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Bank of Japan

Economic Activity, Prices, and Monetary Policy in Japan

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(English translation based on the Japanese original)

I. Developments in Economic Activity and Prices

I would like to start my speech with a look at developments in economic activity and prices.

At the Monetary Policy Meeting (MPM) held on April 26 and 27, 2018, the Bank of Japan published the *Outlook for Economic Activity and Prices*, or the Outlook Report. In this report, the Bank presented its projections for Japan's economic activity and prices through fiscal 2020.

I will explain developments in economic activity and prices by presenting the main content of the Outlook Report.

A. Overseas Economies

Let me first touch on developments in overseas economies. The Bank's assessment is that overseas economies have continued to grow firmly on the whole.

In terms of the outlook, global production and trade activity in the manufacturing sector are likely to be firm and both advanced and emerging economies are projected to grow in a well-balanced manner. A similar view was presented in the *World Economic Outlook* (WEO) released in April 2018 by the International Monetary Fund (IMF).

Looking at developments by major region, the U.S. economy is expected to keep expanding and the European economy is also projected to continue recovering.

The Chinese economy will likely continue to broadly follow a stable growth path as the authorities conduct fiscal and monetary policy in a timely manner.

Other emerging economies and commodity-exporting economies are likely to continue their moderate recovery on the whole.

There are both upside and downside risks to overseas economies, and I consider the outcome of protectionist moves in the United States as the downside risk that is of greatest concern. In the short term, growing uncertainty over U.S. trade policy will likely lead to a sharp rise in volatility in global financial markets. This could in turn exert adverse effects on the sentiment of firms and households. In the medium to long term, if such protectionist moves were to increase globally, this may significantly affect the business strategies of global firms, and the subsequent impact on the capital flow of trade and investment cannot be ignored. Therefore, I will closely monitor whether the protectionist moves entail the risk of causing any imbalances in the global capital allocation.

B. Japan's Economy and Price Developments

1. Current situation

Now I would like to move on to developments in economic activity and prices in Japan.

The Bank's assessment is that Japan's economy is expanding moderately, with a virtuous cycle from income to spending operating. Industrial production has been on an increasing trend, reflecting the increases in demand both at home and abroad, and labor market conditions have continued to tighten steadily. As a result, the output gap -- which shows the utilization of labor and capital -- has widened steadily within positive territory.

On the domestic demand side, business fixed investment has continued on an increasing trend with corporate profits and business sentiment maintaining their improving trend. According to the June 2018 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), business fixed investment plans for fiscal 2018, especially those of large enterprises, showed firms' solid stance. This is evidenced by, for example, the fact that fixed investment plans on a basis close to GDP definition saw a year-on-year increase of 8.7 percent -- a level clearly exceeding the past average of 4.4 percent for the June *Tankan* surveys during the period of fiscal 2004-2017. Turning to the household sector, housing investment has been weakening somewhat, but private consumption has been increasing moderately, albeit with fluctuations, against the background of steady improvement in the employment and income situation. Exports have been on an increasing trend on the back of the firm growth in overseas economies that I mentioned earlier.

On the price front, the year-on-year rate of change in the consumer price index (CPI) for all items less fresh food is in the range of 0.5-1.0 percent, reflecting a rise in energy prices.

2. Outlook

I will now look at the outlook for Japan's economy during the projection period, which covers from fiscal 2018 through fiscal 2020. The economy is likely to continue its moderate expansion. Domestic demand is likely to follow an uptrend, mainly against the background of highly accommodative financial conditions and the underpinnings through government spending. Exports are expected to continue their moderate increasing trend along with the growth in overseas economies. Reflecting this outlook, the economy is likely to continue growing at a pace above its potential in fiscal 2018. From fiscal 2019 through fiscal 2020, the economy is expected to continue on an expanding trend supported by external demand, although the growth pace is projected to decelerate due to a cyclical slowdown in business fixed investment and the effects of the scheduled consumption tax hike. Looking at the medians of the Policy Board members' forecasts in the April 2018 Outlook Report, the real GDP growth rate is projected to be 1.6 percent for fiscal 2018, and 0.8 percent each for fiscal 2019 and 2020.

Let me explain the outlook in detail by major component. First, business fixed investment is likely to continue increasing. This is because, in a situation where extremely stimulative financial conditions are maintained, fixed investment will be positively affected by an improvement in corporate profits, the materialization of the effects of projects conducted under the Fiscal Investment and Loan Program as well as the effects of investment-enhancing tax incentives, and a moderate improvement in growth expectations. Specifically, an increase is likely to be seen in investment such as, (1) that intended for domestic capacity expansion in line with the economic expansion; (2) that related to the 2020 Olympic Games and urban redevelopment projects; (3) that aiming at improving efficiency and saving labor in order to deal with, for example, the labor shortage; and (4) in research and development for growth areas. Private consumption is expected to follow a moderate increasing trend, due mainly to an increase in employee income as well as replacement demand for durable goods, and housing investment is expected to remain more or less flat. Exports will likely continue their increasing trend for the time being, as those of capital goods and IT-related goods, in which Japan has a comparative advantage, are likely to be firm. Thereafter, they are expected to continue their moderate increasing trend, due mainly to the improvement in overseas economies. Industrial production will likely continue to increase firmly for the time being, and thereafter is projected to continue on a moderate increasing trend.

The year-on-year rate of change in the CPI (all items less fresh food) is likely to increase toward 2 percent. This is because, although upward pressure of energy prices is likely to wane moderately, firms are likely to gradually shift their stance toward raising wages and prices with the improvement in the output gap, and inflation expectations are expected to gradually rise. Looking at the medians of the Policy Board members' forecasts in the April 2018 Outlook Report, the year-on-year rate of change in the CPI (all items less fresh food) is projected to be 1.3 percent for fiscal 2018 and -- on a basis excluding the effects of the scheduled consumption tax hike -- 1.8 percent each for fiscal 2019 and 2020.

Developments in prices since the release of the April 2018 Outlook Report have been slightly weak relative to what had been assumed, but I believe that the momentum for price rises remains intact.

I believe that there are the following risks to the outlook. Risks to Japan's economic activity are developments in overseas economies, such as the U.S. economic policies and geopolitical risks, firms' and households' medium- to long-term growth expectations, fiscal sustainability in the medium to long term, as well as the effects of the consumption tax hike scheduled to take place in October 2019. Risks to prices, in addition to the risks that I just mentioned, are developments in firms' and households' medium- to long-term inflation expectations, the fact that there are items for which prices are not particularly responsive to the output gap, as well as developments in foreign exchange rates and international commodity prices going forward.

In assessing the outlook for developments in economic activity and prices, I am paying particular attention to the effects of the scheduled consumption tax hike. On this point, the Bank estimated in the April 2018 Outlook Report that the net burden on households around the time of the consumption tax hike was expected to be smaller than that of the two previous consumption tax hikes. In fiscal 1997, apart from the hike in the consumption tax rate by 2 percentage points to 5 percent, there were additional increases in the household burden in the form of a termination of income tax reductions and an increase in medical costs resulting from reforms of medical care insurance. Together, these were estimated to have resulted in an increase of over 8 trillion yen in the net burden on households. In fiscal 2014, the tax rate was raised by 3 percentage points to 8 percent, and the increase in the net burden on households was estimated to have been about 8 trillion yen. Although measures were taken to reduce the burden, such as increases in welfare benefits, the effects of such measures were lessened by an increase in pension-related burdens. On the other hand, in fiscal 2019, even though the consumption tax rate is scheduled to be raised by 2 percentage points to 10 percent, there are plans to implement a number of measures to mitigate the burden -- such as a reduced tax rate and an increase in welfare benefits for pensioners -- along with the provision of free education. As a result, the net burden on households is estimated to be about 2 trillion yen. Of course, these estimates merely indicate mechanical computations of the net burden on households, and there is inevitably considerable uncertainty as to the impact of the consumption tax hike mainly because the impact on the sentiment of households may differ significantly according to their financial conditions. Given the recent favorable employment situation, the sentiment of households whose main source of income is wages is expected to remain reasonably firm. Meanwhile, households whose main source of income is pensions are expected to be significantly affected by developments in consumer prices of such basic items as food and gasoline, although there are plans to implement measures to mitigate the burden. I believe that it is necessary to carefully monitor the balance of these factors.

II. The Bank's Monetary Policy

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

A. Making Financial Conditions Highly Accommodative

Since the introduction of quantitative and qualitative monetary easing (QQE) in 2013 with a view to achieving the price stability target of 2 percent, the Bank has been maintaining highly accommodative financial conditions by consistently pursuing strong monetary easing. The Bank has been trying to push down the entire yield curve through its large-scale purchases of Japanese government bonds (JGBs) under the framework which I will touch upon later.

The maintenance of highly accommodative financial conditions has led to an improvement in the funding conditions of firms. Importantly, availability of funds has been improving further among small firms in particular. Financial institutions' lending attitudes as perceived by firms are becoming very proactive. In the *Tankan* surveys, the diffusion index (DI) for financial institutions' lending attitudes for small firms has been at a high level last seen at the end of the 1980s. The same can be said about the financial positions of firms. As suggested by the DI for firms' financial positions in the *Tankan* surveys, the momentum for improvement in financial positions has recently been strengthening, particularly among small firms. This improvement in firms' funding conditions is leading to firms' solid stance on business fixed investment, which I mentioned earlier, although the pace of this increase is moderate relative to the high level of corporate profits. This highlights, among other factors, the feature of the current phase of economic recovery in which both domestic and external demand have been driving the economy in a relatively well-balanced manner.[1]

Under these circumstances, the economic activity of firms and households has become invigorated, and the output gap has improved steadily. The Bank believes that it has strongly supported Japan's economic activity by maintaining such accommodative financial conditions.

B. QQE with Yield Curve Control

The framework of QQE with Yield Curve Control adopted by the Bank consists of two major components.

The first component is "yield curve control," in which the Bank controls short-term and long-term interest rates. In the current framework, introduced in September 2016, the Bank sets the short-term policy interest rate and the target level of the 10-year JGB yields as its operating targets. At present, in the guideline for market operations, the Bank sets the short-term rate at minus 0.1 percent and the target level of JGB yields at around 0 percent,

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[1] According to the "Survey of Corporate Attitudes towards Capital Investment in 2018" released by Teikoku Databank, Ltd. on May 16, 2018, in the case of capital investment to the value of 50 million yen or more, about half of firms raised funds for such investment by borrowing from financial institutions.

and conducts JGB purchases so as to achieve this target level. These large-scale purchases of JGBs enable the maintenance of highly accommodative financial conditions, as discussed earlier.

The second component is an "inflation-overshooting commitment," in which the Bank commits itself to continuing to expand the monetary base until the year-on-year rate of increase in the observed CPI exceeds the price stability target of 2 percent and stays above the target in a stable manner. While it is originally allowed to exceed 2 percent as the price stability target needs to be achieved on average over the business cycle, the Bank's commitment demonstrates its unwavering determination not to terminate monetary easing before the price stability target of 2 percent is achieved. In the case of Japan, as is often pointed out, we have yet to reach the situation where people's perception of prices, or so-called inflation expectations, is anchored around the price stability target. In this situation, sending such a strong message is of great significance in anchoring inflation expectations at 2 percent.

C. The Need for Persistent, Strong Monetary Easing

While the Bank's strong monetary easing has showed its intended effects through the maintenance of highly accommodative financial conditions, it is also true that observed prices have not yet been sufficiently firm relative to the steady improvement in economic activity.

As it has become clear that the deflationary mindset is more persistent than was initially assumed, the following opinions about the Bank's monetary policy have increasingly been heard. Specifically, some claim that the price stability target of 2 percent is not needed in Japan. Others -- while acknowledging the need for the 2 percent target -- question the continuation of strong monetary easing. They claim, for example, that the level of interest rates should be adjusted by taking into consideration financial institutions' profits, among other factors. I will discuss the first opinion in detail later. Let me first address the second opinion.

At each MPM, the Bank decides the guideline for market operations based on a comprehensive consideration of (1) the possible spillover effects on bank lending rates and issuance rates for corporate bonds, (2) the impact on economic activity, and (3) the impact on financial functioning, among other factors. As the Bank stated in the *Comprehensive Assessment: Developments in Economic Activity and Prices as well as Policy Effects since the Introduction of QQE*, released in September 2016, the impact on financial functioning should be taken into consideration when conducting monetary policy. In fact, it warrants attention that financial institutions' lending margins have been shrinking due, for example, to strong monetary easing and intensifying competition among banks. It should be noted, however, that since the 1990s, deposit and lending margins have been on a narrowing trend with low economic growth, and in that sense, this has long been a major challenge for financial institutions. In addition, it is an issue of urgent priority to take measures from a medium- to long-term perspective to respond to FinTech and other technological innovations and to changes in the external environment, such as the decline in both population and the number of firms. Structural problems -- which will have an impact on financial institutions' business environment -- and the effects of monetary easing should be analyzed and discussed independently of each other.

At present, Japan's economy has finally reached a state of being no longer in deflation, which is commonly defined as a sustained decline in prices. Given this, it is necessary to ensure that the economy fully overcomes deflation. Needless to say, the Bank does not aim solely at price rises. It is emphasized in the joint statement by the government and the Bank released in 2013 that the achievement of the price stability target of 2 percent should be accompanied by the strengthening of the growth potential of the economy.[2] In addition, in a speech delivered in May 2013, the month following the introduction of QQE, then Deputy Governor Hiroshi Nakaso said that "[t]he price stability target we aim at should be achieved in a virtuous cycle in which the real economy improves in a balanced manner, accompanied by an increase in corporate profits, employment, and wages."[3] On the other hand, as I will discuss in detail later, it is extremely important that Japan's economy fully overcomes

[2] "Joint Statement of the Government and the Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth," January 22, 2013.
[3] Hiroshi Nakaso, "Basic Idea Underlying 'Quantitative and Qualitative Easing'," Speech at the International Conference Organized by the Economic and Social Research Institute, Cabinet Office, Government of Japan, May 31, 2013.

deflation, which is a challenge that the economy has faced for many years.

Amid the persistent deflationary mindset, it may take some time to achieve the price stability target of 2 percent. While strong monetary easing has been maintained for a long period, it is appropriate to continue with strong monetary easing in a persistent and sustainable manner, while being more careful than ever when examining developments in economic activity and prices as well as financial conditions.

III. The Price Stability Target: Why Is It 2 Percent?

Five and a half years have passed since the Bank introduced the price stability target in 2013, but the necessity of the 2 percent price stability target in terms of the year-on-year rate of change in the CPI seems to have not yet been widely accepted by the public.

The Bank's conduct of monetary policy is aimed at "achieving price stability, thereby contributing to the sound development of the national economy." Price stability is defined conceptually as "a state where various economic agents including households and firms may make decisions regarding such economic activities as consumption and investments without being concerned about the fluctuations in the general price level."[4] While it seems that the intuitive desirability of price stability may be readily accepted by the public, defining price stability as a specific numerical value of a particular price index makes it difficult to gain understanding since the definition must inevitably be based on somewhat arbitrary grounds. Overseas central banks also face similar difficulties. In a speech given in January 2017, then Federal Reserve Board Chair Janet L. Yellen -- noting that price stability does not mean having no inflation whatsoever -- explained that, "[b]ased on research and decades of experience, we define [the level of inflation considered as 'price stability'] as 2 percent a year."[5] She then added that most other major central banks adopt an inflation objective similar to the 2 percent price stability defined by the Federal Reserve.

If high inflation is undesirable for the public, the question naturally arises as to why central

[4] Bank of Japan, "The 'Price Stability Target' under the Framework for the Conduct of Monetary Policy," January 22, 2013.

[5] Janet L. Yellen, "The Goals of Monetary Policy and How We Pursue Them," Remarks at the Commonwealth Club, San Francisco, California, January 18, 2017.

banks do not aim for an inflation rate of 0 percent.[6] A number of technical reasons aside, among those central banks that define price stability as an annual inflation rate of 2 percent, the common answer is that this creates a buffer against falling into deflation.[7] This buffer has the following dual meaning: (1) securing a safety margin to avoid deflation as far as possible; and (2) securing room for central banks to reduce interest rates -- that is, to put it simply, since a nominal interest rate level that is neutral to economic activity is determined by the sum of the economy's potential growth rate and an inflation rate, either a rise in potential growth rates or in inflation rates produces an equivalent rise in the level of the neutral nominal interest rate, thereby creating room for monetary easing through interest rate control.

I would like to touch on two points relating to this issue, which I believe are important. The first is the costs of deflation. In Japan, the perception that "deflation should be avoided at all costs" seems to be weaker than in other countries. Particularly following the 2008 global financial crisis, Japan's experience of facing deflation and economic stagnation for a prolonged period has been referred to abroad as "Japanization," and studies have been made to avoid the situation that Japan's economy has faced. One example is a special report published in the American magazine *The International Economy* in 2017, entitled "Is the World at Risk of the 'Japan Disease'?"[8] Authorities, scholars, and experts dealing with economic and financial issues around the world are still engaged in active discussions over the possibility of their respective economies falling into a situation similar to that experienced by Japan's economy and on measures to avoid such an outcome.

Japan's deflation has been receiving attention globally because protracted deflation, even when it is mild and does not produce a deflationary spiral, is viewed as imposing a great burden on the economy for a prolonged period.

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[6] It appears that similar questions are also being raised in the United States, where people's inflation expectations seem to be anchored at around 2 percent. Then Federal Reserve Chair Janet L.Yellen referred to this point in the speech at the Commonwealth Club cited above.

[7] As indicated by Japan's experience of suffering from prolonged deflation, the difficulty of overcoming deflation has become well known. This is perhaps one of the factors that motivated major central banks to reach a consensus of defining price stability as an annual inflation rate of 2 percent.

[8] "Is the World at Risk of the 'Japan Disease'?" *The International Economy*, Summer 2017.

Why exactly is deflation problematic? For households, it is problematic because it often goes hand-in-hand with a decline in their wages. There may be some who argue that, putting aside wages, deflation is actually a desirable phenomenon because it increases real income. Indeed, it may be true that a transient mild deflation would cause no particularly significant problems. If it continues for a protracted period, however, households will ultimately be forced to bear the burden through economic stagnation. Deflation becomes a factor weighing heavily on the economy through a number of channels. One of the well-known textbook examples of the problem is that, when deflation continues, households and firms -- in anticipation of further falls in prices of goods and services and continued uncertainty -- tend to opt for postponing expenditure and reining in borrowing. Such behavior could lead the overall economy to prolonged weak growth and deflation, thereby creating a vicious cycle within the economy.

Furthermore, there also is the complex problem that if deflation drags on, it becomes embedded in the habits of people, making an exit from deflation even more difficult. In the case of Japan, it seems that achieving the price stability target of 2 percent has been made more difficult by the fact that the experience of over 15 years of deflation has become entrenched in people's mindset. In light of these points, a complete exit from deflation under the price stability target of 2 percent will ultimately be desirable for households in Japan. While the rest of the world is trying to learn the lessons of Japan's long period of deflation, we should also face our own experience more squarely.

The second point concerns the importance for Japan of pursuing price increases that are more or less equivalent to those of other countries. Two percent inflation is often referred to as the global standard. More essentially, however, it should be emphasized that the realization of similar inflation rates by Japan and other countries will bring stability of exchange rates in the long run, and ultimately the stability of financial markets and corporate activities. More specifically, from the perspective of corporate managers, while exchange rates fluctuate as a matter of course, if the rates come to be perceived as no longer having long-term trends, reflecting differences in inflation rates at home and abroad, they will no longer significantly undermine business sentiment, albeit with a certain degree of fluctuation. In a situation where further globalization of Japan's economy is expected, Japan must move in tandem with overseas economies to achieve stable growth, in the sense of domestic prices rising to the same degree as those in other economies.