



September 25, 2023

Bank of Japan

## **Japan's Economy and Monetary Policy**

*Speech at a Meeting with Business Leaders in Osaka*

**UEDA Kazuo**

*Governor of the Bank of Japan*

(English translation based on the Japanese original)

## **Introduction**

It is my great pleasure to have the opportunity today to exchange views with a distinguished gathering of business leaders in the Kansai region. I would like to take this chance to express my sincerest gratitude for your cooperation with the activities of the Bank of Japan's branches in Osaka, Kobe, and Kyoto. This is the first time in 20 years, since I was a member of the Bank's Policy Board in 2003, that I have had this kind of chance to meet with those of you in the Kansai business community. I recall that it was very stimulating to exchange views with the business community, and I look forward to hearing your candid opinions today as well.

Before hearing from you, I would like to talk about developments in Japan's economic activity and prices and explain the Bank's thinking on the conduct of monetary policy.

## **I. Japan's Economic Activity**

### ***Current Situation of Economic Activity***

Let me start by talking about the current situation of economic activity in Japan. Japan's economy has recovered moderately, with the materialization of pent-up demand, i.e., demand that had been suppressed during the pandemic, and a waning of supply-side constraints (Chart 1).

In the household sector, private consumption has increased moderately and steadily, as pent-up demand has materialized, mainly for accommodations as well as eating and drinking (Chart 2). In addition, inbound tourism demand has recovered rapidly as entry restrictions to Japan have been lifted.

Turning to the corporate sector, activity for the nonmanufacturing industry has improved due to a recovery in private consumption. In the manufacturing industry, the favorable effects of an increase in automobile production, which reflects a waning of supply-side constraints for semiconductors, have spilled over to related industries. In this situation, exports have been at higher levels than before the pandemic (Chart 3). Corporate profits reached a new peak for the April-June quarter of 2023, partly due to progress in the

pass-through of cost increases to selling prices, and business fixed investment has continued to see firm developments.

### ***Key Points for the Future***

Although real GDP for the April-June quarter showed that domestic demand was somewhat weak, this improving trend in economic activity is likely to continue. However, pent-up demand and the waning of supply-side constraints, which have been driving economic recovery so far, cannot be expected by their nature to continue for long. In terms of economic developments after these tailwinds have subsided, it will be important to examine two points.

The first involves developments in overseas economies. As inflation rates have turned to a clear decline, the real economies of the United States and other countries have been firm and expectations for a soft landing have heightened. At this point, however, inflation rates are still somewhat high relative to the central bank targets. It is difficult to predict whether it is possible to maintain economic growth while bringing inflation rates back down to these targets. In the United States, some indicators suggest a softening in the labor market, such as a decline in the number of job openings; on the other hand, wages have continued to grow at a high rate and there is a possibility that the inflation rate will not decline as much as expected (Chart 4 [left chart]). In addition, continued attention is warranted on the risk that the impact of rapid interest rate hikes to date will turn out to be significant, with a lag, on both the real economy and the financial system. Moreover, due attention needs to be paid to the impact that developments in U.S. financial conditions have on global financial and foreign exchange markets. The slowdown in the pace of pick-up in the Chinese economy is also of concern. The recent weakness in the economy may be attributable to structural factors such as adjustments in the real estate market and a high youth unemployment rate (Chart 4 [right chart]). As there seem to be high uncertainties surrounding the momentum for economic recovery in China, the Bank will closely monitor developments in the economy.

The second point involves whether a virtuous cycle from firms' profits and households' income to their spending will intensify in Japan. In the corporate sector, with profits

remaining at high levels, firms have shown positive developments of allocating profits to investments for future growth, such as investments related to digitalization and decarbonization. In the household sector, even as the contribution from pent-up demand weakens, private consumption is expected to continue increasing, supported by a rise in income. At the moment, with price rises weighing on consumption, households' defensive attitudes toward spending -- such as shifting demand toward inexpensive products -- are being observed with regard to food and other items that have seen large price increases. Consumption of nondurable goods, including these items, has been sluggish as a result (Chart 5). While this year's annual spring labor-management wage negotiations ended in relatively high wage hikes, the Bank will pay close attention to whether moves to increase wages will continue, and whether the underpinning of private consumption from the income side will strengthen.

## **II. Price Developments in Japan**

### ***Sustainable and Stable Achievement of the Price Stability Target***

Next, I will turn to the topic of prices.

The Bank aims to achieve the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases. To this end, the following virtuous cycle needs to be realized: wages increase on the back of economic improvement, leading to stronger purchasing power of households, and in turn price hikes by firms; as a result, corporate sales and profits improve, which becomes the source of successive wage hikes. As such cycle takes shape, inflation expectations of firms and households are expected to rise, and forward-looking wage- and price-setting behavior that anticipates continued price increases is likely to gradually take root. This will result in a more sustainable virtuous cycle between wages and prices.

In this regard, since the late 1990s in Japan, in a situation where the mindset and behavior based on the assumption that wages and prices will not increase have been entrenched in society, wages have not risen firmly in tandem with prices. In the 2000s, although there were times when consumer prices saw relatively large increases owing to higher commodity prices, wages were stagnant, partly because of the severe competitive environment at home

and abroad. From the mid-2010s, as economic activity improved, the rates of increase in both wages and prices turned positive, but both turned out to be modest.

I believe that breaking out of this situation and achieving the virtuous cycle between wages and prices could be significantly beneficial both for individual firms and the overall economy. Up until now, many firms, finding it difficult to raise selling prices, had been somewhat compelled to adopt business strategies that emphasized cutting costs. They also had to be fairly cautious about raising wages, since that would add to fixed costs. If firms can break out of this situation and their price strategies become diverse, they will be better able to turn their focus to aspects other than cutting costs and will have greater scope for acting creatively, such as developing new, high value-added products. This may eventually create an opportunity that leads to their higher productivity. If firms promote these positive developments further, it is expected that the dynamism of the economy will be enhanced. I look forward to hearing your opinions on this matter later.

### ***Current Situation of Prices***

Now, with this goal in mind, I would like to take a look at recent price developments. The year-on-year rate of increase in the consumer price index (CPI, all items less fresh food) started accelerating last year, registering around 4 percent at the beginning of this year. The rate of increase subsequently decelerated, due in part to the government's economic measures pushing down energy prices, but that for August -- the latest figure -- was still at 3.1 percent (Chart 6 [left chart]).

Two forces are at work behind the price rises since last year. The first force is the pass-through of the significant rise in import prices since 2021 to selling prices. Looking at consumer prices by item, the rise has been noticeable for food and other items that use a large proportion of imported goods. Thus, it is clear that this first force has driven much of the price rises to date. That said, this force itself has been led by the temporary shock of increases in import prices, which by its nature will wane eventually. Firms have been passing on cost increases to selling prices to a greater extent than in the past, and it is true that the inflation rate has been above 2 percent for a prolonged period of time. However, it

cannot be judged from this fact alone that Japan's economy is closer to achieving the price stability target in a sustainable and stable manner.

The key to assessing whether it is closer to achieving the price stability target is the second force, which could trigger the virtuous cycle between wages and prices. This force concerns (1) whether the mechanism whereby wages increase on the back of economic improvement, leading to moderate inflation, will strengthen and (2) whether forward-looking wage and price setting that anticipates future price increases will in turn become widespread. In this regard, firms' behavior has begun to shift more toward raising wages and prices in some aspects recently, and my sense is that this second force is gradually starting to have an impact on prices. In terms of wage setting, many firms have shifted to a more strategic approach to recruit and retain employees. During the annual spring labor-management wage negotiations, many firms raised their wage growth rates, partly with the aim of gaining an edge in recruiting new graduates. In addition, the labor market for job changers, excluding public employment services, has expanded as more firms have made full-fledged efforts to recruit those in mid-career as regular employees, and competition over human resources has become more intense. With economic activity recovering and labor shortages growing, firms seem to have reconfirmed the structural issue that constraints on labor supply are likely to tighten, due in part to demographic changes.

In addition, there have been new developments in some firms' approach to setting selling prices. Some firms reported that it took time for them to raise prices last year despite higher costs, since they had not raised selling prices for a long time and lacked the know-how to do so. However, changes in this situation have been seen recently, with firms revising prices more frequently. Moreover, there have been moves to set prices strategically; not only have firms reflected input prices in selling prices, but they also have adopted, for example, dynamic pricing, where they change prices depending on the region or time of day. Some firms have also started to set prices in a forward-looking manner, in which they have raised selling prices in anticipation of future cost increases, such as in terms of wage costs. Such developments warrant attention as important changes that suggest a stronger linkage between wages and prices.

### ***Outlook for Prices***

I will now turn to the outlook for prices. The Bank's baseline scenario is that the main factor pushing up prices will gradually shift from the first force to the second force, intensifying the virtuous cycle between wages and prices. The first force -- namely, the effects of the pass-through of cost increases -- has been led by import prices, and the year-on-year rate of increase in these prices has decelerated after reaching a peak in the middle of last year (Chart 6 [right chart]). Although the first force is partly affected by developments in international commodity prices, it basically is expected to gradually wane. On the other hand, if firms' wage- and price-setting behavior continues to change, it is expected that the second force -- where wage growth accelerates owing to economic improvement, leading to moderate inflation -- will strengthen.

Having made note of these expectations, I must add that there are extremely high uncertainties surrounding the baseline scenario, and that, at this point, it is unclear whether it will bear out. Given, for example, that there will be less room for additional labor supply in Japan, partly due to demographic changes, it seems highly likely that, if the economy continues to improve, competition over human resources will become more intense and wage growth will rise. In fact, corporate behavior may change faster than expected. On the other hand, the argument that it takes considerable time for a fundamental change in a deflationary mindset to happen once it has become entrenched is also persuasive. In addition, if a negative shock were to occur, either in Japan or abroad, this could disrupt the momentum of the changes that have started to be observed and return wages and prices to a situation where they do not increase easily. With many firms withholding judgment at the moment about whether to continue with relatively high wage hikes next year and beyond, it is necessary to examine the extent to which changes in wage-setting behavior are sustainable.

### **III. The Bank's Conduct of Monetary Policy**

Next, I will explain the Bank's conduct of monetary policy.

As I mentioned earlier, the current situation is that changes have started to be seen in some aspects of firms' wage- and price-setting behavior, but there are extremely high

uncertainties as to whether these changes will become widespread. In this situation, the Bank judges that sustainable and stable achievement of the price stability target of 2 percent, accompanied by wage increases, has not yet come in sight. Japan's economy has entered a critical phase in terms of realizing a virtuous cycle between wages and prices, and what is important at this phase is to carefully nurture the buds of change in the economy. Based on this assessment of the situation, the Bank's basic thinking on the conduct of monetary policy is that it is necessary to patiently continue with monetary easing under the framework of yield curve control.

However, while the current framework for keeping long-term interest rates at low levels has a significant stimulus effect on the economy, it also carries the possibility of producing strong side effects in certain phases. Therefore, taking future uncertainties into account and striking a balance between positive effects and side effects allows the Bank to pursue the effects of monetary easing under the current framework. From this perspective, at the Monetary Policy Meeting held in July, the Bank decided to maintain its target level of 10-year Japanese government bond (JGB) yields at "around zero percent" and the fluctuation range of these yields at "around plus and minus 0.5 percentage points from the target level," while it decided to allow them to move beyond the 0.5 percent bounds depending on market conditions, regarding the upper and lower bounds of the range as references, not as rigid limits, in its market operations (Chart 7). This is based on the assessment that, if upward movements in prices continue, attempting to strictly keep long-term interest rates at low levels could affect the functioning of bond markets and the volatility in other financial markets. I believe that conducting yield curve control with greater flexibility has had the effect of enhancing the sustainability of monetary easing under the current framework.

## **Conclusion**

Today, I have talked about recent economic and price developments and the Bank's conduct of monetary policy. I would like to conclude my speech by touching on the review of monetary policy from a broad perspective, which began in April.



Through the review, the Bank aims to deepen its understanding on the positive effects and side effects of various unconventional monetary policy measures it has adopted since the late 1990s and to gain insights that will be useful for future policy conduct (Chart 8). A crucial point in conducting the review is to evaluate the monetary policy measures, not in isolation, but in the context of interactions with Japan's economic conditions at each point in time. It is also necessary to gain a deeper understanding of the reasons why an environment in which prices did not increase easily persisted in Japan.

In proceeding with this review, it is important to incorporate diverse expertise and enhance the review's objectivity and transparency. Thus, using the network of its Head Office and branches, the Bank would like to pursue dialogue with firms. Today also represents a valuable opportunity to exchange views with business leaders in the Kansai region. I would appreciate hearing your candid opinions on topics such as Japan's economic activity and prices, changes in corporate behavior, and the positive effects and side effects of the Bank's various policy measures over the past 25 years.

Thank you very much for your attention.

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## Introduction

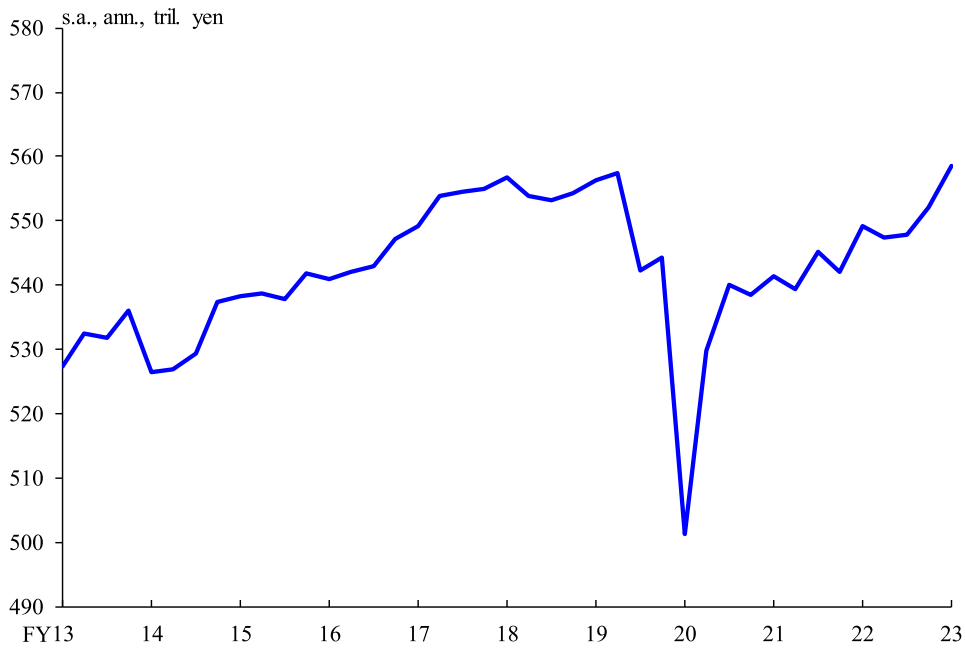
I. Japan's Economic Activity

II. Price Developments in Japan

III. The Bank's Conduct of Monetary Policy

Conclusion

# Real GDP

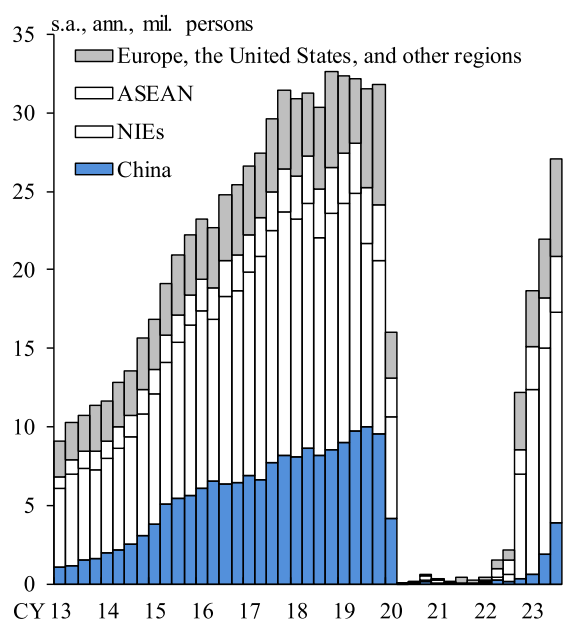
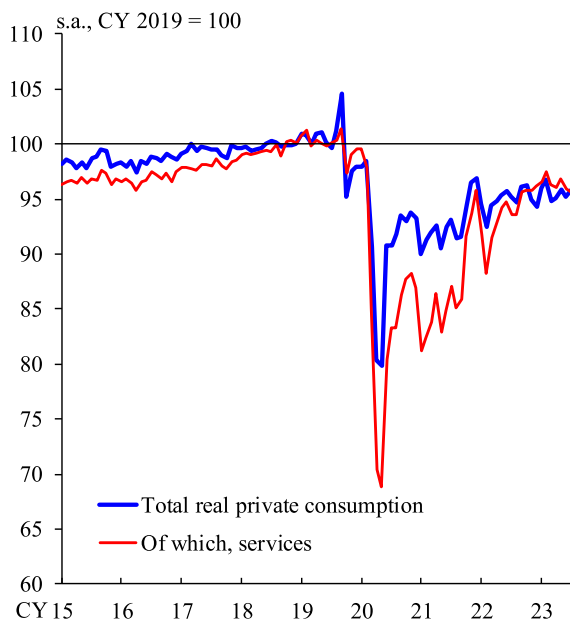


Source: Cabinet Office.

# Private Consumption

*Consumption Activity Index*

*Number of Inbound Visitors*



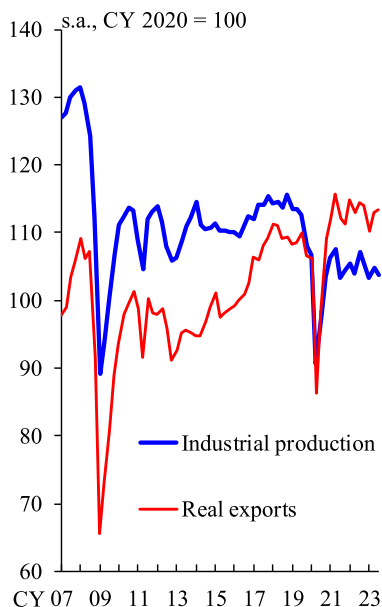
Notes: 1. In the left-hand chart, figures for total real private consumption are the real Consumption Activity Index (travel balance adjusted) based on staff calculations, which exclude inbound tourism consumption and include outbound tourism consumption.

2. In the right-hand chart, figures for Europe, the United States, and other regions include seasonal adjustment errors.

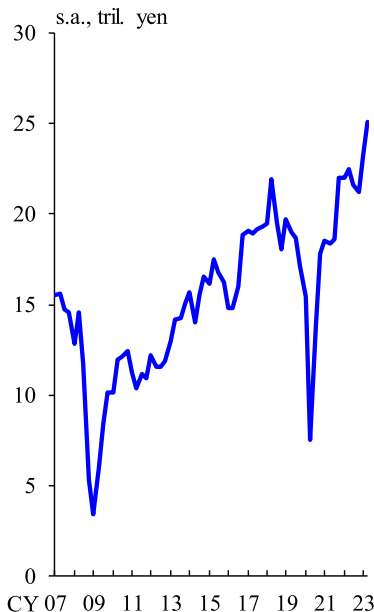
Sources: Bank of Japan; Japan National Tourism Organization (JNTO).

# Corporate Sector

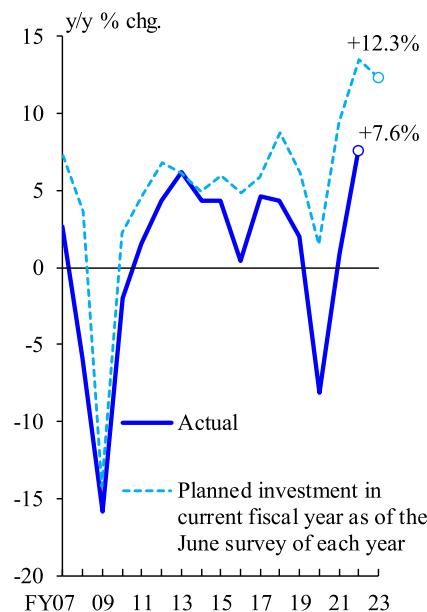
*Exports and Production*



*Current Profits*



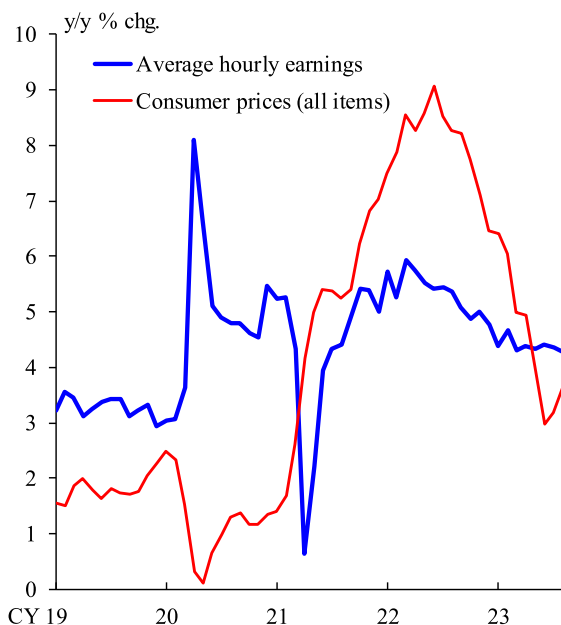
*Business Fixed Investment*



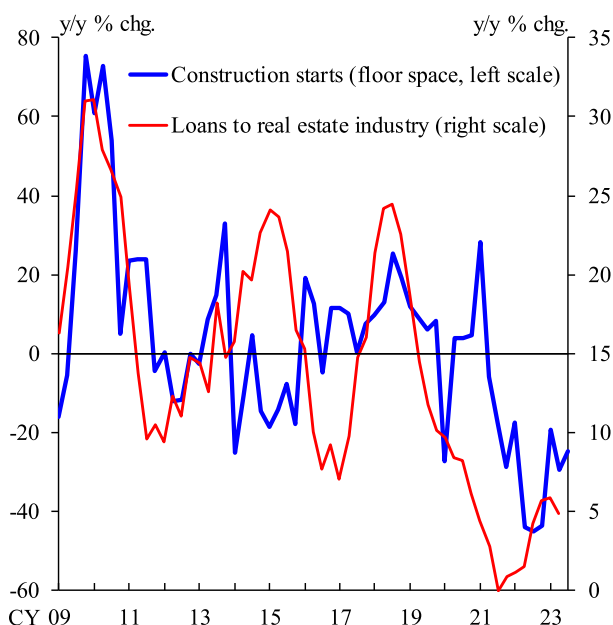
Notes: 1. In the middle chart, figures are based on the *Financial Statements Statistics of Corporations by Industry, Quarterly* and exclude "finance and insurance." Figures from 2009/Q2 onward exclude pure holding companies.  
2. In the right-hand chart, figures are based on the *Tankan*, including software and R&D investments and excluding land purchasing expenses. R&D investment is not included before the March 2017 survey. Figures are for all industries including financial institutions.  
Sources: Ministry of Economy, Trade and Industry; Ministry of Finance; Bank of Japan.

# Key Points for the Future: (1) Overseas Economies

*Wages and Prices in the United States*



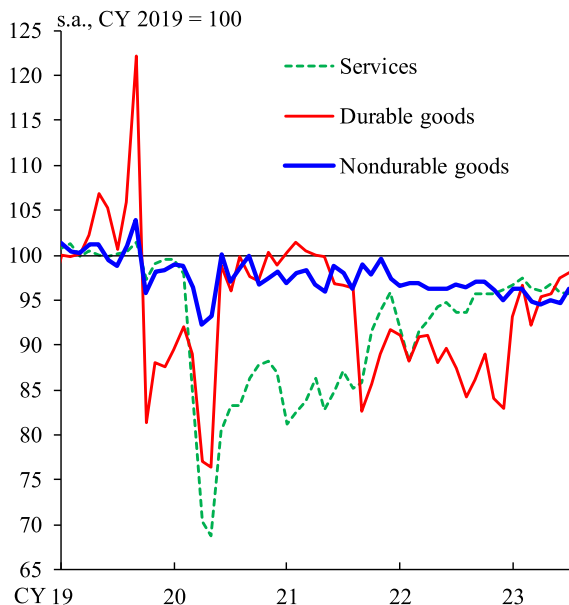
*Chinese Real Estate Market*



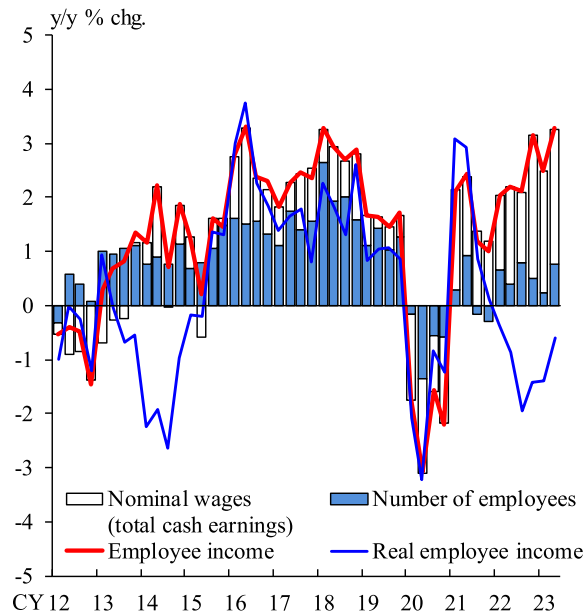
Sources: Haver; CEIC.

## Key Points for the Future: (2) Household Sector

*Private Consumption by Type*



*Employee Income*



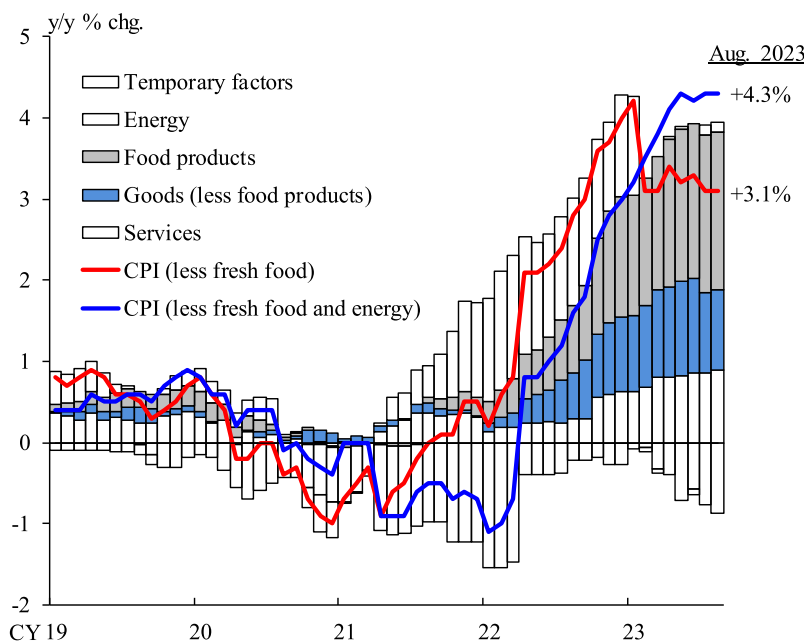
Notes: 1. In the left-hand chart, figures are based on the real Consumption Activity Index.

2. In the right-hand chart, Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. Employee income = Total cash earnings (*Monthly Labour Survey*) × Number of employees (*Labour Force Survey*). Figures from 2016/Q1 onward are based on continuing observations following the sample revisions of the *Monthly Labour Survey*. Figures for real employee income are based on staff calculations using the CPI (less imputed rent).

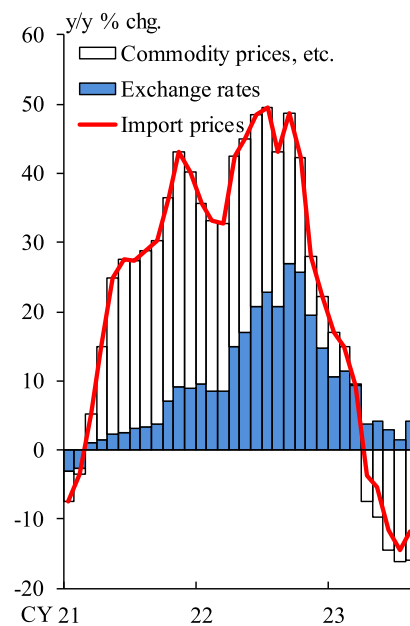
Sources: Bank of Japan; Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

## Consumer Prices and Import Prices

*Consumer Prices*



*Import Prices*



Notes: 1. In the left-hand chart, figures for temporary factors are staff estimates and consist of mobile phone charges and the effects of the consumption tax hike, policies concerning the provision of free education, and travel subsidy programs.

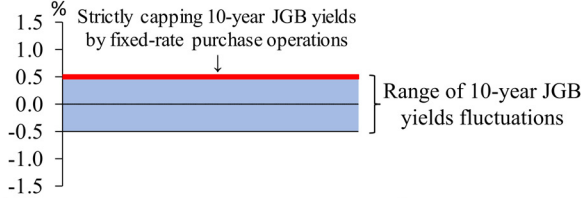
2. In the right-hand chart, the contribution of changes in commodity prices, etc. is calculated using changes in the import price index on a contract currency basis. The contribution of changes in exchange rates is calculated using the difference between the index on a yen basis and that on a contract currency basis.

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

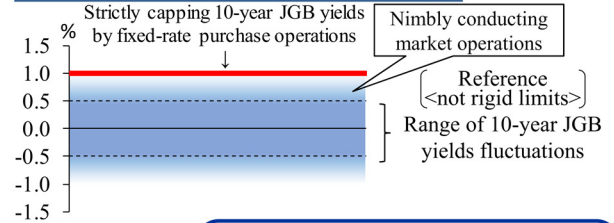
## Conducting Yield Curve Control (YCC) with Greater Flexibility

- The Bank judges that sustainable and stable achievement of the price stability target of 2 percent has not yet come in sight, and thus patiently continues with monetary easing.
- With extremely high uncertainties for economic activity and prices, the Bank enhances the sustainability of monetary easing by conducting YCC with greater flexibility.

### Previous Conduct of YCC



### Conduct of YCC with Greater Flexibility

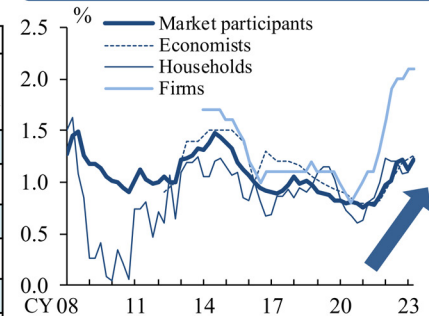


### Outlook for Prices

	y/y % chg.	
	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
Fiscal 2023	+2.5	+3.2
Forecasts made in Apr. 2023	+1.8	+2.5
Fiscal 2024	+1.9	+1.7
Forecasts made in Apr. 2023	+2.0	+1.7
Fiscal 2025	+1.6	+1.8
Forecasts made in Apr. 2023	+1.6	+1.8

Note: Figures indicate the medians of the Policy Board members' forecasts (point estimates).

### Inflation Expectations



Note: Figures for market participants, economists, households, and firms are from "QUICK Monthly Market Survey," "ESP Forecast," "Opinion Survey on the General Public's Views and Behavior," and "Tankan," respectively.

### Enhancing the sustainability of monetary easing by conducting YCC with greater flexibility

- If upside risks to Japan's economic activity and prices materialize
  - Decline in real interest rates
  - Mitigating the effects on the functioning of bond markets, etc.
- If downside risks to Japan's economic activity and prices materialize
  - Decline in long-term interest rates

## Conclusion

## Approach to Conducting the Monetary Policy Review from a Broad Perspective

### 1. Approach to Analyses

- The Bank will assess the effects of various unconventional monetary policy measures that have been implemented over the past 25 years in the context of interactions with developments in economic activity and prices at each point in time. In addition, it will analyze the impact of these measures on financial markets and the financial system, including their side effects.
  - Deepen understanding on (1) how various changes in the economic environment -- e.g., globalization and the declining and aging population -- have affected factors such as corporate and household behavior and the formation mechanisms of wages and prices and (2) the implications that the effects of these changes have had for monetary policy
  - Flexibly consider specific themes of the analyses during the course of the review

### 2. Approach to Exchanging Views and Other Initiatives

- The Bank will incorporate diverse expertise and take various initiatives with a view to enhancing the review's objectivity and transparency. Such initiatives include not only internal analyses but also those listed below.
  - Make use of existing series of materials, such as reports and surveys, and invite public comment
  - Exchange views on occasions such as meetings with local and business leaders
  - Hold discussions, such as at workshops (scheduled around December 2023 and May 2024)
  - Exchange views with foreign experts

### 3. Launch of a Webpage