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Bank of Japan

Outlook for Economic Activity and Prices
(October 2012)

The Bank's View[1]

I. Introduction

This October 2012 issue of the *Outlook for Economic Activity and Prices* (Outlook Report) presents the outlook for Japan's economy through fiscal 2014. The Outlook Report first provides a description of developments in global financial markets and overseas economies that are affecting Japan's economy, followed by the Bank of Japan's assessment of financial conditions in Japan. 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

As for developments in global financial markets, concern about the European debt problem has grown once again since spring 2012; namely, that the fiscal problems in the countries -- Greece, Portugal, and Ireland -- that had already received support from the European Union (EU) and the International Monetary Fund (IMF) would spread to Spain and Italy. This return of concern was caused by heightened uncertainties about the Greek reelection and Spain's financial system problem. Consequently, some nervousness came to be seen in global financial markets on the whole; for instance, with 10-year Spanish government bond yields rising to around 7.5 percent in late July 2012.

European authorities have carried out a range of policy measures in response to such

[1] The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 30, 2012.

developments. In July 2012, a financial support measure was compiled for the injection of capital into Spanish financial institutions. In early September, the European Central Bank (ECB) decided to launch a government bond purchasing program called Outright Monetary Transactions (OMTs). Under the OMTs, the ECB would purchase, without *ex ante* upper limits, government bonds with a remaining maturity of one to three years of countries calling for support from programs including the European Stability Mechanism (ESM) and proceeding with necessary efforts for fiscal consolidation and economic structural reform. In mid-September, the European Commission (EC) proposed a single banking supervisory mechanism within the euro area under the ECB toward the establishment of a framework that enables the ESM to inject capital directly to banks, and in mid-October, the EU leaders agreed that a legislative framework would be in place by end-2012. Thanks to these measures, investors have been somewhat less risk averse on the back of the European debt problem compared to a while ago. Nevertheless, particular attention should be paid to developments in the markets as a number of issues still involve a high degree of uncertainty, including progress in Greece's fiscal and economic structural reform, Spain's potential request for financial support from the ESM, and efforts to establish the single banking supervisory mechanism.

Looking at developments in overseas economies since the second half of 2011, the negative effects stemming from the European debt problem have spread globally through a trade channel as well as a business sentiment channel. In fact, many countries and regions have recently moved deeper into the deceleration phase, especially in the manufacturing sectors of these economies. By region, the U.S. economy has been on a moderate recovery trend on the whole, as is evident in the modest increase in private consumption and signs of a pick-up in the housing market. Nevertheless, the pace of increase in business fixed investment and production has slowed as business sentiment has become cautious on the back of uncertainties associated with developments in overseas economies and the "fiscal cliff." Economic activity in Europe has receded slowly. An adverse feedback loop among the fiscal balance, the financial system, and economic activity has been operating in peripheral countries in the euro area. Such negative effects of the debt problem have spread from peripheral countries to core countries through a decline in trade activities within the euro area and weakening business sentiment. As for the Chinese economy, exports to Europe -- which have a large weight -- have declined, and private real estate investment has slowed mainly due to the effects of policy measures to restrain speculative real estate transactions. Reflecting these developments in demand at home and abroad, the economy has been decelerating at a somewhat faster pace as inventory accumulation has continued in a wide range of industries, including materials industries, and as the inventory adjustment phase has been prolonged. Against the background of weakness in final demand in Europe and China, the pick-up in the NIEs and the ASEAN economies has moderated, particularly in exports and business fixed investment in manufacturing in the corporate sector.[2]

In the Bank's baseline scenario, overseas economies are likely to remain in a deceleration phase for the time being, but will gradually emerge from that phase and turn to a moderate recovery thereafter on the assumption that global financial markets will remain stable on the whole.[3]

Broken down by region, the U.S. economy is expected to continue recovering at a moderate pace throughout the projection period, mainly against the background of accommodative financial conditions, albeit with the effects of fiscal austerity policy. The European economy is likely to lack momentum for recovery on the whole throughout the projection period as fiscal austerity measures continue to be implemented in peripheral countries, although core countries in the euro area are likely to post higher growth gradually due to an increase in exports to outside the area. The Chinese economy is expected to remain in a deceleration phase for the time being, but will register higher growth gradually as positive effects of economic stimulus measures on both the monetary and fiscal fronts start to appear and inventory adjustment progresses. Meanwhile, the pick-up in the NIEs and the ASEAN economies is likely to become more evident as exports gradually start increasing in a situation where domestic demand -- especially private consumption -- maintains firmness.

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[2] In this Outlook Report, the NIEs are South Korea, Taiwan, Hong Kong, and Singapore, and the ASEAN economies are represented by Thailand, Indonesia, Malaysia, and the Philippines.

[3] In October 2012, the IMF revised downward its July projections for global economic growth (calculated as the aggregate of purchasing power parity-weighted GDP growth projections for individual countries or regions) for 2012, 2013, and 2014 by 0.2-0.3 percentage point each to 3.3 percent, 3.6 percent, and 4.1 percent, respectively. The global economy, however, is projected to accelerate at a moderate pace toward the end of the projection period to reach a rate exceeding its past long-term average. For reference, the average growth rate during the 32 years from 1980 to 2011 is 3.4 percent.

III. Japan's Financial Conditions

Financial conditions in Japan have been accommodative in a situation where the Bank pursues powerful monetary easing in a continuous manner. Specifically, firms' funding costs have been hovering at low levels, with the average contracted interest rates on new loans and discounts -- both the short- and long-term rates -- registering a level of 1 percent, even lower than that registered during the first half of the 2000s, the period of quantitative easing. Issuing conditions for CP and corporate bonds have remained favorable on the whole as demand among investors has continued to be resilient, despite the widening of some credit spreads mainly due to worsening corporate performance. A range of indicators representing firms' availability of funds, including 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. Firms have generally been recovering their credit demand, mainly for funds related to reconstruction following the Great East Japan Earthquake as well as those associated with corporate takeover activities. Looking at funding in the corporate sector at home, the year-on-year rate of increase in the amount outstanding of bank lending has risen somewhat recently. The year-on-year rate of change in the amount outstanding of corporate bonds, especially electronic company bonds, has been negative. On the other hand, that of CP has generally been slightly positive.

As such, accommodative financial conditions in Japan have been maintained even in the face of headwinds -- that is, when the earthquake and the European debt problem hit the markets. 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 future developments.[4]

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[4] For more details on the assessment of financial system stability in Japan, see the October 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. The baseline scenario adopted by the Bank this time presumes that the consumption tax, which currently stands at 5 percent, will rise to 8 percent in April 2014 and 10 percent in October 2015, following the passage of the consumption tax-related legislation.[5]

Japan's economy grew at a rate of about 3 percent in the first half of 2012 as domestic demand remained firm, mainly supported by increases in both public and private reconstruction-related demand. Thereafter, however, the economy has been weakening somewhat as exports and industrial production have decreased, reflecting the fact that overseas economies have moved deeper into a deceleration phase.

Japan's economy is expected to level off more or less for the time being. Thereafter, however, as domestic demand remains resilient on the whole and overseas economies gradually emerge from the deceleration phase, the economy is expected to return to a moderate recovery path. As efforts proceed to strengthen the economy's growth potential -- such as firms' efforts to cultivate potential demand at home and abroad and the government's implementation of its growth strategy -- and the medium- to long-term growth expectations for firms and households consequently see a moderate increase toward the end of the projection period, the sustainability of economic recovery is likely to gain momentum.

More concretely, from the latter half of fiscal 2012 toward fiscal 2013, both exports and industrial production are expected to remain relatively weak over that period against the background of prolonged deceleration in overseas economies. Such weakness in exports and industrial production will exert some pressure to restrain business outlays in the manufacturing sector. Domestic demand is expected to remain resilient on the whole, mainly supported by reconstruction-related demand in a broad sense, including investment

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[5] Legislation relating to the "Comprehensive Reform of Social Security and Tax" was passed in the Diet in August 2012.

related to disaster prevention and energy. Nonetheless, it is likely that purchases of cars will decline due to the expiration of subsidies for environmentally friendly cars, and that the pent-up demand after the earthquake disaster will gradually subside. Owing to these developments, domestic demand is unlikely to increase at a pace that will offset the weakness in exports, and the economy is expected to level off more or less for the time being.

Thereafter, however, as overseas economies gradually emerge from the deceleration phase, exports and industrial production are likely to start picking up and favorable spending activity in the economy as a whole is expected to gain momentum slowly. In fiscal 2013, the economy is expected to grow at a pace that is clearly above its potential as a pick-up in overseas economies gradually becomes evident and private domestic demand increases at a robust pace, coupled with rising corporate profits and labor income, whereas support from reconstruction-related demand -- in particular, public demand -- will diminish slowly.[6] In the second half of fiscal 2013, a front-loaded increase in demand prior to the consumption tax hike is likely to take place on a large scale, generating a considerably higher growth rate temporarily.[7]

In fiscal 2014, the underlying trend of the economy -- that is, to exclude the fluctuations

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[6] Japan's potential growth rate during the projection period is estimated to be "around 0.5 percent" on average, although it is expected to rise gradually toward the end of the projection period. 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. For more details on the estimation of the potential growth rate, see Box 4 of the Outlook Report in October 2010.

[7] The consumption tax hike will affect the economy mainly by generating a front-loaded increase in demand and subsequent decline prior to and after the tax hike (an intertemporal substitution effect). An effect from a decline in real income as a result of price rises could also take place, but given that households to some extent have already expected the future tax hike on the back of severe fiscal conditions in a somewhat long-term perspective, it is unlikely that this effect will be as substantial as that estimated mechanically from the decline in income. Altogether, the consumption tax hike on real GDP is expected to have the effect of pushing up the economic growth rate for fiscal 2013 by around 0.3 percentage point and pushing down the rate for fiscal 2014 by around 0.7 percentage point. There are still several areas for which details have yet to be finalized, including measures to accommodate large swings and to alleviate the tax burden regarding the purchases of automobiles and houses; the effect of the tax hike this time on the economy is subject to considerable uncertainty and the estimates presented above are subject to a considerable margin of error.

stemming from the consumption tax hike -- is projected to grow at a rate somewhat higher than its potential as overseas economies are likely to register growth above the historical long-term average and the stimulative effects of low interest rates will strengthen on the back of improvement in corporate profits and higher growth expectations, all of which will underpin private domestic demand. Nonetheless, the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike is likely to be seen mostly in the first half of fiscal 2014; thus, the growth rate in fiscal 2014 as a whole will probably be at a somewhat low level, slightly above 0 percent.

The timing for Japan's economy to emerge from the leveling-off period and start recovering is expected to be delayed from the previous projection, mainly reflecting the fact that overseas economies have moved deeper into the deceleration phase. The delay in the anticipated timing of the recovery is being incorporated into this baseline scenario, and the growth rate for fiscal 2012 consequently is expected to be lower than the one presented in the interim assessment in July 2012. Excluding the effect of the front-loaded increase in demand prior to the consumption tax hike, the growth rate for fiscal 2013 is also expected to be somewhat lower than the one in the previous assessment.

A more detailed explanation of the outlook, broken down by the corporate and household sectors, is as follows.

In the corporate sector, while exports -- especially those bound for Europe and China -- are likely to remain relatively weak for the time being, they are expected to reverse course and start picking up as overseas economies gradually emerge from the deceleration phase, due in particular to the policy effects to stimulate the economy in China. In the meantime, domestic demand is expected to remain resilient on the whole, mainly supported by reconstruction-related demand in a broad sense and by accommodative financial conditions. Specifically, public investment is likely to continue increasing. Against the background of firms' increasing awareness of the need for disaster prevention and business continuity, as well as their putting business resources into renewable energy-related businesses, business fixed investment -- particularly that unlikely to be affected by cyclical factors, such as investment aimed at preventing disaster and that related to energy -- is expected to remain firm. As domestic demand is expected to remain resilient on the whole and overseas economies will recover gradually, as mentioned earlier, an improving trend in corporate profits is likely to become evident slowly. Against such a backdrop, business fixed investment as a whole is expected to maintain its moderate increasing trend throughout the projection period, although it is likely to show somewhat weak movement, mainly in the manufacturing sector, due to the weakness in exports and industrial production.

Regarding the household sector, as for employment and income conditions, the supply and demand balance in the labor market is expected to remain on an improving trend on the whole, supported by resilient domestic demand. For the time being, however, weakness in exports and industrial production will exert forces to ease labor supply and demand conditions through a decrease in overtime hours worked and in new job offers. As for the average wage per worker, the severe business performance in fiscal 2011, caused by the earthquake disaster, will exert downward pressure on bonuses this winter. Consequently, labor income is likely to stay flat more or less for the time being. Nevertheless, private consumption is expected to remain resilient on the whole, supported by firms' efforts to create new business to meet the demand of the elderly, whose consumption is relatively unsusceptible to the labor income conditions. For the time being, however, the increasing pace of private consumption is likely to decelerate, compared with that in the first half of 2012, reflecting the end of subsidies for the purchase of environmentally friendly cars and the diminishing pent-up demand that had sustained consumption at a relatively high rate. Thereafter, exports and industrial production will start to pick up reflecting the aforementioned improvement in overseas economies, and an improving trend in employment and income conditions, with some time lag, will gradually materialize, underpinning private consumption. Meanwhile, housing investment is likely to increase moderately throughout the projection period against the backdrop of reconstruction-related demand and a low interest rate environment.

B. Outlook for Prices

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. In concrete terms, 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 year-on-year rate of change in the consumer price index (CPI), and it has set a goal of 1 percent for the time being. With "the price stability goal in the medium to long term" in mind, the outlook for price developments is examined next.

Looking back at the developments in the CPI (for all items less fresh food, and the same 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 narrow 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. Against such a background, the year-on-year rate of change in the CPI has recently been around 0 percent. As such, from a somewhat long-term perspective, there is a mild positive correlation between the rate of change in the CPI and the aggregate supply and demand balance.

As for the outlook for the environment surrounding prices, the aggregate supply and demand balance is likely to level off for the time being, reflecting the aforementioned outlook for economic activity. Thereafter, it is expected to continue a moderate improving trend with some fluctuations, caused by the effects of the consumption tax hike. Medium- to long-term inflation expectations can be assumed to remain stable throughout the projection period, given that the expectations of market participants and economists have been stable at around 1.0 percent on balance and households have not changed their views notably. As for international commodity prices, there has been a slight rise in crude oil and crop prices due to a heightened geopolitical risk and the weather. On average, however, prices are expected to remain more or less flat, reflecting the deceleration of overseas economies. Thereafter, they 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.

On the basis of the aforementioned environment, in terms of the outlook for prices -- excluding the direct effects of the consumption tax hike -- the domestic corporate goods price index (CGPI) is expected to decline on a year-on-year basis for the time being, reflecting some weakness in international commodity prices. After fiscal 2013, however, it is expected to return to a moderate rising trend, reflecting a modest increase in international commodity prices and the improvement in the aggregate supply and demand balance.[8]

The year-on-year rate of change in the CPI is expected to hover around 0 percent for the time being and start rising gradually thereafter as the aggregate supply and demand balance improves. In fiscal 2014, it appears likely that it will move steadily closer toward 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 July interim assessment, the year-on-year rates of change in the CPI in fiscal 2012 and 2013 are revised downward from those in July. This is partly because an improvement in the aggregate supply and demand balance is expected to delay reflecting the downward revision of economic outlook. Furthermore, the downward correction in crude oil prices also contributed to the downward revision in the CPI projection.

There are both cyclical and structural reasons why it has taken a long time for the aggregate supply and demand balance to improve. In terms of a cyclical factor, there is still room for such improvement given the considerably significant economic downturn caused by the Lehman shock. Consequently, it is expected to be in the latter half of the current projection period that the balance is largely restored, giving rise to clearer upward pressure on prices, notwithstanding the continued growth above its potential.

In terms of a structural factor, it can be pointed out that the economic growth rate has been on a declining trend. While globalization and the rapid aging of and decline in the population proceed, there has not been sufficient progress with efforts to strengthen the growth potential of the economy and review the social security system in order to enhance its sustainability. As a result, the medium- to long-term growth expectations of firms and households have been adversely affected, leading these entities to become cautious in terms of their spending behavior. The lack of progress with regard to improving the aggregate supply and demand balance, due to a chronic shortage of demand, appears to have exerted downward pressure on prices. Going forward, as efforts to strengthen the growth potential of the economy gradually materialize and the growth expectations of households and firms rise moderately, such downward pressure is projected to weaken slowly.

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[8] The effect of the consumption tax hike on prices can be estimated by assuming that the rise in the consumption tax will be fully passed on for all items taxable at present. In fiscal 2014, the domestic CGPI will be pushed up by 2.9 percentage points and the CPI by 2.0 percentage points.

V. Upside and Downside Risks

A. Risks to Economic Activity

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

The first risk concerns developments in global financial markets and overseas economies. As for the European debt problem, partly because a range of policy measures have been implemented by the European authorities, a tail risk of global financial market turmoil -- due to concern about the financial system -- causing a significant global economic downturn has decreased somewhat. Nonetheless, there are still various challenges in order to overcome the European debt problem.

On the one hand, there is a possibility that credibility will be strengthened in the markets, acting as an upside risk to the global economy, if progress is made, beyond the assumption of the baseline scenario, with fiscal, financial system, and economic structural reforms in the respective countries in Europe, as well as with the fiscal and financial integration of the whole area, while market stability is secured, mainly through the ECB's initiatives to provide ample liquidity and introduce a government bond purchasing program. On the other hand, there is also a possibility that strains in global financial markets will intensify once again in case of a reemergence of concern about the implementation of such reforms, acting as a downside risk to the global economy and consequently to Japan's economy.

In addition to the channels through global financial markets described earlier, overseas economies continue to be surrounded by various risk factors. In particular, a risk of further prolonged deceleration, even if these economies manage to avoid a significant decline, requires attention. In advanced economies such as the United States and Europe, those economic entities -- that have been burdened with excess debts resulting from the emergence of credit bubbles toward the mid-2000s and the subsequent burst -- are likely to maintain cautious investment and spending attitudes until their debts return to adequate levels. Under such circumstances, advanced economies appear unlikely to accelerate with the materialization of an upside risk, and they are likely to remain vulnerable to a downside risk. While potential growth in emerging economies is higher than that in advanced economies, the former will be affected by the balance-sheet adjustment in the latter through a trade channel as well as a financial market channel. In addition, some of the emerging economies -- including China -- for which relatively high growth has been maintained so far, face various types of structural problems toward the transition to a sustainable growth path. It is necessary to pay attention to developments in these emerging economies.

Looking more closely at risk factors in respective regions, with regard to the U.S. economy, although balance-sheet repair in the household sector has been making some progress gradually on the back of a pick-up in the housing market, there is still a long way to go. In addition to the negative effects stemming from the European debt problem, uncertainty surrounding the future course of fiscal policy, including the issue referred to as the "fiscal cliff," may exert significant restraining pressure on economic activity. On the other hand, if uncertainty surrounding fiscal policy diminishes as a result of the resolution of the fiscal cliff, this may exert upward pressure on the economy, mainly through improvement in business and household sentiment. In Europe, while some core countries including Germany may post higher growth, mainly led by exports, there is also a downside risk of the economic recession possibly continuing for longer than expected due to the debt problem in peripheral countries causing even stronger spill-over effects in core countries. In emerging and commodity-exporting economies, there remains considerable uncertainty regarding the timing of a return to a sustainable growth path and the level of potential growth rate in the medium to long term. In particular, the Chinese economy is vulnerable to the effects of the European debt problem because its share of exports to Europe is high; there is a risk that the improvement in the supply and demand balance might take a long time, especially in materials industries, burdened with excess capital stock. In addition, thanks to stimulative measures associated with monetary and fiscal policies, there have been signs of improvement in domestic demand -- for example, in terms of infrastructure investment -- but uncertainty surrounding the magnitude of such policy measures remains considerable. It is necessary to pay close attention to whether the Chinese economy will successfully make a transition from a high growth phase to a sustainable stable growth phase in the long run while the economic structure of China will change from one that places much weight on exports and fixed asset investment to one that focuses on spending, overcoming the excess capacity problem. Furthermore, given that Japan and China are closely interrelated, as is partly evident in the global supply chain network, the recent bilateral relationship is likely to have an effect on Japan as well as China. On this point, close attention should be paid to whether this may push down Japan's economy through the effects on trade, investment activities, and the number of Chinese visitors to Japan.

The second risk relates to uncertainty with regard to firms' and households' medium- to long-term growth expectations. In the baseline scenario, such expectations are likely to rise, albeit moderately, toward the end of the projection period as efforts to strengthen growth potential will gradually bear fruit. However, changes of growth expectations are possible in either the upside or downside direction depending on future developments. For instance, given that the capturing of global demand and relocation of global business operations to enhance efficiency are critical challenges facing firms, expansion in production and business operations overseas is expected to continue. If such expansion is not compensated for by new domestic production activities, firms' and households' medium- to long-term growth expectations might decline. Similarly, with regard to problems concerning the supply and demand of electric power, there is a possibility that production could be restrained during periods of high electric power demand, depending on various factors including the weather. Attention should be paid not only to such short-term effects but also to the possibility of an eventual decline in medium- to long-term growth expectations. On the other hand, such 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 and diversifying domestic demand, and making innovations in energy-related technologies and business models – proceed considerably and prove highly fruitful.

Third, there is uncertainty with regard to the effect of the consumption tax hike. In the baseline scenario, the estimates of the front-loaded increase in demand and subsequent decline prior to and after the consumption tax hike have been made, based on past episodes at home and abroad; however, such estimates are subject to change, depending on the aforementioned growth expectations and institutional changes other than the consumption tax hike. Furthermore, if the tax hike alleviates the public's concern about fiscal sustainability and the social security system, there is a possibility that it could provide a positive impetus for economic activity. On the other hand, there is a risk that consumption could be suppressed further than expected once the public increasingly starts to cut back on its spending due to a decline in real purchasing power.

Fourth, there are various problems regarding Japan's fiscal sustainability. To be specific, in the event that the general public's confidence in fiscal sustainability declines, people's increasing concern about the future, particularly the one related to the higher tax burden, 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 concern 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 monitoring Japan's conduct of fiscal policy in a more critical way amid heightening concern about public debt in many advanced countries. In this situation, if many market participants come to believe that efforts to achieve fiscal consolidation are insufficient -- despite some progress that has been made -- 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.

As for risks specific to prices, the first concerns uncertainty associated with the responsiveness of prices to the aggregate supply and demand balance. It has been observed in recent years among many advanced economies that prices tend to respond to changes in the aggregate supply and demand balance to a lesser extent, with severe price competition among firms mainly against the backdrop of globalization of the economy and deregulation. Similarly in Japan, despite improvement in the aggregate supply and demand balance, the inflation rate hardly picked up in the mid-2000s. More recently, however, factors working toward restoring price responsiveness to the supply-demand balance have also been observed, as supported by the fact that low-priced import goods from China have not increased substantially and firms have been increasingly differentiating their products and services. In the Bank's baseline scenario, taking into account these recent changes, the year-on-year rate of change in the CPI is expected to rise gradually as the aggregate supply and demand balance improves. Nevertheless, careful attention should be paid to whether firms will raise prices as anticipated in accordance with improvement in economic conditions, as there is a high degree of uncertainty concerning the extent to which prices respond to changes in the aggregate supply and demand balance.

The second risk concerns developments in firms' and households' medium- to long-term inflation expectations. As noted above, these expectations have been stable on the whole thus far. On the one hand, if firms and households increasingly expect from recent and past price developments that the pace of increase in prices will remain slow, downward pressure may be exerted on actual prices as well as wages. On the other hand, once the efforts to strengthen growth potential proceed and firms' medium- to long-term growth expectations rise higher than expected as potential demand materializes, firms' and households' medium- to long-term inflation expectations may improve and prices may rise higher than anticipated.

The third risk concerns developments in import prices. There is a possibility that crude oil prices may show large fluctuations, mainly reflecting geopolitical risk. Crop prices may also entail uncertainty, with potential for movement in either direction depending on the weather. 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 concerns 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 2014. As noted earlier, Japan's economy is expected to level off for the time being and return to the moderate recovery path as domestic demand remains resilient on the whole and overseas economies gradually emerge from the deceleration phase.

The year-on-year rate of change in the CPI, excluding the effects of the consumption tax hike, is expected to hover around 0 percent for the time being and start rising gradually thereafter as the aggregate supply and demand balance improves. In fiscal 2014, it appears likely that it will move steadily closer toward the Bank's "price stability goal in the medium to long term" of 1 percent for the time being. In assessing comprehensively the outlook for economic activity and prices that has been described above, the Bank expects that Japan's economy will return to the sustainable growth path with price stability in the longer run.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy, including those that have a longer time horizon than in the first perspective. In the area of economic activity, although tail risks arising from the European debt problem are waning somewhat, a high degree of uncertainty remains concerning global financial markets and overseas economies, and it is still an important downside risk. In the meantime, medium- to long-term growth expectations could move in either the upside or downside direction depending on the outcome of the efforts to strengthen growth potential. Furthermore, the effects of the consumption tax hike on economic activity are highly uncertain given the previous episodes at home and abroad. Efforts to ensure fiscal sustainability could also significantly affect economic developments. On the price front, careful attention should be paid to the responsiveness of prices to the aggregate supply and demand balance as well as future developments in medium- to long-term inflation expectations and international commodity prices.

Financial imbalances should be examined, from the viewpoint of long-term risks that will significantly impact economic activity and prices when they materialize, although the probability of their appearance is low. Specifically, the total amount of credit by Japan's financial institutions to firms and households relative to economic activity has been around its long-term trend. As such, there is no evidence at this point that warns of financial imbalances stemming from bullish expectations. Nonetheless, while the amount outstanding of government debt has accumulated to a substantially high level, financial institutions' lending remains lackluster and their holding of government bonds tends to increase significantly. Thus, due attention needs to be paid to a possibility that some events might trigger a pick-up in long-term interest rates, which would have significant effects on financial institutions and consequently on Japan's economy as a whole. From this viewpoint, it is important to ensure that fiscal sustainability in the medium to long term be maintained and to preserve credibility in the conduct of monetary policy.[9]

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 and returning Japan's economy to the sustainable growth path with price stability by pursuing powerful monetary easing as well as supporting efforts to strengthen the growth potential of Japan's economy and to increase lending by financial institutions.

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 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. With regard to the Program, the Bank will continue pursuing powerful monetary easing in a continuous manner by steadily increasing its purchases of financial assets in order for the size of the Program to reach about 91 trillion yen by the end of 2013. In pursuing such powerful easing, the Bank will ascertain whether there is any significant risk to the sustainability of economic growth, including from the accumulation of financial imbalances.

Second, while pursuing powerful monetary easing, the Bank will also continue to engage in efforts to strengthen the foundations for Japan's economic growth as a central bank, in order to help firms and households take advantage of accommodative financial conditions and undertake investment and spending activities proactively. 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, it is imperative to do the

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[9] For more details on the assessment of the financial system stability in Japan from the viewpoint of financial imbalances, see the October 2012 issue of the Bank's *Financial System Report*.

following. First, the government should seek to create a more conducive environment in such areas as regulation. Second, private financial institutions should carry out their financial intermediation function to the full extent and encourage firms to take advantage of accommodative financial conditions from the lending side. Furthermore, in a situation where the government debt to GDP ratio has become the highest among advanced economies, it is necessary that fiscal sustainability in the medium to long term be maintained as described above. Thus it is important that all economic entities -- including business firms, financial institutions, the government, and the Bank -- continue to exert efforts within their respective roles.

The Bank will continue to conduct monetary policy in an appropriate manner. It will also do its utmost to ensure the stability of Japan's financial system, while giving particular attention to developments in global financial markets.

(Appendix)

Forecasts of the Majority of Policy Board Members

y/y % chg.

	Real GDP	Domestic CGPI	CPI (all items less fresh food)
Fiscal 2012	+1.4 to +1.6 [+1.5]	-1.2 to -0.9 [-1.1]	-0.1 to -0.1 [-0.1]
Forecasts made in July 2012	+2.2 to +2.4 [+2.2]	-0.3 to 0.0 [-0.2]	+0.1 to +0.3 [+0.2]
Fiscal 2013	+1.3 to +1.8 [+1.6]	+0.1 to +0.7 [+0.5]	+0.2 to +0.6 [+0.4]
Forecasts made in July 2012	+1.6 to +1.8 [+1.7]	+0.6 to +0.8 [+0.6]	+0.5 to +0.7 [+0.7]
Fiscal 2014	+0.2 to +0.7 [+0.6]	+3.7 to +4.4 [+4.2]	+2.4 to +3.0 [+2.8]
Excluding the effects of the consumption tax hike		+0.8 to +1.5 [+1.3]	+0.4 to +1.0 [+0.8]

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 scheduled consumption tax hikes for 2014 and 2015 -- of 8 percent and 10 percent, respectively -- are incorporated in the forecasts presented in this Outlook Report. In terms of the outlook for the CGPI and the CPI, individual Policy Board members make their forecasts based on figures excluding the direct effects of the consumption tax hike.

5. The forecasts for the CGPI and the CPI for fiscal 2014 that incorporate the direct effects of the consumption tax hike are constructed as follows. First, the contribution to prices from the tax hike is mechanically computed on the assumption that the tax increase will be fully passed on for all taxable items. The domestic CGPI will be pushed up by 2.9 percentage points and the CPI by 2.0 percentage points. Second, these figures are added to the forecasts made by the Policy Board members.

6. 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 toward the latter half of the projection period may be slightly lower than the above forecasts based on the Fix-Weighted Index Formula.

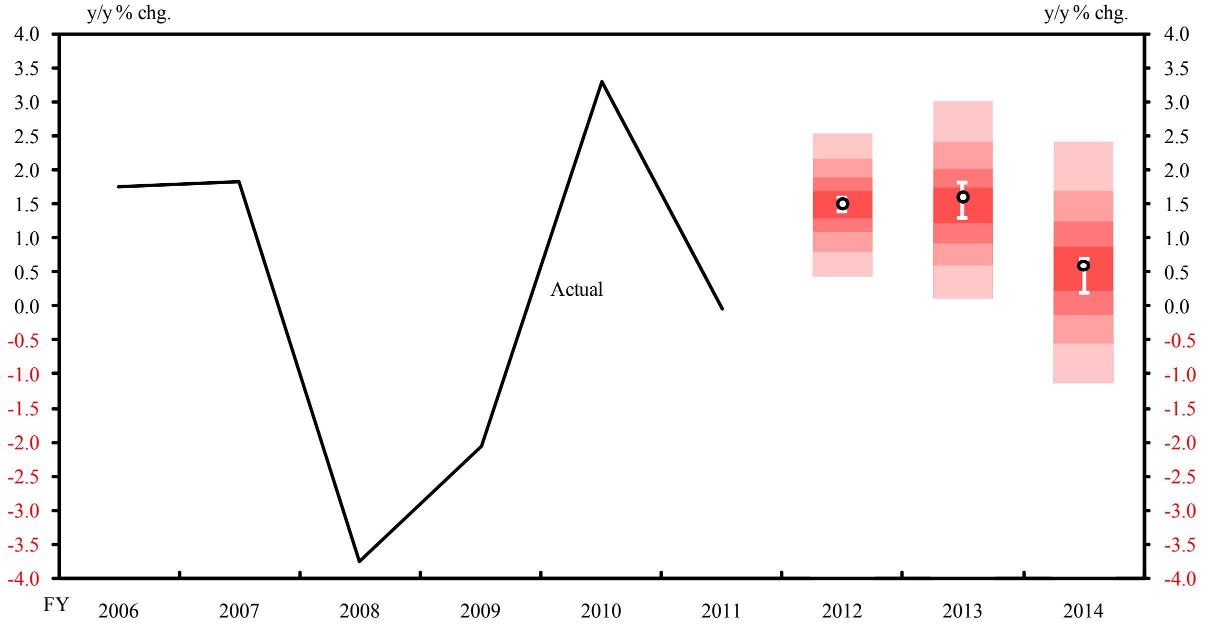
7. The ranges shown below include the forecasts of all Policy Board members.

y/y % chg.

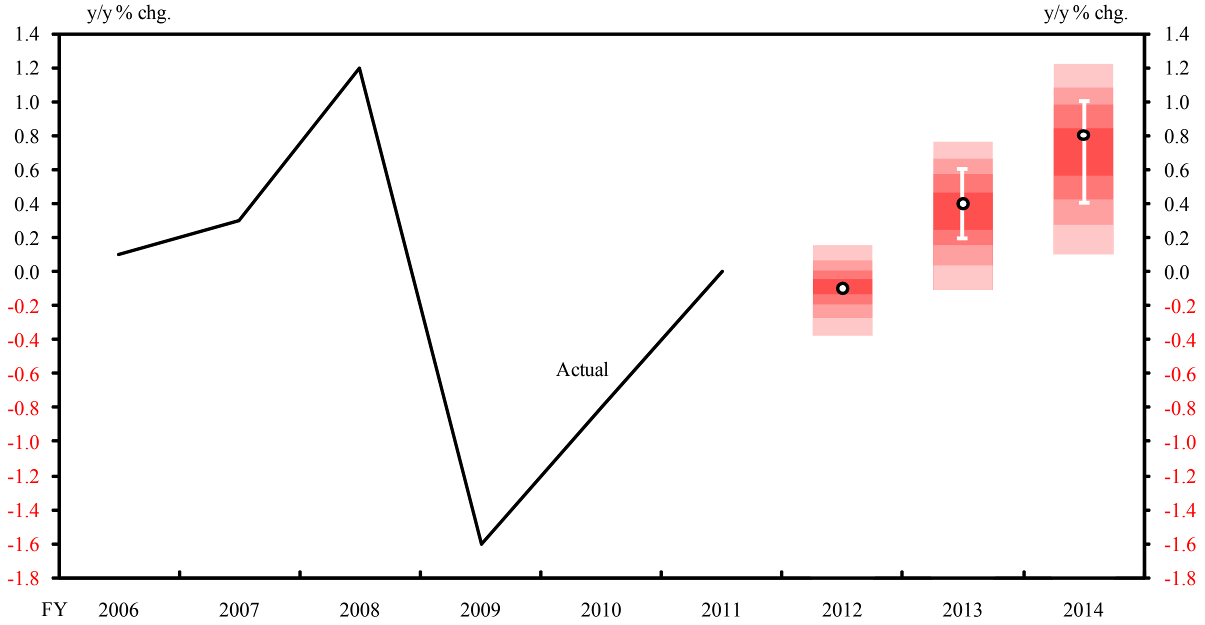
	Real GDP	Domestic CGPI	CPI (all items less fresh food)
Fiscal 2012	+1.2 to +1.7	-1.3 to -0.8	-0.1 to 0.0
Forecasts made in July 2012	+2.1 to +2.4	-0.5 to 0.0	+0.1 to +0.4
Fiscal 2013	+1.0 to +1.8	-0.2 to +0.8	-0.1 to +0.6
Forecasts made in July 2012	+1.5 to +1.8	+0.5 to +1.0	+0.4 to +0.8
Fiscal 2014	+0.1 to +0.8	+3.3 to +4.5	+2.2 to +3.0
Excluding the effects of the consumption tax hike		+0.4 to +1.6	+0.2 to +1.0

Forecast Distribution Charts of Policy Board Members

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. Based on the aggregated probability distributions (i.e., the Risk Balance Charts) compiled from the distributions of individual Policy Board members, the Forecast Distribution Charts are compiled as follows. First, upper and lower 10 percentiles of the aggregated distributions are trimmed and second, colors indicated below are used to show the respective percentiles of those distributions.

Upper 40% to lower 40%	Upper 30 to 40% & lower 30 to 40%	Upper 20 to 30% & lower 20 to 30%	Upper 10 to 20% & lower 10 to 20%

2. 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* .

3. The circles in the bar charts indicate the median of the Policy Board members' forecasts (point estimates). The vertical lines in the bar charts indicate the range of the forecasts of the majority of Policy Board members.

4. The forecast for the CPI excludes the direct effects of the scheduled consumption tax hikes.