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# Current Conditions and Outlook for the Japanese Economy and Monetary Policy

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The Japanese economy is on a gradual recovery trend. After moving up and down following the sharp fall from the 2020 COVID-19 crisis, economic activities have finally been gradually recovering since the October-December quarter of last year. Economic activities have been further expanding since this April, centered on services.

According to the most recent world economic outlook by the International Monetary Fund (IMF), the growth rate for next year is projected to be 1.6%, which is more or less the same as the projected growth rate for this year. While negative growth is projected for Germany and Italy in Europe and the possibility of negative growth in the US cannot be denied, in Japan a recovery is likely to continue.

Nevertheless, the actual conditions of the Japanese economy are not strong. Japan's real gross domestic product (GDP) has yet to surpass the record high posted in 2018. With the above-mentioned growth rates, it will just finally recover the 2018 level by 2023. Looking at real GDP in other major countries and regions since 2019, US real GDP has already greatly exceeded the 2019 level, in part due to robust domestic demand, and it exhibited exceptional strength. The present levels in the eurozone, the UK, and China do not differ greatly from 2019. The weakness of the recovery in Japan stands out even more in comparison with these countries and regions.

The drop in the potential growth rate to below 1% has an impact on the weakness of Japan's economic recovery. The Japanese economy is fragile against various economic crises, and also lacks a strong rebound and dynamism. The factors contributing to these trends are the aging of society with a declining birthrate (the decline in the working-age population and the decline in total working hours) and the scant progress in the accumulation of capital stock with sluggish capital investment.

The output gap which measures the difference between the actual economic activities and its potential output has been in negative territory since 2019, suggesting that insufficient demand relative to production capacity is continuing. Although real consumption continues to gradually recover, it remains below the pre-COVID level. In particular, food consumption has been dropping since the COVID-19 crisis, and while the consumption of durable consumer goods sharply increased at one point from stay-at-home demand, it is presently decreasing rapidly. Services are finally improving from a rather depressed level, and a gradual recovery is expected to continue in the service industry including tourism and entertainment.

**Why is inflation low in Japan?**

Global inflation rates are greatly rising. The main reason is the surge in energy prices, followed by the increase in food prices. These reflect the sharp increases in commodity prices since 2021, the war in Ukraine, China's tight COVID policy, etc.

The rate of inflation in the United States has decreased somewhat from July this year with the drop in gasoline prices, but it remains high at 7.7%. The labor market remains tight as employment continues to rise and the number of job openings remain significantly large. Companies especially in the services sector where demand is picking up continue to raise their sales prices to maintain profits.

Meanwhile, in Europe, the spike in energy prices is the overwhelming cause of inflation, and currency depreciation has also resulted in high inflation. The rate of inflation in the eurozone has most recently been around 10%, and the rates in Germany and Italy in particular, which have greatly depended on Russian gas, reached 10.4% and nearly 12%, respectively. The inflation rate in the UK is also above 10%. While inflation will gradually decline in the Europe in the near future, it will take more time for inflation to subside compared with the United States. In any case, it is likely to take 2–3 years before it returns to the 2% inflation in the US and Europe.

In contrast to the US and Europe, the rate of inflation in Japan is presently at a lower level of 3%. The "inflation rate excluding fresh foods" and the "inflation rate excluding fresh foods and energy" which the Bank of Japan (BOJ) use as reference indicators are 3.0% and 1.8%, respectively. This shows that energy is the main cause of inflation in Japan. The depreciation of the yen which has been advancing since the beginning of the year is also pushing up import prices and accelerating inflationary pressure.

Looking at the relation between corporate goods prices and consumer prices for food and petroleum products, petroleum products prices have been passed onto consumer prices from relatively early on to some extent. Food prices also see some passing of higher wholesale food prices onto retail prices but with some lag.

Then, why is the rate of inflation in Japan so low compared with the US and Europe? Most of the world's central banks focus on "core inflation rates" which exclude the price fluctuations of all food and energy, all which are easily impacted by international commodity prices. In the US and Europe, even looking at these indices, the inflation rates are above 5%, and price rises are spreading across a wide range of items. In contrast, in the case of Japan, the inflation rate for services is just 0.2% and is hardly rising at all. The "Western-type core inflation rate" which excludes all food products (including both fresh foods and other food products) and energy is just 0.9% well below the BOJ's 2% inflation target. This makes it very different from inflation in the US and Europe.

Services prices are low because they are hardly rising at all aside from the food service industry. Companies in the service industry must be suffering from the sharp rise in electricity bills, but the prices of many items including rent, education, health and welfare services, and communications charges are not rising. In as much as overall services prices are not rising across the board as they are in the US and Europe, Japan's household burden is relatively moderate except for low-income households.

While global energy prices and food prices remain at a high level, they have declined substantially from their peak levels. That impact should gradually appear as a decline in the inflation level in Japan as well from around the spring of 2023.

**Yen depreciation and US monetary policy**

The pressure for the depreciation of the yen is largely caused by the interest rate differential between the US and Japan and the overall rise in the dollar index, as well as the deterioration of Japan's trade balance. According to a purchasing power parity basis, the depreciation of the yen is excessive.

The November 2, 2022 meeting of Federal Open Market Committee (FOMC) of the Federal Reserve maintained the interest rate hike of 75 basis points for four consecutive meetings, raising the policy interest rate (the federal funds rate) to 3.75–4.0%. The long-term yields picked up after Federal Reserve Chair Jerome Powell pointed out at the press conference that "we may ultimately move to higher levels than we thought at the time of the September meeting". However, when the subsequent announcement that the October unemployment rate had risen slightly to 3.7% and the October inflation rate of 7.7% had been lower than what market expected, markets now view that the pace of interest rate hikes will slow down. The US dollar index declined somewhat as well. The present market outlook on the policy rate is that the interest rate will be raised by 50 basis points in the next December FOMC meeting and will be raised toward 5.0-5.25% by September 2023, and then maintain that level for the rest of the year.

Because US inflation rate and long-term interest rate trends are difficult to predict, US stock prices and the yen-dollar exchange rate will continue to be unstable for the time being. There are increasing market concerns that the US economy may fall into negative growth in 2023 if the policy interest rate is lifted to 5% or higher. This means that the inversion in the US government bond yield curve will advance further. An inverted yield curve is the phenomenon whereby the long-term and short-term interest rates are reversed because while short-term rates rise sharply from monetary tightening, long-term rates do not rise as much as the short-term rates, reflecting concerns over a recession. Because the 10-year yield gap between the US and Japan has a greater impact on the yen-dollar exchange rate than the gap in the policy rates, there is a possibility that the depreciation pressures on the yen will weaken once the terminal rate of the policy rate becomes clearer in 2023.

**Is the BOJ an outlier?**

Domestic and foreign media often describe the BOJ's monetary policy as an "outlier." They point out that while many central banks are raising interest rates, only Japan is maintaining a low interest-rate policy. To be sure, excluding China—which has a similar inflation rate to Japan and implemented two interest-rate cuts this year—the situation in Japan is unique.

However, as stated above, Japan's Western-style core inflation rate has been below 2%. Also, the rise in long-term inflation expectations is not enough to be of any concern. While household and corporate long-term inflation expectations have risen substantially, those on three year or five year ahead are lower than those for one year ahead. Market based long-term inflation projections (such as break-even inflation rate, inflation swap rate, etc.) are well below 2%.

In other words, inflation trends in Japan are unlikely to be strong enough to require interest-rate hikes aiming at suppressing domestic demand in order to lower inflation as compared with the US and Europe. So long as monetary policy judgment is made based on price stability, BOJ's decision to maintain the low interest rate policy may not be unusual. If the inflation rate in Japan were to rise much further and core inflation were to largely surpass 2%, the likelihood of examining adjustments in monetary policy would probably increase.

**The future of the BOJ's monetary policy**

The BOJ has adopted measures to enhance policy flexibility. In 2018, a target range of plus or minus 0.2% was explicitly introduced for 10-year interest rates, and in 2021 this was expanded to plus or minus 0.25%. Boosting flexibility by expanding the leeway somewhat further is consistent with the policy line implemented thus far. Rather than increasing interest rates, the goal is to enhance policy flexibility. Having some modulation in monetary policy in line with business cycles could make it more effective and improve the functions of bond markets.

However, because there is presently a high level of uncertainty regarding US inflation rates and the terminal rate of US policy rate hikes, and because interest rates are rising globally, the BOJ is thought to be cautious about taking action. In Japan as well, the 30-year interest rate has risen since the beginning of the year and it has presently reached around 1.5%, showing the first clear rising trend since 2013. As enhancing flexibility under such conditions could result in an additional increase in ultra-long interest rates, unless there is a substantial change in inflation conditions, the BOJ is likely to maintain the current conditions. The BOJ is believed to maintain the status quo for the time being regarding when it will enhance flexibility, but if US monetary tightening and the bond market settle down in 2023, that might become the situation for seeking out the timing. On that occasion, it is conceivable that the BOJ might make a decision carefully while maintaining close dialog with the market.

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