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Bank of Japan

Japan's Economy and Monetary Policy

Speech at a Meeting with Local Leaders in Shizuoka

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(English translation based on the Japanese original)

Introduction

It is my pleasure to have the opportunity today to exchange views with leaders in administrative, economic, and financial areas in Shizuoka Prefecture. I would like to take this chance to express my sincere gratitude for your cooperation with the activities of the Bank of Japan's Shizuoka Branch. Before hearing from you, I will explain Japan's economic activity and prices, as well as the Bank's conduct of monetary policy.

I. Developments in Economic Activity and Prices

Current Situation of Economic Activity and Prices

I will start by talking about developments in economic activity and prices. Please take a look at Chart 1. Japan's economy has recovered moderately, although some weakness has been seen in part. It is expected to keep growing at a pace above its potential growth rate.

Let me move on to Chart 2. Corporate profits have been on an improving trend. In this situation, business fixed investment plans in the December 2024 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) indicate that the year-on-year rate of increase in planned investment for fiscal 2024 is over 10 percent. Although some projects had to be postponed due to labor shortages in construction, this means that the increase in business fixed investment is likely to continue for an extended period.

Turning to Chart 3, private consumption has been on a moderate increasing trend. This is attributable to an accelerated rate of increase in employee income on the back of base pay hikes and a rise in bonuses. Anecdotal information, various surveys, and other sources collected so far suggest that, in the annual spring labor-management wage negotiations currently in process, wages are likely to continue rising steadily, following last year's solid wage increases. This is also expected to support private consumption.

Please take a look at Chart 4. The year-on-year rate of increase in the consumer price index (CPI) for all items excluding fresh food had decelerated, as the effects of a pass-through to consumer prices of cost increases led by the past rise in import prices waned. However, the rate has accelerated again recently, due to factors such as a rise in the price of rice. As for the outlook, the year-on-year rate of increase in the CPI (all items less fresh food) is expected to

slow down toward 2 percent. It is likely to be in the range of 2.5-3.0 percent for fiscal 2024, at around 2.5 percent for fiscal 2025, and at around 2 percent for fiscal 2026. This is based on the projection that the effects of cost-push factors will continue to wane, although there will be ongoing moves to pass on higher costs to prices, including increased personnel expenses reflecting wage hikes.

Relationship between Prices, Wages, and Private Consumption

Please take a look at Chart 5. In forecasting economic activity and prices, the most important aspect on the domestic demand side is the relationship between wages and prices, which are both rising, and their impact on private consumption. The year-on-year rate of increase in the CPI has remained above 2 percent for nearly three years, since exceeding 2 percent in April 2022. Simply adding up the increase over the three years on a fiscal year basis yields an increase in the CPI of 8.4 percent. In comparison, nominal wages for full-time employees, on a basis that includes bonuses, have increased by 8.3 percent. Wages have finally caught up with inflation, buoyed by the high wage hikes earlier this fiscal year. That said, wage growth should essentially exceed the rise in prices, reflecting productivity growth. My hope, therefore, is for wages to rise further this spring.

Meanwhile, from a slightly more micro-level perspective, the situation in the corporate sector varies depending on individual circumstances, such as between large firms and smaller firms. The third and fourth rows of the table in Chart 5 show that the increase in hourly wages for part-time workers and in the minimum wage has exceeded the figure in the second row. Faced by such a situation in the labor market, smaller firms need to carry out relatively high wage hikes to attract people to their workforce. Such differences have been seen within the household sector as well, such as the starting salaries of new graduates and the wages of younger workers rising at a high rate, while the wages of middle-aged and older workers have risen at a lower rate. Moreover, structurally, the older generation is less likely to benefit from wage increases since their income mainly consists of pensions.

Let me move on to Chart 6. While it is difficult to generalize, as it is mainly the older generation that owns assets in Japan, credit card data suggest that the older individuals are, the more restrained their spending behavior tends to be. Firms that focus on this consumer

demographic as their customer base are of the view that it is difficult to pass on rising personnel expenses to selling prices, given the tough sales environment. While the term "price pass-through" tends to conjure up images of supply chains in manufacturing industries, many smaller firms operate in business-to-consumer industries. Although many firms in these industries feel the need to pay high wages to attract and retain employees, their sales environment appears to be less favorable.

The differences that exist within the household and corporate sectors are often described as "polarization." Under such circumstances, it is especially important to grasp local economic conditions, which cannot be fully captured using macro data. The microeconomic information that the Bank receives from all of you at its Head Office and branches is invaluable. We appreciate your continued cooperation.

II. The Bank's Conduct of Monetary Policy

Recent Conduct of Monetary Policy

Next, I will discuss the Bank's conduct of monetary policy. Please take a look at Chart 7. At the Monetary Policy Meeting (MPM) in January, the Bank raised its short-term policy interest rate by 0.25 percentage points, to around 0.5 percent.

As I mentioned earlier, the year-on-year rate of increase in the CPI has remained above 2 percent for nearly three years. Against this backdrop, a policy interest rate of around 0.25 percent was very low, and real interest rates -- which take inflation into account -- were significantly negative. Even after raising the policy interest rate to around 0.5 percent, accommodative financial conditions have continued to firmly support the economy. Japan's economy has been recovering, albeit at a moderate pace, and underlying inflation has likely been rising, accompanied by wage increases. In this situation, adjusting the degree of monetary accommodation gradually, while maintaining accommodative financial conditions, will lead to stability in economic activity and prices in the long run. The developments in economic activity and prices that I outlined earlier are generally in line with what the Bank had anticipated, and this is why it made the policy adjustment.

While this was the main reason for the policy interest rate hike, the key criteria regarding the timing of the hike were developments in overseas economies, especially the U.S. economy. Shortly after the Bank raised the policy interest rate for the second time in July last year, U.S. employment statistics fell short of market expectations, raising concerns over a slowdown in the U.S. economy. Stock prices around the world declined sharply, and the U.S. dollar fell in the foreign exchange market. The yen-dollar exchange rate fluctuated substantially, partly reflecting the yen's prior depreciation. In addition, the fall in stock prices in Japan was greater than in other countries.

At a meeting with local leaders that same week, I said that the Bank would not raise its policy interest rate further when the financial and capital markets were unstable, and mentioned that the market reaction to U.S. economic indicators for a single month seemed too large and that the U.S. economy would most likely have a soft landing. Subsequently, most figures for U.S. employment statistics were relatively favorable. At present, the market consensus is that the employment data at that time were simply noise.

Please turn to Chart 8. Even at the time, in the United States, it was highlighted that the weakness in employment and the strength of the GDP data, particularly private consumption, seemed to be paradoxical. If one wanted to explain the data in a reasonable manner, one could argue that, even though employment and income were weak, people were dipping into their savings and spending, but that this dynamic would eventually run out of steam and GDP growth would slow down. The forecasts at that time are represented by the red dotted line in the left-hand graph. However, the GDP data were revised and, as shown in the graph in the middle, it turned out that the saving rate had not fallen, as was the case for the employment data I mentioned earlier. Meanwhile, as shown in the right-hand graph, inflation has come down to the 2-3 percent range, although the decline has paused somewhat since autumn. I think it is fair to say that the U.S. economy is in a well-balanced state.

With regard to the outlook, there are factors that can affect both economic activity and prices in the United States, such as the policies of the new administration. Geopolitical tensions also remain heightened. The future course of these factors and expectations regarding them will have an impact on business and household sentiment, not only in the United States but also

around the world, and on developments in global financial and capital markets. Uncertainties regarding the global economy remain high, and due attention continues to be warranted here.

Questions about the Policy Interest Rate Hikes from Two Directions

The Bank terminated its large-scale monetary easing in March 2024 and subsequently raised the policy interest rate in July 2024 and January 2025. This policy conduct has been met with questions from two opposite directions. One question concerns why the Bank continues with a low policy interest rate of around 0.5 percent when prices have been rising by more than 2 percent for nearly three years. The answer is that (1) the current price rises still reflect the cost-push caused by global inflation, and this will eventually wane, and that (2) underlying inflation, where prices rise accompanied by wage increases, has not yet reached 2 percent. Please look at Chart 9. While CPI inflation, as shown in the left-most graph, has been above 2 percent, underlying inflation is still below 2 percent, as shown in the three graphs to the right. Tightening monetary policy in this situation would suppress economic activity, and wages would not rise. Inflation would also eventually fall below 2 percent.

A critical question from the opposite direction is why the Bank raises the policy interest rate when economic recovery is weak. The response here is, first of all, that a policy interest rate of around 0.5 percent is sufficiently accommodative and provides strong support for the economy. Moreover, the fact that there have been severe labor shortages at the current growth rate and that prices and wages have been rising (even though underlying inflation has not reached 2 percent) means that Japan's potential growth rate is lower than the current growth rate. According to estimates by the Bank's staff, Japan's potential growth rate is around 0.5 percent. If we want higher growth, measures to increase the growth potential of the economy are needed, such as raising productivity.

Please take a look at Chart 10. In this regard, it appears that personnel constraints are limiting the potential growth rate. Normally, when firms face labor shortages, they try to substitute labor with machinery or software. However, as can be seen in the two upper graphs, while labor shortages have recently become increasingly acute, firms' perception of their production capacity suggests neither severe shortages nor excess. This is a phenomenon that has not been seen much in the past, and it is particularly noticeable in nonmanufacturing industries. The

Bank therefore examined the extent to which labor and capital can be substituted for one another in each industry. The results are shown in the bottom graph. In some nonmanufacturing industries, such as accommodations as well as eating and drinking services on the far right, almost no substitution has occurred, so that labor shortages are directly limiting production (i.e., the provision of services). In fact, hotels and Japanese-style inns across the country have noted that they have to turn down reservations despite having rooms available because they cannot find enough staff. In addition to being inherently labor-intensive, the industries on the right side of the graph consist mostly of small firms that are less likely to benefit from labor-saving investment. This means that even if they replaced jobs with machines, this would not be equivalent to compensating for one employee. I think that it is not enough to simply encourage labor-saving investment; instead, we need to address this issue of substitutability through, for example, the joint introduction of software or the consolidation of businesses to reach a larger scale. As you all know, raising productivity is a long and steady process. I believe we need to think concretely about measures to help micro-level efforts in the workplace.

Outlook for Prices and the Path of Policy Interest Rate Hikes

Let me move on to Chart 11. Regarding the conduct of monetary policy going forward, if the outlook for economic activity and prices presented in the *Outlook for Economic Activity and Prices* (Outlook Report) is realized, the Bank will accordingly continue to raise the policy interest rate and adjust the degree of monetary accommodation. In this regard, the key point of the outlook is that the Bank expects the 2 percent price stability target to be achieved. In other words, the Bank expects that the year-on-year rate of increase in the CPI will decline toward 2 percent as the effects of the cost-push wane, while underlying inflation will rise toward 2 percent, accompanied by wage increases. As a result, both actual inflation and underlying inflation are expected to be at around 2 percent in the second half of the projection period of the January Outlook Report (sometime during the period from the second half of fiscal 2025 to fiscal 2026).

The policy interest rate at that time is considered to approach an interest rate level that is neutral to economic activity and prices. In theory, this level is 2 percent plus the natural rate of interest. However, while the natural rate of interest is conceptually an important criterion

for distinguishing between monetary easing and tightening, estimates of the natural rate of interest range from a minimum of around minus 1 percent to a maximum of around plus 0.5 percent, depending on the estimation method. Moreover, as these estimates are subject to estimation error, the range is too wide for the estimates to be used in actual policy conduct. In practice, the Bank will examine the response of economic activity and prices as it raises the policy interest rate, and at present the Bank does not know for certain what the interest rate level that is neutral to economic activity and prices will be. I think that it will be possible for the Bank to proceed while examining the response of economic activity if it raises the policy interest rate at a pace in line with expectations.

Market Views and Interest Rate Formation

Please refer to Chart 12, which shows the policy interest rate path projected by financial markets. To reiterate, the Bank's rate hike process is conditional on its outlook for economic activity and prices presented in the Outlook Report being realized. Market participants may have projections for economic activity and prices that differ from the Bank's outlook, and could also have an array of views of the natural rate of interest. Based on their projections and views, market participants forecast the path of the policy interest rate and its level at the end of the rate hike process. Healthy functioning of the financial markets will require market participants to accurately understand the Bank's policy reaction function, which reflects the Bank's thinking on the conduct of monetary policy, and to form interest rates by plugging their own projections of economic activity and prices into the function. I thus think that the Bank communicating only "the" answer of the future policy interest rate could do away with the market's valuable information creation function.

The Bank has presented a consistent policy reaction function since the April 2024 Outlook Report. On this basis, if market participants' views of economic activity and prices change (i.e., if the figures plugged into the Bank's policy reaction function change), market interest rates would fluctuate accordingly. Normally, however, market participants' views of economic activity and prices change continuously, so interest rates are expected to develop in a stable manner reflecting these views.

Moreover, long-term interest rates are formed by adding the term premium for each maturity to the projections for the policy interest rate path. The Bank's purchases of Japanese government bonds (JGBs) have compressed the term premium, mainly through the impact based on the amount outstanding of its JGB holdings (the stock effect). In this regard, the Bank has been gradually reducing its purchase amount of JGBs in accordance with the reduction plan decided in July 2024; however, the decrease in the amount outstanding of its JGB holdings has been limited, and therefore monetary easing effects are likely to continue at a large scale. In the reduction plan, the Bank explained its thinking that (1) in principle, long-term interest rates are to be formed freely in financial markets, and the Bank expected that the rates would fluctuate to some degree in response to factors such as market views of economic activity and prices and developments in interest rates overseas, and that (2) in an exceptional situation where long-term interest rates rose rapidly in a manner that differed from normal market developments, the Bank, from the perspective of encouraging the stable formation of interest rates, would make nimble responses by, for example, increasing the amount of JGB purchases and conducting fixed-rate purchase operations of JGBs and the Funds-Supplying Operations against Pooled Collateral. This thinking, of course, remains valid.

As described, the Bank has not changed its thinking on the policy conduct regarding the short-term policy interest rate and on JGB purchases. In the process of the exit from large-scale monetary easing, the Bank will continue to communicate and conduct operations as appropriate for the stable formation of interest rates.

III. The Review of Monetary Policy from a Broad Perspective

Please take a look at Chart 13. Last December, the Bank published a report entitled the "Review of Monetary Policy from a Broad Perspective" (hereafter, the Review), which examined Japan's economy and monetary policy over the 25 years since the start of the deflationary period. During the review process, which lasted a year and eight months, the Bank received cooperation and opinions from a large number of firms, including firms from Shizuoka Prefecture, as well as financial institutions, market participants, and academic experts. I would like to take this opportunity to express my gratitude once again. Due to time

constraints today, instead of introducing the content of the Review, I would like to look back on the past 25 years, sharing some of my personal experiences.

Monetary Policy up to the Early 2010s

Please take a look at Chart 14. The monetary easing in the first 15 years up to the early 2010s did not produce the required easing effects because real interest rates could not be lowered sufficiently, due to the constraint that nominal interest rates could not be lowered substantially below zero percent. However, the biggest issue at the time was problems in the financial system, and I think that the effect of monetary easing in preventing the collapse of the financial system by supplying liquidity was more important than is generally appreciated. In the early 2000s, I worked in the Bank Examination and Surveillance Department's bank group, where I was engaged in monitoring financial institutions and handling practical aspects of the lender of last resort (LLR) loans. At the time, financial institutions were in the midst of disposing of nonperforming loans and were keenly aware of their capital constraints. I feel that, back then, an important part of the transmission mechanism of monetary policy was not fully functional, and easing effects were not fully transmitted. Moreover, from the perspective of one who observed financial institutions' daily funding on the ground, my honest impression was that it was a relief that this was during a period of quantitative easing. In fact, there was a significant sense of tension, with the Bank monitoring some financial institutions' funding in great detail, calculating their cash flow down to the maturity of individual large time deposits. I think that the extremely ample provision of liquidity to the market through the Quantitative Easing Policy enabled the problems in the financial system to be resolved without causing a sudden collapse due to funding issues.

Although monetary easing up to this stage was considered unconventional monetary policy, it primarily focused on forward guidance and did not extend to negative interest rates or lowering long-term interest rates through JGB purchases. In the early stages of quantitative easing, the Bank slightly increased its purchases of JGBs, but this was a measure to increase current account balances held by financial institutions at the Bank, which were the operating target, and was not aimed at lowering interest rates. While other central banks were also purchasing long-term government bonds at that time, the consensus then was not to use such purchases for intervening to guide interest rates, so as to avoid affecting the functioning of

markets or causing delicate issues with regard to fiscal policy, which I will discuss later. In central banking, there had long been a rule of expanding the balance sheet in line with the growing volume of the currency, and this rule served as a self-imposed restriction on government bond purchases. When the Bank introduced quantitative easing, it partially modified this, creating a new rule, the "banknote principle." There was a sense that if purchases of long-term JGBs were to be increased, some kind of guiding principle was needed.

Next, please take a look at Chart 15. The consensus I just described changed dramatically in the wake of the Global Financial Crisis. With global financial and capital markets remaining unstable and growth and inflation rates falling, central banks around the world were forced to introduce powerful monetary easing measures. The adoption of unconventional monetary policies in many countries seems to have been inevitable, as the impact of one country's monetary policy naturally depends on its relative relationship with those of other countries, given the interconnectedness of global financial markets. When discussing the pros and cons of unconventional monetary policies, it is necessary to consider the global context at the time, and I think that, ultimately, the question comes down to the assessment of the central banking community as a whole.

Large-Scale Monetary Easing since 2013

Against the background just described, the Bank from 2013 onward embarked on large-scale monetary easing, including Quantitative and Qualitative Monetary Easing, the Negative Interest Rate Policy, and Yield Curve Control (YCC). This series of policies stimulated economic activity and prices through the core mechanism of monetary policy: lowering real interest rates. Looking again at Chart 14, real interest rates, represented by the blue lines, have been significantly negative for the period that is not shaded.

Please take a look at Chart 16. While some experts do not regard such lowering of interest rates as very effective, I think this is probably due to the fact that the easing effects were mainly transmitted through the market. It is true that when interest rates are already close to zero, lowering them further will not make firms want to invest, and only around 30 percent of the policy effect was transmitted through the lending channel. Over 50 percent was transmitted via financial and capital markets, such as through stock prices and exchange rates.

On the other hand, those who think that large-scale monetary easing was effective highlight the fact that Japan's economy was previously suffering from factors such as excessive appreciation of the yen and stagnant stock prices, and that the introduction of large-scale monetary easing resolved these issues. However, some of the positive effects of the easing must be discounted, since these market developments also reflected external factors, such as recovery in the global economy. In any case, it is fair to say that the decline in real interest rates brought by large-scale monetary easing stimulated economic activity and prices, mainly through the financial and capital market channel.

Please see Chart 17. As a result, combined with various government measures, large-scale monetary easing created more than 5 million jobs and eliminated the slack in the labor market, which was the root cause of deflation. I think that the essence of a deflationary economy is a work-sharing economy burdened with surplus personnel. Looking back, from the 1990s onward, the growth rate of Japan's economy declined and there was a chronic shortage of demand due to the collapse of the bubble economy as well as delayed adaptation to globalization and the declining birthrate and aging population. The typical solution to this would have been to accept a temporary increase in unemployment and bankruptcies in order to achieve a quick economic turnaround, which is what was the case in the U.S. economy during and after the COVID-19 pandemic, for example. By contrast, the social and economic choices made in Japan at that time pushed firms to maintain employment while receiving various support, which kept unemployment at low levels. The trade-off was a long period of excess employment and firm numbers, which prevented wages and product prices from rising. This became the social "norm," and actions that went against this norm were sometimes criticized.[1]

The Bank felt that the only way to resolve this entrenched situation was to provide strong stimulus to the economy and bring the labor market into a state of labor shortage. On Christmas day in 2014, at an early stage of large-scale monetary easing, Mr. Kuroda, who was Governor at the time, gave a speech at Keidanren (Japan Business Federation) entitled

[1] These points are analyzed in more detail in Uchida, S., "Price Dynamics in Japan over the Past 25 Years," keynote speech at the 2024 BOJ-IMES Conference hosted by the Institute for Monetary and Economic Studies, Bank of Japan, May 27, 2024.

"Welcome to the 2 Percent Club." For the Bank, this was an "aggressive" title for a speech. In his speech, the Governor argued that, after overcoming deflation, firms that did not believe in the achievement of 2 percent inflation would become more active, and the competition over securing the labor force, for example, would become intensified, and moreover that the favorable financial conditions of the transitional period would not be forever and this was a great chance, on a first-come, first-served basis. While the invitation was a bit too early, after 10 years we are now approaching this situation. In broad terms, the aims of large-scale monetary easing are being realized, and I think the easing has worked in the direction of revitalizing Japan's economy.

Effects and Side Effects of Large-Scale Monetary Easing

Nevertheless, there is no such thing as a free lunch, and there were side effects to large-scale monetary easing. Please refer to Chart 18. So far, the positive effects have outweighed the side effects. However, it should be noted that this assessment comes with a caveat, as there is a possibility of larger side effects emerging in the future.

Of the several side effects of large-scale monetary easing, distortions in financial markets and the impact on financial institutions' profits are inseparable from the positive effects. Thus, in pursuing monetary easing, the Bank has always been mindful to strike a balance between the positive and negative effects. In the meantime, there are two side effects that are somewhat different in nature from the ones I just mentioned: the first relates to the link between low interest rates and productivity, and the second relates to the link with fiscal policy.

Starting with the former, some argue that low interest rates have kept so-called zombie firms alive and held back long-term productivity growth. There are opinions both in favor of and against this argument in academia, and the Review does not reach a conclusion on this issue. In my view, given the experience of the generation that faced the so-called employment ice age, the positive effects of the high-pressure economy caused by monetary easing, which improved the employment environment for subsequent generations, were greater than the side effects of low interest rates, and hence acted in the direction of increasing productivity. Since firms' moves to maintain employment during the deflationary period were aimed at workers already employed, these moves resulted in firms holding back their recruitment of people entering the labor market. Given that Japan's labor market was largely characterized by

lifetime employment, opportunities for younger workers to gain employment or receive on-the-job training (OJT) were hindered, and this was a significant factor leading to the decline in productivity for the economy as a whole. Moreover, even if the negative effect of low-productivity firms surviving or a slowdown in business dynamics were greater (which I do not think is the case), this, in my view, is not something that was inseparable from low interest rates, but rather the result of social and economic choices, including the provision of subsidies. To reiterate, my view is that, given Japan's strong social aversion to unemployment, only labor shortages rather than interest rates could be the driving force of stimulating business dynamics.

Next, I would like to turn to the link with fiscal policy. On this point, the Review states that "in the exchange of views conducted . . . it was pointed out that the large-scale monetary easing implemented by the Bank led to a loosening of fiscal discipline," and that "it is crucial for the Bank to continue to clearly explain as it has been doing continuously and consistently, that the aim of monetary policy . . . should not be to support monetary financing of government debt." The Bank has received criticism that this description is insufficient and unsatisfactory. While there are various ways to discuss this issue, and speaking briefly may cause misunderstanding, my own view, to put it bluntly, is as follows.

First of all, while the debates over monetary financing of government debt and fiscal moral hazard are related, these are separate issues. As experts often point out, whether a central bank engages in monetary financing of government debt is not something that is resolved by the central bank simply saying that it has no intention to do so. Throughout the entire monetary easing process, it is necessary for the central bank to implement monetary policy that is appropriate for economic activity and prices. In other words, the result must be that the central bank does not deviate from necessary policies out of consideration of the fiscal situation. So far, the Bank has implemented necessary policies, including policy interest rate hikes and reductions in its purchase amount of JGBs. By all means, the Bank will continue to conduct policy that is appropriate for economic activity. On this basis, however, to ultimately convince people that the aim of monetary policy is not to support monetary finance, we should wait for further progress in the exit process from large-scale monetary easing.

Next, the issue of fiscal moral hazard -- that is, whether fiscal discipline has loosened due to large-scale monetary easing -- depends on how we measure fiscal discipline. If we focus on whether it became easier for the government to spend, there is no doubt that the government sector, the borrowing entity, benefited from lower interest rates. On the other hand, if we focus on the impact on the fiscal situation, this is likely to be better compared to a scenario in which the economy followed a lower growth path in the absence of large-scale monetary easing. While various arguments can be made on this point, I want to discuss it from a slightly different angle. Let's say that large-scale monetary easing was necessary in terms of economic activity and prices (it is of course possible to question this condition, but that is an issue that should be discussed separately from the side effects). Based on this condition, if large-scale monetary easing has the side effect of loosening fiscal discipline, the government should respond to it. This will allow the government and the central bank taken together to implement policies that are appropriate for economic activity. It is certainly not optimal for the central bank to avoid implementing policies necessary for the economy simply to avert loosening fiscal discipline.

This point became a common challenge around the world during the COVID-19 pandemic and was frequently discussed at the international conferences I attended. The policy mix of fiscal expansion -- accompanied by increased issuance of government bonds -- and monetary easing -- including purchases of government bonds -- can be a delicate issue in terms of both monetary financing of government debt and fiscal discipline. A general consensus at the time was that large-scale coordination of fiscal and monetary policy requires strong discipline to ensure that each fulfills its respective mission. In Japan, this point was included in a joint statement issued by the government and the Bank in January 2013, well before the pandemic.

The Exit from Large-Scale Monetary Easing

Finally, although it does not represent a side effect itself, one thing to consider when introducing unconventional policy measures is the exit from the measures. No architect would design a building without considering its demolition. When the Bank designed the large-scale monetary easing measures, it certainly was mindful of the exit process. One specific example is the feature for conducting the supply of funds at long-term fixed interest rates, which was incorporated into the Bank of Japan Financial Network System (BOJ-NET) when the system

was upgraded after the monetary easing was introduced. The supply of such funds was implemented in the final phase of YCC. While there was discussion at the time as to whether this feature was really necessary, we asked the IT department to incorporate it into the system, saying that it would likely be necessary sometime during the period of moving toward the exit. As seen in this example, much of the Bank's ability to implement monetary policy is supported by the contributions made by the staff members that carry out operational functions at the Head Office and branches.

Although the exit process has only just begun, the Bank has passed two difficult hurdles that we thought would be major challenges: the first expansion of the range of 10-year JGB yield fluctuations under YCC in December 2022, and the termination of large-scale monetary easing in March 2024. Of course, it has not been all smooth sailing. In the case of the former, the Bank subsequently had to purchase 100 percent of certain government bond issues for several months, which significantly distorted market functioning.

In the case of the latter, please have a look at Chart 19. In March 2024, when the Bank terminated large-scale monetary easing, it explained that accommodative financial conditions would be maintained, which generated a sense of security in the markets. However, this came at the expense of an accumulation of so-called yen carry positions. The unwinding of these yen carry positions when the Bank raised its policy interest rate in July was one of the factors behind the large fluctuations in exchange rates and stock prices.

I think that, going forward, the Bank needs to continue to exercise ingenuity and strike a balance in both its operations and communication. In this sense, the ultimate pros and cons of large-scale monetary easing are yet to be determined. Put differently, proceeding successfully with the exit process will improve the overall assessment of the Bank's policies, so we are committed to conducting policy appropriately.

IV. My Hope for the Economy of Shizuoka Prefecture

Please take a look at Chart 20. In closing, I would like to talk about the economy of Shizuoka Prefecture. In addition to a warm climate and abundant tourism, agricultural, forestry, and fishery resources, Shizuoka Prefecture's location offers convenient access to both Tokyo and

Nagoya, making it a popular destination for people to relocate to. Despite this well-endowed environment, the prefecture has not rested on its laurels, but rather has made distinct progress in addressing some of the issues I have discussed today.

In Japan's current labor market, there is much competition among firms and regions to find ways of attracting young people. In Shizuoka Prefecture, the public and private sectors have been working together to support startups and create attractive work opportunities for young people. Business matching events in Shizuoka City have yielded many connections between firms in the prefecture and startups elsewhere.

Moreover, it is important to devise ways to address labor shortages at the microeconomic level, as I mentioned. In this regard, the trial runs of self-driving trucks and buses on public roads in Shizuoka Prefecture is a leading example.

Lastly, while avoiding taking risks was an option during the deflationary period, the rule that holds in the "2 Percent Club" is that chances are seized on a first-come, first-served basis, as spelled out in the principle of capitalism. In Shizuoka Prefecture, the spirit of "*yaramaika*" -- which means to "just set out to do something" in the local dialect -- has been passed down, and this can be seen in efforts such as moves by manufacturing firms in the western part of the prefecture to expand business in India at an early stage. I would like to conclude my remarks by expressing the hope that, under this new rule book, the economy of Shizuoka Prefecture will continue to flourish. Thank you very much for your attention.

Japan's Economy and Monetary Policy

Speech at a Meeting with Local Leaders in Shizuoka

March 5, 2025

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Deputy Governor of the Bank of Japan

Introduction

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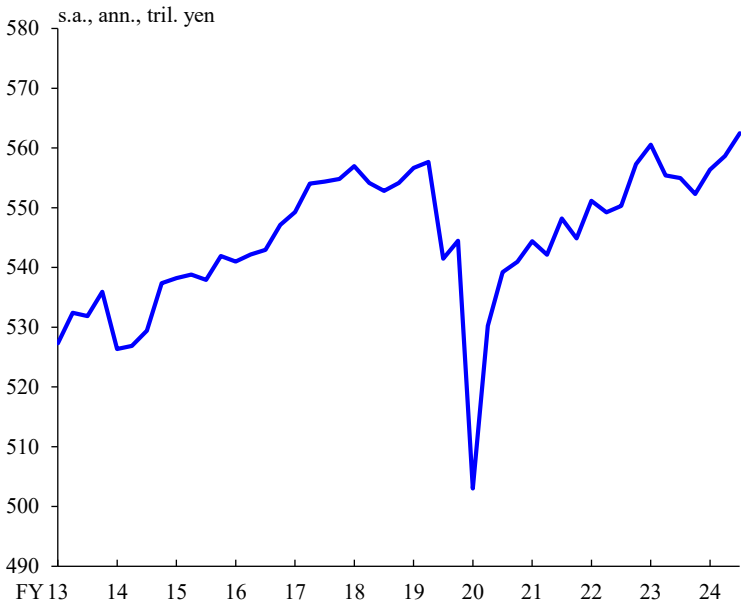
IV. My Hope for the Economy of Shizuoka Prefecture

Chart 1

Real GDP

Developments over Time



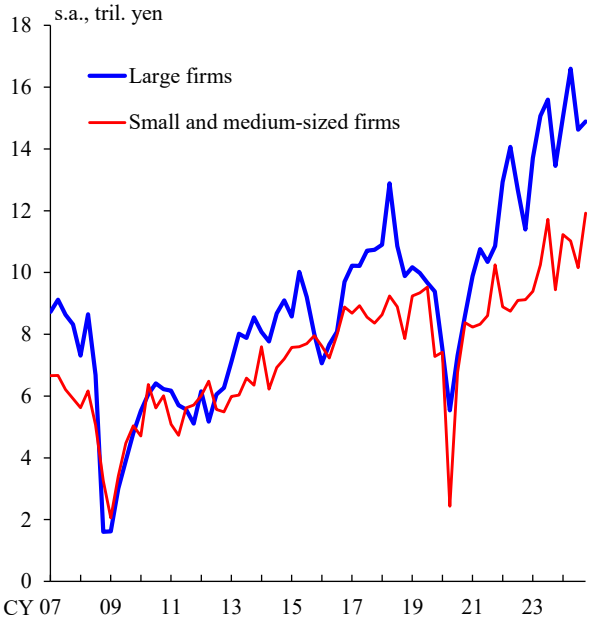
The BOJ's Forecasts (January 2025 Outlook Report)

Note: In the right-hand chart, the forecasts presented are the medians of the Policy Board members' forecasts.
Sources: Cabinet Office; Bank of Japan.

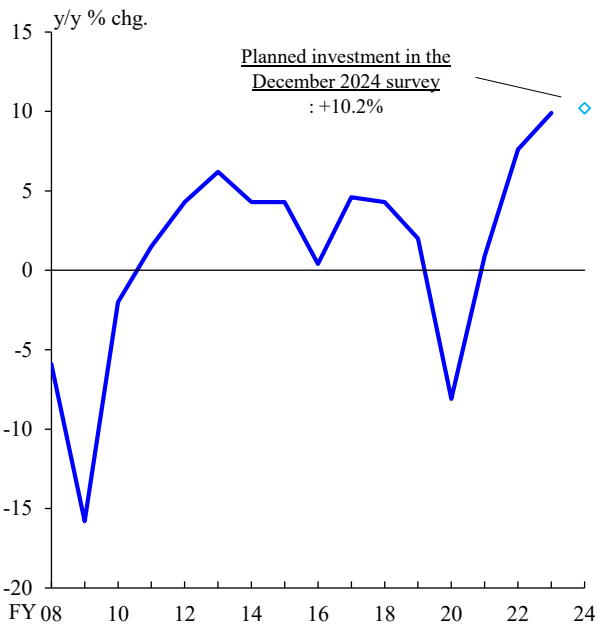
Chart 2

Corporate Sector

Corporate Profits



Business Fixed Investment

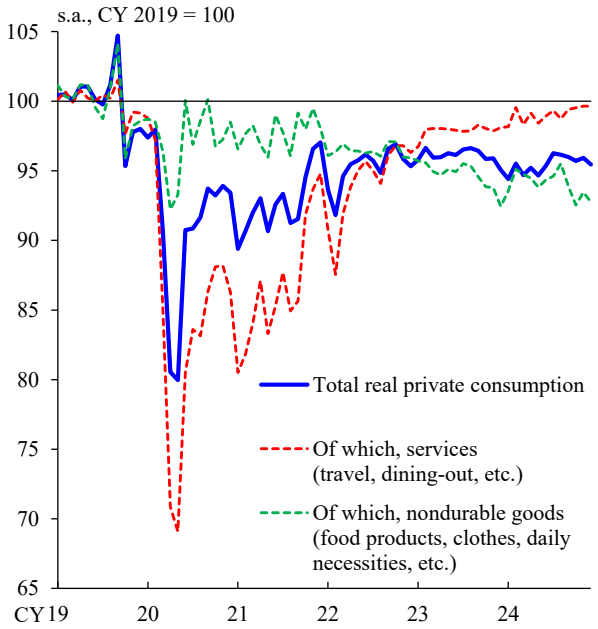


Notes: 1. In the left-hand chart, figures are current profits based on the *Financial Statements Statistics of Corporations by Industry, Quarterly* and exclude "finance and insurance." Figures from 2009/Q2 onward exclude pure holding companies.
2. In the right-hand chart, figures are based on the *Tankan*, 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: Bank of Japan; Ministry of Finance.

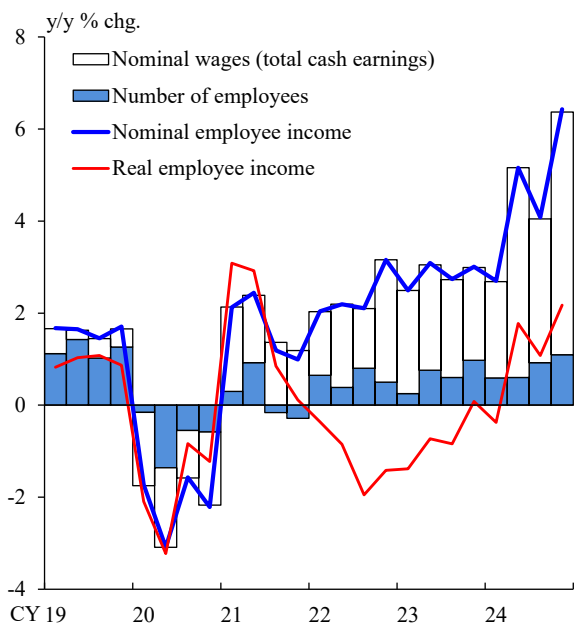
Chart 3

Household Sector

Private Consumption



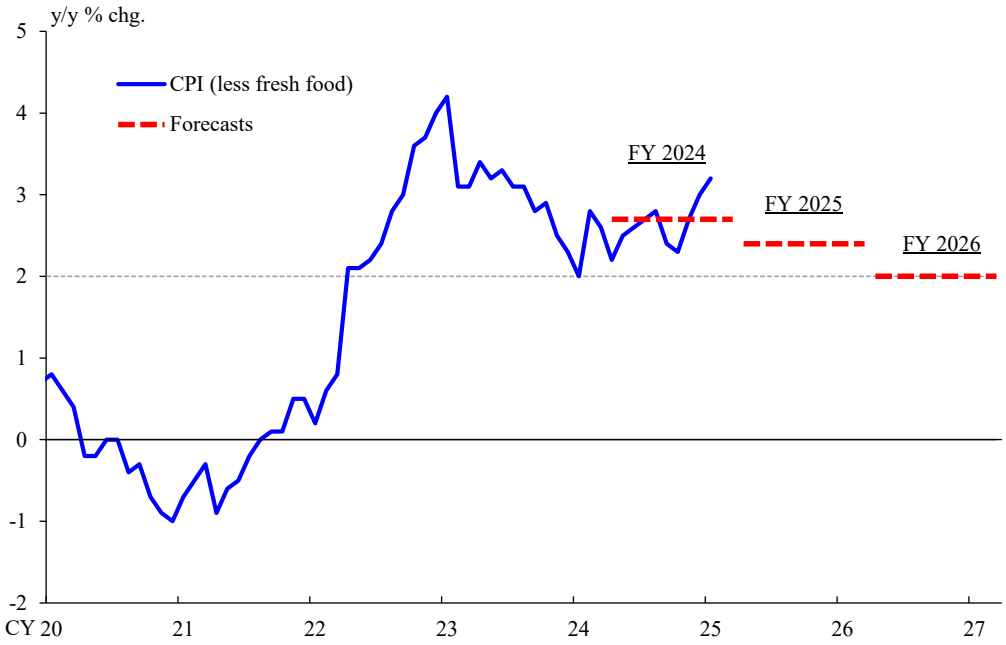
Employee Income



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, Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February. Nominal employee income = Total cash earnings (*Monthly Labour Survey*) × Number of employees (*Labour Force Survey*). Figures for real employee income are based on staff calculations using the CPI (less imputed rent). Figures from the *Monthly Labour Survey* are based on continuing observations following the sample revisions. Figures for 2024/Q4 are those for December.
Sources: Bank of Japan; Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare.

Chart 4

Consumer Prices



Note: The forecasts presented are the medians of the Policy Board members' forecasts in the January 2025 Outlook Report.
Sources: Ministry of Internal Affairs and Communications; Bank of Japan.

Chart 5

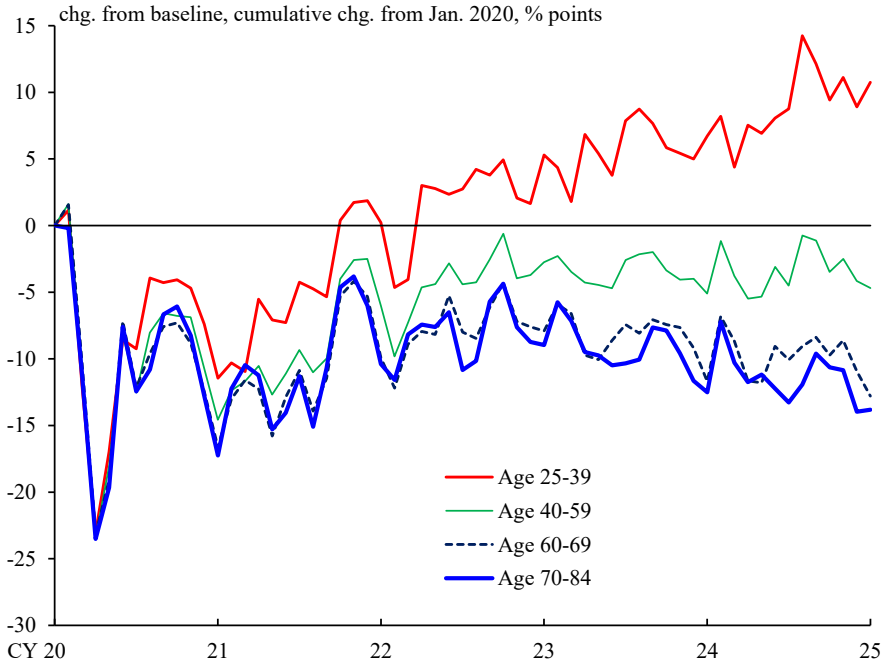
Wages and Consumer Prices

y/y chg.	FY 2022	FY 2023	FY 2024	Total
CPI (less fresh food)	3.0%	2.8%	2.6%	8.4%
Nominal wages (full-time employees)	2.2%	2.2%	3.9%	8.3%
Hourly nominal wages (part-time employees)	1.2%	3.1%	4.4%	8.8%
Minimum wage	3.3%	4.5%	5.1%	12.9%

Note: The figure for the CPI for fiscal 2024 is the April 2024-January 2025 average. Figures for nominal wages and hourly nominal wages for fiscal 2024 are the April-December averages (based on continuing observations following the sample revisions).
Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare.

Chart 6

Real Private Consumption by Age



Notes: 1. The baseline is the average for the corresponding months for fiscal 2016 through fiscal 2018.
2. Figures take changes in the number of consumers into account. Real values are obtained using the corresponding CPI for each item. (The CPIs are the same for all age groups).
Sources: Nowcast Inc./ JCB, Co., Ltd., "JCB Consumption NOW"; Ministry of Internal Affairs and Communications, etc.

Chart 7

Decision at the January 2025 MPM

Japan's economic activity and prices have been **developing generally in line with the Bank's outlook**, and **the likelihood of realizing the outlook has been rising**.

Medians of the Policy Board Members' Forecasts (y/y % chg.)

	Fiscal 2024	Fiscal 2025	Fiscal 2026
Real GDP	0.5 (-0.1)	1.1 (—)	1.0 (—)
CPI (all items less fresh food)	2.7 (+0.2)	2.4 (+0.5)	2.0 (+0.1)
CPI (all items less fresh food and energy)	2.2 (+0.2)	2.1 (+0.2)	2.1 (—)

Note: Figures in parentheses indicate changes from the October 2024 Outlook Report.

Wages

- Firms have expressed the view that they will **continue to raise wages steadily**, following the solid wage increases last year.

Prices

- With wages continuing to rise, **underlying CPI inflation has been increasing gradually toward 2 percent**.
- CPI inflation is likely to be at around 2.5 percent for fiscal 2025, due to the higher import prices stemming from the yen's depreciation etc.

Overseas economies

- Global financial and capital markets have been **stable on the whole**, while attention has been drawn to various uncertainties.

Adjusting the degree of monetary accommodation from the perspective of sustainable and stable achievement of the price stability target of 2 percent

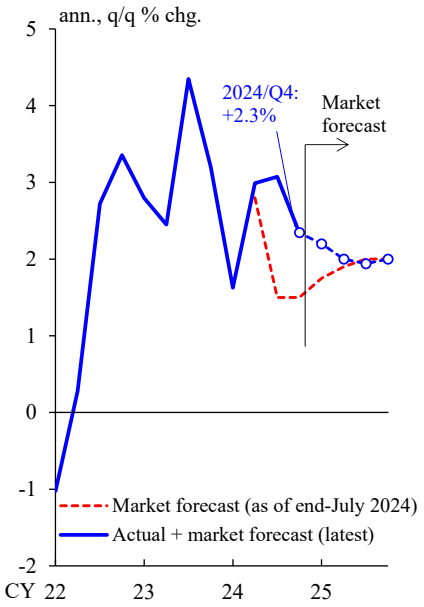
Short-term interest rate : raised to "around 0.5%"
(uncollateralized overnight call rate) (previously "around 0.25%")

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

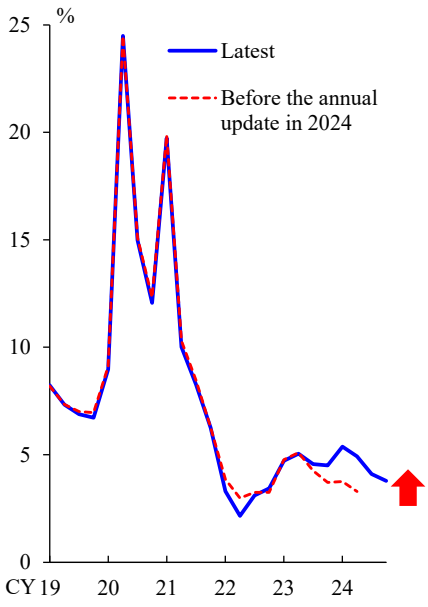
Chart 8

U.S. Economy

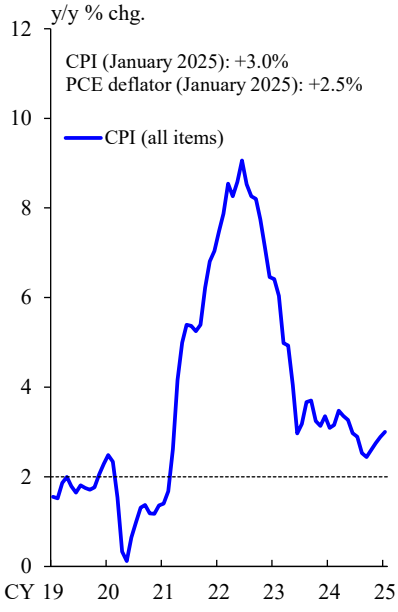
GDP Forecast by Market Participants



Saving Rate



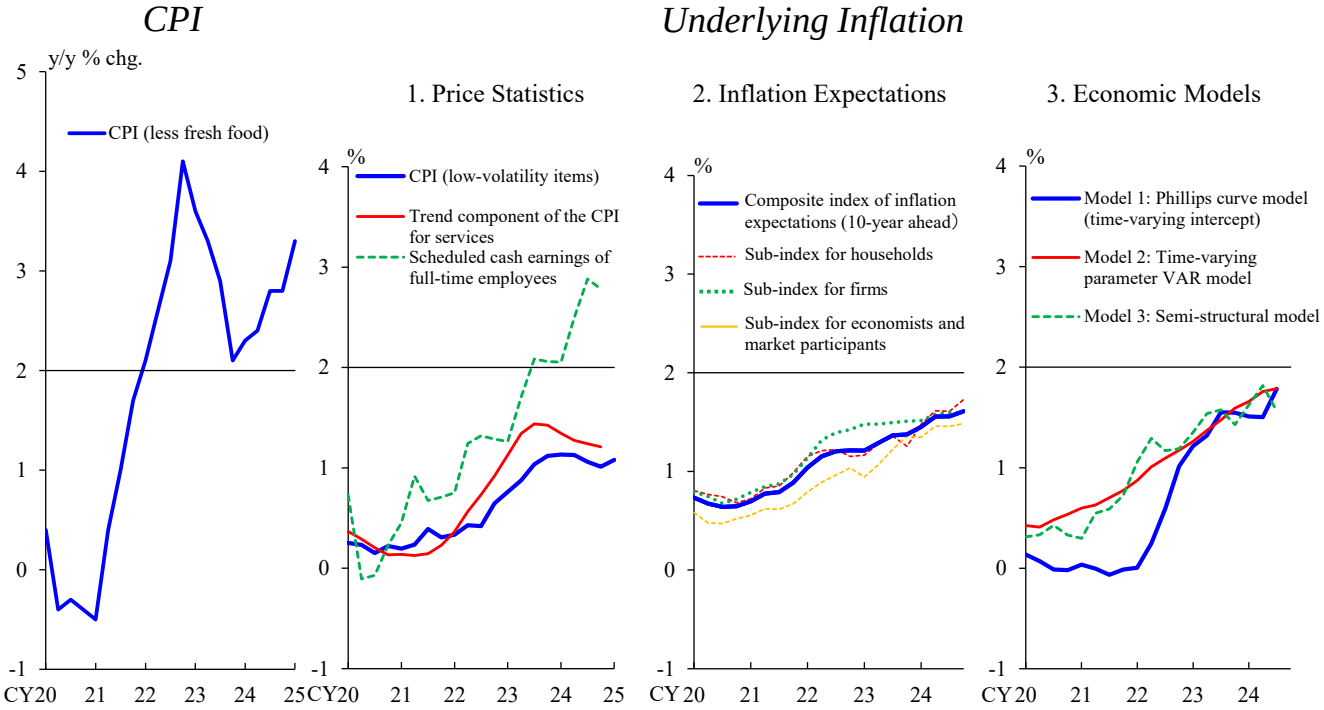
CPI



Notes: 1. In the left-hand chart, the market forecast is based on a survey by Bloomberg.
2. In the middle chart, figures for the saving rate are calculated as follows:
Saving rate = (Nominal disposable personal income - Nominal personal outlays) / Nominal disposable personal income × 100.
Sources: Bloomberg; Haver.

Chart 9

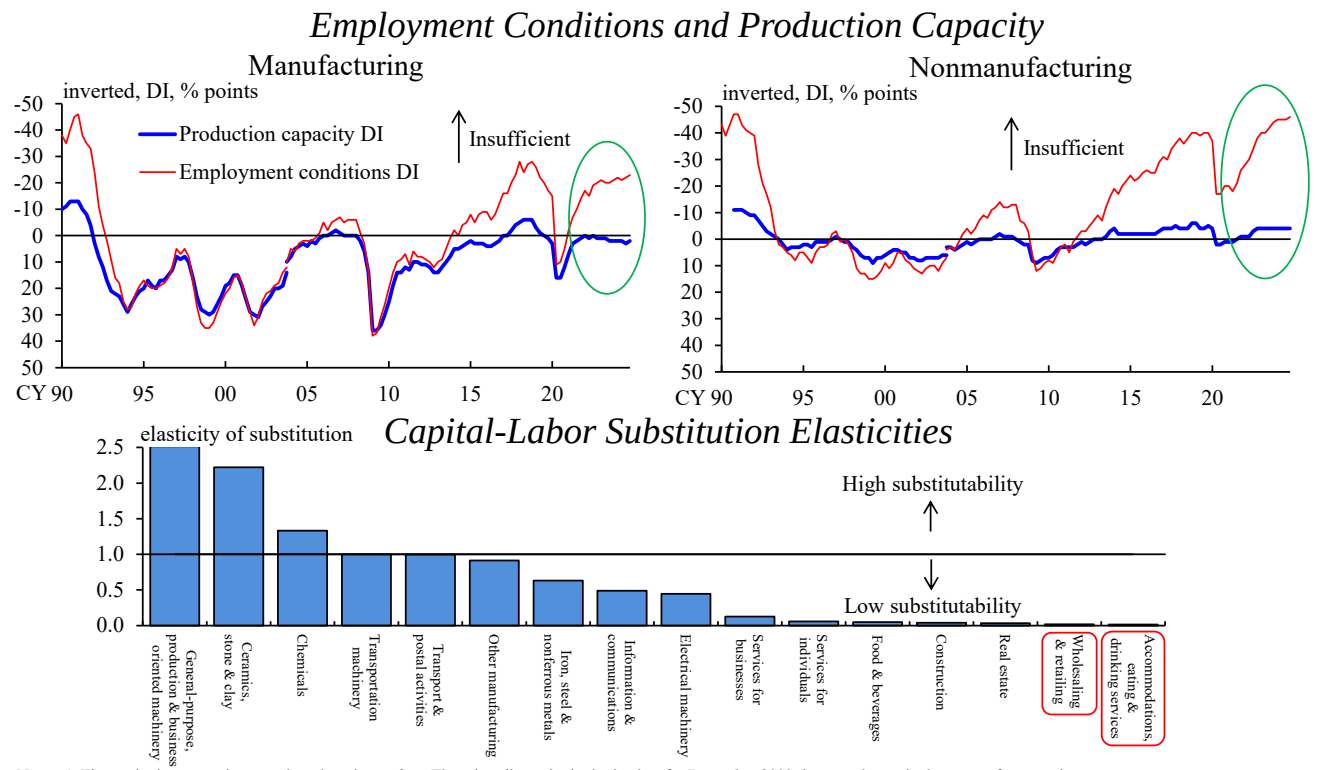
CPI and Underlying Inflation



Notes: 1. In the left-most chart, figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hike, policies concerning the provision of free education, and travel subsidy programs. The figure for 2025/Q1 is that for January.
2. For details of the approaches on which the three other charts are based, see Box 4 of the April 2024 Outlook Report. In the chart titled "1. Price Statistics," figures for scheduled cash earnings of full-time employees are based on continuing observations following the sample revisions. The CPI (low-volatility items) figure for 2025/Q1 is that for January.
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; Cabinet Office; Google Trends.

Chart 10

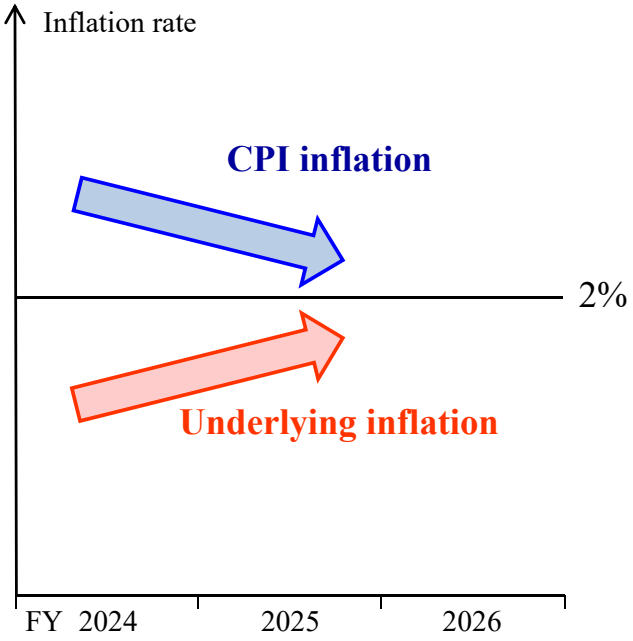
Substitutability between Capital and Labor



Notes: 1. Figures in the upper charts are based on the *Tankan*. There is a discontinuity in the data for December 2003 due to a change in the survey framework.
2. In the lower chart, figures for the elasticity of substitution are calculated by estimating CES production functions by industry using the following variables from the *Financial Statements Statistics of Corporations by Industry, Quarterly*: value added, tangible fixed assets (excluding construction in progress), and the number of employees. For details of the estimations, see Box 2 of the January 2025 Outlook Report.
Sources: Ministry of Finance; Cabinet Office; Bank of Japan.

Chart 11

Schematic Illustration of Future CPI Inflation and Underlying Inflation



Interest rate that is neutral to economic activity and prices

Price stability target of 2%

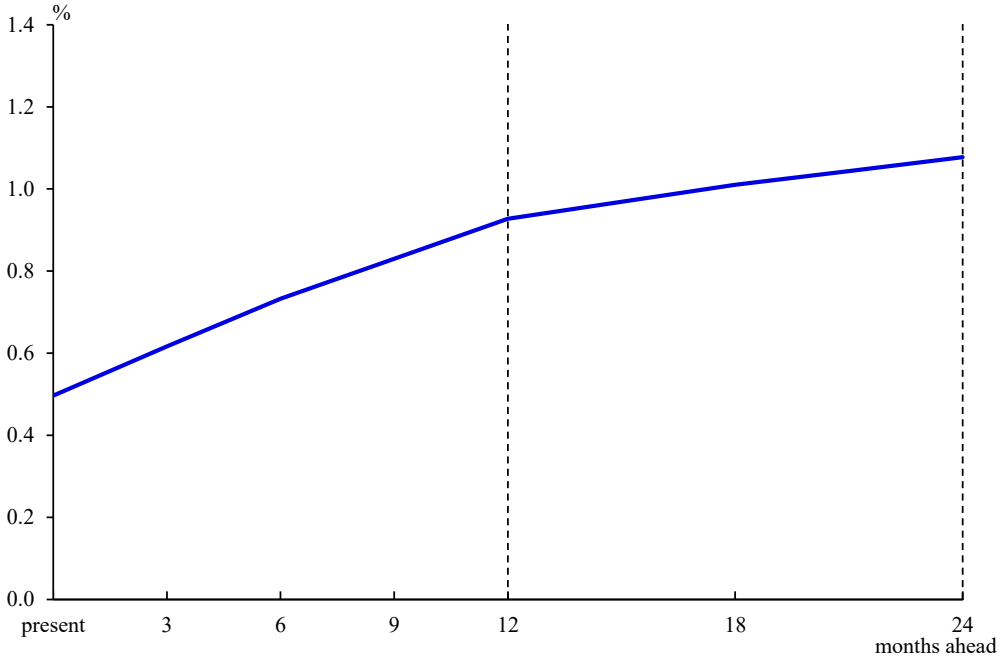
\+

Natural rate of interest*

*The estimates of various models range from around minus 1.0% to around plus 0.5%. Moreover, each estimate is subject to estimation error.

Chart 12

Market Expectations for the BOJ's Policy Interest Rate



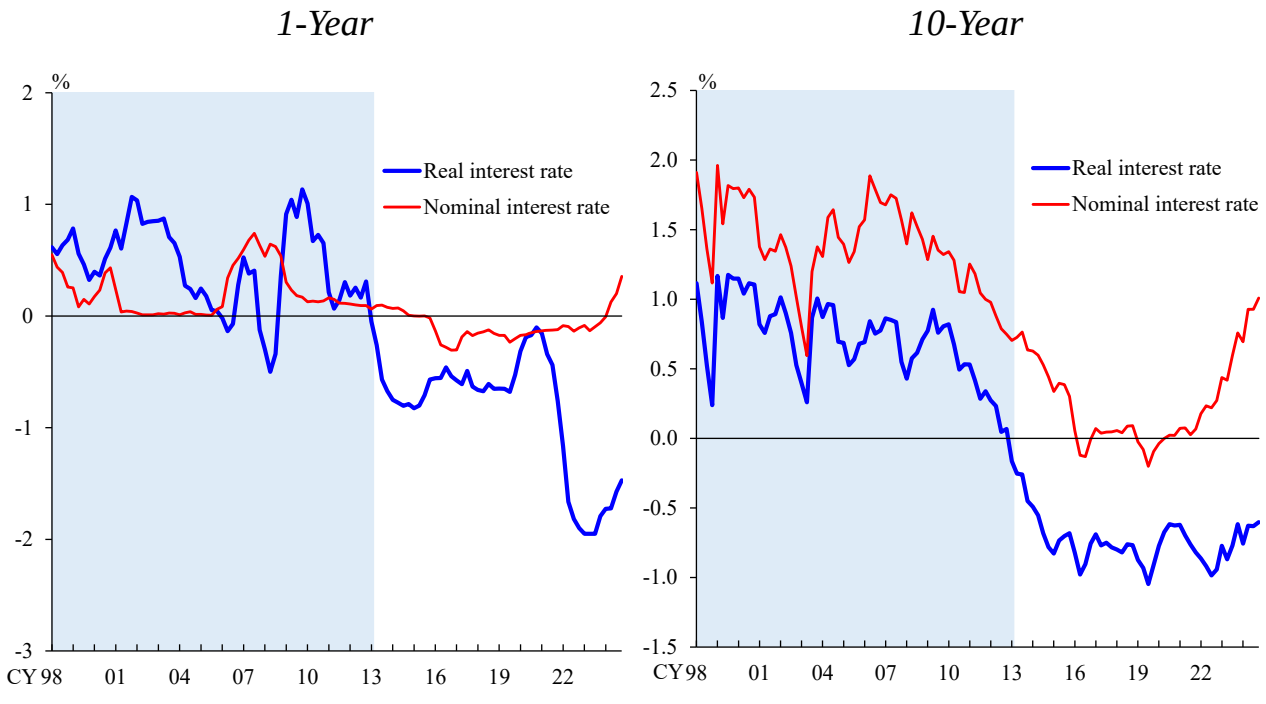
Note: The figure for the present is the 3-month yen overnight index swap (OIS) rate. Figures for 3, 6, and 9 months ahead are 3-month forward rates, those for 12 and 18 months ahead are 6-month forward rates, and the figure for 24 months ahead is the 12-month forward rate, all calculated from the yen OIS rates. Figures are as of March 3, 2025.
Source: Bloomberg.

Chart 13

Review of Monetary Policy from a Broad Perspective

Chart 14

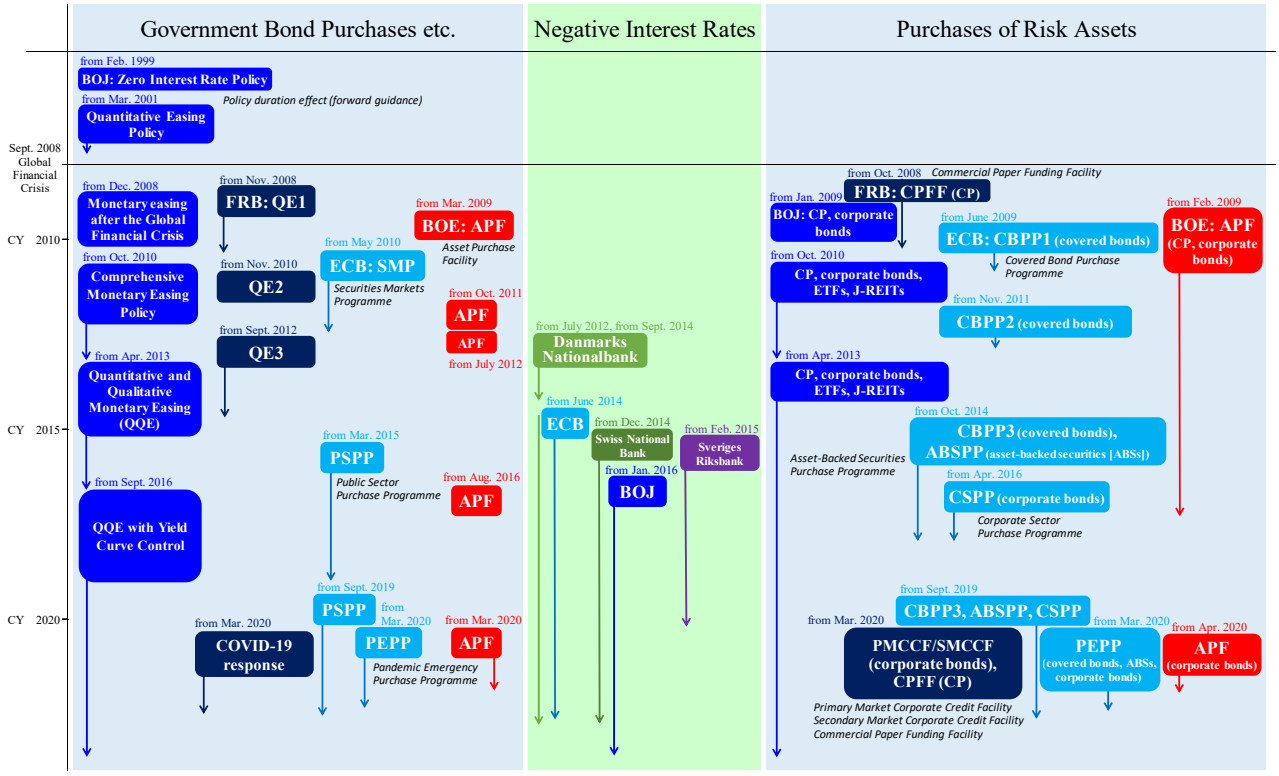
Real Interest Rates



Note: Figures for real interest rates for each maturity are calculated as government bond yields minus the composite index of inflation expectations (staff estimates) for the corresponding maturity.
Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey <Bonds>"; Consensus Economics Inc., "Consensus Forecasts"; Bloomberg.

Chart 15

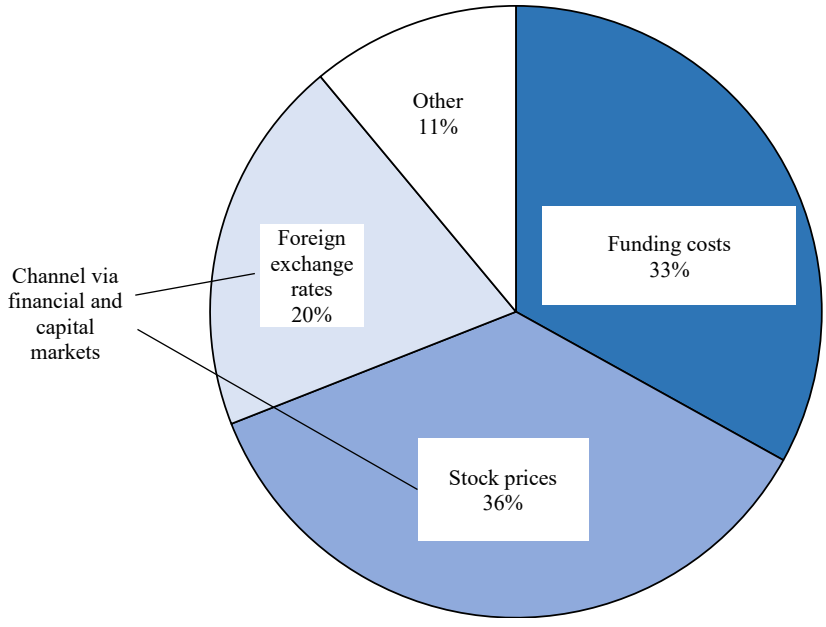
Unconventional Monetary Policies by Central Banks



Note: For government bond and risk asset purchases, major measures implemented by the Bank of Japan (BOJ), the U.S. Federal Reserve (FRB), the Bank of England (BOE), and the European Central Bank (ECB) are shown. For negative interest rates, measures implemented by other central banks are also included. For details, refer to the websites of the respective central banks.
Sources: Respective central banks.

Chart 16

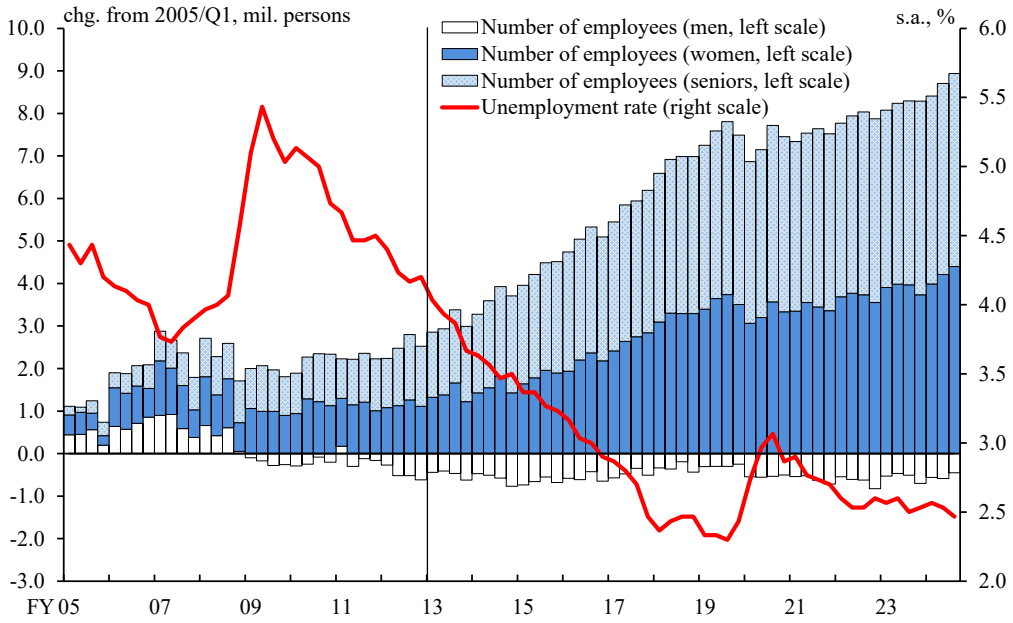
Transmission Channels of the Decline in Interest Rates Resulting from Large-Scale Monetary Easing



Note: The chart shows the contribution of each channel to the 5-year cumulative effect of the decline in interest rates on the output gap. The estimates are obtained using a VAR model with coefficient restrictions. For details of the estimation, see Chart 1-3-16 in the "Review of Monetary Policy from a Broad Perspective."
Sources: Bank of Japan; Bloomberg, etc.

Chart 17

Labor Market



Note: Figures for men and women are for employees aged between 15 and 64, while those for seniors are for employees aged 65 and over.
Source: Ministry of Internal Affairs and Communications.

Chart 18

Impact of the Large-Scale Monetary Easing since 2013

Assessment of the Effects and Side Effects of Large-Scale Monetary Easing

- Although there have been certain side effects on financial markets and financial institutions' profits, the overall effect on the Japanese economy so far appears to have been positive.
- However, attention should be paid to the possibility that the negative effects may become larger in the future, such as the possibility that the functioning of the JGB market does not fully recover or possible side effects of large-scale monetary easing materialize at a later date.

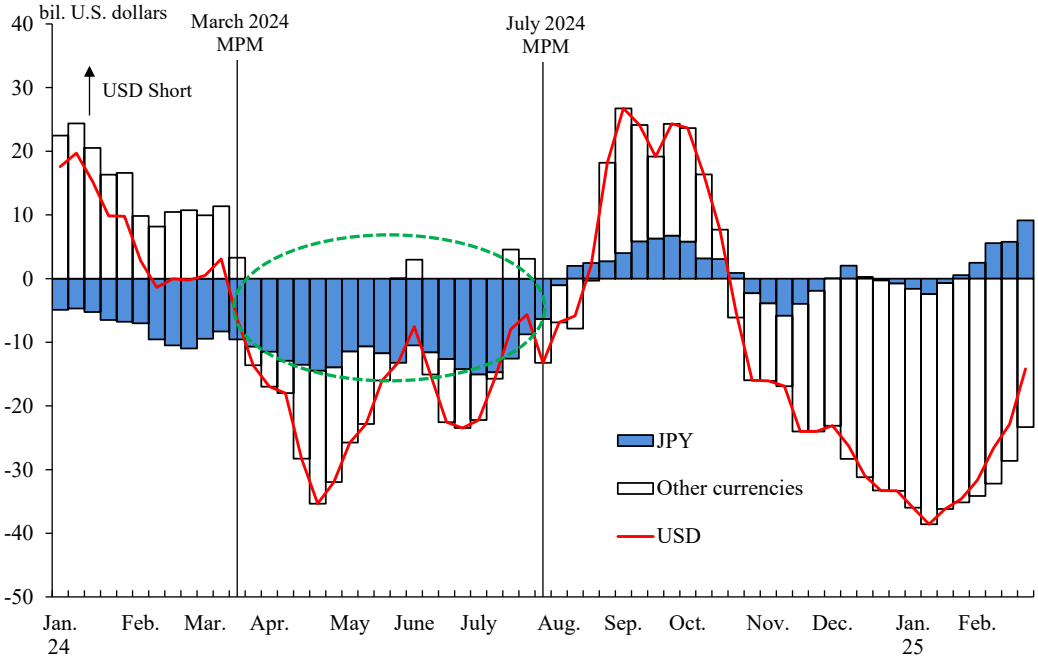
Issues with Regard to Large-Scale Monetary Easing

- Functioning of financial markets
- Functioning of financial intermediation
- Supply side of the economy (growth, productivity, etc.)
- Relationship between Monetary and Fiscal Policy

Chart 19

Financial Markets

Yen Carry Positions (IMM Net Positions)



Note: IMM (International Money Market) net positions are the total of non-commercial and non-reportable positions against the U.S. dollar in currency futures transactions. Other currencies include pound sterling and the euro, Australian dollar, Canadian dollar, Swiss franc, Mexican peso, and New Zealand dollar.
Source: Bloomberg.

Chart 20

Initiatives in Shizuoka Prefecture

Business Matching Events with Startups

Source: TECH BEAT Shizuoka.

Trial Runs of Self-Driving Buses

Source: Fuji City.