April 27, 2012

Bank of Japan

Outlook for Economic Activity and Prices
(April 2012)

The Bank's View[1]

I. Introduction

This April 2012 issue of the *Outlook for Economic Activity and Prices* (Outlook Report) presents the outlook for Japan's economy through fiscal 2013. The Outlook Report first provides a description of developments in global financial markets and overseas economies that are affecting trends in Japan's economy, followed by the Bank of Japan's assessment of the nation's financial conditions. Next, taking these into account, the scenario for economic activity and prices considered to be the most likely by the Bank -- its baseline scenario -- is described, and upside and downside risks associated with the scenario are examined. Lastly, a summary of the Bank's basic thinking on the conduct of monetary policy is provided.

II. Global Financial Markets and Overseas Economies

Strains in global financial markets had intensified since last summer toward the end of 2011, mainly due to concern about the European debt problem. Governments and central banks around the globe have implemented various measures in response. The European Central Bank (ECB) conducted large-scale longer-term refinancing operations (LTROs) with a maturity of 36 months. With regard to Greece, which faced the most serious debt problem, restructuring of debts held by private creditors was implemented, and this allowed the European Union (EU) and the International Monetary Fund (IMF) to decide on the second financial support program. Progress was also made in efforts to enhance fiscal discipline as well as the financial capacity to respond to crises through provision of funds. Specifically, EU member states signed the Fiscal Compact and agreed to boost the lending

[1] The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on April 27, 2012.

capacity of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). Meanwhile, at the end of November 2011, six central banks including the Bank of Japan announced coordinated actions to address pressures in global money markets, such as a reduction of interest rates on the fixed-rate U.S. dollar funds-supplying operations. With the implementation of these measures, funding conditions for European and U.S. financial institutions have been improving and global financial markets have generally regained stability, as evident in developments such as declines in short-term interest rates in the euro and U.S. dollar interbank markets. Government bond yields in countries facing serious fiscal situations have declined compared with the period from autumn 2011 toward the beginning of 2012, although upward pressure persists.

In such a circumstance, a tail risk -- namely, the likelihood of global financial market turmoil causing a significant global economic downturn -- has been decreasing after causing serious concern around the end of last year. Somewhat positive developments have been observed in the global economy, including the continued moderate improvement in the U.S. economy. Reflecting these developments, risk aversion among global investors has weakened compared with the second half of 2011, and positive market developments have been observed, including a pick-up in stock prices around the globe and in international commodity prices as well as a narrowing of credit spreads on corporate bonds in the U.S. and European markets. In the foreign exchange market, reflecting a reversal of extreme "flight to safe assets," the yen has depreciated somewhat against both the U.S. dollar and the euro compared with around the end of 2011.

Next, the pace of growth in overseas economies has moderated since spring 2011, mainly due to increased strains in global financial markets reflecting the effects of the European debt problem and to the effects of the earlier monetary tightening in emerging and commodity-exporting economies. More recently, although overseas economies have remained in a deceleration phase, some improvement has been observed. By region, the U.S. economy has continued to recover at a moderate pace. Specifically, in the corporate sector, business fixed investment has been increasing moderately against the background of solid corporate profits. In the household sector, private consumption has recently been firm, mainly due to a moderate improvement in employment, despite the continued burdens of balance-sheet repair. The sluggishness in the European economy remains strong mainly due to the effects of fiscal austerity measures. More recently, however, the economy generally stopped deteriorating further as financial markets have regained some stability. Emerging and commodity-exporting economies have maintained relatively high growth on the whole, and the pace of growth has stopped decelerating of late, as exports to advanced economies are no longer decreasing and domestic demand has been firm in a situation where inflation rates have generally been on a declining trend.

In the Bank's baseline scenario, the pace of recovery in overseas economies is likely to gradually pick up led by emerging and commodity-exporting economies, on the assumption that global financial markets will generally remain stable. Therefore, the average annual growth rates of overseas economies during the projection period are forecast to be relatively high compared with past long-term averages.[2] When looking at a breakdown by country and region, the U.S. economy is likely to continue recovering at a moderate pace against the background of accommodative financial conditions, although the burdens of balance-sheet repair will remain. The European economy is likely to head toward a moderate recovery based on the assumption that the tail risk stemming from the debt problem will not materialize, but such momentum will likely be restrained by the continuation of fiscal austerity. Meanwhile, emerging and commodity-exporting economies are likely to maintain relatively high growth as the virtuous circle of production, income, and spending is expected to gradually strengthen, mainly against the background of a recovery in advanced economies and a receding of inflationary pressure, which in turn provides room for monetary easing.

III. Japan's Financial Conditions

Japan's financial conditions have continued to ease as the Bank has pursued powerful

[2] In January 2012, the IMF revised downward its September 2011 projections for global economic growth (calculated as the aggregate of purchasing power parity-weighted GDP growth projections for individual countries or regions), particularly those for European economies. Following this downward revision, the projections were revised upward in April 2012, albeit slightly. The global economy is projected to grow by 3.5 percent in 2012, and is expected to accelerate once again by 4.1 percent in 2013. For reference, the average growth rate during the 30 years since 1980 is 3.3 percent.

monetary easing. Specifically, market interest rates, including longer-term ones, have remained at extremely low levels, and firms' funding costs have declined moderately. Issuing conditions for CP have remained favorable. In the corporate bond market, issuing conditions continue to be generally favorable except for electric power companies, which face considerable uncertainty concerning their business environment. Firms continue to view financial institutions' lending attitudes as being on an improving trend, and have retained their recovered financial positions on the whole. Despite some differences depending on the size of firms, the respective indicators representing financial institutions' lending attitudes as perceived by firms and the financial positions of firms have been at levels exceeding the average for the period since 2000. As for credit demand, firms have shown signs of increasing their demand mainly for working capital and funds related to mergers and acquisitions. Looking at funding in the corporate sector, the year-on-year rate of change in the amount outstanding of bank lending, after turning positive at the end of 2011, has recently risen further. The year-on-year rate of change in the amount outstanding of CP and corporate bonds combined has generally been slightly positive.

As such, Japan's financial conditions have maintained stability and have not been significantly affected even during phases of heavy strains in global financial markets caused by the European debt problem. Such stability in financial conditions can be attributed to the reasonable amount of tolerance that Japan's financial system possesses for negative shocks, including an economic downturn, a stock price plunge, and a rise in long-term interest rates, as well as to the Bank's powerful monetary easing. In terms of the outlook, these accommodative financial conditions are expected to support a transition toward a self-sustaining recovery in domestic private demand. Taking into account the increasing global linkages of financial markets, however, it is necessary to maintain vigilance with regard to the possibility that global financial markets will affect Japan's financial system and its financial conditions, depending on developments.[3]

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[3] For more details on the assessment of the financial system stability in Japan, see the April 2012 issue of the Bank's *Financial System Report*.

IV. Baseline Scenario of the Outlook for Economic Activity and Prices in Japan

A. Outlook for Economic Activity

On the basis of the aforementioned developments in overseas economies and the financial environment at home and abroad, the following examines the scenario for Japan's economy that the Bank considers to be the most likely -- that is, the baseline scenario.

Japan's economic activity, after a further plunge caused by the Great East Japan Earthquake while in the process of recovering from the Lehman shock, picked up steadily until the beginning of autumn 2011 with the restoration of supply chains. Thereafter, in the second half of fiscal 2011, economic activity remained more or less flat mainly due to an adverse effect of the slowdown in overseas economies and the appreciation of the yen on exports and production. The growth rate for fiscal 2011 is expected to have been slightly negative, reflecting the post-quake economic downturn, as projected in the interim assessment in January 2012.

More recently, although Japan's economic activity has remained more or less flat, it has become increasingly evident that the economy is shifting toward a pick-up phase as positive developments have become widespread. Taking into account the recent developments, the outlook for Japan's economy can be described as follows. The economy is expected to return to a moderate recovery path in the first half of fiscal 2012 as the pace of recovery in overseas economies picks up, led by emerging and commodity-exporting economies, and as reconstruction-related demand after the earthquake disaster gradually strengthens. Specifically, exports are expected to resume an increasing trend, and a rise in reconstruction-related demand -- in terms of both public and private demand -- is expected to contribute to economic growth throughout the fiscal year. Under these circumstances, in fiscal 2012, the economy is likely to register a relatively high rate of growth, supported by gradually increasing momentum generated from the transmission mechanism in which the strength in production feeds through into income and spending. In fiscal 2013, the economy is expected to grow at a pace that is clearly above its potential as overseas economies continue to see relatively high growth, although the growth rate is expected to be somewhat lower than that in fiscal 2012 because the positive effects from reconstruction-related demand will gradually diminish.[4] Growth rates for the 2012 and 2013 fiscal years are expected to be somewhat higher than the projection in the January 2012 interim assessment, especially for fiscal 2012, mainly due to slightly improved market conditions on the reduced risk of the European debt problem causing financial market turmoil.[5] More detailed explanations of the outlook, broken down by the corporate and household sectors, are as follows.

Regarding the corporate sector, exports have remained more or less flat but positive developments have gradually come to be observed, as evidenced by the fact that they have already recovered from the plunge caused by the effects of the flooding in Thailand and global inventory adjustments in IT-related goods have almost reached completion. Regarding the outlook, exports are expected to resume an increasing trend as overseas economies are likely to emerge from the current deceleration phase and as downward pressure from the yen's appreciation gradually wanes. As for reconstruction-related demand, a part of this has already materialized, including for the restoration of disaster-stricken facilities, pent-up consumption demand following a temporary restraint after the disaster, and for the removal of debris as well as construction of temporary housing. With public investment recently beginning to increase, reconstruction-related demand is expected to gain further momentum.[6] Against the background of such developments in demand at home and abroad, production and corporate profits are expected to increase, and business fixed investment is likely to continue rising at a moderate pace on the assumption

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[4] Japan's potential growth rate during the projection period is estimated to be "around 0.5 percent" based on a standard production function approach. However, estimates of the potential growth rate are subject to a considerable margin of error as they greatly depend on the specific methodology employed and could change as more data for the relevant period become available.

[5] A potential increase in the consumption tax rate and its effects are not incorporated in the projections in this edition of the Outlook Report. The past experiences of Japan and other countries reveal a temporary rush in demand in the period preceding an increase in the consumption tax rate, which subsequently was reversed.

[6] Looking at the reconstruction-related budget, most of what was presented in the Basic Guidelines for Reconstruction in response to the Great East Japan Earthquake -- namely, a total of at least 19 trillion yen or so over a period of five years -- has already been allocated through expenses related to the earthquake disaster in the supplementary budget for fiscal 2011 and in the initial budget for fiscal 2012. This large budget amounts to about 4 percent of Japan's overall GDP and over 60 percent of the total GDP of the four disaster-stricken prefectures (Iwate, Miyagi, Fukushima, and Ibaraki).

that firms will maintain their medium- to long-term growth expectations.[7]

As for the employment and income environment surrounding the household sector, there has been improvement, as seen in the moderate rise in the ratio of job offers to applicants. Regarding the outlook, positive effects of a pick-up in economic activity, especially production, are likely to gradually spill over to the employment and income environment on the whole, although differences among regions -- including disaster-stricken areas -- and industries will likely remain. However, considering the possibility that the weakness in corporate performance for fiscal 2011 -- mainly due to the earthquake disaster, the slowdown in overseas economies, and the yen's appreciation -- will have lagged effects, improvement in the employment and income environment is expected to become evident only in the second half of fiscal 2012 onward. Private consumption has recently firmed up amid improvement in economic activity and the labor supply and demand situation from the plunge caused by the earthquake disaster, as well as in consumer sentiment. In addition to temporary factors such as the effects of demand-boosting measures for automobiles, this is attributed to gradual progress in capturing potential demand related to the aging population. With regard to the outlook, private consumption is expected to gradually increase at a faster pace against a backdrop of recovery in the employment and income environment. In the meantime, backed by low interest rates and a rise in reconstruction-related demand, housing investment will likely continue to increase moderately throughout the projection period.

B. Outlook for Prices

The Bank conducts monetary policy based on the principle that it should achieve price stability, thereby contributing to the sound development of the national economy. In doing so, the Bank publishes, in a numerical form, "the price stability goal in the medium to long term," which is the inflation rate that it judges to be consistent with price stability sustainable over the medium to long term. The Bank judges "the price stability goal in the medium to long term" to be in a positive range of 2 percent or lower in terms of the

[7] According to the "Annual Survey of Corporate Behavior" released by the Cabinet Office (survey conducted in January 2012), firms expect the average economic growth rate over the next three to five years to be around 1.5 percent, having risen somewhat compared with survey results obtained in 2011 before the earthquake.

year-on-year rate of change in the consumer price index (CPI); more specifically, it has set a goal of 1 percent for the time being. With this "price stability goal in the medium to long term" in mind, the following examines the outlook for price developments.

Looking back at the developments in the CPI (for all items less fresh food, and hereafter) from a somewhat long-term perspective, the year-on-year rate of decline -- after reaching a historical trough of 2.4 percent in August 2009 -- has continued to slow consistently since around the end of 2009 with a gradual improvement in the degree of utilization of labor and production capacity -- that is, the aggregate supply and demand balance of goods and services -- and has recently been at around 0 percent.

Regarding the outlook for the environment surrounding prices, as mentioned earlier the aggregate supply and demand balance is expected to continue improving with the economy's moderate recovery trend. Medium- to long-term inflation expectations can be assumed to remain stable throughout the projection period, given that the perceptions of market participants and economists have been stable, at around 1.0 percent, and that households have not changed their views notably. There has been a slight rise in international commodity prices, especially crude oil prices, mainly due to a heightening of geopolitical risk. Commodity prices are likely to follow a moderate rising trend against the background of an increase in demand for food and energy arising from growth in emerging economies.

As for the outlook for prices on the basis of the aforementioned environment, the domestic corporate goods price index (CGPI) is expected to continue rising moderately on a year-on-year basis throughout the projection period, reflecting a moderate increase in international commodity prices and the improvement in the aggregate supply and demand balance. On the assumption that medium- to long-term inflation expectations remain stable, the year-on-year rate of change in the CPI is expected to gradually rise to a range of above 0.5 percent and less than 1 percent toward the latter half of the projection period as the aggregate supply and demand balance improves. Thereafter, it will likely be not too long before the rate reaches the Bank's "price stability goal in the medium to long term" of 1 percent for the time being.

Comparing the current projection for the CPI with that in the January 2012 interim assessment, the year-on-year rate of change in the CPI is likely to be somewhat higher. This is partly because the economic projection has been revised somewhat upward, and this is expected to improve the aggregate supply and demand balance. The correction of the appreciation of the yen and a rise in crude oil prices also contributed to the upward revision in the CPI projection.

As mentioned earlier, price developments have been on an improving trend approaching the "price stability goal in the medium to long term," but some more time will be needed before the goal is achieved.[8] In this regard, in terms of a mechanism in which strength in economic activity generates inflationary pressure, both cyclical and structural factors appear to play a role. In terms of a cyclical factor, there is still room for the aggregate supply and demand balance to improve given the significant economic downturn resulting from the recession following the bankruptcy of Lehman Brothers. Consequently, it is projected that, even with a moderate economic recovery going forward, the balance between the aggregate supply and demand will be largely restored only around the end of the current projection period, giving rise to clearer upward pressure on prices. In terms of a structural factor, it could be pointed out that the economic growth rate has been on a declining trend. While the aging of the population proceeds at a pace unprecedented in other countries, there has not been sufficient progress in efforts to strengthen the growth potential of the economy and the review of the social security system to enhance its sustainability. As a result, firms and households lowered their growth expectations, turning cautious in terms of their spending behavior. Such a situation is believed to have exerted downward pressure on prices.

V. Upside and Downside Risks

A. Risks to Economic Activity

The aforementioned outlook is the scenario the Bank considers to be the most likely -- in other words, its baseline scenario. The following upside and downside risks concerning

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[8] Looking at the annual rate of change in the CPI on a fiscal-year basis since the 1990s, the improvement of almost 1 percentage point within a year occurred only in periods when the consumption tax rate was raised or international commodity prices rose significantly.

the outlook for economic activity warrant attention.

The first risk concerns developments in overseas economies, including those in global financial markets and the impact of international commodity prices on economic activity. Although a tail risk of global financial market turmoil causing a significant global economic downturn has decreased, various challenges remain before the European debt problem, the fundamental cause of such risk, can be resolved. There is a possibility that credibility will be strengthened in markets, acting as an upside risk to the global economy, if steady progress is made -- while market stability is secured, mainly through provision of funds by the ECB -- in reforms such as an increase in competitiveness among peripheral countries and ensuring of fiscal sustainability. There is also a possibility that strains in global financial markets will intensify once again in the face of a reemergence of concern about the implementation of such reforms, acting as a downside risk to the global economy, and consequently Japan's economy.

In addition to the shocks arising from global financial markets described above, overseas economies continue to be surrounded by various other uncertainties. While the European economy may post higher growth, mainly supported by the strong global competitiveness of core euro area countries, there is also a downside risk due to fiscal austerity and a deterioration of financial conditions in peripheral countries. With regard to the U.S. economy, there is considerable uncertainty regarding the progress in balance-sheet repair. Pressure from such repair appears to have gradually receded given that five to six years have already passed since housing prices peaked. Momentum for economic recovery may therefore strengthen if the bottoming out of the housing market becomes evident together with improvement in employment conditions. On the other hand, there is a possibility that the pace of economic recovery will remain more moderate than expected due to further prolonged adjustments. There is also a high degree of uncertainty surrounding the future course of fiscal policy in the United States. Regarding emerging and commodity-exporting economies, there remains considerable uncertainty about whether these can make a soft landing by realizing price stability and economic growth at the same time. Taking into account the robust potential demand and significant room for supporting the economy through fiscal and monetary stimulus, these economies may grow at a faster pace if inflationary pressures recede swiftly. At the same time, the pace of growth may slow if inflationary pressures are not sufficiently contained, mainly due to a persistent rise in wages and high crude oil prices.

Meanwhile, with regard to international commodity prices, if prices such as those of crude oil rise further, mainly due to heightening geopolitical risk, downside risks to the global economy will increase; for Japan, which is a resource-importing country, deterioration in the terms of trade will weigh on corporate profits and households' real purchasing power. In contrast, if the rise in international commodity prices reflects an expansion of the global economy, positive aspects such as an increase in exports might exceed a negative impact of deterioration in the terms of trade.

Second, there is uncertainty with regard to reconstruction-related demand. Recently, such demand, including public investment aimed at restoration of capital stock, has gradually been strengthening, as progress has been made in drawing up reconstruction plans and the supplementary budget is being executed. As for the outlook, while reconstruction-related demand is expected to become increasingly evident, these developments could be affected by various bottlenecks on the supply side, such as a shortage in construction workers. The extent to which the reconstruction-related demand will push the growth rate upward is subject to uncertainty at this point. The crucial question is whether it will simply end up as a temporary increase or lead to a continuous rise in private demand by lessening uncertainty about the future via a clearer path toward resuscitation of regional economies.

Third, there is uncertainty with regard to firms' and households' medium- to long-term growth expectations. Although no significant changes are assumed in the baseline scenario, changes in either direction are possible depending on future developments. For example, expansion in production and business operations overseas is expected to continue, considering that the capturing of global demand and relocation of global business operations to enhance efficiency are critical challenges facing firms. If such an expansion is not compensated for by new domestic production activities, however, firms' and households' medium- to long-term growth expectations regarding domestic demand and employment might decline. Similarly, with regard to problems concerning the supply and demand of electric power, there is a possibility that production will be restrained during periods of high electric power demand, such as in the summer, depending on various factors including the weather. Attention should be paid not only to such short-term effects but also to the chances of an eventual decline in medium- to long-term growth expectations. On the other hand, medium- to long-term growth expectations might improve if efforts in various areas aimed at strengthening the growth potential of Japan's economy -- such as exploring global demand, capturing the needs of the elderly population as well as diversified domestic demand, reviewing the operational risk management structure, and making innovations in energy-related technologies and business models -- proceed in a steady manner and positive effects start to appear.

Fourth, there are various problems regarding Japan's fiscal sustainability. For example, taking into account that the household saving rate has stopped declining in recent years, regardless of the advance in the aging of the population, there is a possibility that the accumulation of government debt will generate public anxiety about the sustainability of the social security system as well as a future increase in the tax burden, thereby causing people's spending behavior to become cautious. In the event that the general public's confidence in fiscal sustainability declines, people's increasing anxiety about the future could lead the economy to deviate downward from the baseline scenario. On the other hand, if the medium- to long-term path toward fiscal consolidation becomes evident and the sustainability of the social security system improves, such anxiety will be alleviated and this would have a positive effect on the economy. Given the progress in the globalization of financial markets, market participants seem to be taking a more critical view of Japan's conduct of fiscal policy amid rising concern about public debt in many advanced countries. In this situation, should market participants come to believe that efforts to achieve fiscal consolidation are insufficient, this will lead to a rise in long-term interest rates, which will have adverse effects on financial institutions and consequently on Japan's economy as a whole.

B. Risks to Prices

There is also uncertainty regarding the outlook for prices, which could deviate either upward or downward from the projection. To begin with, if any of the aforementioned upside and downside risks to economic activity materialize, prices might be affected accordingly. There are also the following risks specific to prices. The first concerns developments in firms' and households' medium- to long-term inflation expectations. While the Bank judges that some more time will be needed before the year-on-year rate of increase in the CPI reaches 1 percent, in such an environment downward pressure may be exerted on actual prices and wages if firms and households increasingly expect that the pace of a rise in prices will remain slow. On the other hand, if efforts to strengthen growth potential succeed in bringing about differentiated new goods and services, potential demand will materialize, leading to a rise in prices and possibly resulting in higher medium- to long-term inflation expectations. In such a scenario, the growth rate will increase and prices might deviate upward by even more than would be expected from the higher growth rate.

The second risk concerns developments in import prices. There is a possibility that crude oil prices will show large fluctuations, mainly reflecting geopolitical risk. Uncertainty also surrounds developments in other primary commodities, with potential for movement in either direction. Fluctuations in foreign exchange rates could also affect consumer prices, both directly through changes in import prices and indirectly through changes in economic activity.

VI. Conduct of Monetary Policy

The Bank assesses the aforementioned economic and price situation from two perspectives and then outlines its thinking on the future conduct of monetary policy with the "price stability goal in the medium to long term" in mind.

The first perspective from which the Bank assesses the situation is an examination of the baseline scenario for the outlook for economic activity and prices -- that is, the scenario considered to be the most likely -- through fiscal 2013. As noted earlier, Japan's economy is expected to return to a moderate recovery path in the first half of fiscal 2012 as the pace of recovery in overseas economies picks up, led by emerging and commodity-exporting economies, and as reconstruction-related demand after the earthquake disaster gradually strengthens. On the assumption that medium- to long-term inflation expectations remain stable, the year-on-year rate of change in the CPI is expected to gradually rise to a range of above 0.5 percent and less than 1 percent toward the latter half of the projection period as the aggregate supply and demand balance improves. Thereafter, it will likely be not too long before the rate reaches the Bank's "price stability goal in the medium to long term" of 1 percent for the time being. In comprehensively assessing the outlook for economic activity and prices described above, the Bank expects that Japan's economy will return to a sustainable growth path with price stability in the longer run.

The assessment from the second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy, including risks that have a longer time horizon than in the first perspective.[9] In the area of economic activity, although tail risks arising from the European debt problem have waned, a high degree of uncertainty remains concerning global financial markets and overseas economies. There is also a possibility that a further hike in international commodity prices will exert an adverse impact on domestic private demand, mainly through a decline in real purchasing power associated with deterioration in terms of trade. Furthermore, uncertainty is inherent in the reconstruction-related demand in terms of its pace of strengthening and the economic effects. Meanwhile, medium- to long-term growth expectations could either rise or fall depending on efforts to strengthen growth potential. Efforts to ensure fiscal sustainability could also significantly affect economic developments. On the price front, careful attention should be paid to future developments in international commodity prices and in medium- to long-term inflation expectations.

As for the future conduct of monetary policy, based on the examinations from the two perspectives described above, the Bank is committed to conducting appropriate policy aimed at overcoming deflation by pursuing powerful monetary easing and supporting efforts to strengthen the economy's growth potential.

First, the Bank aims to achieve its "price stability goal in the medium to long term" of 1 percent for the time being in terms of the year-on-year rate of increase in the CPI through

[9] For example, the Bank examines risk factors that will significantly impact economic activity and prices when they materialize, although the probability of such risks arising is low.

the pursuit of powerful monetary easing, conducting its virtually zero interest rate policy and implementing the Asset Purchase Program mainly through the purchase of financial assets. The Bank will continue with this powerful easing until it judges the 1 percent goal to be in sight, on condition that it identifies no significant risk to the sustainability of economic growth, including from the accumulation of financial imbalances. In this regard, it is unlikely that a financial imbalance has been emerging as a result of excessive optimism at this point.[10] At the same time, financial institutions hold a large amount of government bonds in a situation where the outstanding amount of government debt has accumulated to a substantially high level. Due attention needs to be paid to a possibility that some events will trigger a rise in long-term interest rates, which would cause significant damage to the economy and the financial system. From this viewpoint, it is important to maintain credibility in the conduct of monetary policy.

Second, while pursuing powerful monetary easing, the Bank will also engage in efforts to strengthen the foundations for Japan's economic growth as a central bank. Japan's economy currently confronts the long-term structural challenge of declining trend growth rates amid the situation of a rapidly aging population. In order to overcome this challenge and establish a new basis for economic growth, business firms need to become more innovative in an effort to add value to their activities and explore new sources of demand both at home and abroad. With the aim of supporting such positive movements by firms, the government should seek to create a more conducive environment and private financial institutions should make efforts to strengthen the foundation for economic growth. In addition, given that Japan's ratio of government debt to GDP is the largest among advanced economies, it is crucial to ensure fiscal sustainability over the medium to long term. As described above, it is important for business firms, financial institutions, the government, and the Bank each to continue exerting efforts within their respective roles.

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[10] For more details, see the April 2012 issue of the Bank's *Financial System Report*

(Appendix 1)

Forecasts of the Majority of Policy Board Members

y/y % chg.

	Real GDP	Domestic CGPI	CPI (all items less fresh food)
Fiscal 2011	-0.2 to -0.2 [-0.2]	+1.7	0.0
Forecasts made in January 2012	-0.4 to -0.3 [-0.4]	+1.8 to +1.9 [+1.8]	-0.1 to 0.0 [-0.1]
Fiscal 2012	+2.1 to +2.4 [+2.3]	+0.4 to +0.7 [+0.6]	+0.1 to +0.4 [+0.3]
Forecasts made in January 2012	+1.8 to +2.1 [+2.0]	-0.1 to +0.2 [+0.1]	0.0 to +0.2 [+0.1]
Fiscal 2013	+1.6 to +1.8 [+1.7]	+0.7 to +0.9 [+0.8]	+0.5 to +0.7 [+0.7]
Forecasts made in January 2012	+1.4 to +1.7 [+1.6]	+0.6 to +1.0 [+0.8]	+0.4 to +0.5 [+0.5]

Notes: 1. Figures in brackets indicate the median of the Policy Board members' forecasts (point estimates).

2. The forecasts of the majority of the 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 figure and the lowest figure excluded. The range does not indicate the forecast errors.

3. Individual Policy Board members make their 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 real GDP figures for fiscal 2011 are Policy Board members' estimates. The figures for the domestic CGPI and the CPI (all items less fresh food) are actual values.

5. The CPI using the Chain-Weighted Index Formula has also been released as a reference. Based on this chain-weighted index, the year-on-year rate of change in the CPI around fiscal 2013 may be slightly lower than the above forecasts based on the Fix-Weighted Index Formula.

6. The ranges shown below include the forecasts of all Policy Board members.

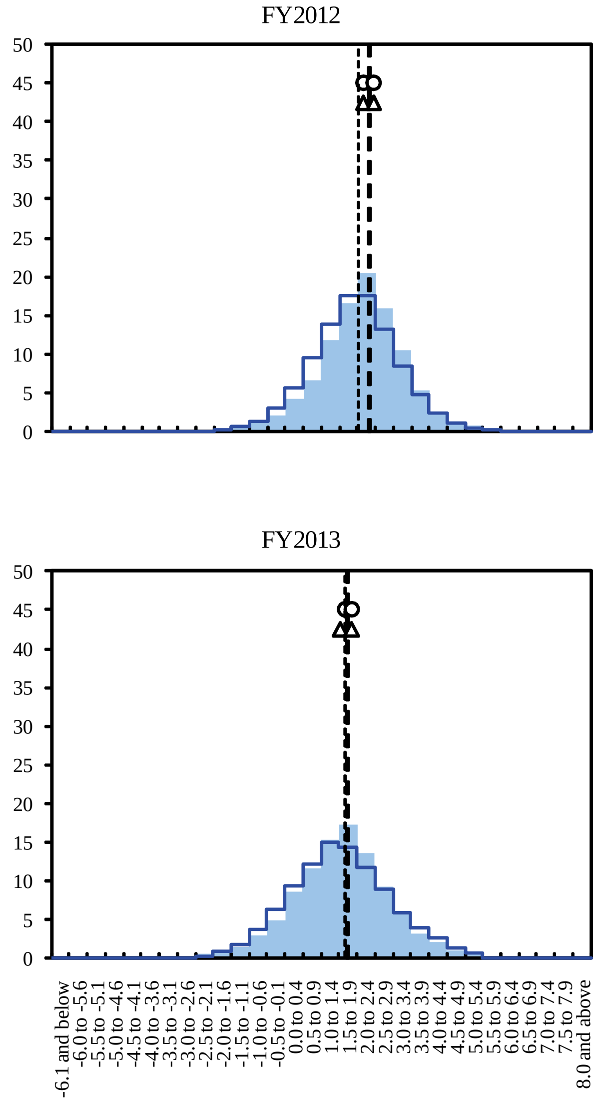
y/y % chg.

	Real GDP	Domestic CGPI	CPI (all items less fresh food)
Fiscal 2011	-0.2 to -0.1	+1.7	0.0
Forecasts made in January 2012	-0.5 to -0.3	+1.7 to +1.9	-0.1 to 0.0
Fiscal 2012	+2.1 to +2.4	+0.3 to +0.8	+0.1 to +0.4
Forecasts made in January 2012	+1.8 to +2.2	-0.2 to +0.2	-0.2 to +0.3
Fiscal 2013	+1.5 to +1.8	+0.6 to +1.0	+0.4 to +0.8
Forecasts made in January 2012	+1.4 to +1.8	+0.5 to +1.0	+0.2 to +0.6

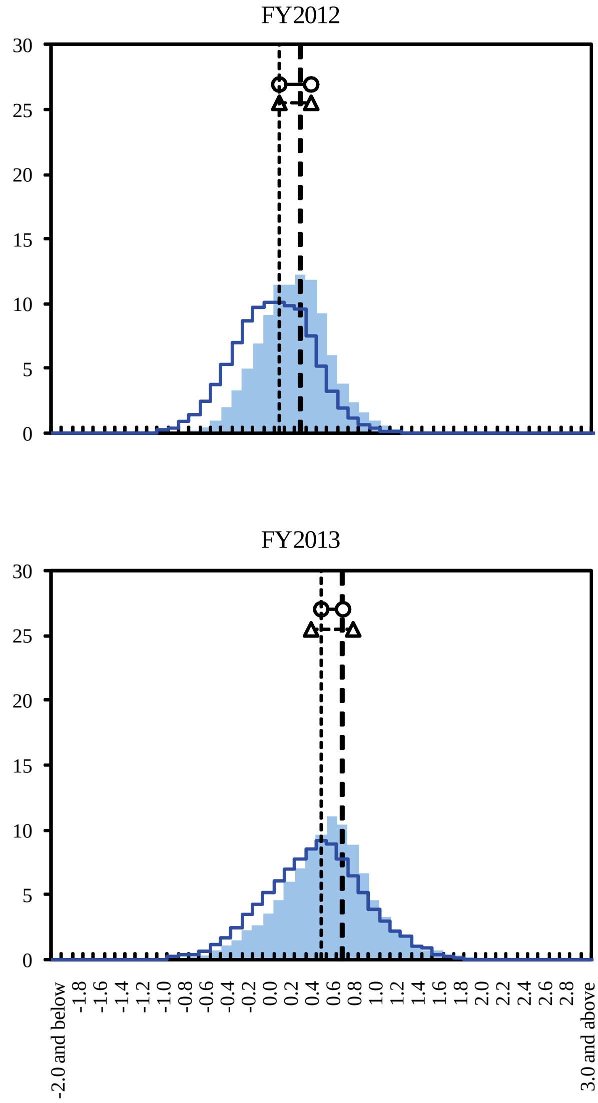
(Appendix 2)

Risk Balance Charts

(1) Real GDP



(2) CPI (All Items Less 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 April 2012, and solid lines represent those in January 2012.

2. Heavy vertical dashed 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. Thin vertical dashed lines indicate the median of the Policy Board members' forecasts (point estimates) in January 2012.

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*.