May 13, 2022
Bank of Japan

Outlook for Economic Activity and Prices and Monetary Policy

Speech at a Meeting Held by the Naigai Josei Chosa Kai (Research Institute of Japan) (via webcast)

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(English translation based on the Japanese original)

Introduction

It is my pleasure to have the opportunity to address you today at the Naigai Josei Chosa Kai.

Japan's economy is in the process of recovering from a significant downturn caused by the novel coronavirus (COVID-19) two years ago. Although attention should continue to be paid to the impact of COVID-19 as a factor, for example, to push down services consumption or to constrain exports and production, such as through supply-chain disruptions, downward pressure on economic activity stemming from such impact has waned gradually, due in part to the widespread vaccinations. However, Russia's invasion of Ukraine this February has added a new geopolitical shock, for which the course is difficult to project. This has heightened uncertainties surrounding Japan's economy; for example, it has led to significant rises in global commodity and grain prices and exerted downward pressure on overseas economies by directly and indirectly affecting trade activity and sentiment.

In this situation, the Bank of Japan, at the Monetary Policy Meeting (MPM) held at the end of April, updated its projections for Japan's economic activity and prices through fiscal 2024 and released them in the April 2022 *Outlook for Economic Activity and Prices* (Outlook Report). At the same time, in order to reduce uncertainties in financial markets, the Bank clarified its current stance of conducting aggressive monetary easing through yield curve control. Today, I would like to talk about the Bank's view on Japan's economic activity and prices based on the Outlook Report and explain its thinking on the conduct of monetary policy, including its decisions at the April MPM.

I. Economic Developments

Outlook for Overseas Economies

Let me start with overseas economies. The growth rate of overseas economies saw a substantial year-on-year decline of 3.1 percent for 2020 due to the impact of COVID-19, exceeding the decline during the Global Financial Crisis (Chart 1). However, these economies turned to a strong recovery for 2021, growing at a significantly high rate of 6.1 percent. Looking ahead, the growth in overseas economies is expected to decelerate compared with 2021 due to the impact of the situation surrounding Ukraine spilling over to economic activity, as seen in surges in commodity and grain prices, but these economies are projected to remain on a recovery trend as the impact of COVID-19 wanes. The latest *World Economic Outlook* released by the International Monetary Fund (IMF) last month shows that the global economy is expected to grow at a rate of 3.6 percent for both 2022 and 2023, staying at around the long-term average since 1990. As the growth in overseas economies, albeit decelerating, remains steady, Japan's exports and production are likely to continue increasing, mainly for automobile-related goods, for which supply-side constraints are expected to wane, and for digital-related goods, which have seen an expansion in global demand.

Baseline Scenario of the Outlook for Japan's Economy

Next, I would like to talk about developments in Japan's economy. While the economy has been swinging up and down due to successive waves of COVID-19, it has continued to pick up as a trend. For the October-December quarter of last year, it grew at a significantly high rate of 4.6 percent on an annualized quarter-on-quarter basis with the low level of confirmed new cases of COVID-19; however, for the January-March quarter of this year, it saw a clear slowdown due to the lingering effects of supply-side constraints -- such as on semiconductors and parts and components -- and to stronger downward pressure on services consumption stemming from the spread of the Omicron variant. Looking at the situation since early spring, although the adverse effects of rising commodity prices resulting from the situation surrounding Ukraine have begun to be reflected in business sentiment in particular, private consumption has started picking up again with the lifting of the priority measures to prevent the spread of disease in late March.

Given this situation, the latest Outlook Report presents the outlook for Japan's economy by dividing the three-year projection period through fiscal 2024 into two phases (Chart 2). The first phase is from the beginning to the middle of the projection period. Although an outflow of income from Japan due to rising commodity prices is expected to exert downward pressure on the economy in this phase, the Bank projects that the economy will grow at a relatively high rate, because pent-up demand is likely to continue materializing with the impact of COVID-19 and supply-side constraints waning and with support from such factors as accommodative financial conditions. To elaborate a bit further, prices of commodities such as crude oil, natural gas, and coal, and prices of grains, such as wheat, have seen a significant rise, albeit with fluctuations, reflecting heightened supply concerns as a result of Russia's invasion of Ukraine (Chart 3). Since Japan relies on imports for most of these commodities and grains, rises in these prices lead to an outflow of income from Japan, i.e., trading losses. This puts downward pressure on households' real income and corporate profits through higher energy and food prices. Normally, such downward pressure on income would act to constrain domestic demand; however, in the current phase, domestic demand is expected to keep seeing a relatively firm recovery. Reasons for this include the following. First, it is projected that, as the situation with COVID-19 improves and as the resumption of consumption activities progresses while public health is being protected, mainly due to the widespread vaccinations and the rollout of antiviral medicines, pent-up demand will materialize to a considerable degree in services consumption such as dining-out and travel with withdrawals of savings that have accumulated as a result of pandemic-related restrictions (Chart 4). While the current levels of dining-out and travel remain low, at only about 70 percent of pre-pandemic levels, this also means that there is still relatively large room for growth in services consumption. Second, the government's comprehensive emergency measures are expected to have the effect of easing downward pressure on households' real income through gasoline subsidies and subsidies for low-income households. Third, the normalization of supply chains and the easing of parts shortage are likely to increase production that has been constrained and in turn lead to a recovery in the consumption of durable goods such as automobiles and to an increase in business fixed investment, which has seen slow progress.

The second phase is from the middle of the projection period. In this phase, the Bank projects that the pace of economic growth will decelerate as upward pressure from the materialization of pent-up demand wanes. However, Japan's economy is projected to continue growing at a pace above its potential growth rate. This will likely occur as the outflow of income due to high commodity prices comes to a halt and a virtuous cycle from income to spending intensifies gradually with financial conditions remaining accommodative. In the household sector, improvement in employee income is likely to support an increase in private consumption. Employee income is likely to continue increasing moderately on the back of a rise in the number of non-regular employees associated with a recovery in the face-to-face services sector and of an increase in wage inflation that reflects tightening labor market conditions. Supported by this increase in employee income and an easing of downward pressure from rising energy prices on real income, private consumption is expected to keep increasing steadily, albeit with slower materialization of pent-up demand. In the corporate sector, profits are likely to return to an improving trend since upward pressure on raw material costs is expected to wane gradually. This increase in corporate profits, coupled with accommodative financial conditions, is projected to support investment to address labor shortage, digital-related investment, and research and development (R&D) investment related to growth areas and decarbonization.

In terms of the medians of the Policy Board members' forecasts, the economy is expected to register a high growth rate of 2.9 percent for fiscal 2022 (Chart 2). The growth rate is then expected to be at 1.9 percent for fiscal 2023 and 1.1 percent for fiscal 2024, showing that the economy is projected to continue growing, albeit more slowly, at a pace above its potential growth rate. Compared with the projections presented in the previous Outlook Report released in January, the projected growth rate for fiscal 2022 is lower due to the effects of the rise in commodity prices and the slowdown of overseas economies, while it is higher for fiscal 2023, partly owing to a rebound from the lower projection in the previous year.

Risks to Economic Activity for the Time Being

However, the Bank considers that risks to the baseline scenario are skewed to the downside for the time being, mainly due to COVID-19 and the situation surrounding Ukraine. Vigilance against COVID-19 by Japanese households has been persistent, particularly among seniors. In fact, developments in services consumption by age group based on credit card transaction data show that, during the spread of the Omicron variant since the beginning of the year, services consumption for the younger age group has been steady at around the same level as before the pandemic, whereas the older the age group, the weaker their services consumption has been relative to the pre-pandemic period (Chart 4). Under these circumstances, if the improvement in the situation with COVID-19 takes too long, some of the "forced savings," which has accumulated as a result of pandemic-related restrictions, may transform into "precautionary savings" to prepare for future uncertainties, and withdrawals of such accumulated savings may not proceed smoothly. There is also a risk that a resurgence of COVID-19 at home and abroad and the resultant strict restrictions in some countries and regions will cause, for example, supply-chain disruptions, and Japanese firms will face prolonged and amplified supply-side constraints. In this regard, it is important to note that disruptions of distribution networks due to lockdowns in Shanghai and other parts of China have begun to constrain Japan's exports and production from the supply side, particularly in the automobile and related industries, which involve a wide range of firms.

Furthermore, there are extremely high uncertainties over the situation surrounding Ukraine. Depending on how the situation develops, there is also a risk of significant fluctuations in commodity prices, as well as one of a downturn in overseas economies. Moreover, amid concern over acceleration in the pace of reduction in monetary accommodation -- mainly for advanced economies facing a continued rise in inflation -- there is a risk of instability in global financial and capital markets, including foreign exchange markets. In this regard, it is necessary to bear in mind that sharp fluctuations in foreign exchange rates would increase uncertainties about the future and negatively affect the economy by, for example, making it more difficult for firms to formulate business plans and prompting them to postpone business fixed investment. The Bank will pay close attention to the impact of fluctuations in global financial and capital markets on Japan's economic activity and prices.

II. Price Developments

Baseline Scenario of the Outlook for Consumer Prices

Next is the outlook for prices (Chart 5). The year-on-year rate of change in the consumer price index (CPI) for all items excluding fresh food is expected to increase clearly in positive territory -- reflecting a significant rise in energy prices -- from April, when the effects of a reduction in mobile phone charges start to dissipate. In fact, looking at the CPI for Tokyo's 23 wards, for which figures are released ahead of those for the CPI for Japan, the year-on-year rate of increase for all items excluding fresh food accelerated from 0.8 percent for March to 1.9 percent for April. Under these circumstances, the year-on-year rate of change in the CPI for fiscal 2022 for Japan -- in terms of the median of the Policy Board members' forecasts -- is projected to be 1.9 percent, a significant upward revision from the median presented in the January Outlook Report and close to 2 percent. However, the main reason for the increase in inflation that is expected for the time being is a rise in energy prices, such as gasoline prices and electricity and gas charges, which almost automatically reflect developments in commodities prices, such as crude oil prices, when excluding government subsidies. Like other central banks and international organizations, the Bank does not project that prices of crude oil and other commodities will continue rising at the same pace, and therefore forecasts that the positive contribution of the rise in energy prices to the CPI will gradually wane. As a result, the rate of increase in the CPI for fiscal 2023 is expected to be 1.1 percent, which is a clear deceleration from fiscal 2022.

Thus, the year-on-year rate of change in the CPI is projected to increase to around 2 percent for fiscal 2022, led by the rise in energy prices; however, the range of items for which prices increase is expected to be limited. The distribution of price changes of items that make up the CPI shows that, while prices of energy-related items such as gasoline prices and electricity charges have recently risen at a notably high rate, the distribution of the rates of change in prices of most other items has been centered on 0 percent (Chart 6). There have been no substantial changes from the pre-pandemic period to the fact that the peak of the distribution of price changes across CPI items is around 0 percent; in other words, the weight of items for which prices are unchanged is the largest. On the other hand, the price change distribution of the United States shows that the distribution itself has shifted in the direction of larger price increases. It can therefore be said that the recent rise in inflation in the United States reflects price increases in a wide range of items rather than being driven by only a few items, such as energy.

Outlook for Consumer Prices Excluding Energy

However, the year-on-year rate of change in Japan's CPI excluding temporary disturbances, a measure of underlying inflation, is expected to steadily increase in positive territory, albeit moderately, throughout the projection period.

The Bank's price stability target is defined as an inflation rate of 2 percent based on the CPI for all items, which comprehensively covers goods and services consumed by households.

However, because there are considerable temporary fluctuations in fresh food prices in Japan due to the weather and other factors, the Bank has traditionally presented its forecasts of CPI inflation excluding fresh food in the Outlook Report. Recently, energy prices have also risen significantly on the back of the rise in international commodity prices resulting from the situation surrounding Ukraine, diverging from actual economic conditions in Japan. Under these circumstances, in order to provide a quantitative and easy-to-understand explanation of its projections for underlying inflation, the Bank has decided to include its forecasts for the CPI excluding fresh food and energy in the most recent Outlook Report (Chart 7).[1] The Bank's CPI forecasts on this basis, i.e., excluding fresh food and energy, show a moderate increase in the rate of inflation from 0.9 percent for fiscal 2022, to 1.2 percent for fiscal 2023, and 1.5 percent for fiscal 2024. Thus, when the impact of temporary large fluctuations in energy prices is excluded, the underlying inflation rate is expected to moderately rise in positive territory throughout the projection period on the back of improvement in the output gap and rises in medium- to long-term inflation expectations and wage inflation.

Medium- to Long-Term Inflation Expectations and Wages

For the underlying inflation rate to rise, the inflation driven by energy prices needs to shift to a "broad-based" and "sustainable" inflation accompanied by increases in corporate profits and wages. In this regard, short-term inflation expectations of households, firms, and market participants have risen clearly recently through the mechanism of adaptive inflation expectations formation that reflects the rise in energy and other prices (Chart 8). The Bank will pay close attention to whether these developments will spill over to medium- to long-term inflation expectations and in turn raise wage inflation.

[1] To accurately capture developments in underlying inflation, it is important to comprehensively examine various core indicators, including but not limited to the CPI excluding fresh food and that excluding fresh food and energy. The Bank therefore estimates indicators of the CPI, such as the diffusion index for the share of price-increasing items minus the share of price-decreasing items, the trimmed mean, the mode, and the weighted median, and publishes them following the release of the CPI for Japan every month. For the calculation methods and the characteristics of various core indicators, see Hogen, Y., Kawamoto, T., and Nakahama, M., "Core Inflation and the Business Cycle," *Bank of Japan Review Series*, no. 15-E-6, November 2015; and Shiratsuka, S., "Performance of Core Indicators of Japan's Consumer Price Index," *Bank of Japan Review Series*, no. 15-E-7, November 2015.

Wages have a dual nature: while they represent costs for firms, they also represent income for households. This is a major difference from imported raw materials, which are merely firms' costs. In other words, wages are the price paid for the labor required for the production of all goods and services. Therefore, higher wages lead to upward pressure on selling prices for a wide range of goods and services through higher labor costs. On this point, services prices in Japan have changed only infrequently, and have for a long time been less likely to rise than the prices of goods, which are more sensitive to economic activity. However, if wages rise firmly, it is expected that upward pressure on services prices, in which labor costs make up a large share, will increase, and inflation will become "broad-based." At the same time, since wages are the source of households' income, increases in wages will also lead to an improvement in households' tolerance for price hikes. In other words, if households' real purchasing power increases as a result of wage increases, making it easier for them to accept price hikes, the "sustainability" of inflation will also increase. Inflation brought about by this process will push up corporate profits through rises in selling prices and further generate sources for wage increases.

Given this interdependence between wages and prices, both need to rise (Chart 9). From a somewhat long-term perspective, Japan's labor productivity per hour has risen at an average annual rate of about 1 percent.[2] Moreover, given that the Bank's price stability target is 2 percent in terms of the year-on-year rate of change in the CPI, the sustainable rate of nominal wage growth consistent with this productivity and inflation would be around 3 percent. With a view to achieving the price stability target of 2 percent in a sustainable and stable manner, the Bank considers that what is necessary is not just price rises but the formation of a virtuous cycle in which prices rise amid a situation of increases in real wages and real income.

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[2] For labor productivity per hour, see Kuroda, H., "Japan's Inflation Dynamics and the Role of Monetary Policy," speech at Columbia University in New York, April 22, 2022, https://www.boj.or.jp/en/announcements/press/koen_2022/ko220423a.htm/.

III. The Bank's Conduct of Monetary Policy

Now, let me move on to the Bank's conduct of monetary policy.

Monetary Easing to Achieve the Price Stability Target of 2 Percent in a Sustainable and Stable Manner

With the United States and Europe reducing monetary accommodation and Japan's CPI inflation rate expected to be at around 2 percent for the time being, some have asked whether the Bank should also scale back its monetary easing. However, given current developments in economic activity and prices in Japan, the Bank considers it necessary to support economic recovery from the impact of COVID-19 with aggressive monetary easing.

That is, unlike in the United States and the euro area, where GDP has already recovered to above pre-pandemic levels, Japan's GDP is still more than 2 percent below the pre-pandemic level (Chart 10). The output gap, which shows the utilization of factors of production in the economy as a whole, is estimated to have remained negative. In addition, as I explained earlier in detail, the recent rise in commodity prices has led to a considerable outflow of income from Japan. In other words, the economy has faced downward pressure from the income side while the recovery from the pandemic has been weak compared with the United States and Europe. Furthermore, the rise in prices expected in the short run will be driven by energy prices and lack sustainability, and there has been no sharp increase in medium- to long-term inflation expectations. The role of monetary policy in these circumstances is to firmly support the recovery of aggregate demand by providing accommodative financial conditions. Against this background, the Bank -- by creating a macroeconomic environment in which it is likely that labor market conditions will tighten and wages will rise -- aims to achieve the price stability target of 2 percent in a sustainable and stable manner amid a virtuous cycle in which real income increases.

Clear Monetary Easing Stance

As the specific measure of such monetary easing, the Bank considers it appropriate to maintain the current guideline for market operations of keeping 10-year Japanese government bond (JGB) yields at around zero percent under yield curve control. Moreover, the Bank has decided that, in order to strike a balance between controlling interest rates and maintaining market functioning, the range of 10-year JGB yield fluctuations should be between around plus and minus 0.25 percent from zero percent. Under these circumstances, the Bank has been purchasing the necessary amount of 10-year JGBs so that their yields remain within the range of zero percent plus and minus 0.25 percent.

Recently, rising long-term interest rates in the United States and Europe have temporarily exerted upward pressure on the long-term interest rate in Japan (Chart 11). To ensure that 10-year JGB yields do not exceed the upper limit of 0.25 percent even in these cases, the Bank has conducted the existing measures of fixed-rate purchase operations, in which it purchases an unlimited amount of JGBs at fixed rates decided in advance, and fixed-rate purchase operations for consecutive days, in which it conducts such operations consecutively over multiple business days. In order to make its stance clear, the Bank decided at the MPM held at the end of April to offer to purchase 10-year JGBs at 0.25 percent every business day through fixed-rate purchase operations, unless it was highly likely that no bids would be submitted. While some market participants have attempted to predict the future course of the Bank's policy stance based on whether or not fixed-rate purchase operations are conducted, the Bank considers that announcing in advance that it will conduct these operations essentially every business day will ensure market stability.

Conclusion

Thus far, I have explained the baseline scenario of and risks to the outlook for economic activity and prices based on the Outlook Report and have also outlined the Bank's thinking behind its conduct of monetary policy. Japan's economy is still on its way to recovery from the significant downturn caused by COVID-19, and it has remained under downward pressure from the pandemic. The recent rise in commodity prices has negatively affected domestic demand through a decline in real income. In addition, while the inflation rate is expected to rise to around 2 percent in the short run, this will be driven by energy prices and lack sustainability. The Bank therefore does not consider that scaling back the current monetary easing is appropriate. In this regard, I would like to reemphasize that the current situation of Japan's economy is completely different from the United States and Europe, where economies have already recovered to above pre-pandemic levels and inflation rates have reached around 8 percent.

In recent years, economic uncertainties have increased significantly due to non-economic factors such as frequent natural disasters, the COVID-19 pandemic, and Russia's invasion of Ukraine. Not only is it difficult to predict how such shocks unfold, there is also a lack of sufficient data and accumulated knowledge on the spillover effects of such shocks on the economy. Given such great uncertainties, central banks need to conduct monetary policy by extensively examining, without any preconceptions, a variety of data available at the time. The Bank will continue to make efforts to accurately assess developments in economic activity and prices and disseminate information on the reasons for its policy decisions and the details of its decisions in a careful and easy-to-understand manner.

Thank you very much for your attention.

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Introduction

I. Economic Developments

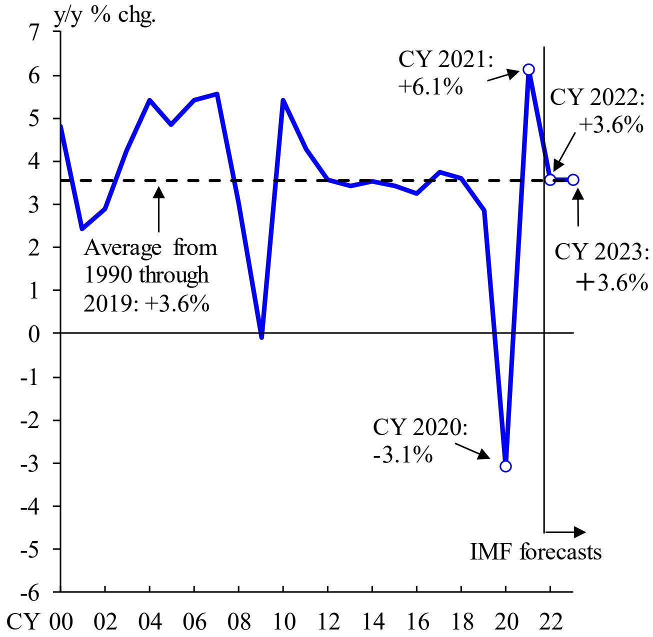
II. Price Developments

III. The Bank's Conduct of Monetary Policy

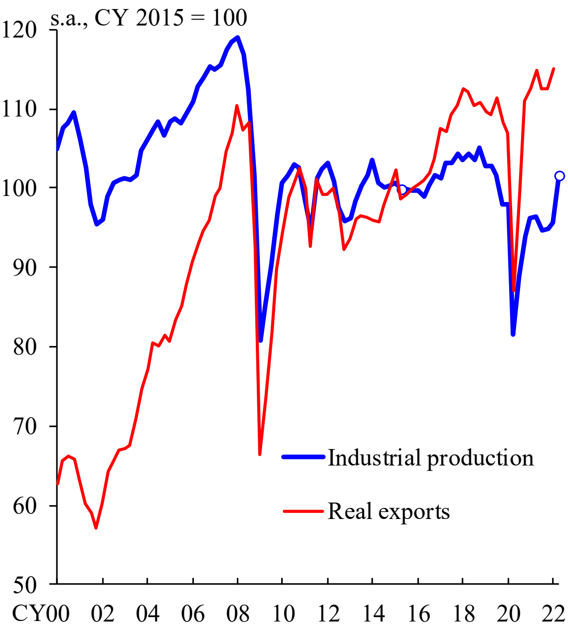
Conclusion

Overseas Economies and Exports & Production

Global Growth Rate (IMF's April 2022 WEO)

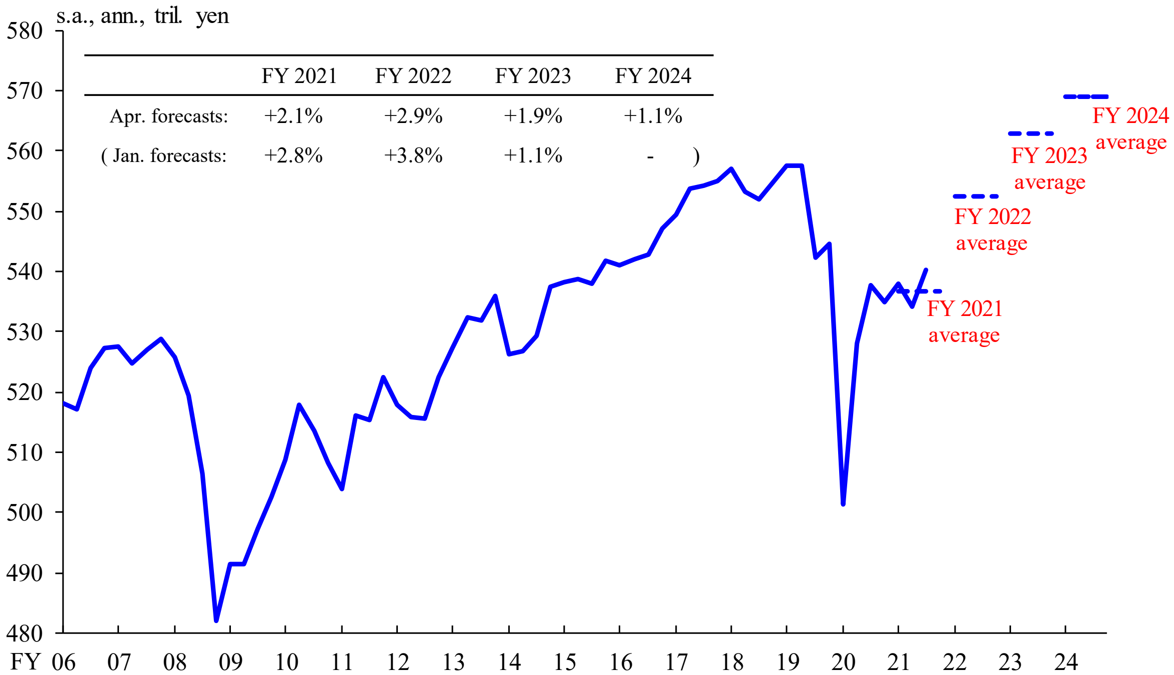


Japan's Exports and Production



Note: In the right-hand chart, the figure denoted by the round marker is calculated based on METI projections for April and May 2022.
Sources: IMF; Ministry of Finance; Ministry of Economy, Trade and Industry (METI); Bank of Japan.

The Bank's Forecasts for Real GDP



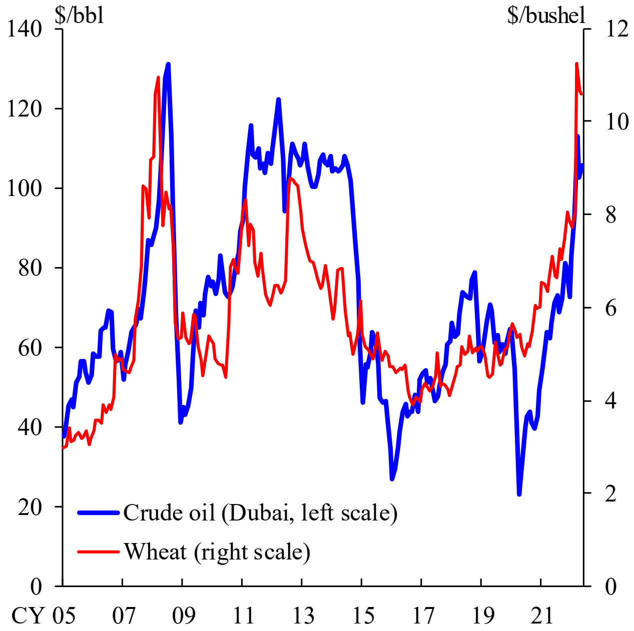
	FY 2021	FY 2022	FY 2023	FY 2024
Apr. forecasts:	+2.1%	+2.9%	+1.9%	+1.1%
(Jan. forecasts:	+2.8%	+3.8%	+1.1%	-)

Note: Figures for fiscal 2021-2024 are the medians of the Policy Board members' forecasts (point estimates).
Sources: Cabinet Office; Bank of Japan.

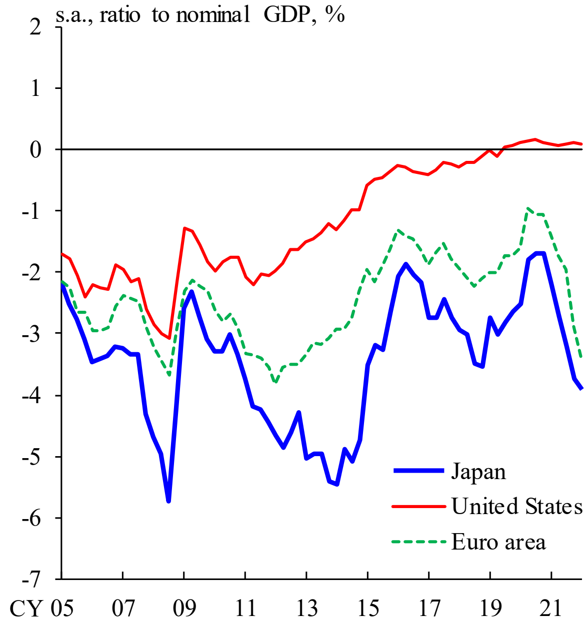
Chart 3

Commodity Prices and Trade Balance in Energy

Commodity Prices



Trade Balance in Mineral Fuels

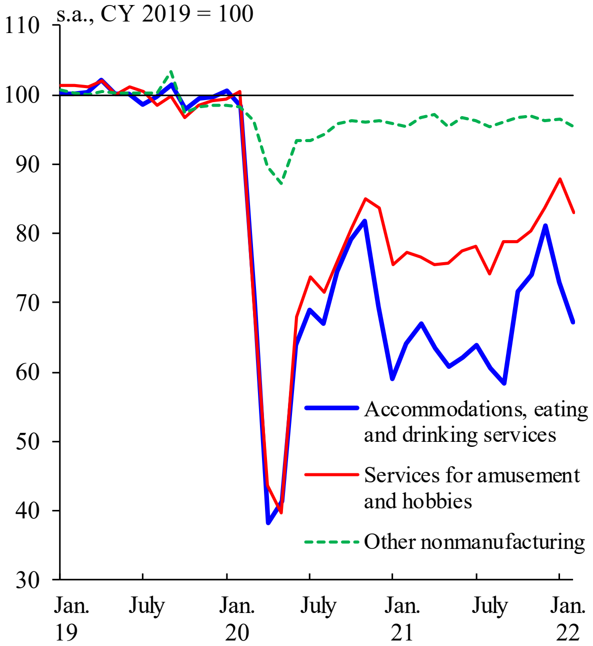


Note: In the right-hand chart, the figure for 2022/Q1 for Japan is calculated using its nominal GDP for 2021/Q4 and that for the euro area is calculated using its trade balance for January-February 2022 and its nominal GDP for 2021/Q4.
Sources: Bloomberg; Ministry of Finance; Cabinet Office; Haver.

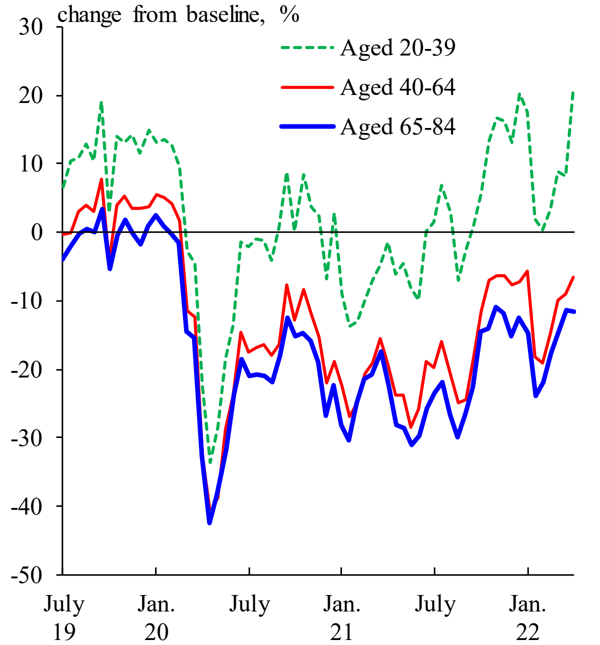
Chart 4

Services Consumption

Level of Economic Activity in Services Sector



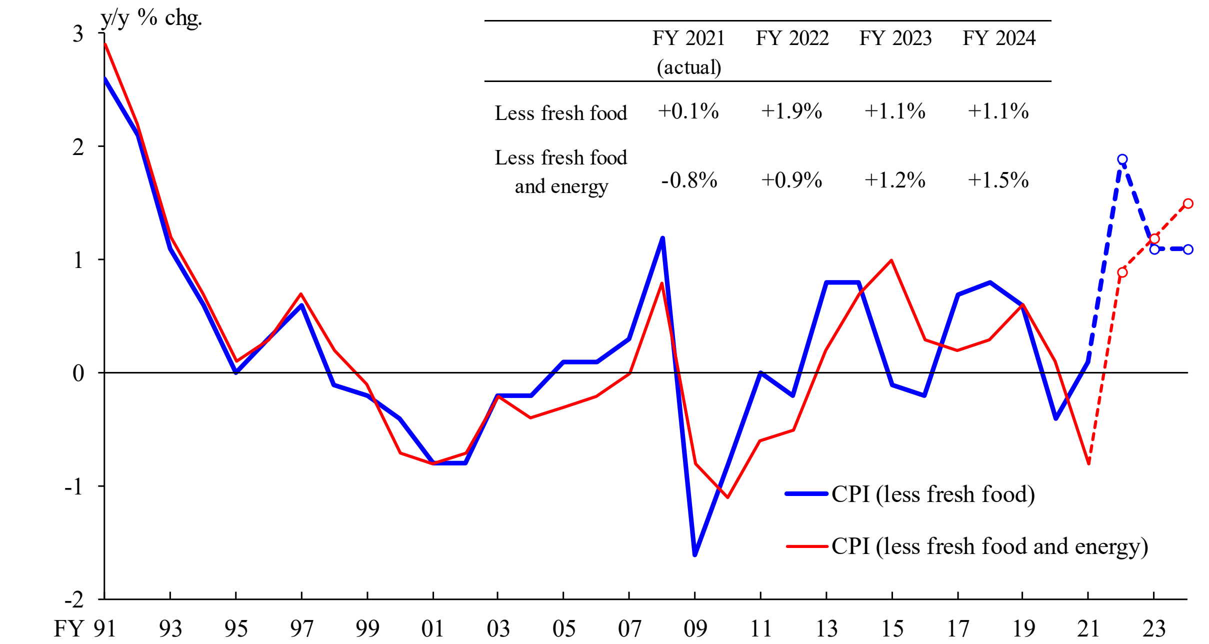
Developments in Services Consumption by Age



Note: In the right-hand chart, figures are from the reference series in *JCB Consumption NOW*, which take changes in the number of consumers into account. Figures are the arithmetic averages of the corresponding age groups in five-year increments. The baseline is the average for the corresponding half of the month for 2016 through 2018.
Sources: Ministry of Economy, Trade and Industry; Nowcast Inc./ JCB, Co., Ltd., "JCB Consumption NOW."

Chart 5

The Bank's Forecasts for CPI

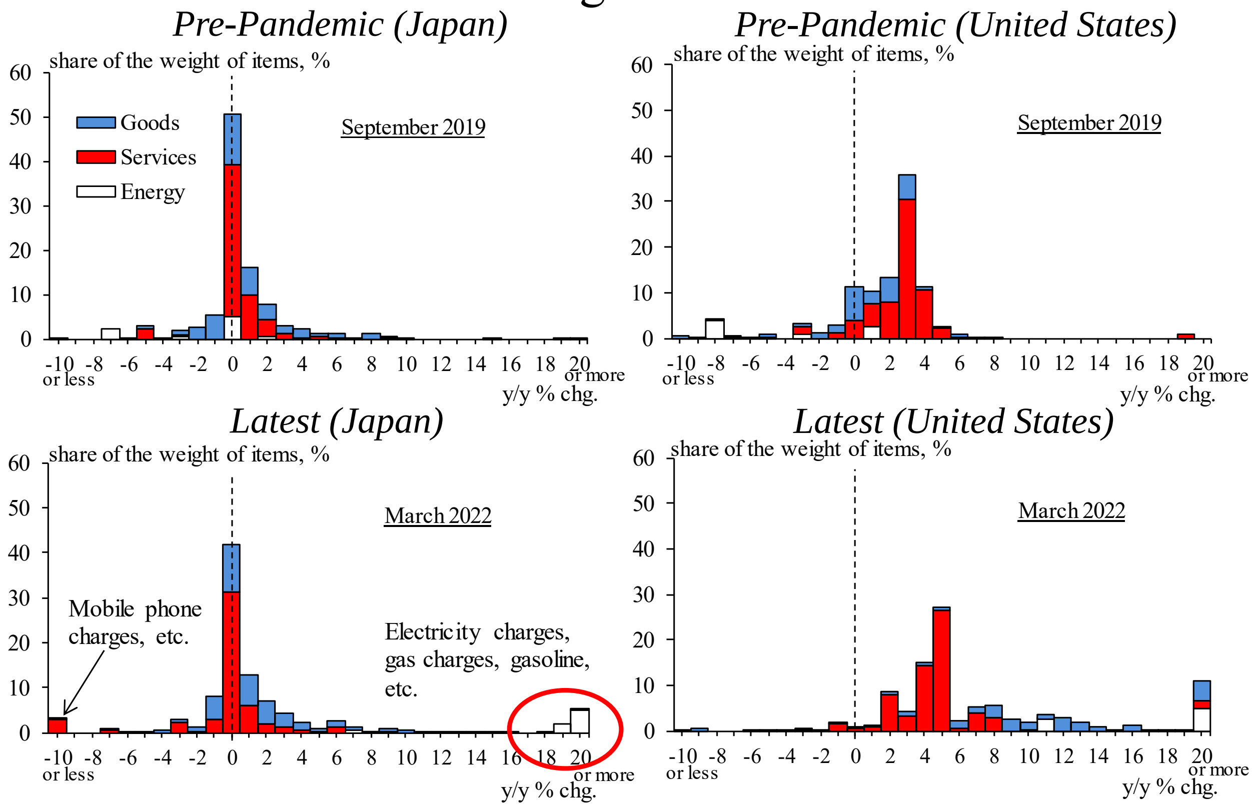


	FY 2021 (actual)	FY 2022	FY 2023	FY 2024
Less fresh food	+0.1%	+1.9%	+1.1%	+1.1%
Less fresh food and energy	-0.8%	+0.9%	+1.2%	+1.5%

Note: Figures exclude the direct effects of the consumption tax hikes in April 1997 and in April 2014. The percentage figures are the medians of the Policy Board members' forecasts (point estimates).
Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

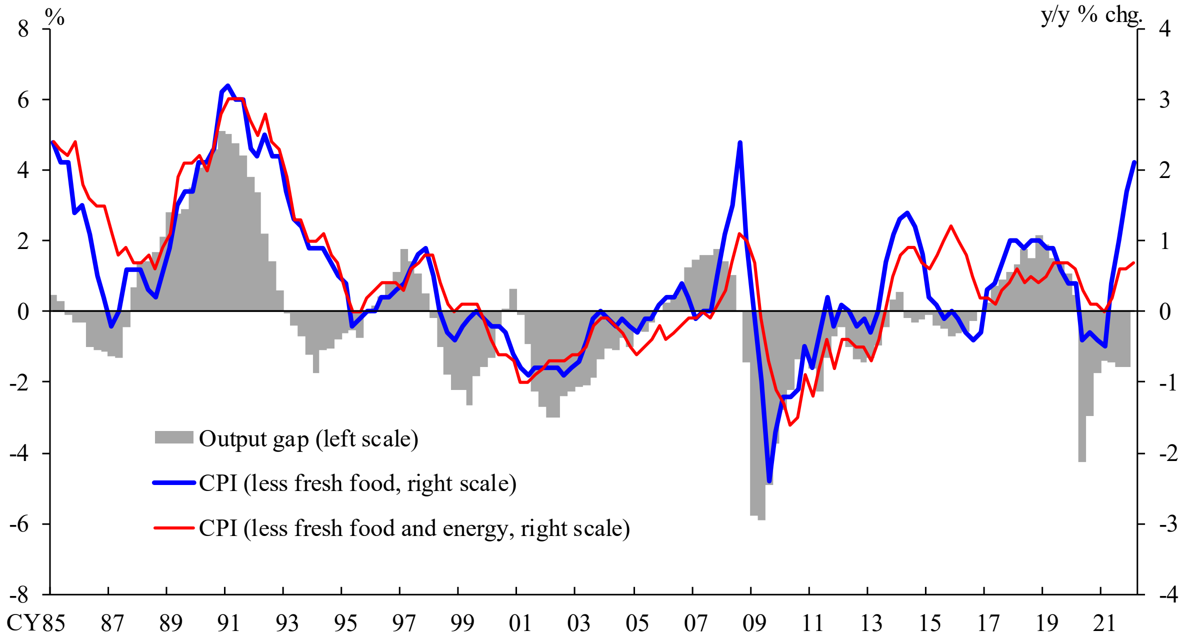
Chart 6

Price Change Distributions



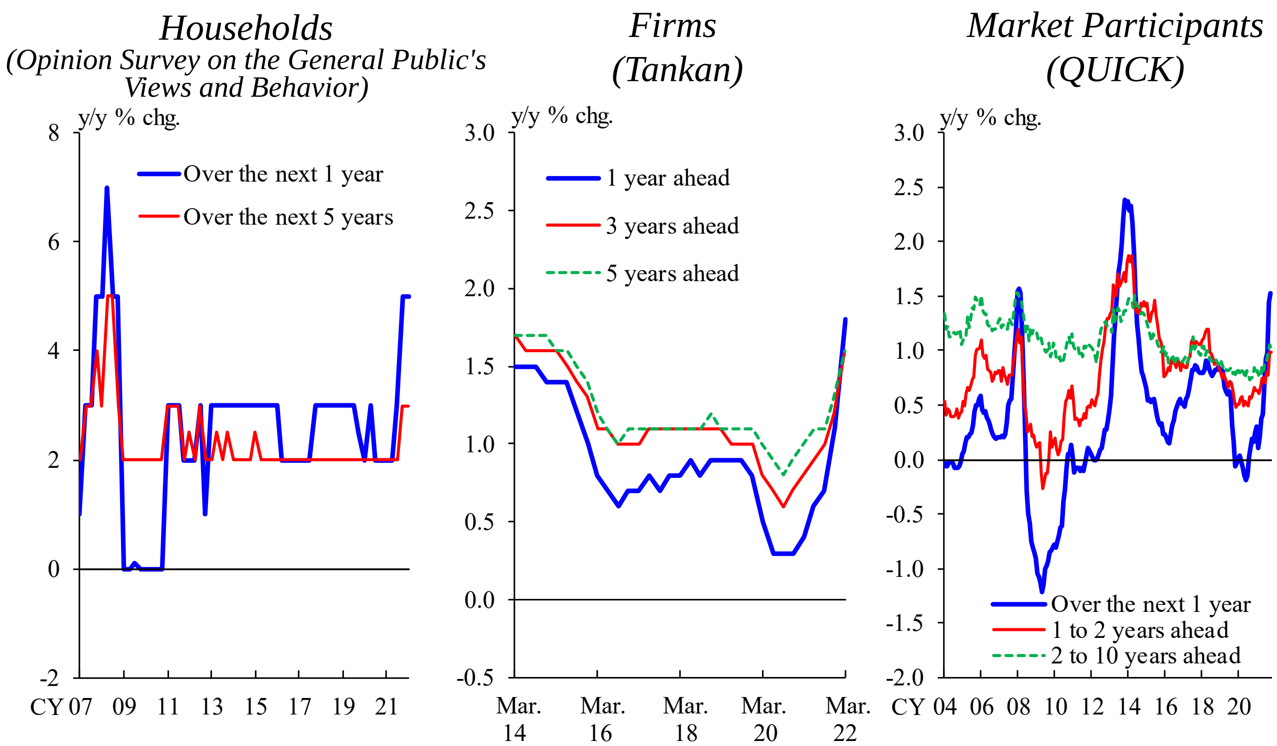
Note: Figures for the United States are for the CPI for all items. Those for Japan are for the CPI for all items excluding fresh food.
Sources: Ministry of Internal Affairs and Communications; BLS.

Output Gap and Inflation Rate



Note: The CPI 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 the "Go To Travel" campaign, which covers a portion of domestic travel expenses. Figures for the output gap are staff estimates.
Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

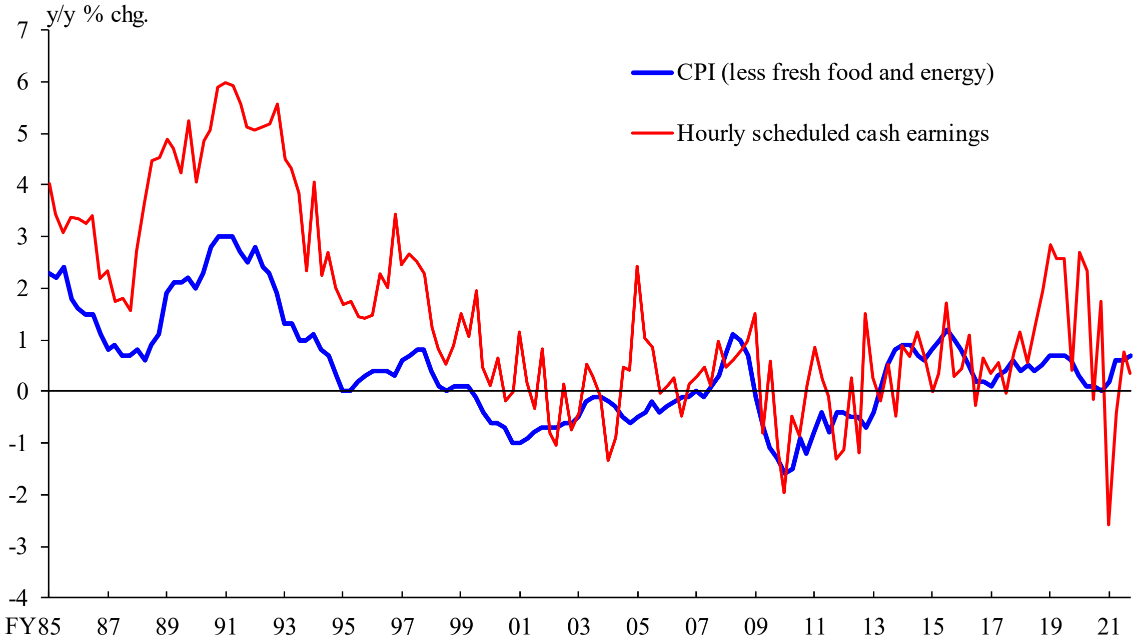
Inflation Expectations



Notes: 1. In the left-hand chart, figures are the medians of the answers to quantitative questions.
2. In the middle chart, figures show the inflation outlook of enterprises for general prices (all industries and enterprises, average).
Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey <Bonds>."

Chart 9

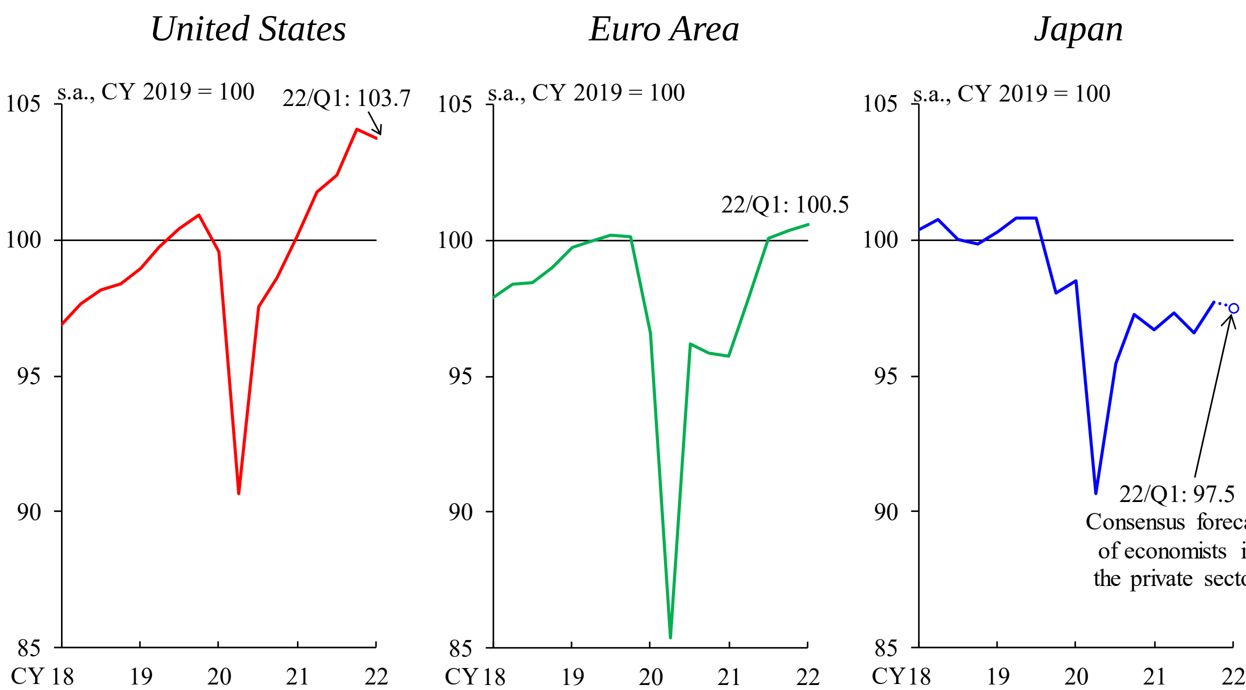
Prices and Wages



Notes: 1. For hourly scheduled cash earnings, Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. The figures are for full-time and part-time employees before fiscal 1994 and are for full-time employees thereafter.
2. The CPI 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 the "Go To Travel" campaign, which covers a portion of domestic travel expenses.
Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare.

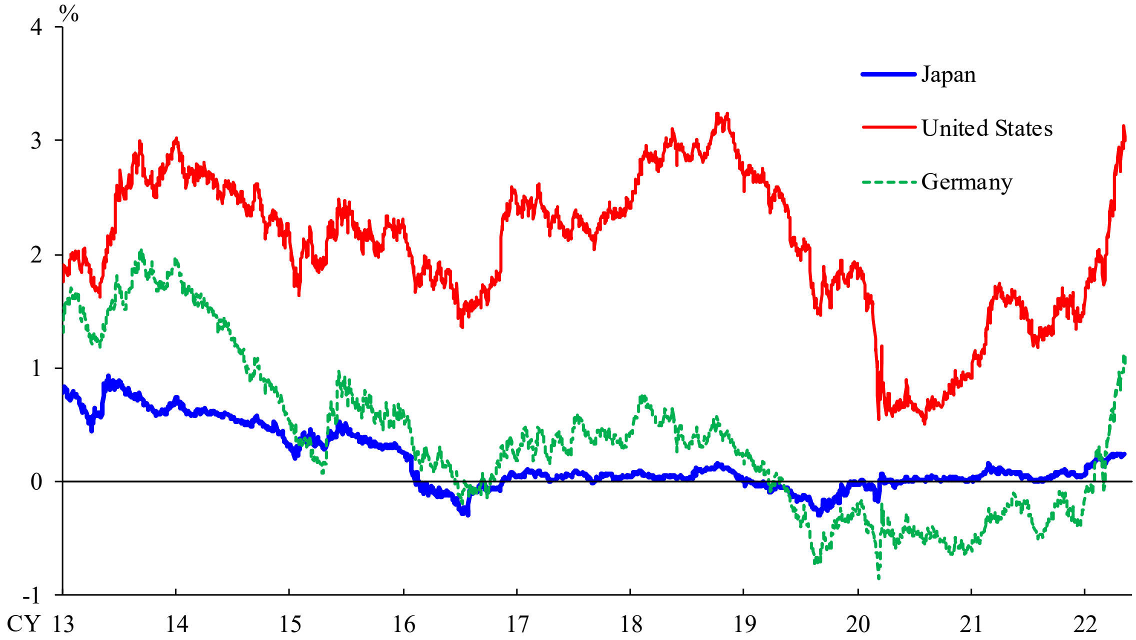
Chart 10

Real GDP in the United States, the Euro Area, and Japan



Note: In the right-hand chart, the consensus forecast is from the *ESP Forecast* (survey period: March 31-April 7).
Sources: Haver; JCER, "ESP Forecast"; Cabinet Office.

Long-Term Government Bond Yields in Japan, the United States, and Germany



Source: Bloomberg.