October 31, 2013

Bank of Japan

Outlook for Economic Activity and Prices
(October 2013)

The Bank's View[1]

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

A. Outlook for Economic Activity

Japan's economy has been recovering moderately. On the demand side, while exports have been picking up at a somewhat slower pace, domestic demand, notably private consumption, has been firm. Reflecting such domestic and external demand, on the production side, the pace of increase in industrial production has remained moderate while activity in the nonmanufacturing sector, including services and construction, has been somewhat strong.

Looking ahead, while domestic demand is likely to maintain firmness as external demand is expected to increase, albeit moderately, a virtuous cycle among production, income, and spending is likely to be maintained. Therefore, while the economy will be affected by the front-loaded increase and subsequent decline in demand prior to and after the two scheduled consumption tax hikes, it is likely to continue growing at a pace above its potential, as a trend.[2]

The above projection assumes the following underlying developments.

First, as the Bank of Japan steadily pursues quantitative and qualitative monetary easing (QQE), financial conditions are likely to become more accommodative. Namely, under the QQE, upward pressure on nominal long-term interest rates has been contained while

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[1] The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 31, 2013.

[2] Japan's potential growth rate -- under a certain methodology -- is estimated to be "around 0.5 percent" on average during the projection period, and is expected to rise gradually toward the end of the projection period. However, it should be noted that estimates of the potential growth rate are subject to a considerable margin of error as they rely on the specific methodology employed and could change as more data for the relevant period become available.

inflation expectations have been rising on the whole, and thus real interest rates are trending downward. The year-on-year rate of change in the amount outstanding of bank lending has been rising moderately. Stimulative effects of such accommodative financial conditions on private demand are likely to strengthen as economic activity improves.

Second, while overseas economies have been somewhat weaker than anticipated at the time of the *Outlook for Economic Activity and Prices* (Outlook Report) in April 2013, they are expected to pick up gradually -- particularly the advanced economies -- on the assumption that global financial markets remain generally stable. Looking at respective major countries and regions, the U.S. economy is expected to gradually accelerate its pace of recovery, mainly as accommodative financial conditions will be maintained and the fiscal drag will gradually fade. While adjustment pressure associated with the European debt problem is likely to remain, the European economy is expected to gradually pick up, supported mainly by an improvement in households' and firms' sentiment. The Chinese economy is likely to maintain stable growth at around the current pace as authorities carry out policy measures to underpin economic activity while progressing with structural reforms. By contrast, growth in other emerging and commodity-exporting economies will likely continue to lack momentum for the time being, due partly to a tightening trend in financial conditions.

Third, public investment is expected to continue hovering at a high level through the first half of fiscal 2014, mainly reflecting an anticipated additional boost from new economic measures scheduled to be formulated as well as the effects of various past economic measures.

Fourth, firms' and households' medium- to long-term growth expectations are expected to rise moderately, due mainly to the government's regulatory and institutional reforms, various anticipated tax reduction measures for businesses, and firms' tapping of domestic and external demand.

Given these assumptions, to elaborate on economic activity during the projection period, <u>in the second half of fiscal 2013</u> exports and industrial production are expected to increase, albeit moderately, as overseas economies head toward a pick-up while the lagged effects of past foreign exchange developments provide underlying support. Against such a backdrop, a pick-up in business fixed investment will become further pronounced, reflecting an improvement in corporate profits, and private consumption is also expected to remain resilient, underpinned by an improvement in the employment and income situation. In addition, as a front-loaded increase in demand prior to the consumption tax hike will take place for private consumption and housing investment, it is projected that the growth rate for the second half of fiscal 2013 will be significantly elevated.[3] The growth rate for fiscal 2014 will slow substantially compared with the previous fiscal year, as there will be a decline in demand from the front-loaded increase in demand prior to the consumption tax hike, mainly in the first half. Nevertheless, the growth in exports is expected to accelerate as a pick-up in overseas economies becomes evident, and business fixed investment will likely continue to increase firmly, partly due to monetary easing and the effects of various tax reduction measures for businesses. Owing to these developments, the economy will likely continue growing at a pace above its potential. Also, for fiscal 2015, while fluctuations in demand stemming from the scheduled second consumption tax hike are anticipated, a virtuous cycle among production, income, and spending will be maintained and the economy is expected to continue growing at a pace above its potential. Comparing the current projection with that in the July 2013 interim assessment, the growth rates are expected to be more or less unchanged.

B. Outlook for Prices

The year-on-year rate of increase in the consumer price index (CPI, for all items less fresh food, and the same hereafter) has been expanding of late, and recently has been in the range of 0.5-1.0 percent.

Examining major factors that determine inflation rates into the future, first, the aggregate supply and demand balance is expected to follow a moderate improving trend, albeit with some swings due to the scheduled consumption tax hikes, causing excess demand over supply to expand toward the latter half of the projection period. Meanwhile, a tightening

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[3] The effects of the consumption tax hikes on the economic growth rate for each fiscal year are estimated as follows: an increase of around 0.3 percentage point for fiscal 2013, a decrease of around 0.7 percentage point for fiscal 2014, and an increase of around 0.2 percentage point for fiscal 2015. However, it should be noted that these estimates are subject to considerable uncertainty given that they depend partly on income conditions and price developments at each point in time, and therefore are subject to a considerable margin of error.

of labor supply and demand conditions is expected to become evident, and nominal wages are likely to see gradual upward pressure. Second, medium- to long-term inflation expectations are likely to continue on a rising trend under the QQE, partly supported by a rise in the observed inflation rate, gradually converging to around 2 percent -- the price stability target. Such a rise in inflation expectations is expected to gradually carry through to the price and wage formation of economic entities including firms and households. Third, import prices are expected to exert upward pressure for the time being, reflecting developments in international commodity prices and foreign exchange rates.

Based on the above, the outlook for the year-on-year rate of change in the CPI (excluding the direct effects of the consumption tax hikes) is as follows.[4] It is expected to follow a rising trend, reflecting factors such as the improvement in the aggregate supply and demand balance, as well as the rise in medium- to long-term inflation expectations, and it is likely to reach around 2 percent -- the price stability target -- toward the latter half of the projection period. Comparing the current projection with that in the July 2013 interim assessment, the projected rates of change in the CPI are more or less unchanged.

II. Upside and Downside Risks

A. Risks to Economic Activity

The following are upside and downside risks to the Bank's aforementioned baseline scenario regarding the economy. First, there is uncertainty regarding developments in overseas economies. The pace of recovery in the U.S. economy may become faster or slower depending on developments such as the effects of new energy sources and consequences of the fiscal problem. As for the European economy, amid remaining sluggishness for the time being, attention should continue to be paid mainly to future developments in the debt problem. As for the Chinese economy, uncertainty is high with respect to effects of the structural problems of excess production capacity and excess debt. Other emerging and commodity-exporting economies, some of which are facing structural

[4] The effects of the two scheduled consumption tax hikes on prices can be mechanically estimated by assuming that the rise in the consumption taxes will be fully passed on for all currently taxable items. On this basis, the CPI will be pushed up by 2.0 percentage points in fiscal 2014 and 1.3 percentage points in the second half of fiscal 2015 (0.7 percentage point for fiscal 2015 as a whole).

problems such as current account deficits, warrant attention together with developments in the global financial markets.

Second is developments in households' employment and income situations. As mentioned earlier, economic recovery has so far been led by firm domestic demand, mainly private consumption. For domestic demand to continue to maintain its firmness in the future, it is important to maintain a virtuous cycle whereby improvement in the employment and income situation supports consumption. In this regard, close attention should be paid to whether wages will be increased, reflecting a tightening of labor supply and demand conditions and a rise in inflation expectations, when there is an improvement in corporate profits on the one hand but a continued severe competitive environment surrounding firms on the other hand.

Third is the effects of the consumption tax hikes. Consumption tax is an indirect tax that is imposed broadly on consumption in general, and the hikes will have adverse effects on households' real disposable income. However, forces to mitigate adverse effects on consumption to some extent could be at work, partly because (1) various economic measures are scheduled to be taken by the government, (2) the tax hikes seem to have already been factored in substantially among households, and (3) the rate hikes are expected to have the effect of alleviating households' future concerns over the fiscal condition and the social security system. Attention should be paid to the effects of consumption tax hikes as they may differ depending on income conditions and developments in prices at each point in time, including the magnitude of the front-loaded increase and subsequent decline in demand prior to and after the tax hikes.

Fourth, firms' and households' medium- to long-term growth expectations may be either raised or lowered depending on future developments in regulatory and institutional reforms as well as tax reforms, innovation in the corporate sector, and the income situation in the household sector. In addition, from a somewhat longer-term perspective, some positive effects from the hosting of the Tokyo 2020 Summer Olympic Games might be expected.

Fifth, in the event that confidence in fiscal sustainability in the medium to long term declines, the economy may deviate downward from the baseline scenario through increases in people's concerns regarding the future, and rises in long-term interest rates that are unwarranted by economic fundamental conditions. On the other hand, there is also a possibility that the economy will deviate upward from the baseline scenario if confidence in the path toward fiscal consolidation strengthens and people's concerns regarding the future are alleviated.

B. Risks to Prices

The following are upside and downside risks specific to prices. The first concerns the high uncertainty regarding developments in firms' and households' medium- to long-term inflation expectations. While there is a possibility that people's inflation expectations may not readily rise in reflection of the moderate decline in prices and wages observed in the past, there is also a possibility that they will rise relatively quickly with a rise in observed inflation and wages. Furthermore, effects on these expectations of a price increase associated with the consumption tax hikes in items across the board warrant attention.

Second, there is uncertainty regarding the responsiveness of prices to the aggregate supply and demand balance. Attention needs to be paid to whether firms will raise prices and wages in accordance with the extent to which the supply and demand balances in goods and services as well as employment tighten under a highly competitive environment sustained over time.

Third, there continues to be high uncertainty regarding developments in import prices, reflecting fluctuations in international commodity prices and foreign exchange rates, and the extent to which such developments are passed on to domestic prices.

III. Conduct of Monetary Policy

In the context of the price stability target, the Bank assesses the aforementioned economic and price situation from two perspectives and then outlines its thinking on the future conduct of monetary policy.[5]

The first perspective concerns an examination of the baseline scenario for the outlook. Japan's economy is judged as likely to achieve around 2 percent inflation and return to a sustainable growth path toward the latter half of the projection period.

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[5] See the Bank's statement released on January 22, 2013, titled "The 'Price Stability Target' under the Framework for the Conduct of Monetary Policy."

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. With regard to the baseline scenario for economic activity, upside and downside risks can be assessed as being balanced, although uncertainty remains high, including that regarding developments in overseas economies. Risks on the price front also can be assessed as being largely balanced, although considerable uncertainty surrounds developments in medium- to long-term inflation expectations. Examining financial imbalances from a longer-term perspective, there is no sign at this point of excessively bullish expectations in asset markets or in the activities of financial institutions. Nevertheless, due attention needs to be paid to the fact that financial institutions' holdings of government bonds have remained at an elevated level while the amount outstanding of government debt has shown a cumulative increase.[6]

As for the future conduct of monetary policy, under the QQE favorable developments have been widely seen, such as an improvement in the real economy and financial markets, as well as people's sentiment and expectations, and Japan's economy has been following the path toward achieving the 2 percent price stability target as expected. The Bank will continue with the QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate.

[6] For more details, see the October 2013 issue of the Bank's *Financial System Report*.

(Appendix)

Forecasts of the Majority of Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2013	+2.6 to +3.0 [+2.7]	+0.6 to +1.0 [+0.7]	
Forecasts made in July 2013	+2.5 to +3.0 [+2.8]	+0.5 to +0.8 [+0.6]	
Fiscal 2014	+0.9 to +1.5 [+1.5]	+2.8 to +3.6 [+3.3]	+0.8 to +1.6 [+1.3]
Forecasts made in July 2013	+0.8 to +1.5 [+1.3]	+2.7 to +3.6 [+3.3]	+0.7 to +1.6 [+1.3]
Fiscal 2015	+1.3 to +1.8 [+1.5]	+1.6 to +2.9 [+2.6]	+0.9 to +2.2 [+1.9]
Forecasts made in July 2013	+1.3 to +1.9 [+1.5]	+1.6 to +2.9 [+2.6]	+0.9 to +2.2 [+1.9]

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 assuming the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy.

4. The scheduled consumption tax hikes for April 2014 and October 2015 -- to 8 percent and 10 percent, respectively -- are incorporated in the forecasts. In terms of the outlook for the CPI, individual Policy Board members make their forecasts based on figures excluding the direct effects of the consumption tax hikes.

5. The forecasts for the CPI for fiscal 2014 and fiscal 2015 that incorporate the direct effects of the consumption tax hikes are constructed as follows. First, the contribution to prices from each tax hike is mechanically computed on the assumption that the tax increase will be fully passed on for all taxable items. The CPI for fiscal 2014 and fiscal 2015 will be pushed up by 2.0 percentage points and 0.7 percentage point, respectively. Second, these figures are added to the forecasts made by the Policy Board members.

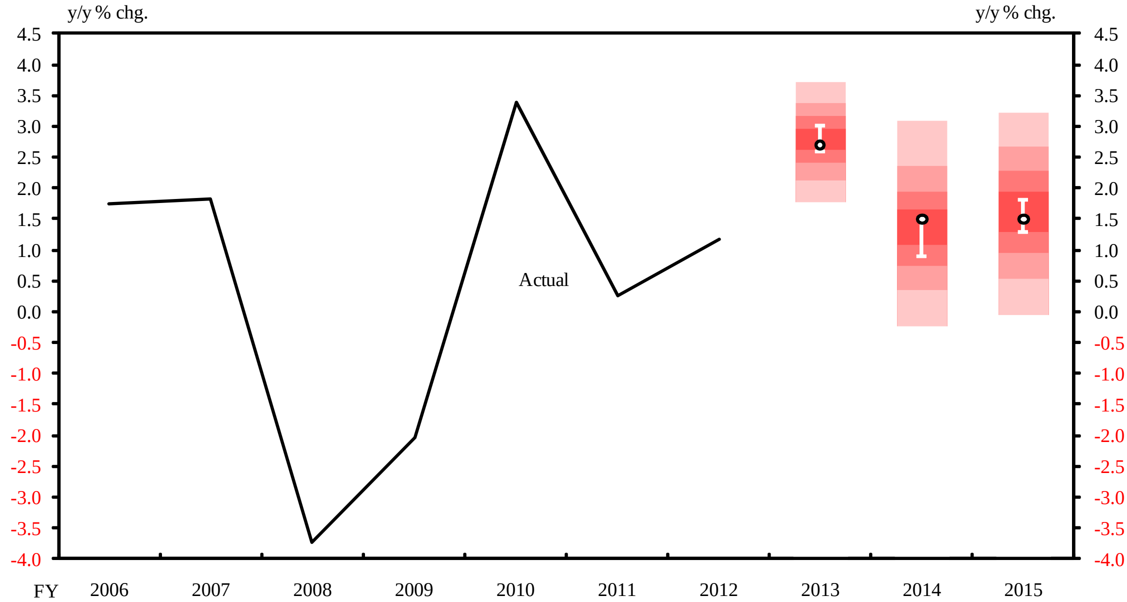
6. The ranges shown below include the forecasts of all Policy Board members.

y/y % chg.

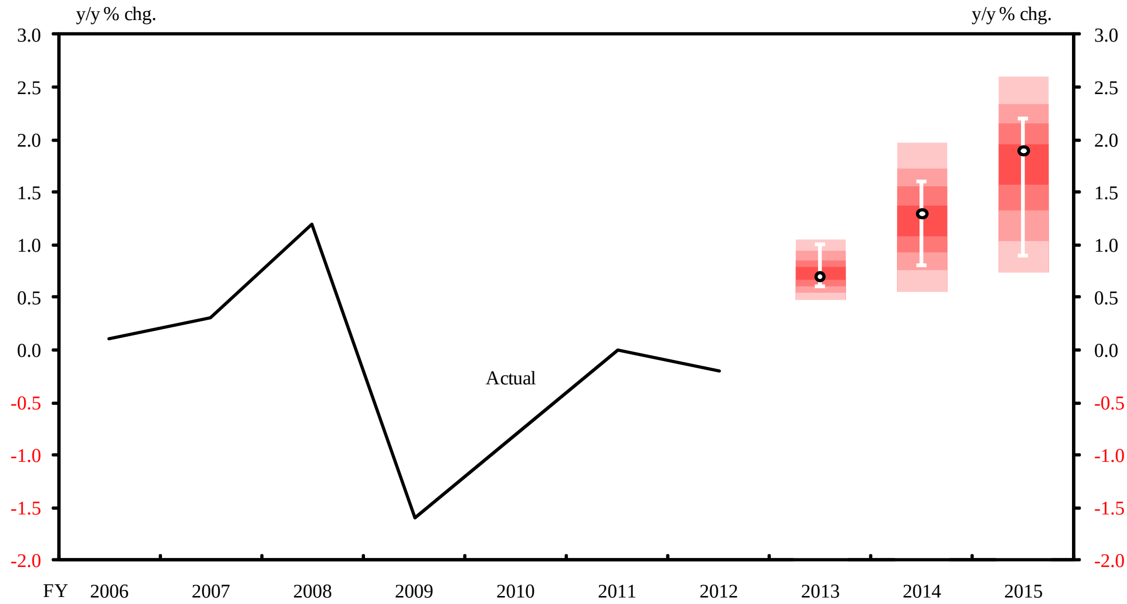
	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2013	+2.6 to +3.0	+0.6 to +1.0	
Forecasts made in July 2013	+2.3 to +3.0	+0.4 to +1.0	
Fiscal 2014	+0.5 to +1.6	+2.6 to +3.7	+0.6 to +1.7
Forecasts made in July 2013	+0.4 to +1.5	+2.6 to +3.7	+0.6 to +1.7
Fiscal 2015	+1.2 to +2.0	+1.4 to +2.9	+0.7 to +2.2
Forecasts made in July 2013	+1.2 to +2.1	+1.4 to +3.0	+0.7 to +2.3

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.