September 12, 2024

Bank of Japan

Economic Activity, Prices, and Monetary Policy in Japan

Speech at a Meeting with Local Leaders in Okayama

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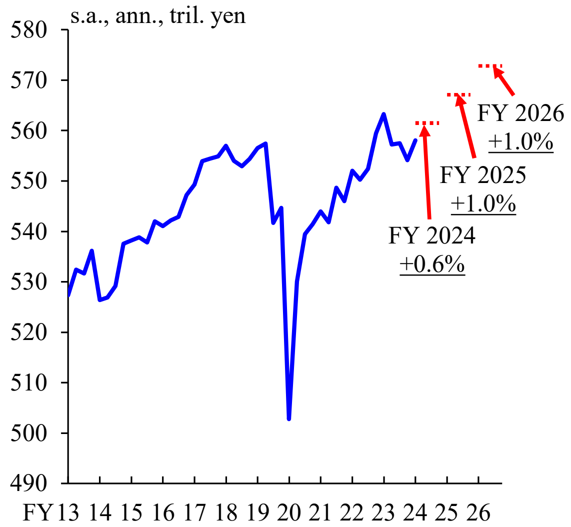
(English translation based on the Japanese original)

I. Economic Activity and Prices

A. Economic Activity

I will begin my speech by talking about economic activity in Japan. The Bank of Japan assesses that the economy has recovered moderately on the whole, although some weakness has been seen in part. In terms of the median of the Policy Board members' forecasts -- as presented in the July 2024 *Outlook for Economic Activity and Prices* (Outlook Report) -- Japan's real GDP growth rate is expected to be at 0.6 percent for fiscal 2024, 1.0 percent for fiscal 2025, and 1.0 percent for fiscal 2026 (Chart 1). While the projected growth rate for fiscal 2024 appears to be low, this reflects the impact of the negative growth registered toward the end of fiscal 2023, partly due to the effects of a suspension of production and shipments at some automakers. That said, looking at the growth rates during the course of fiscal 2024 on a quarter-on-quarter basis suggests that Japan's economy is likely to achieve firm growth. Thereafter, the economy is projected to keep growing at a pace above its potential growth rate, as a virtuous cycle from income to spending gradually intensifies.

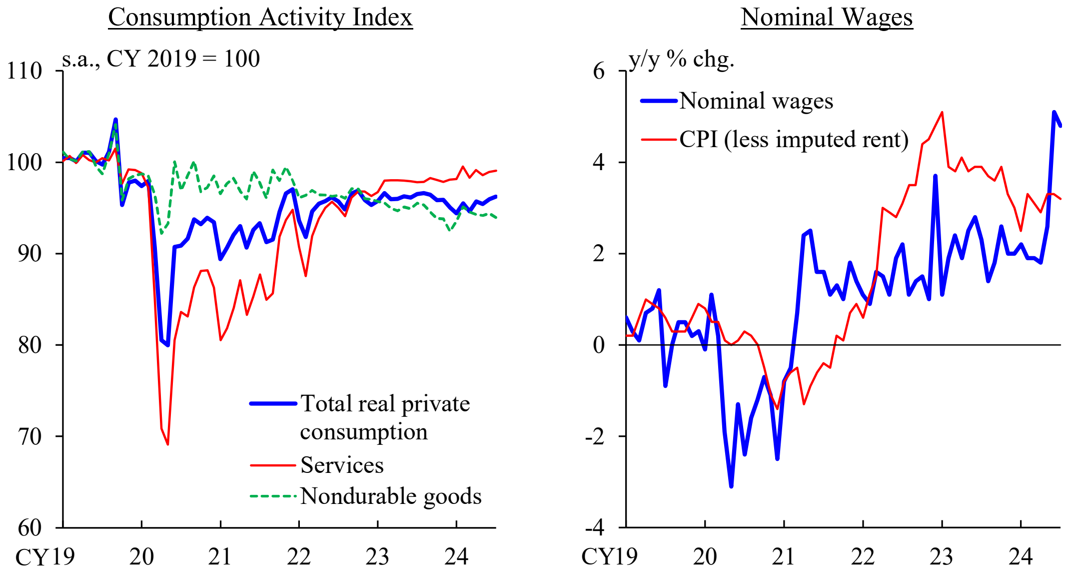
Chart 1: The Bank's Forecasts for Real GDP



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

As background to what I just outlined, let me now explain developments in private consumption and business fixed investment in detail. First, private consumption as a whole has been resilient, although consumption of nondurable goods, such as food and clothes, has followed a decreasing trend in real terms after excluding price rises, amid households' defensive attitudes toward spending in reflection of high prices (Chart 2). As for these defensive attitudes, while some households have shifted toward less expensive products due to high prices, many of them appear to be selective in their consumption -- that is, they actively spend on products or services that meet their values and cut back other spending. Given that consumer behavior could have changed in response to the COVID-19 pandemic, I feel that the actual condition of private consumption may not be as weak as the statistics suggest. With respect to income, real wages have improved recently, although for some time nominal wage growth was not keeping up with inflation. Regarding the outlook, private consumption is projected to increase moderately, underpinned by an improvement in real wages. This is in view of the following: (1) the results of the annual spring labor-management wage negotiations this year revealed that the wage growth rate was significantly higher than the previous year, including among small and medium-sized firms and (2) anecdotal information from firms -- which was gathered through the Bank's Head Office and branches -- suggests that a wider range of firms have actually been raising wages, partly because they

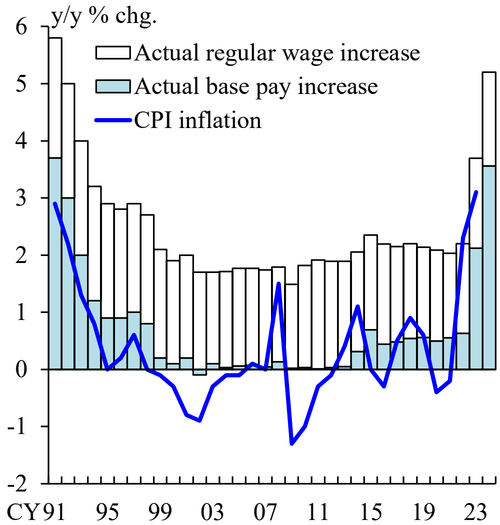
Chart 2: Private Consumption



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

are feeling the need to retain and recruit human resources to address labor shortages (Chart 3). Moreover, the fact that a rapid and one-sided depreciation of the yen -- which had a negative impact on consumer sentiment -- has been corrected to a certain extent is expected to promote the moderate increase in private consumption.

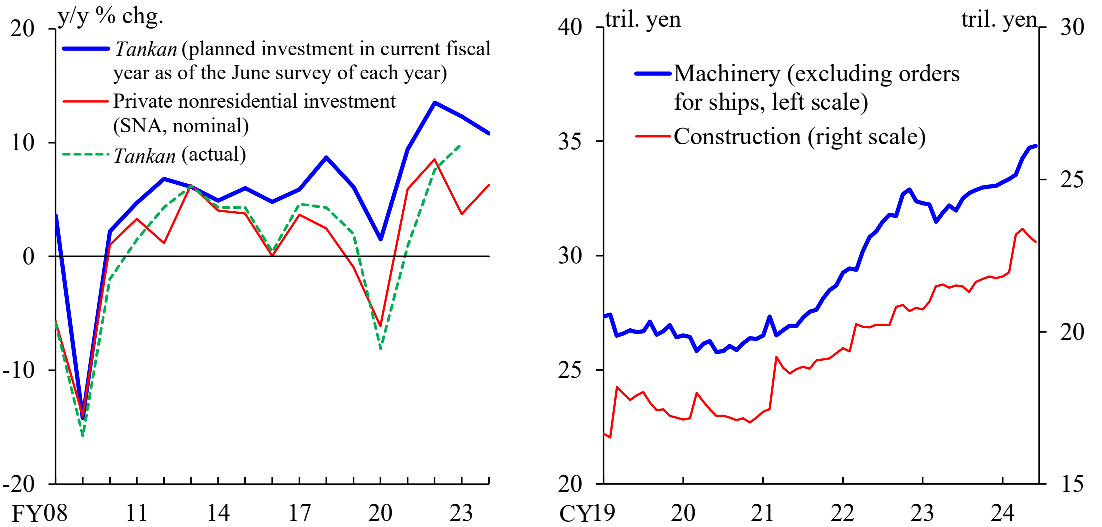
Chart 3: Results of the Annual Spring Labor-Management Wage Negotiations



Notes: 1. Figures for "CPI inflation" are for all items less fresh food, excluding the effects of the consumption tax hikes.
2. Figures for "actual base pay increase" and "actual regular wage increase" from 1991 to 2014 are those published by the Central Labour Relations Commission, while those from 2015 to 2024 are figures released by the Japanese Trade Union Confederation (Rengo). Figures are based on the wage negotiation results of labor unions for which the base pay increase is clear.
Sources: Central Labour Relations Commission; Ministry of Internal Affairs and Communications; Rengo.

Next, I will turn to business fixed investment. On the back of favorable corporate profits on the whole, business fixed investment has been on a moderate increasing trend; as for the business fixed investment plans in the June 2024 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the reported rate for fiscal 2024 indicates a relatively high increase compared with past June *Tankan* surveys (Chart 4). Under such circumstances, the remaining orders for machinery and construction have stayed on an increasing trend, as there have been some cases where firms postponed fixed investment in response to labor shortages. Regarding the outlook, although the amount of business fixed investment could be pushed down due to these postponements, such investment is likely to follow a long-term uptrend. This is due to firm demand for fixed investment, such as investment to address labor shortages and digital-related investment, as well as investments associated with the green transformation and with strengthening supply chains.

Chart 4: Business Fixed Investment



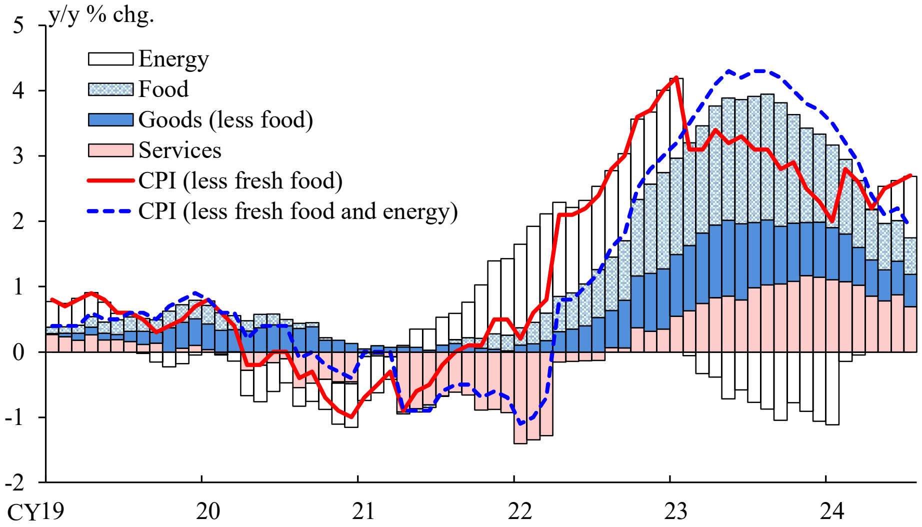
Notes: 1. In the left panel, *Tankan* figures include software and R&D investments and exclude land purchasing expenses. Figures are for all industries including financial institutions.
2. In the left panel, the figure for "private nonresidential investment" for fiscal 2024 is for 2024/Q2.
3. In the right panel, figures for "construction" are based on a survey of 50 major construction companies.

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

B. Price Developments

Turning to Japan's price developments, the year-on-year rate of increase in the consumer price index (CPI) for all items excluding fresh food has been lower than before, in the range of 2.5-3.0 percent recently; that for all items excluding fresh food and energy, for which prices fluctuate significantly, has been at around 2 percent (Chart 5). The contribution of goods

Chart 5: Consumer Prices

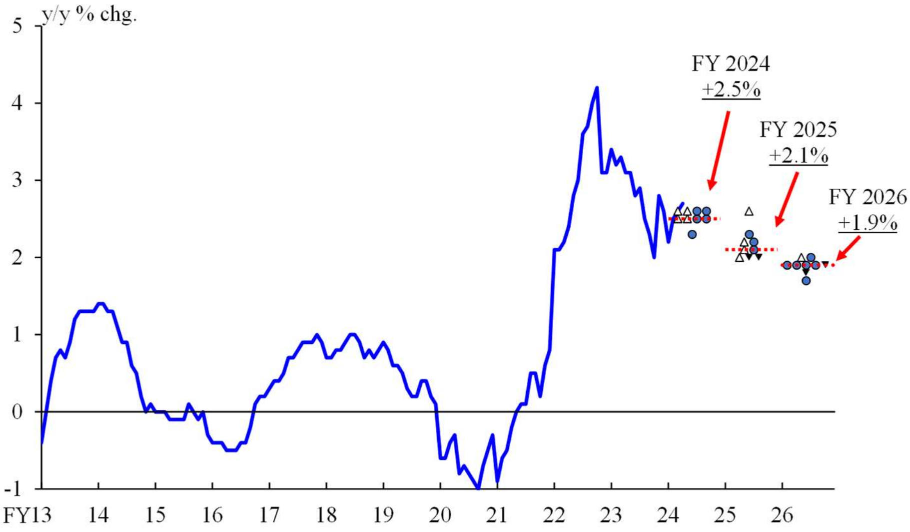


Source: Ministry of Internal Affairs and Communications.

prices to the rate of increase in the CPI has been declining due to the waning effects of a pass-through to consumer prices of cost increases led by the past rise in import prices. On the other hand, the CPI has been pushed up by increases in services prices resulting from the pass-through of higher personnel expenses to consumer prices.

In terms of the median of the Policy Board members' forecasts, the CPI (all items less fresh food) is projected to continue to see a year-on-year rate of increase of around 2 percent -- specifically, 2.5 percent for fiscal 2024, 2.1 percent for fiscal 2025, and 1.9 percent for fiscal 2026 (Chart 6). Although there could be an upward or downward deviation in CPI figures, price developments have been on track to achieve the price stability target. The Bank therefore assesses that the likelihood of realizing this target has continued to rise.

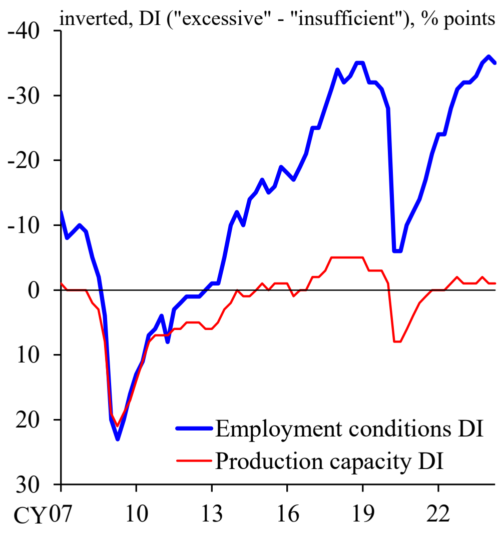
Chart 6: The Bank's Forecasts for the CPI



Notes: 1. Figures are the CPI for all items less fresh food, excluding the effects of the consumption tax hikes.
2. The locations of ●, △, and ▼ in the chart indicate figures for each Policy Board member's forecasts. The risk balance assessed by each Policy Board member is shown by the following shapes: ● indicates that a member assesses "upside and downside risks as being generally balanced," △ indicates that a member assesses "risks are skewed to the upside," and ▼ indicates that a member assesses "risks are skewed to the downside." The dotted lines show the medians of the Policy Board members' forecasts presented in the July 2024 Outlook Report.
Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

Regarding the outlook for prices, I am concerned that risks are possibly becoming more skewed to the upside. The first risk concerns the impact of labor shortages. The June *Tankan* suggests that firms perceive labor shortages to be at substantially high levels (Chart 7). My impression is that such shortages have become supply-side constraints, thereby causing some industries to face short supply and excess demand. For example, the hotel industry inevitably has to limit occupancy rates while the taxi industry has been suffering from a shortage of drivers. Furthermore, some manufacturing firms have been unable to operate at full capacity due to labor shortages. Such a situation could cause prices to deviate upward from the baseline scenario. Second, firms could make further progress than anticipated in passing on increased personnel expenses to selling prices, in a situation where wage growth is expected to be higher than the previous year. That said, firms, especially small and medium-sized firms, have continued to report that it has been difficult to pass on their employees' higher wages to selling prices. Third, import prices, which had once settled down, have been on an uptrend again, partly because the yen has depreciated from the beginning of this year, despite being corrected to a certain extent recently. In terms of passing on higher import prices, the cost pass-through rate -- which shows the extent to which firms pass on cost increases to product prices -- has been on the rise in recent years. Thus, the uptrend in import prices could have a greater impact on the CPI than before.

Chart 7: Firms' Perception of Labor and Production Capacity Shortages (*Tankan*)



Note: Figures are for all industries and enterprises.
Source: Bank of Japan.

II. Conduct of Monetary Policy

A. July 2024 Monetary Policy Meeting (MPM)

Now, I would 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 made in March 2024, it has regarded guiding the short-term interest rate as a primary policy tool. While the Bank intends to adjust the degree of monetary accommodation in response to an increase in the likelihood of achieving the price stability target, it decided at the July MPM to raise the target level of its short-term policy interest rate by 0.15 percentage points, to around 0.25 percent (Chart 8).

Chart 8: Change in the Guideline for Money Market Operations (July 2024)

- Japan's economic activity and prices have been **developing generally in line with the Bank's outlook**. Moves to raise wages have been spreading.
- The year-on-year rate of change in import prices has turned positive again, and **upside risks to prices require attention**.

Medians of the Policy Board members' forecasts (y/y % chg.)

	Fiscal 2024	Fiscal 2025	Fiscal 2026
Real GDP	0.6 (-0.2)	1.0 (—)	1.0 (—)
CPI (all items less fresh food)	2.5 (-0.3)	2.1 (+0.2)	1.9 (—)
CPI (all items less fresh food and energy)	1.9 (—)	1.9 (—)	2.1 (—)

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

Risk balance assessments on prices

Fiscal 2024	Fiscal 2025	Fiscal 2026
Upside	Upside	Balanced

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: (uncollateralized overnight call rate) **raised to "around 0.25%"** (previously "around 0 to 0.1%")

- 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 July Outlook Report will be realized, the Bank will accordingly continue to raise the policy interest rate and adjust the degree of monetary accommodation.

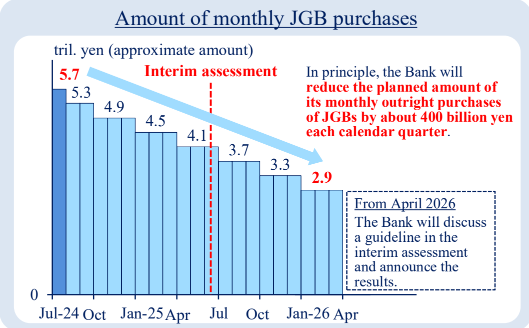
The Bank also decided on a plan for the reduction of its purchase amount of Japanese government bonds (JGBs) covering the period until March 2026, aimed at enhancing the predictability of its future JGB purchases and allowing long-term interest rates to be determined by the market (Chart 9). It should be noted, however, that the Bank has continued with JGB purchases to avoid bringing about discontinuous changes from the large-scale monetary easing conducted in the past, and not as an active monetary policy tool. Going into the details of the plan, the Bank intends to gradually reduce the amount of its monthly outright purchases of JGBs -- which amounted to about 6 trillion yen up until the July 2024 MPM --

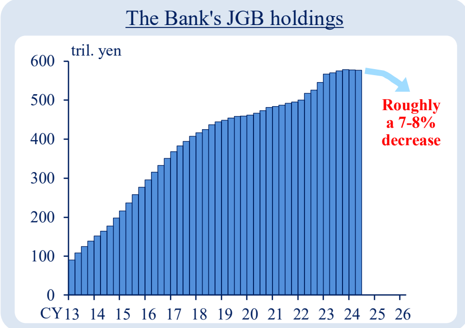
Chart 9: Plan for the Reduction of the Purchase Amount of JGBs (July 2024)

The concept of the plan for the reduction until March 2026

1. Long-term interest rates: to be formed in financial markets in principle
2. JGB purchases: appropriate for the Bank to reduce its purchase amount of JGBs in a predictable manner, while allowing enough flexibility to support stability in the JGB markets

Reduction in a Predictable Manner





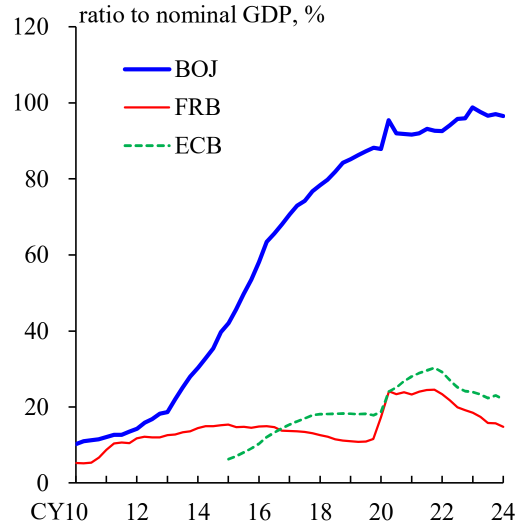
Allowing Enough Flexibility

1. The Bank will **conduct an interim assessment of the plan at the June 2025 MPM**.
2. In the case of a rapid rise in long-term interest rates, the Bank will make nimble responses by, for example, increasing the amount of JGB purchases.
3. The Bank is prepared to amend the plan at the MPMs, if deemed necessary.

to about 3 trillion yen over a period of around a year and a half. Moreover, with a view to allowing a certain degree of flexibility in the plan, the Bank's decisions included the following: (1) it would conduct an interim assessment of the plan in June 2025 and (2) in the case of a rapid rise in long-term interest rates, would make nimble responses by, for example, increasing the amount of JGB purchases regardless of the monthly schedule of such purchases.

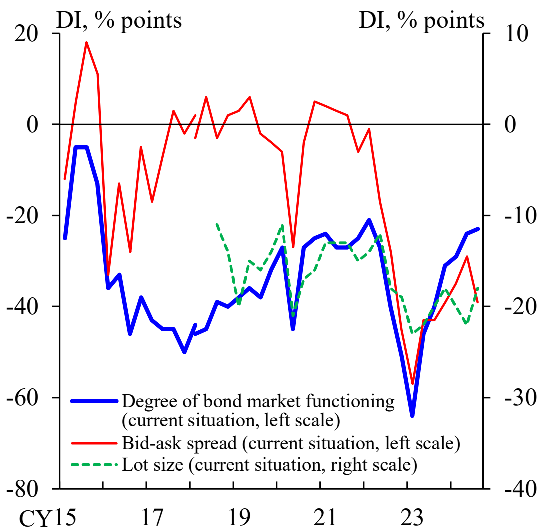
While the amount outstanding of the Bank's JGB holdings stands close to 600 trillion yen, the amount in terms of the ratio to nominal GDP is larger by far relative to the United States and Europe (Chart 10). Since JGBs are redeemed at maturity, reducing the purchase amount so that it falls below the redemption amount would lower the amount outstanding of the Bank's JGB holdings. Reducing the purchase amount at the pace decided at the July MPM, however, will require considerable time for the Bank to normalize its balance sheet -- that is, to reduce the amount outstanding of its JGB holdings to a level where further reductions are no longer necessary. That said, it is appropriate for the Bank to set the pace of reduction at this level to proceed with the reduction without causing market disruption. The degree of JGB market functioning has stayed low, albeit having improved, and such side effects of the Bank's large amount of JGB holdings will likely remain for some time in the process of normalizing the balance sheet (Chart 11).

Chart 10: Government Bond Holdings of Major Central Banks



Sources: Cabinet Office; Eurostat; Federal Reserve Board; U.S. Bureau of Economic Analysis; Bank of Japan.

Chart 11: Degree of Bond Market Functioning



Notes: 1. The DIs for "degree of bond market functioning," "bid-ask spread," and "lot size" are calculated as "high" - "low," "tight" - "wide," and "large" - "small," respectively.
2. The survey from February 2018 onward includes responses from major insurance companies, asset management companies, etc., in addition to those from eligible institutions for the Bank's outright purchases and sales of JGBs. Regarding the figures for February 2018, the reference data, which are based on responses only from eligible institutions for the Bank's outright purchases and sales of JGBs, are also indicated.
Source: Bank of Japan.

In my view, the Bank's future policy conduct will be crucial to normalizing large-scale monetary easing, and there is still a long way to go. Moreover, I have come to recognize once again the need for the Bank to carefully examine the balance between the positive effects and costs of quantitative monetary easing -- should the situation require reconsideration of such a policy measure in the future -- as well as the steps toward an exit I discussed earlier.

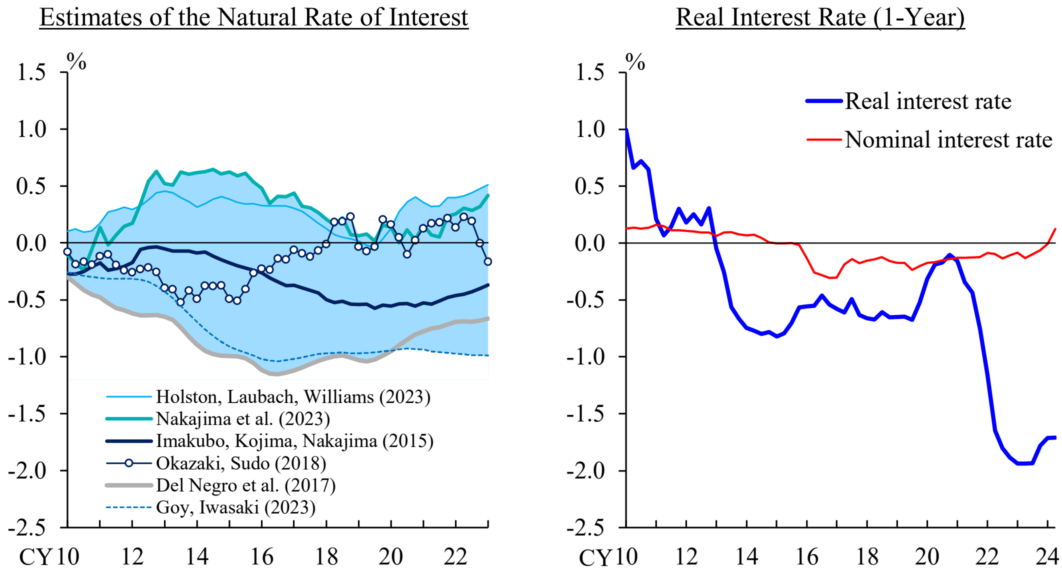
B. Conduct of Monetary Policy over the Projection Period

Let me return to the guiding of the short-term interest rate as a primary policy tool.

Underlying CPI inflation is expected to increase gradually; in the second half of the projection period presented in the July Outlook Report -- which covers the period through fiscal 2026 -- it is likely to be at a level that is generally consistent with the price stability target. If this outlook is realized, I think it will be necessary for the Bank to raise the short-term policy interest rate to a level that is neutral to economic activity and prices -- i.e., the nominal neutral interest rate -- by the second half of the projection period that runs through fiscal 2026. The reason is that, if the short-term interest rate stays below the level that is neutral to economic activity and prices, this will push up inflation higher than necessary.

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. That said, the natural rate of interest is not directly observable, and estimates of it vary widely depending on the estimation method employed (Chart 12). The real interest rate -- calculated as the nominal interest rate minus the expected rate of inflation -- has been

Chart 12: 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 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.

clearly negative, falling below all estimates of the natural rate of interest. This implies that the current short-term interest rate level provides accommodative financial conditions; in other words, it is at a level that will push up economic activity and prices.

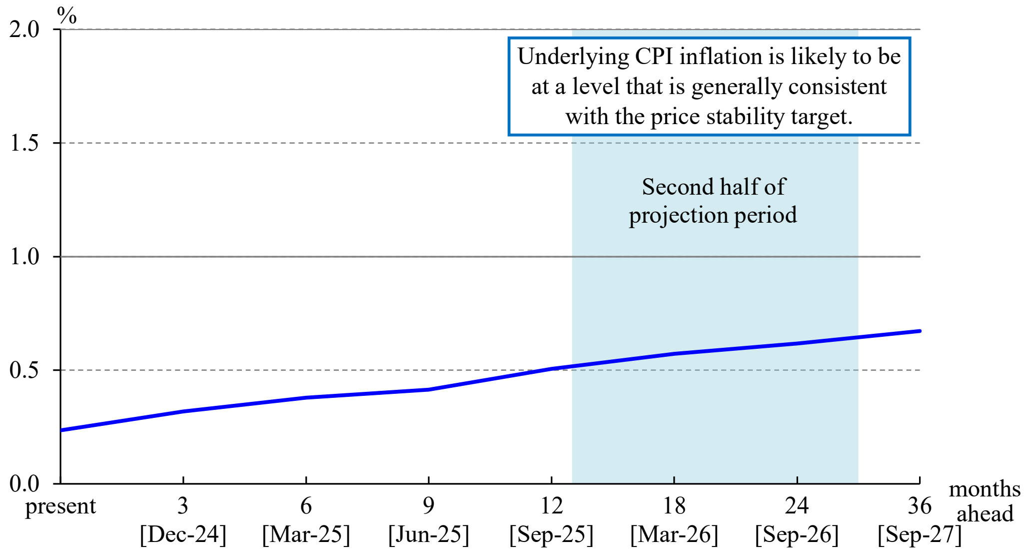
My sense is that the neutral interest rate would be at least around 1 percent. Therefore, I think it is necessary for the Bank to raise the short-term interest rate to at least that level by the second half of the projection period that runs through fiscal 2026 to contain upside risks to prices and achieve the price stability target in a sustainable and stable manner.

However, how economic agents in Japan, which has long experienced a state without meaningful interest rates, react to interest rates is an issue that warrants careful attention without any preconceptions. Thus, bearing in mind that the short-term interest rate should be at the 1 percent level by the second half of the projection period that runs through fiscal 2026, I think the Bank needs to gradually raise this rate in response to the increase in the likelihood of achieving the price stability target. While doing so, it also needs to determine the appropriate level of the short-term interest rate by paying attention to how the economy and prices respond to the rate hikes.

Stock prices in Japan and foreign exchange rates saw large fluctuations at the beginning of August. While this was likely due to a depreciation of the U.S. dollar and a fall in stock prices on a global scale, triggered by concerns over a slowdown in the U.S. economy reflecting weak economic indicators, some have associated the fluctuations with the Bank's monetary policy. Some have argued that the policy revision made at the end of July was a step taken too early, while some have argued it was a step too late. Taking a brief look back on monetary policy, since April, the Bank has been consistent with its intention that, if the outlook for economic activity and prices is realized, it will adjust the degree of monetary accommodation. However, I believe it is important for the Bank to take stock -- even if only in retrospect -- of whether this intention was adequately conveyed to the market and whether there was a more appropriate way for the Bank to respond to market reactions, and thereby continuously seek to improve its communication with the market. I also think the Bank needs to continue to keep a close watch on developments in financial and capital markets and their impact on economic activity and prices.

The market currently expects the pace of short-term interest rate hikes to be moderate (Chart 13). Of course, the pace of the Bank's rate hikes could only be at this level depending on developments in economic activity and prices. If the Bank does raise the short-term interest rate at this pace, however, the rate will likely not reach the neutral interest rate by the second half of the projection period. In addition, the possibility that this could further heighten upside risks to prices, which are of concern, or result in the Bank having to conduct rapid interest rate hikes at a later stage, cannot be ruled out. To avoid such risks, I think the Bank needs to raise the policy interest rate in a timely and gradual manner, while giving due consideration to developments in financial markets as well as paying attention to how the economy and prices respond.

Chart 13: Market Expectations for the Bank's Policy Interest Rate

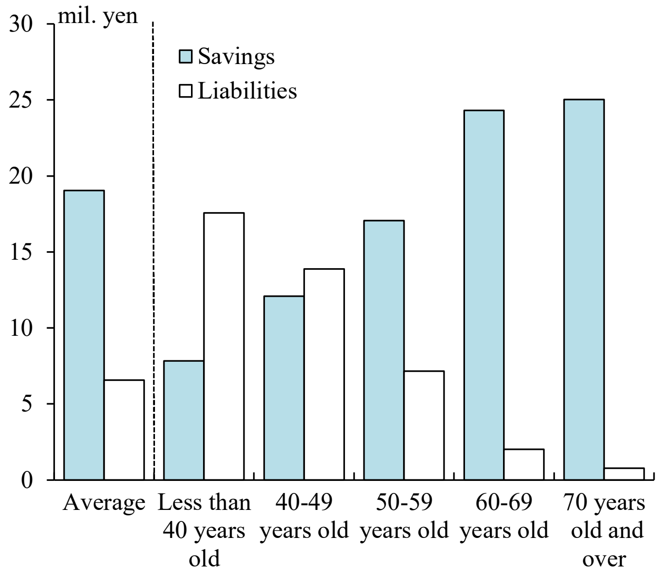


Notes: 1. The figure for the present is the 3-month yen OIS rate. Figures for 3, 6, and 9 months ahead are 3-month forward rates, those for 12 and 18 months ahead are 6-month forward rates, and those for 24 and 36 months ahead are 12-month forward rates, all calculated from the yen OIS rates. Figures are as of September 5, 2024.
2. The projection period is from fiscal 2024 to fiscal 2026.
Source: Bloomberg.

I would also like to consider the impact on various economic agents of raising the short-term interest rate. Roughly speaking, since net borrowers pay interest and net savers receive interest, raising the short-term interest rate increases the burden on net borrowers and increases interest income for net savers. Therefore, the impact of raising the short-term interest rate differs depending on, for example, whether a household has a housing loan and whether a firm has borrowings or has savings in excess of its borrowings. Furthermore, I think it is necessary to pay attention both to the channels through which short-term interest rate hikes affect economic activity and to the changes in the economic and price situation that led to the rate hikes, in addition to interest rate developments.

For example, looking at household savings and liabilities by age group of the household head, households in their 40s or younger have larger liabilities, while those in their 50s or older have larger savings (Chart 14). Thus, disregarding various assumptions, interest rate hikes, on average, tend to increase the burden on households in their 40s or younger and be more beneficial for those in their 50s or older. When considering the impact of interest rate hikes, however, it is also necessary to take into account the fact that (1) the extent to which short-term interest rate hikes are reflected in mortgage rates depends on the decisions of the lending financial institutions and, in many cases, a mechanism is in place to prevent sudden increases in monthly loan repayments and (2) many households with a housing loan are working households, some of which benefit from wage increases.

Chart 14: Household Savings and Liabilities

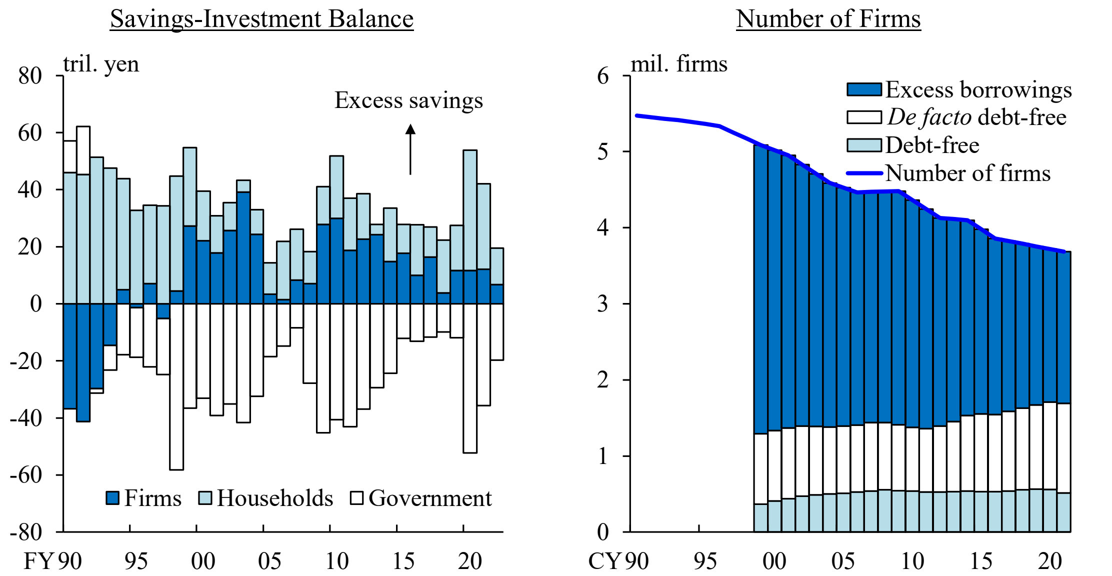


Note: Figures are 2023 averages for two-or-more-person households.
Source: Ministry of Internal Affairs and Communications.

Households in their 50s or older have significant net savings, and their interest income is expected to increase in line with a rise in deposit interest rates -- although the extent of the rise will depend on the decisions of financial institutions. Moreover, an increase in stable interest income is highly likely to improve the sentiment of households that have been reluctant to withdraw the principal of their deposits, preferring to save up for retirement.

Turning to the corporate sector, while firms have long been net savers on a flow basis, reducing borrowings and accumulating funds on hand, the proportion of debt-free or *de facto* debt-free firms -- defined as firms whose cash and deposits exceed their total amount of borrowings -- has been increasing (Chart 15). Hence, the corporate sector is likely to be more resilient to the impact of short-term interest rate hikes than in the past. In addition, solid corporate profits are expected to mitigate the effects of higher interest payments if the outlook for Japan's economy mentioned earlier is realized -- namely, that the economy will grow at a pace above its potential growth rate, as a virtuous cycle from income to spending gradually intensifies. Furthermore, on a different note, if interest rates rise and function effectively as a hurdle rate, firms, to survive, will be pressured to concentrate their business resources in areas that earn enough profits to cover the interest cost -- in other words, businesses with high added value.[1] Consequently, this is expected to stimulate business metabolism and raise productivity.

Chart 15: Firms' Financial Condition



Notes: 1. In the left panel, figures are based on the *Flow of Funds Accounts*.
2. In the right panel, figures show the number of privately owned establishments from the *Economic Census for Business Frame* and the *Economic Census for Business Activity* (*Establishment and Enterprise Census* up to 2006, interpolated for years with no data), decomposed using the shares of each group based on data from Teikoku Databank. Figures cover privately owned establishments (single-unit establishments and head offices).

Sources: Ministry of Internal Affairs and Communications; Small and Medium Enterprise Agency; Teikoku Databank; Bank of Japan.

[1] Regarding the hurdle rate function of interest rates, see Tamura, N., "Economic Activity, Prices, and Monetary Policy in Japan," speech at a meeting with local leaders in Aomori, March 27, 2024, https://www.boj.or.jp/en/about/press/koen_2024/ko240403a.htm.

Interest rate hikes will also have an impact on the government. Speaking in general terms, it is important to steadily ensure the market credibility of fiscal management.

The Bank will continue to attentively assess the impact of changes in the policy interest rate, including the effects described earlier, and conduct monetary policy as appropriate, in response to developments in economic activity and prices as well as financial conditions.

Thank you.