October 31, 2008

Bank of Japan

Outlook for Economic Activity and Prices
(October 2008)

[The Bank's View][1]

The environment surrounding Japan's economic activity and prices from fiscal 2008 to 2010 is attended by a significant level of uncertainty, arising from the range of possible developments in the global financial situation and how these affect the real economy, as well as developments in commodity prices. When making future projections of economic activity and prices under these circumstances, careful assessment of risk factors becomes even more important than usual given that the probability of the baseline scenario being realized is not as high as in the past. Due consideration has been paid to these issues in forming the outlook for economic activity and prices detailed below.

I. Outlook for Economic Activity

Economic activity in Japan has become increasingly sluggish due to the effects of earlier increases in energy and materials prices and the leveling-off of exports. Compared with the interim assessment conducted in July, both exports and domestic private demand in the first half of fiscal 2008 seem to have been weaker, against the backdrop of a slowdown in overseas economies and a decline in real purchasing power reflecting deterioration in the terms of trade.

The Bank's projection from the second half of fiscal 2008 through fiscal 2010 is that increased sluggishness in economic activity will likely remain until around the middle of fiscal 2009. During this period, domestic private demand is likely to be relatively weak due mainly to the earlier deterioration in the terms of trade. Exports are also expected to weaken somewhat against the backdrop of the slowdown in overseas economies and the

[1] The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 31, 2008.

appreciation of the yen. Thereafter, the growth rate is expected to pick up gradually, as the effects of earlier increases in energy and materials prices abate and overseas economies move out of their deceleration phase, although the timing is likely to be sometime after the middle of fiscal 2009.

The rates of real GDP growth for fiscal 2008 and fiscal 2009 are likely to be around 0 percent and around 0.5 percent, respectively, and the growth rate for fiscal 2010 is expected to be around the potential growth rate.[2]

The key features of the outlook are as follows.

A. Overseas Economies

Growth in overseas economies is likely to continue to slow in coming quarters. In the United States, the sharp decline in housing prices has continued and lending attitudes of financial institutions have become tighter. The resultant tightening of financial conditions has exerted downward pressure on private demand in spite of the low level of the policy interest rate. The growth rate of the U.S. economy is expected to remain low over the next several quarters, given the negative feedback loop operating between financial markets and the real economy. Growth in European economies is also likely to remain slow due to worsening export conditions and tighter financial conditions in addition to weaker private demand in the area due to earlier increases in energy and materials prices. Growth rates in Asian emerging economies are also likely to decline somewhat reflecting worsening export conditions.

Further ahead, the outlook largely depends on how the financial crises in the United States and Europe and the subsequent fallout are resolved. In this context, developments in the U.S. economy in particular have an important bearing. It is projected that the U.S. economy will gradually return onto a sustainable growth path as the adjustments in the housing market progress and measures introduced to stabilize the financial system start to take effect. However, this will likely occur in the latter half of the projection period. Reflecting this, recovery in the growth rate of overseas economies as a whole is not likely to

[2] The Bank's estimate of the current potential growth rate is around 1.5 percent or somewhat higher.

become evident before around the middle of fiscal 2009.

B. The Corporate Sector

In the corporate sector, the earning environment for firms is likely to remain severe in coming quarters as the effects of the slowdown in overseas economies and the appreciation of the yen are felt on top of earlier increases in materials prices. Business fixed investment is likely to remain sluggish over the next several quarters. However, it is unlikely to drop significantly because, so long as firms expect global demand to continue to grow over the medium to long term, they are unlikely to feel their capital stocks to be excessive and also because they are expected to push forward with investment plans to save on energy and resources. Thereafter, growth in business fixed investment will likely pick up gradually, assisted by improved business conditions as the effects of earlier increases in materials prices dissipate and overseas economies move out of their deceleration phase.

C. The Household Sector

Growth in private consumption is likely to be sluggish over the next several quarters, reflecting the rises in energy and food prices and the deterioration of the employment and income situation. Thereafter, growth in private consumption is expected to recover gradually, as the pace of increase in energy and food prices moderates and the employment and income situation improves.

D. Financial Conditions

The current low level of interest rates is likely to support private demand by providing accommodative financial conditions. The level of short-term real interest rates remains low relative to the potential growth rate. Medium- to long-term interest rates have declined reflecting market participants' views on the prospects for the economy. In evaluating financial conditions, developments in credit spreads and availability of funds are also important. In this regard, liquidity pressures remain comparatively low and credit spreads in financial markets generally narrow relative to U.S. and European markets. However, the influence of the turmoil in global financial markets has been emerging in Japanese financial markets as can be seen in nervous conditions in money markets and significant declines in stock prices. Firms' fund-raising conditions, as reflected in financial institutions' lending attitudes and investors' willingness to invest in CP and corporate bonds, are also likely to increase in severity reflecting the decline in corporate profits and the increase in credit costs at financial institutions until around the middle of the projection period.

II. Outlook for Prices

Given this economic outlook, the environment surrounding prices can be summarized as follows. The level of resource utilization, in terms of labor and production capacity, is currently at or somewhat below its historical average. Going forward, aggregate supply and demand conditions are expected to loosen, with real GDP growth falling short of the potential growth rate over the next several quarters. Thereafter, resource utilization is projected to recover gradually as the economy moves out of its current sluggish phase. Meanwhile, it is likely that unit labor costs (labor costs per unit of output) will remain relatively weak. Short-term inflation expectations in the private sector currently seem to be relatively high following rises in the prices of frequently purchased items. Judging from developments in other indicators such as long-term interest rates, however, medium-term inflation expectations appear still to be stable and second-round effects -- price inflation in excess of that required to pass through increases in import prices -- have not emerged.

Looking at price indices, the pace of increase in the domestic corporate goods price index (CGPI) will largely depend on developments in the prices of commodities such as crude oil and on exchange rates; however, it is likely to stabilize so long as commodity prices do not start to surge again.

The rate of increase in the consumer price index (CPI) for all items excluding fresh food is expected to decline gradually, as prices of energy and food stabilize with the output gap remaining negative and wages weak, while medium-term inflation expectations are likely to remain stable. On a fiscal year-on-year basis, the CPI (excluding fresh food) is projected to rise by around 1.5 percent in fiscal 2008, remain more or less flat in fiscal 2009, and register an increase in the range of 0.0-0.5 percent in fiscal 2010.

III. Upside and Downside Risks

The outlook above, considered the most likely projection by the Bank, is subject to both upside and downside risks with regard to economic activity and prices, and these require close attention especially when the outlook for economic activity and prices is extremely uncertain, as at present.

The following upside and downside risks bear upon the outlook for economic activity.

The first risk concerns the ongoing financial crises in the United States and Europe and their impact. Since the U.S. subprime mortgage problem surfaced in the summer of 2007, losses incurred by U.S. and European financial institutions have continued to expand against the backdrop of significant declines in the prices of securitized products and the increase in impaired assets that has accompanied deteriorating real economic conditions. Lending attitudes of financial institutions have therefore tightened and strains in financial markets have intensified significantly, as seen in the expansion of various credit spreads along with the drying up of liquidity. Looking forward, if strains in financial markets intensify further, the risk-taking capacity of financial institutions and investors may decline and this could result in even tighter financial conditions and a worsening negative feedback loop between financial markets and the real economy, causing lower economic growth in the United States and Europe. Even after strains in financial markets have eased as a result of the various measures taken by governments and central banks, there is a high probability that the impact of such shifts in the risk-taking behavior of financial institutions and investors will persist.

The second risk concerns developments in emerging economies and commodity-exporting countries. In China, the economy continues to show high growth, albeit at a somewhat slower pace, and, depending on developments in macroeconomic policy, the economic growth rate may exceed expectations. There is also a risk of the growth rate falling below expectations if China proves more susceptible than anticipated to slower growth in industrialized economies. In other emerging economies, there are both upside and downside risks, depending on developments in global financial markets, industrialized economies, and commodity prices. In commodity-exporting countries, increased expenditure on, for example, infrastructure investment may push up growth rates. On the other hand, if commodity prices continue to fall, this may restrain these countries' expenditure and result in weaker economic growth.

The third risk concerns developments in energy and materials prices. Although the prices of crude oil and other commodities have recently fallen back, it is assumed that, in the medium term, they will rise moderately, supported by growing demand especially in emerging economies. If, however, world economic growth should exceed its sustainable level, commodity prices may rise more than expected, potentially causing increased inflationary pressures across the world. This could also raise the specter of a subsequent economic slowdown. Moreover, higher commodity prices would mean an increase in the outflow of income going abroad from countries, such as Japan, that are commodity importers, and this could have a negative impact on the expenditure of Japanese firms and households. On the other hand, a continued fall in commodity prices would support domestic private demand by improving the terms of trade, and thereby lead to higher economic growth. It should be noted, however, that, if such a fall in commodity prices were exclusively the result of slower growth of the world economy, it would inevitably be accompanied by a decrease in exports.

The fourth risk concerns firms' expectations of future growth. In this outlook, it is assumed that firms' expectations of global demand over the medium to long term will remain unaffected by the current sluggishness in the economy, and thus that business fixed investment will recover at a moderate pace. However, if the slowdown in overseas economies becomes significant or prolonged, firms' growth expectations may weaken, causing the projections, especially those concerning business fixed investment, to deviate downward.

The fifth risk concerns developments in financial conditions. There is a possibility that, if increased strains in global financial markets should result in significant fallout in Japanese financial markets, or if financial institutions tighten their lending attitudes, pressures acting to depress the real economy from the financial side may become more marked. From a longer-term perspective, attention should continue to be paid to the risk that prolonged accommodative financial conditions together with a gradual rise in the growth rate may lead to larger swings in economic and financial activity as well as in prices. Looking back on worldwide economic developments since around the middle of this decade, while the world economy has enjoyed a sustained run of higher growth with a prolonged period of accommodative financial conditions, it has also seen imbalances accumulate on both the real and financial sides of the economy. The current financial turmoil worldwide, the surge in energy and materials prices, and the subsequent slowdown in world economic growth may be considered part of the process of correcting these imbalances.

Turning to the outlook for inflation, it should be noted that there are also considerable uncertainties attending inflation that could cause it to deviate either upward or downward from the rate projected. If any of the above-mentioned upside or downside risk factors affecting the level of economic activity should materialize, prices may be expected to respond accordingly. There are also the following risk factors that are specific to prices. The first of these concerns changes in the inflation expectations of households and the price-setting behavior of firms. If the prices of frequently purchased consumer goods and services should continue to rise, consumers' inflation expectations may remain at a high level. Firms may continue passing previous increases in materials prices through to sales prices, generating the risk of a rise in medium-term inflation expectations. In either case, prices would deviate above the projection. On the other hand, given the severity of competition in the goods and services markets, it is possible that firms will strengthen their cost reduction efforts and the extent of pass-through may not be as large as expected. The second risk concerns developments in import prices. Considerable uncertainty surrounds developments in commodity prices such as crude oil, leaving the potential for movement in either direction. If the downside risks to the world economy should materialize, this may lead to a further fall in commodity prices and a subsequent decline in consumer prices. Fluctuations in foreign exchange rates can affect consumer prices not only by influencing the level of economic activity but also through changes in import prices.

IV. Conduct of Monetary Policy

To realize sustainable growth with price stability, the Bank assesses the economic and price situation from two perspectives and then outlines its thinking on the future conduct of monetary policy, taking account of the "understanding of medium- to long-term price stability" -- that is, the level of inflation that each member of the Policy Board understands, when conducting monetary policy, as being consistent with price stability over the medium to long term.[3]

The first perspective involves assessing the most likely outlook for economic activity and prices through fiscal 2010. It is expected that, from the middle of fiscal 2009, growth will gradually rise toward its potential but that until then increased sluggishness in economic activity will remain. The year-on-year rate of change in the CPI (excluding fresh food) is likely to decline gradually from the current level of around 2.5 percent to be more or less flat in fiscal 2009 and register an increase in the range of 0.0-0.5 percent in fiscal 2010. In sum, Japan's economy, in the longer run, is most likely to return onto a sustainable growth with price stability. However, this outlook is largely dependent on the future course of the world economy. Given recent developments in the world economy and global financial markets, it needs to be noted not only that it will take some time for the world economy to make the requisite adjustments and for the necessary conditions for Japan's economic recovery to be satisfied, but also that the level of uncertainty in the outlook has increased.

The second perspective assesses the risks considered most relevant to the conduct of monetary policy, including risks that have a longer time horizon than the first perspective. As noted earlier, those that demand attention are the increasing downside risks to the economy stemming from uncertainties regarding future developments in global financial markets, the U.S. and European financial systems, and overseas economies. It should also be noted that, if there should be an increase in the severity of the lending attitudes of Japanese financial institutions, there would be a risk of a downward pressure also being exerted on Japan's real economy from the financial side. Regarding the outlook for prices, attention should be paid to upside risks stemming from further increases in energy and materials prices as well as changes in consumers' inflation expectations and the price-setting behavior of firms. The upside risks to prices, however, seem to have decreased compared with the past. On the other hand, there is also a possibility that the rate of increase in prices will decline more than expected, if downward risks to the economy materialize or commodity prices fall further.

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[3] The "understanding of medium- to long-term price stability " reviewed in April 2008, expressed in terms of the year-on-year rate of change in the CPI, falls in the range approximately between 0 and 2 percent, with most Policy Board members' median figures at around 1 percent.

Based on the examination from the two perspectives described above, it is expected that Japan's economy, in the longer run, will return onto a path of sustained growth with price stability. However, the level of uncertainty in the outlook and downside risks to the economy have both increased.

The Bank will carefully assess the future outlook for economic activity and prices, closely considering the likelihood of its projections as well as factors posing upside or downside risks, and will implement monetary policy appropriately. At the current juncture, particularly close attention should be paid to the risk of downward deviation in economic activity due to developments in the U.S. and European financial systems and global financial markets as well as their subsequent impact on the real economy.

In a period of increased strains in financial markets, one important contribution a central bank can make is to ensure stability in financial markets through its provision of liquidity. Stability in financial markets is a vital precondition for low interest rates to produce their maximal monetary easing effect. Continuing to carefully monitor market developments and keeping in close contact with overseas central banks, the Bank will do its utmost to ensure market stability by conducting appropriate money market operations.

(Appendix 1)

Forecasts of the Majority of Policy Board Members

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2008	+0.1 to +0.2 [+0.1]	+4.3 to +4.8 [+4.6]	+1.5 to +1.6 [+1.6]
Forecasts made in July 2008	+1.2 to +1.4 [+1.2]	+4.7 to +5.0 [+4.8]	+1.7 to +1.9 [+1.8]
Fiscal 2009	+0.3 to +0.7 [+0.6]	-1.4 to -0.4 [-0.8]	-0.2 to +0.2 [0.0]
Forecasts made in July 2008	+1.4 to +1.6 [+1.5]	+1.8 to +2.0 [+1.8]	+1.0 to +1.2 [+1.1]
Fiscal 2010	+1.5 to +1.9 [+1.7]	-0.3 to +0.5 [+0.3]	+0.1 to +0.5 [+0.3]

Notes: 1. Figures in brackets indicate forecast medians.

2. The forecasts of the majority of Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate, namely the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the highest and lowest figures excluded. It should be noted that the range does not indicate the forecast errors.

3. Individual Policy Board members make the above forecasts with reference to the view of market participants regarding the future course of the policy interest rate -- a view that is incorporated in market interest rates.

4. The forecasts of all Policy Board members may be summarized as follows.

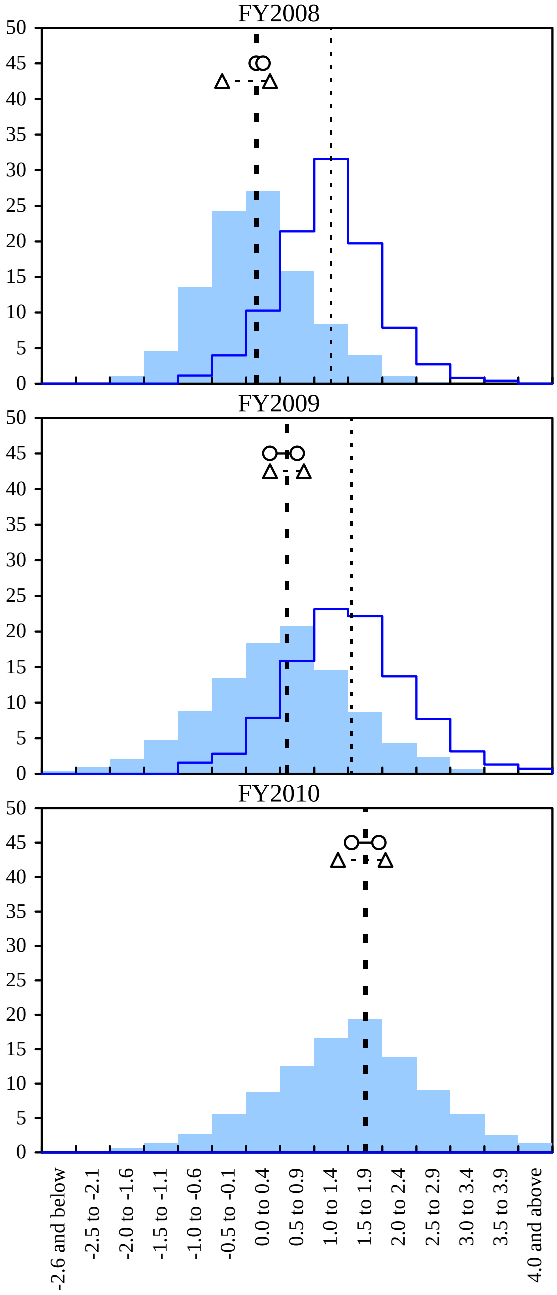
y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2008	-0.4 to +0.3	+4.0 to +4.8	+1.5 to +1.7
Forecasts made in July 2008	+1.1 to +1.5	+4.6 to +5.2	+1.5 to +2.0
Fiscal 2009	+0.3 to +0.8	-1.5 to -0.2	-0.3 to +0.3
Forecasts made in July 2008	+1.4 to +1.7	+1.7 to +2.4	+1.0 to +1.3
Fiscal 2010	+1.3 to +2.0	-0.3 to +0.6	-0.1 to +0.5

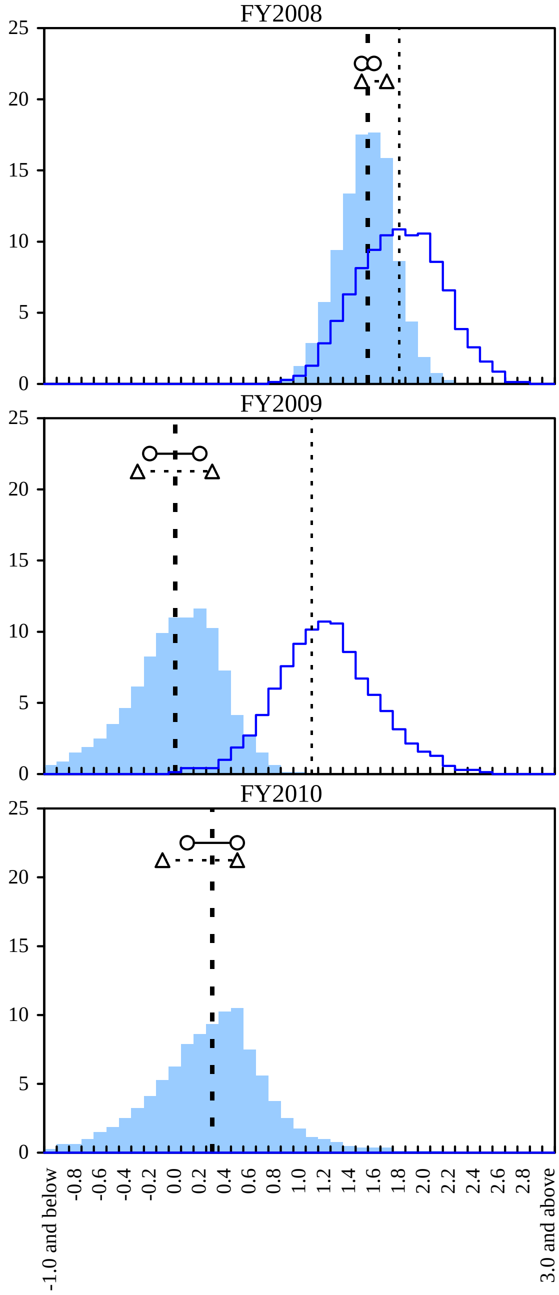
(Appendix 2)

Risk Balance Charts

(1) Real GDP



(2) CPI (Excluding Fresh Food)



Notes: 1. Vertical axes in the charts represent probability (%), while horizontal axes represent the year-on-year percentage changes in the respective indicators. Bar charts represent the probability distributions in October 2008, and solid lines represent those in July 2008.

2. Vertical dashed heavy lines indicate the median of the Policy Board members' forecasts (point estimates). O——O indicates the range of the forecasts of the majority of Policy Board members. Δ- - - -Δ indicates the range of the forecasts of all Policy Board members.

3. Vertical dashed thin lines indicate the median of the Policy Board members' forecasts (point estimates) in July 2008.

4. For the process of compilation of the Risk Balance Charts, see the box on page 9 of the April 2008 *Outlook for Economic Activity and Prices.*