September 24, 2024
Bank of Japan

Japan's Economy and Monetary Policy

Speech at a Meeting with Business Leaders in Osaka

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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. I look forward to hearing your candid opinions, which will be useful in the Bank's policy decisions and business operations.

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. Economic Activity and Prices

Current Situation of and Outlook for Economic Activity

Let me start by talking about the current situation of and outlook for economic activity in Japan. As shown in Chart 1, real GDP for the April-June quarter of 2024 increased clearly. The Bank assesses that the economy has recovered moderately, although some weakness has been seen in part, and expects that it will continue to recover moderately.

Looking at the corporate sector, business sentiment has stayed at a favorable level and corporate profits have continued to increase. As shown in Chart 2, while the improvement in corporate profits is particularly notable among large manufacturers, which have benefited from the weaker yen, corporate profits in the nonmanufacturing industry also have been on an increasing trend, including at small and medium-sized firms. Against this background, firms have indicated that they are planning to maintain strong business fixed investment. Specifically, they have planned medium- to long-term investment projects, including projects related to digitalization and vehicle electrification, projects to address climate change, and projects associated with urban redevelopment. In addition, firms have made business fixed investments in response to factors such as the increase in inbound tourism, and have increased labor-saving investment given the ongoing labor shortages. Thus, the Bank expects the virtuous cycle in the corporate sector to continue, in which high levels of profits lead to increased business fixed investment.

Turning to the household sector, Chart 3 shows that private consumption, particularly of services, has been on a moderate uptrend, although price rises have affected consumption of nondurable goods, such as food products and daily necessities, for which price hikes have been especially large. Against this backdrop, looking at nominal wages in Chart 4, scheduled cash earnings have risen at a higher rate, reflecting the outcome of the annual spring labor-management wage negotiations, and summer bonuses have increased firmly in response to firms' strong business performance last year. Moreover, the government's cuts in income tax and inhabitant tax as well as emergency measures against higher electricity and gas charges, for example, have pushed up households' disposable income in real terms. Although private consumption is expected to be affected in the short run by factors including the natural disasters that occurred this summer, it is likely to increase moderately with rising income.

Of course, there are a variety of both upside and downside risks to this baseline scenario. Here, I would like to highlight two.

The first is developments in overseas economies, especially the U.S. economy, and their impact on financial and foreign exchange markets. As shown in Chart 5, while the policy interest rate in the United States has remained high at over 5 percent, the economy has nevertheless generally been solid, led by private consumption. Recently, inflation has been declining as labor market conditions have eased, and last week the Federal Reserve decided to cut its policy rate. If the Federal Reserve's decision leads to a soft landing for the U.S. economy, in which the inflation rate declines toward 2 percent while a significant slowdown in the economy is avoided, this will likely have a positive impact on Japan's economy. However, uncertainty remains about the future course of the U.S. economy. In particular, there is uncertainty regarding how the earlier policy rate hikes and other factors will affect the labor market, and it is necessary to closely examine the impact of easing labor market conditions on private consumption. The Bank of Japan will continue to closely monitor how future developments in the U.S. economy and developments in financial and capital markets in Japan and abroad will affect Japan's economic activity and prices.

The second risk concerns the outlook for private consumption. As I mentioned earlier, a precondition for the scenario in which private consumption rises moderately is that wages continue to show solid growth and household income increases. I will discuss this point later, along with the outlook for prices.

Current Situation of and Outlook for Prices

Let me now turn to developments in prices. As shown in Chart 6, the year-on-year rate of change in the consumer price index (CPI) for all items excluding fresh food was 2.8 percent in August 2024.

A breakdown of the year-on-year rate of change in the CPI shows that the rates of increase in the prices of food products and of other goods, which had been pushing up overall prices substantially until last year, have declined. This is because cost-push pressure from the rise in import prices after the pandemic has eased. On the other hand, prices of services, in which labor costs account for a large share of costs, have continued on a moderate uptrend. A more detailed look at developments in services prices by item, as depicted in Chart 7, clearly shows that the impact of wage increases has intensified. That is, while notably large price increases were seen last year for items such as dining-out due to the impact of higher import prices, prices for items with a high labor cost share did not rise much. In contrast, recently, price increases of around 2 percent can be observed for a wide range of items. These goods- and services-level price developments suggest that the reason for price increases has shifted from the rise in import prices to wage increases that reflect continued improvement in economic activity.

Under these circumstances, the trend in inflation excluding short-term fluctuations, which the Bank calls underlying inflation, is gradually rising toward 2 percent. This is confirmed by the various estimates of underlying inflation shown in Chart 8.

Looking ahead, underlying inflation is likely to continue rising and in the second half of the projection period through fiscal 2026 to be at a level that is generally consistent with the price stability target of 2 percent. This projection is based on the assumption that the changes in firms' wage- and price-setting behavior that have been underway for the past several years will take hold in society and that wage increases will continue into the next fiscal year and beyond.

Meanwhile, the macroeconomic environment that has supported wage increases to date, such as labor shortages and favorable corporate profits, has remained in place. Please take a look at Chart 9. Labor market developments show that the room for further increases in labor supply is becoming limited, partly reflecting demographic developments, so that the structural shortage of labor is likely to intensify. Moreover, as I mentioned earlier, corporate profits have been favorable, and although labor costs have increased, the labor share has in fact fallen to a level not seen since the first half of the 1990s.

However, it is necessary to carefully examine whether developments in overseas economies and other factors will have an impact on Japan's corporate profits and corporate behavior. In addition, attention is warranted on the fact that even if the corporate sector as a whole is performing well, the business environment faced by individual firms varies amid the substantial changes in economic activity and prices. The Bank will continue to closely monitor whether sustained wage hikes and their pass-through to selling prices will be achieved in a wide range of firms and whether the linkage between wages and prices will strengthen steadily.

II. The Bank's Conduct of Monetary Policy

July 2024 Monetary Policy Meeting

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

At the July 2024 Monetary Policy Meeting (MPM), the Bank decided on a plan for the reduction of its purchase amount of Japanese government bonds (JGBs) and changed the policy interest rate. I will first briefly explain the background to these decisions.

Please take a look at Chart 10. Let me start with the plan for the reduction of the purchase amount of JGBs. The Bank had already decided at the June MPM that it would reduce its purchase amount of JGBs, based on the understanding that, in principle, long-term interest rates are to be formed in financial markets. After carefully collecting views from market participants, at the July MPM, the Bank decided on a detailed plan for the reduction. Going forward, it will reduce its purchase amount of JGBs in a predictable manner, while allowing enough flexibility to support stability in the JGB markets.

Let me move on to Chart 11. The Bank raised the policy interest rate by around 0.15 percent, deciding to "encourage the uncollateralized overnight call rate to remain at around 0.25 percent." This decision was based on the aforementioned assessment that Japan's economic activity and prices had been generally in line with the Bank's outlook and that underlying inflation had risen moderately. In addition, the Bank took into account that import prices had risen again, reflecting the yen's depreciation since the beginning of this year, and that this had posed an upside risk to prices. In this situation, the Bank judged it appropriate to raise the policy interest rate and adjust the degree of monetary accommodation from the perspective of sustainable and stable achievement of the price stability target of 2 percent.

Market Developments since August and Future Conduct of Monetary Policy

After the turn of August, the U.S. dollar weakened and stock prices declined worldwide, triggered by a growing concern over a slowdown in the U.S. economy. The U.S. dollar-yen exchange rates exhibited more volatility, since large positions that had been built up on a weaker yen were unwound, partly due to the Bank of Japan's policy change. Stock prices in Japan declined significantly for a time compared to other economies.

I am aware of the criticism that one of the reasons for such large market fluctuations in August is that the Bank's thinking on the conduct of monetary policy was not shared widely enough with the public. The Bank has explained its basic thinking on policy conduct through, for example, the *Outlook for Economic Activity and Prices* (Outlook Report), speeches, and press conferences, and will continue to provide detailed explanation and communicate carefully to the public. I will take this opportunity today to describe two points regarding the future conduct of monetary policy, taking account of the change in situation since August.

The first is the Bank's basic thinking on the conduct of monetary policy. The Bank considers that, if underlying inflation rises in line with its outlook, it will be appropriate to accordingly raise the policy interest rate and adjust the degree of monetary accommodation. The real interest rate, that is, the nominal interest rate minus the expected rate of inflation, has been significantly negative even after the policy interest rate hike in July, and it is likely that this will keep stimulating economic activity and pushing up the inflation rate. In the phase where underlying inflation is around 2 percent, it will become less necessary to further push up inflation, and thus it will be desirable to bring the policy interest rate closer to the level that is neutral to economic activity and prices. In other words, if the outlook for economic activity and prices presented in the Outlook Report is realized, the Bank will accordingly raise the policy interest rate.

The second point concerns the actual conduct of monetary policy based on this basic thinking. Given the high uncertainties surrounding economic activity and prices, unexpected situations may occur. Actual policy needs to be conducted in a timely and appropriate manner while taking account of various uncertainties, rather than based on a fixed schedule set in advance.

In the current situation, the Bank needs to monitor with utmost vigilance developments in overseas economies, particularly the U.S. economy, and those in financial and capital markets, which have remained unstable. It also needs to carefully examine how these developments will affect the outlook for Japan's economic activity and prices, risks surrounding them, and the likelihood of realizing the outlook. Moreover, since Japan has remained under a low interest rate environment for an extended period of time, it is important for the Bank to strive to examine how economic activity and prices will respond to interest rate hikes. Meanwhile, the yen's one-sided depreciation has been retraced since August and the rise in import prices has slowed recently. Accordingly, the upside risk to prices reflecting higher import prices has become smaller. In making policy decisions, the Bank will need to carefully assess factors such as developments in financial and capital markets at home and abroad and the situation in overseas economies underlying these developments. We have enough time to do so.

Achieving price stability through appropriate policy conduct is the basis for sustainable economic growth. Last year at this meeting, I stated that "achieving the virtuous cycle between wages and prices could be significantly beneficial both for individual firms and the overall economy." I am more convinced of this, given that the results of extensive surveys among firms indicated that many preferred a situation in which wages and prices rise moderately to a deflationary period in which neither rise. Japan's economy must avoid returning to deflation. On the other hand, looking back at the history of Japan and overseas, it is clear that when high inflation takes hold in society or inflation accelerates, this has a negative effect on economic activity. The Bank will conduct monetary policy as appropriate, aiming to achieve the price stability target of 2 percent in a sustainable and stable manner, while taking account of upside and downside risks to economic activity and prices, and I believe that this stance will bring about positive effects on the national economy as a whole.

Concluding Remarks

Today, I have talked about 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 last year.

Through the review, the Bank aims to deepen its understanding on various unconventional monetary policy measures it has adopted since the late 1990s and to gain insights that will be useful for future policy conduct. In proceeding with this review, the Bank has incorporated diverse expertise and has made a particular effort in enhancing the review's objectivity and transparency by gathering views from professionals in each field, including at this meeting last year.

Currently, the Bank is compiling the findings from the initiatives just mentioned and internal analyses. It plans to publish the results by the end of the year after the discussions at the MPMs. I believe that the process of objectively looking back on the past has allowed us to better understand why it is taking considerable time to achieve price stability, as well as the positive effects and side effects of unconventional monetary policy. The results of the review are not supposed to affect the Bank's conduct of monetary policy in the near term, but from a somewhat long-term perspective, they are expected to provide valuable inputs that will allow us to gain deeper insight into monetary policy.

Thank you very much for your attention.

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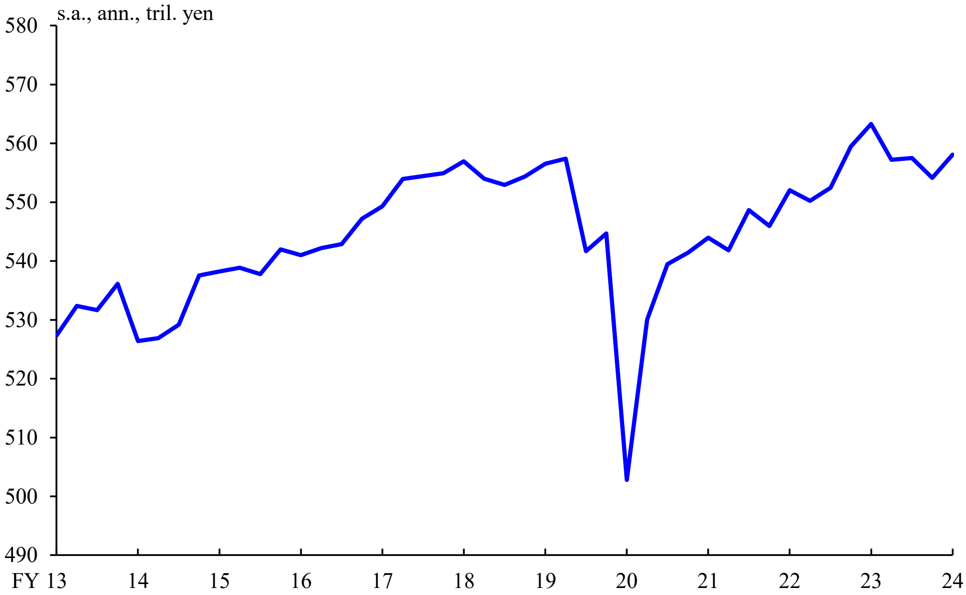
Chart 1

Real GDP



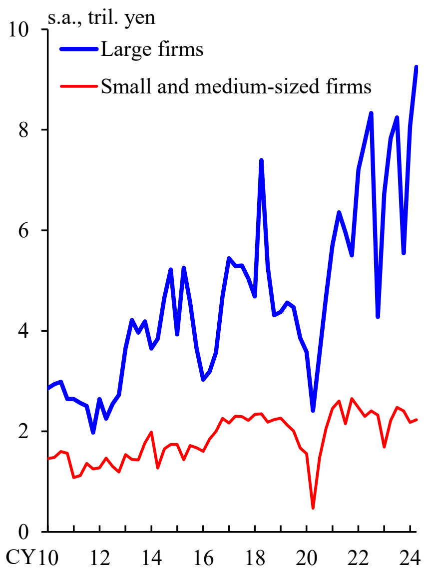
Source: Cabinet Office.

Chart 2

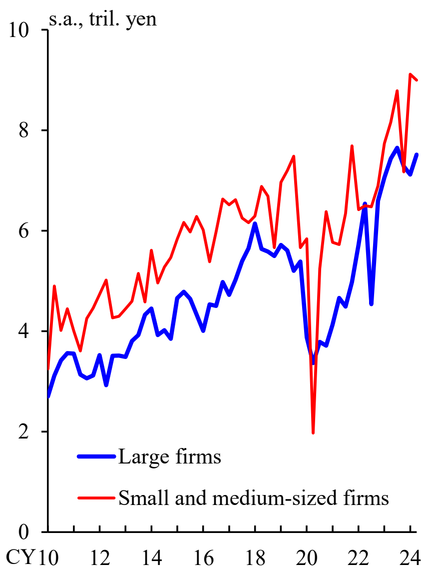
Corporate Sector

Current Profits

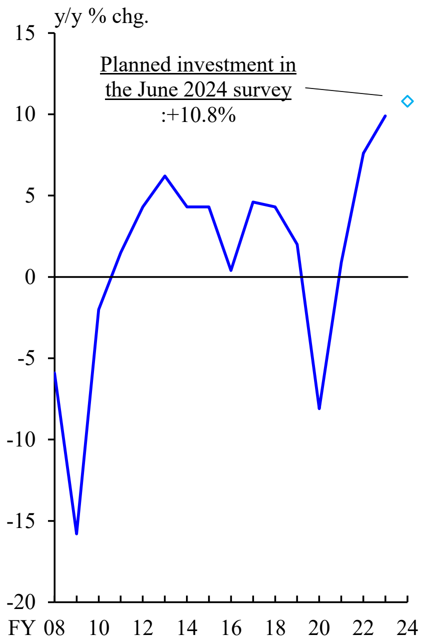
Manufacturing



Non-manufacturing



Business Fixed Investment

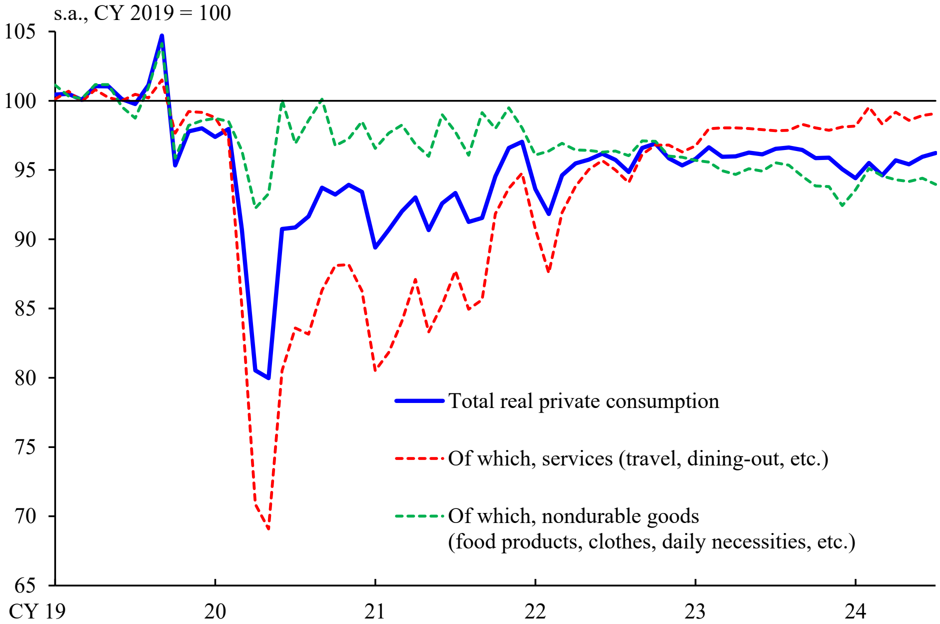


Notes: 1. Figures for current profits are based on the *Financial Statements Statistics of Corporations by Industry, Quarterly* and exclude "finance and insurance" and pure holding companies.
2. In the right-hand chart, figures are based on the *Tankan*, including software and R&D investments and excluding 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 Finance; Bank of Japan.

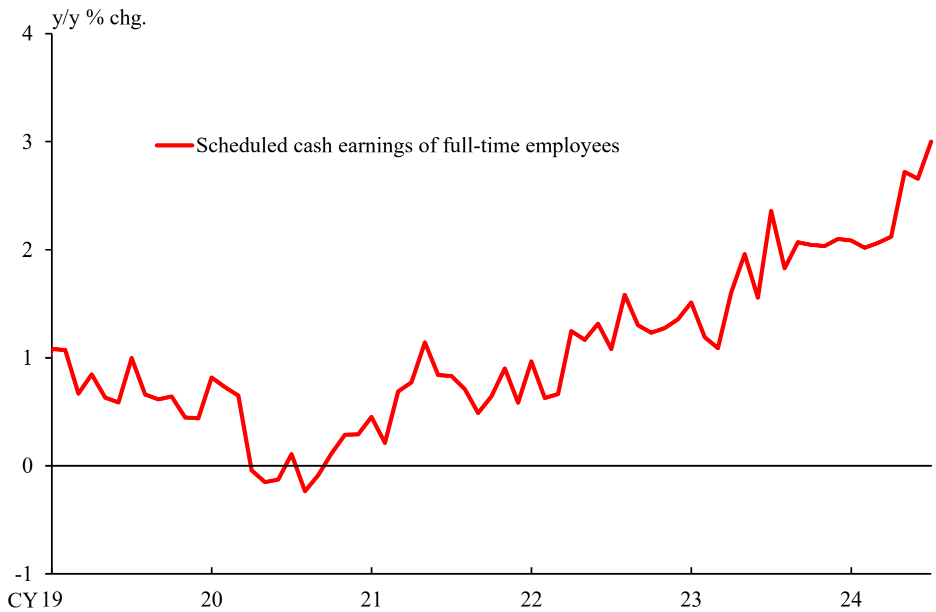
Household Sector

Real Private Consumption



Note: 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.
Source: Bank of Japan.

Nominal Wages



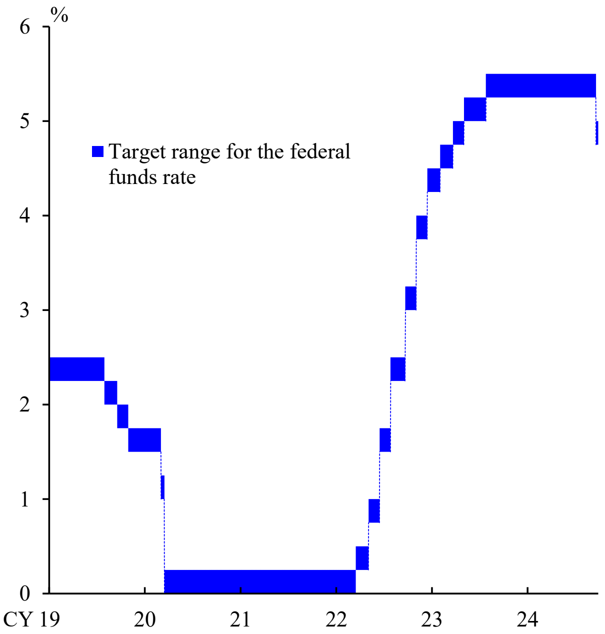
Note: Figures are based on continuing observations following the sample revisions.
Source: Ministry of Health, Labour and Welfare.

I. Economic Activity and Prices

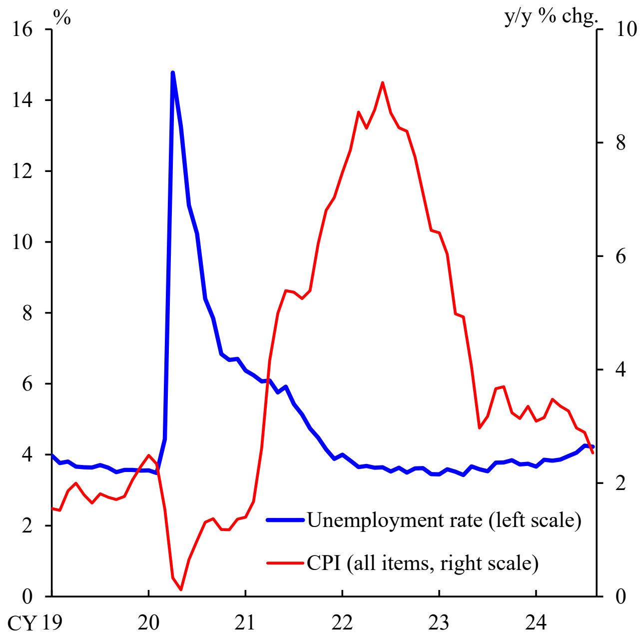
Chart 5

U.S. Economy

Policy Interest Rate



Employment and Prices



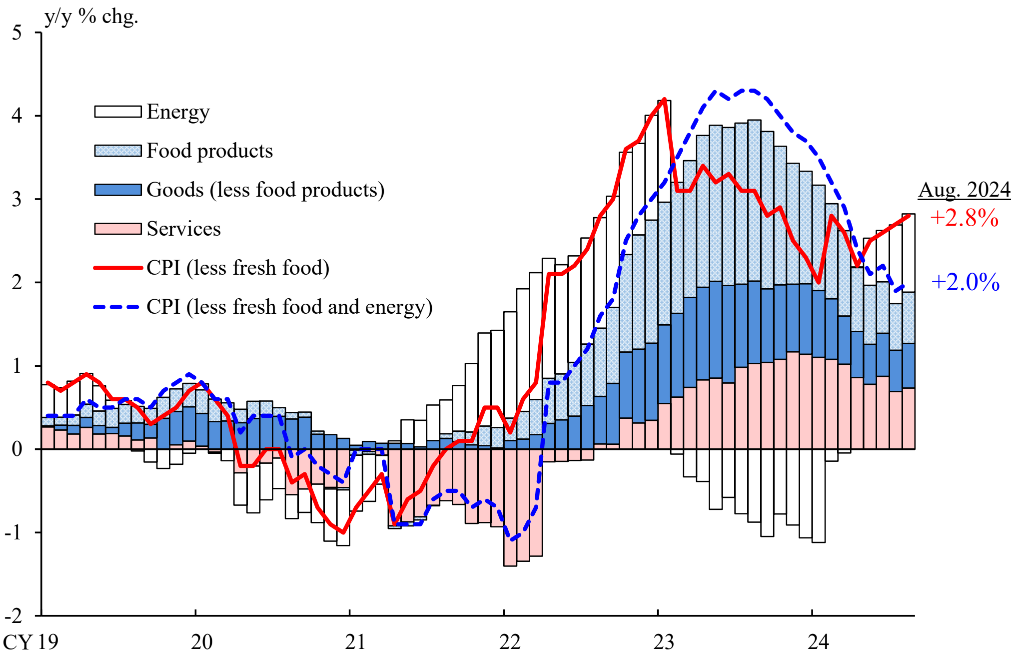
Sources: Bloomberg; Haver.

I. Economic Activity and Prices

Chart 6

Price Developments

CPI

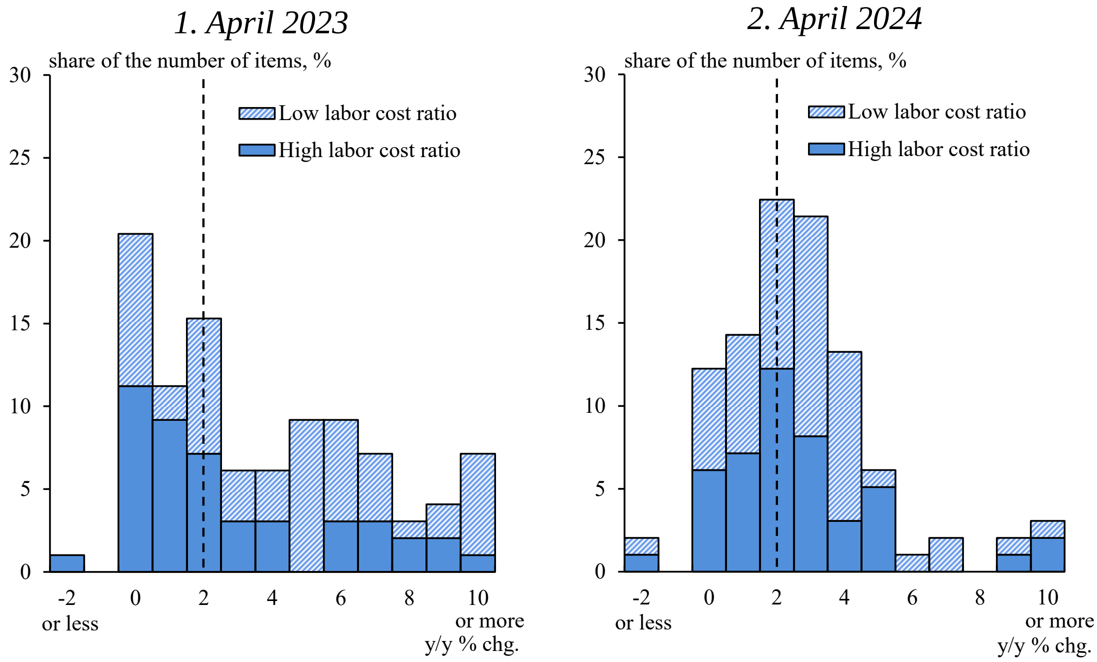


Source: Ministry of Internal Affairs and Communications.

Chart 7

Developments in Services Prices

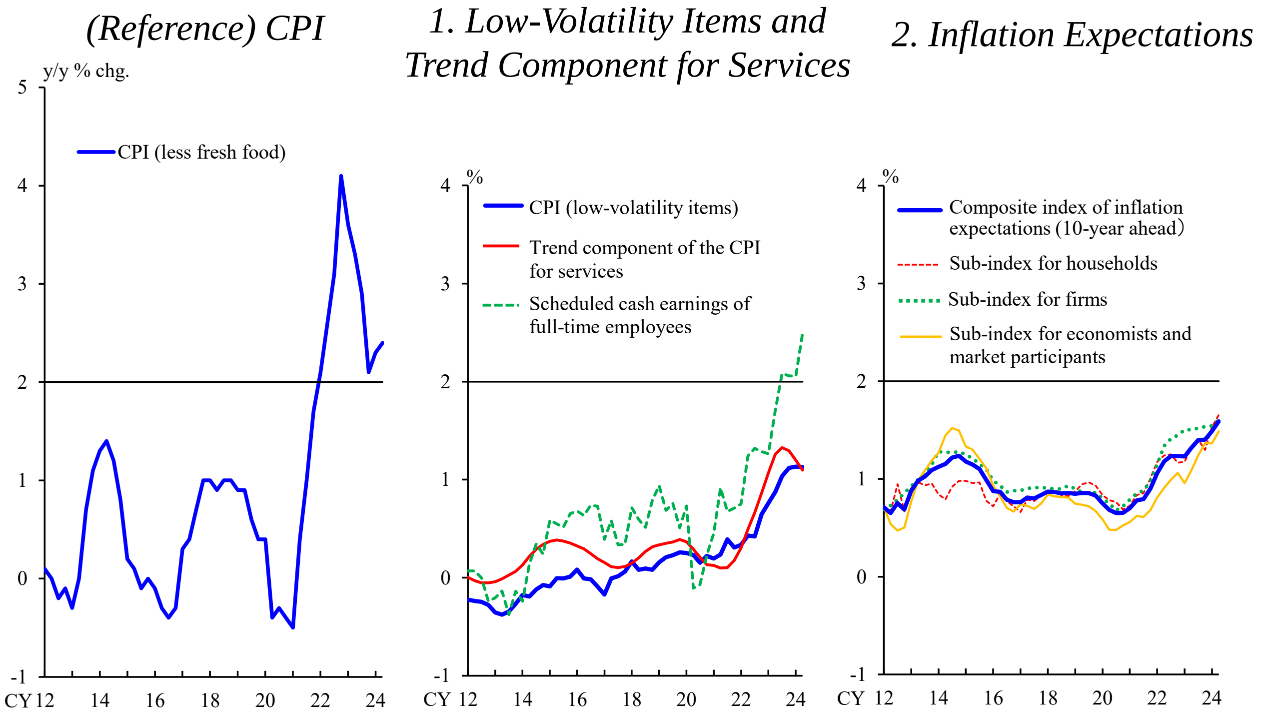
Price Change Distribution of General Services



Notes: 1. Figures show the CPI for general services (less housing rent). Figures are staff estimates and exclude the effects of policies concerning the provision of free education and the effects of travel subsidy programs.
2. CPI items are matched to the items in the *2015 Input-Output Tables for Japan* and grouped in terms of the share of "wages and salaries" and other labor costs in the domestic output of those items. Figures for items with a high (low) labor cost ratio are for items that fall into the top (bottom) 50 percent in general services (less housing rent).
Source: Ministry of Internal Affairs and Communications.

Chart 8

Developments in Underlying Inflation

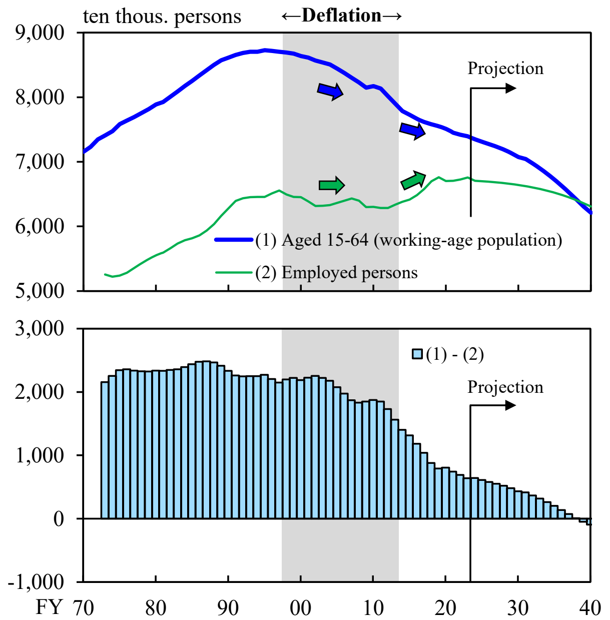


Notes: 1. In the left-hand chart, figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs.
2. For details of the approaches on which the middle and right-hand charts are based, see Box 4 of the April 2024 Outlook Report. In the middle chart, figures for scheduled cash earnings of full-time employees from 2016 onward are based on continuing observations following the sample revisions.
Sources: Bank of Japan; Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; QUICK, "QUICK Monthly Market Survey <Bonds>"; Consensus Economics Inc., "Consensus Forecasts"; Bloomberg.

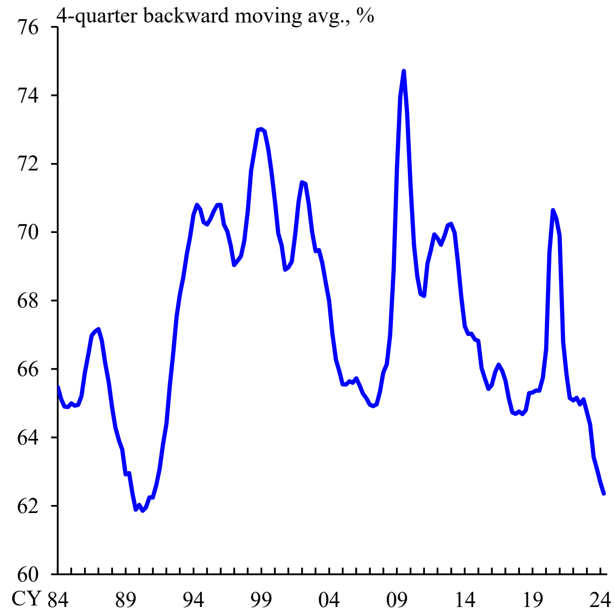
Chart 9

Labor Market

Working-Age Population and Number of Employed Persons



Labor Share



Notes: 1. In the left-hand chart, the projection for the working-age population is by the National Institute of Population and Social Security Research. The projection for the number of employed persons is calculated based on projections by the Japan Institute for Labour Policy and Training.
2. In the right-hand chart, figures are based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. Figures exclude "finance and insurance" and those for 2009/Q2 onward also exclude pure holding companies.
Labor share = Personnel expenses / Value-added, and Value-added = Operation profits + Personnel expenses + Depreciation expenses.

Sources: Ministry of Internal Affairs and Communications; National Institute of Population and Social Security Research; Japan Institute for Labour Policy and Training; Ministry of Finance.

Chart 10

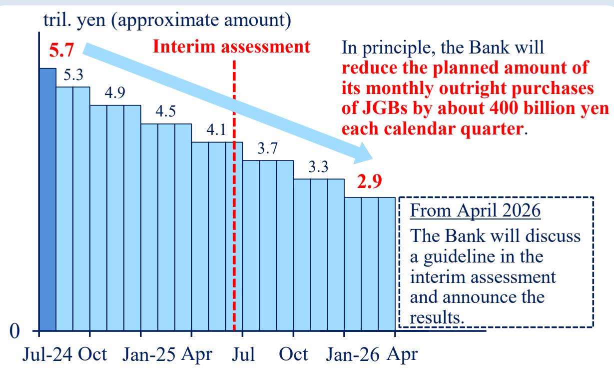
Decisions at the July 2024 MPM (1): Plan for the Reduction of the Purchase Amount of JGBs

The concept of the plan for the reduction until March 2026

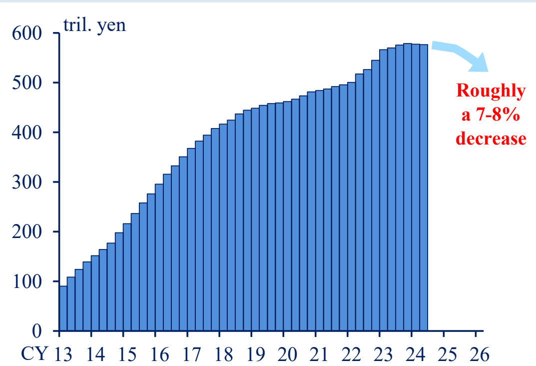
1. Long-term interest rates: to be formed in financial markets in principle
2. JGB purchases: appropriate for the Bank to reduce its purchase amount of JGBs in a predictable manner, while allowing enough flexibility to support stability in the JGB markets

Reduction in a Predictable Manner

Amount of monthly JGB purchases



The Bank's JGB holdings



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.

Decisions at the July 2024 MPM (2): Change in the Guideline for Money Market Operations

- 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.