks warrant attention. Meanwhile, although Japan's consumer

price inflation has generally been at around 3 percent, the policy interest rate has remained at 0.5 percent, which is low relative to the United States and the euro area.

Japan's actual inflation has been markedly above the 2 percent price stability target for quite a while. Moreover, my view is that risks to prices are becoming more skewed to the upside. At the same time, however, it is also true that U.S. tariff policy could weigh heavily on the U.S. economy in the future, and this could adversely affect Japan's economy. In order to prepare for such a situation, with both upside and downside risks to economic activity and prices, I believe that it is important from a risk management perspective for the Bank to move closer to a neutral monetary policy stance.

Chart 15 shows developments in the real interest rate in Japan, calculated as the nominal interest rate minus the expected rate of inflation. It has been markedly negative, falling below all estimates of the natural rate of interest. Put differently, this implies that Japan's current short-term interest rate is below the neutral interest rate, meaning that it provides accommodative financial conditions, or in other words, pushes up economic activity and prices.

Chart 15: Natural Rate of Interest and Real Interest Rate



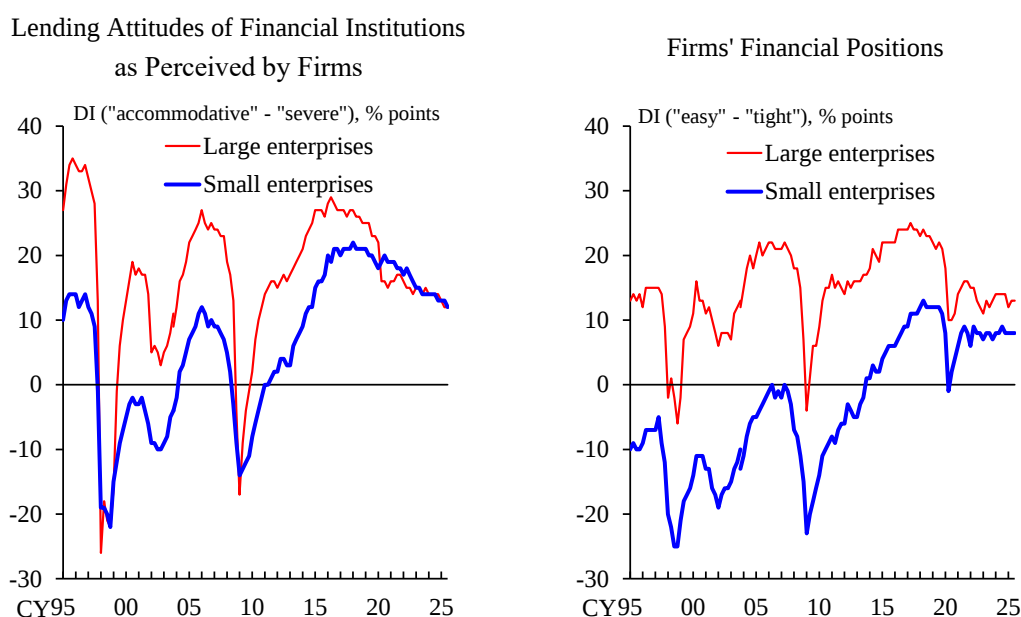
Notes: 1. In the left panel, natural interest rate estimates are based on Bank staff calculations using models proposed in the respective papers. The shaded area indicates the range of natural interest rate estimates from the minimum to the maximum.

2. In the right panel, the real interest rate is calculated as 1-year government bond yields minus the composite index of inflation expectations (Bank staff estimates).

Sources: Bloomberg; Cabinet Office; Consensus Economics Inc., *Consensus Forecasts*; Ministry of Finance; Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications; QUICK, *QUICK Monthly Market Survey <Bonds>*; Bank of Japan.

Conceptually, the neutral interest rate is the sum of the natural rate of interest -- which is the real interest rate level that is neutral to economic activity and prices -- and the expected rate of inflation. As I have previously stated, my sense is that the neutral interest rate should be at least around 1 percent. However, since the natural rate is not directly observable and estimates vary widely depending on the methodology used, in my view, the only way to determine where the level of the neutral interest rate actually stands in the territory of 1 percent and over is to examine the response of economic activity and prices as the Bank raises the policy interest rate. So far, the Bank has raised the policy interest rate to 0.5 percent, but my view is that the impact of the policy interest rate hikes on Japan's overall economy has been extremely limited. I believe that the policy interest rate is still far away from the neutral interest rate. In fact, as shown in Chart 16, financial institutions' lending attitudes as perceived by firms have remained accommodative on the whole, and firms' financial positions have continued to be favorable overall.

Chart 16: Lending Attitudes of Financial Institutions and Firms' Financial Positions



Note: Figures are based on the *Tankan*, and are for all industries. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

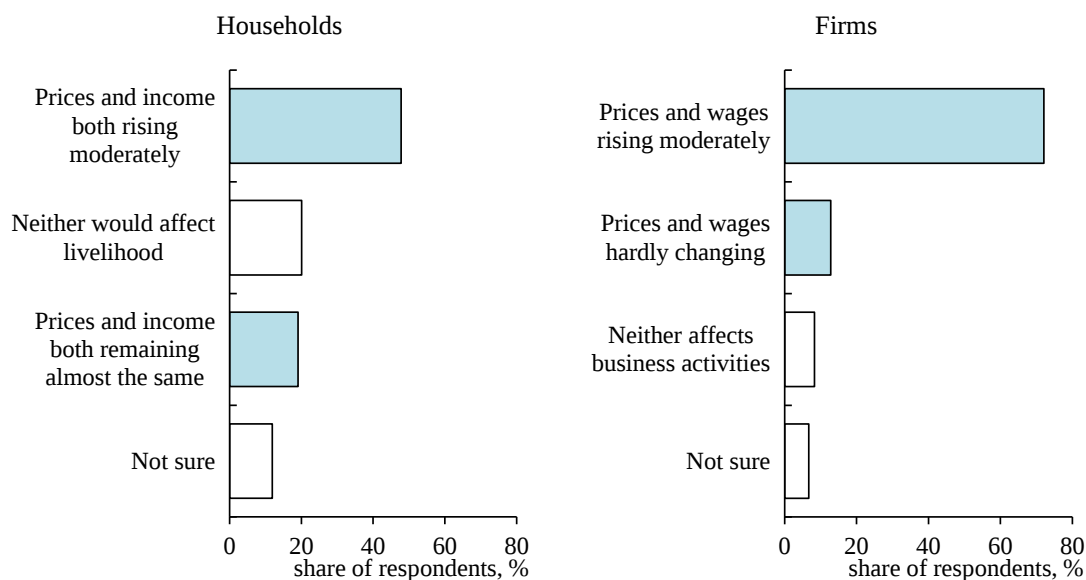
Source: Bank of Japan.

As I mentioned earlier when I discussed economic activity and prices, I believe it has become more likely that the price stability target will be achieved earlier than expected, considering the agreement in Japan-U.S. negotiations on tariff policy, the positive wage- and price-setting behavior being maintained among firms, and upside risks to prices. If the Bank raises its policy interest rate too late and prices become substantially higher than expected -- that is, if

the Bank falls behind the curve -- it will have to conduct policy interest rate hikes rapidly to stabilize prices, which could ultimately inflict significant damage on Japan's economy.

Chart 17 shows the response of households and firms when asked about their preferences regarding prices, income, and wages. The most common response from both households and firms was that they preferred a situation in which both prices and income (wages) rise moderately. After a long period in which both prices and wages hardly changed, Japan's economy has finally transitioned to a situation in which they both rise. It is now vital to establish these rises at favorable levels that can be described as moderate. Japan's economy must avoid returning to a situation in which both prices and wages hardly change due to premature monetary tightening. At the same time, the economy must avoid persistent inflation that cannot be described as moderate. Furthermore, I feel it is necessary to recognize that, if interest rates are too low relative to the inflation rate, the real value of deposits will continue to decrease, and households that do not benefit from wage increases, such as retirees, will continue to face difficult times.

Chart 17: Preferences regarding Prices, Income, and Wages



Note: Figures for households are based on the *Opinion Survey on the General Public's Views and Behavior* (September 2024 Survey). Those for firms are based on the *Survey regarding Corporate Behavior since the Mid-1990s*.
Source: Bank of Japan.

Given that there are currently both upside and downside risks, I do not believe that the Bank should immediately raise the policy interest rate to a restrictive level in an attempt to curb inflation. That said, with risks to prices becoming more skewed to the upside, in order to

prevent future shocks arising from possible rapid policy interest rate hikes, I believe that the Bank is now in the phase of deciding on raising its policy interest rate, thereby adjusting the degree of monetary accommodation and setting the rate a little closer to the neutral interest rate.

Thank you.