January 29, 2016
Bank of Japan

Outlook for Economic Activity and Prices (January 2016)

The Bank's View[1]

Summary

- Japan's economy has continued to recover moderately, although exports and production have been affected by the slowdown in emerging economies. Through fiscal 2017, domestic demand is likely to follow an uptrend, with a virtuous cycle from income to spending being maintained in both the household and corporate sectors, and exports are expected to increase moderately on the back of emerging economies moving out of their deceleration phase. Thus, Japan's economy is likely to be on a moderate expanding trend.
- The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is likely to be about 0 percent for the time being, due to the effects of the decline in energy prices, and, as the underlying trend in inflation steadily rises, accelerate toward 2 percent. Meanwhile, assuming that crude oil prices will rise moderately from the recent level, it is likely that the contribution of energy items to the year-on-year rate of change in the CPI will decrease gradually from the current level of slightly more than minus 1 percentage point, but remain negative until the end of fiscal 2016.[2] Based on this assumption, the timing of the year-on-year rate of change in the CPI reaching around 2 percent -- the price stability target -- is projected to be around the first half of fiscal 2017.[3,4] Thereafter, the year-on-year rate of change in the CPI is likely to be around 2 percent on average.
- Comparing the current projections with the previous ones, the projected growth rates are more or less unchanged. The projected rate of increase in the CPI for fiscal 2016 is lower, and the projection for fiscal 2017 is more or less unchanged. The downward revision of the projection for the CPI and the delay in the projected timing of the CPI reaching around 2 percent are due to the assumption of lower crude oil prices.
- As for the conduct of monetary policy, the Bank introduced "Quantitative and Qualitative Monetary Easing (QQE) with a Negative Interest Rate" in order to achieve the price stability target of 2 percent at the earliest possible time. It will continue with "QQE with a Negative Interest Rate," 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 risks to economic activity and prices, and take additional easing measures in terms of three dimensions -- quantity, quality, and interest rate -- if it is judged necessary for achieving the price stability target.

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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 January 28 and 29, 2016.

2 Individual Policy Board members make their forecasts assuming that Dubai crude oil prices will rise moderately from the recent 35 U.S. dollars per barrel to the range of 45-50 dollars per barrel toward the end of the projection period. Under this assumption, the contribution of energy items to the year-on-year rate of change in the CPI (all items less fresh food) is estimated to be around minus 0.9 percentage point for fiscal 2015, and approximately in the range of minus 0.7 to minus 0.8 percentage point for fiscal 2016. More specifically, the contribution is expected to start to lessen in the second half of fiscal 2016 and reach around 0 percentage point during the first half of fiscal 2017.

3 The Bank has set the price stability target at 2 percent in terms of the year-on-year rate of change in the all-item CPI. Projections are made on the all-item CPI excluding fresh food, for which prices tend to be largely affected by unpredictable factors such as weather.

4 The projection of the year-on-year rate of change in the CPI for fiscal 2017 excludes the direct effects of the consumption tax hike. The January 2016 *Outlook for Economic Activity and Prices* (Outlook Report) assumes that the consumption tax will rise to 10 percent in April 2017 and that a reduced tax rate will be applied to food and beverages -- excluding alcohol and dining-out -- and newspapers.

I. The Current Situation of Economic Activity and Prices in Japan

Japan's economy has continued to recover moderately, although exports and production have been affected by the slowdown in emerging economies. Overseas economies -- mainly advanced economies -- have continued to grow at a moderate pace, despite the slowdown in emerging economies. In this situation, exports have been picking up, although sluggishness remains in some areas. On the domestic demand side, business fixed investment has been on a moderate increasing trend as corporate profits have continued to improve markedly. Against the background of steady improvement in the employment and income situation, private consumption has been resilient and housing investment has been picking up. Public investment has been on a moderate declining trend, although it remains at a high level. Industrial production has continued to be more or less flat. Financial conditions are accommodative. On the price front, the year-on-year rate of change in the CPI (all items less fresh food, and the same hereafter) is about 0 percent. Inflation expectations appear to be rising on the whole from a somewhat longer-term perspective, although some indicators have recently shown relatively weak developments.

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

A. Outlook for Economic Activity

Looking ahead, Japan's economy is likely to be on a moderate expanding trend because domestic demand is likely to follow an uptrend, with a virtuous cycle from income to spending being maintained in both the household and corporate sectors, and because exports are expected to increase moderately on the back of emerging economies moving out of their deceleration phase.

Specifically, the economy is expected to continue growing at a pace above its potential through fiscal 2016.[5] Thereafter, through fiscal 2017, it is projected to maintain its positive growth, although with a slowing in its pace to around a level somewhat below the

[5] Japan's potential growth rate is estimated to be around 0.5 percent or lower recently under a specific methodology, and is expected to rise gradually toward the end of the projection period. However, the estimate of the potential growth rate varies depending on the methodologies employed and could be revised as the sample period becomes longer over time. Thus, it should be regarded as being subject to a considerable margin of error.

potential growth rate. The slowdown is due mainly to (1) the effects of a front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike planned in April 2017 and (2) cyclical deceleration.

The above projection assumes the following underlying developments.

First, as the Bank of Japan continues with "QQE with a Negative Interest Rate," aiming to achieve the price stability target of 2 percent as long as it is necessary for maintaining that target in a stable manner, financial conditions are likely to remain accommodative and continue stimulating the economy.[6,7]

Second, overseas economies are expected to moderately increase their growth rates as it is likely that advanced economies will continue to see firm growth and emerging economies will move out of their deceleration phase on the back of the developments in advanced economies.

Third, public investment is expected to follow a moderate downtrend from the current relatively high level, and thereafter level off toward the end of the projection period.

Fourth, firms' and households' medium- to long-term growth expectations are expected to rise moderately against the backdrop of progress in implementation of the government's growth strategy, including regulatory and institutional reforms, an increase in labor participation by women and the elderly under such strategy, firms' continued efforts toward improving productivity and discovering potential domestic and external demand, and steady progress in overcoming of deflation.

Given these assumptions, economic activity during the projection period can be elaborated on as follows. <u>For the second half of fiscal 2015 through fiscal 2016</u>, exports are expected to continue picking up for the time being, and after that they are likely to increase

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[6] See the Bank's statement released on January 29, 2016, entitled "Introduction of 'Quantitative and Qualitative Monetary Easing with a Negative Interest Rate.'"

[7] Individual Policy Board members make their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy. Specifically, each Policy Board member makes an assumption about the future path of short- and long-term interest rates based on their market rates, with the difference in the outlook for prices between that presented in the Outlook Report and that of market participants in mind, and also taking into account the effects of today's policy decisions.

moderately as emerging economies are expected to move out of their deceleration phase. Past foreign exchange rate developments are also likely to support exports. With capacity utilization rates rising supported by a pick-up in exports and production, and with record profits seen at Japanese firms and monetary accommodation continuing to provide a boost, business fixed investment is projected to continue increasing, additionally reflecting firms' positive stance on domestic investment. Private consumption is projected to rise moderately, led by continued steady improvement in the employment situation and a resultant increase in wages, and by the positive effects of the decline in energy prices through raising real income. Industrial production is expected to start picking up as the effects of the slowdown in emerging economies abate and as the inventory adjustments progress, and after that it is likely to increase moderately reflecting demand both at home and abroad.

Through fiscal 2017, the economy is likely to be affected by the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike scheduled to take place in April 2017, and the pace of increase in business fixed investment is likely to decline, reflecting a cycle in the accumulation of capital stock.[8] However, exports are projected to continue increasing moderately owing to overseas economic growth, and domestic private demand is likely to be resilient, supported by accommodative financial conditions and heightened growth expectations. Meanwhile, Japan's potential growth rate is expected to follow a moderate increasing trend through the projection period, pushing up the economy's growth in the medium to long term. Reflecting these developments, the economy is projected to maintain its positive growth in fiscal 2017, although with a slowing in its pace to around a level somewhat below the potential growth rate.

Comparing the current projections with the previous ones, the projected growth rates are more or less unchanged.

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[8] The effects of the two rounds of consumption tax hikes on the economic growth rate for each fiscal year are quantitatively estimated as follows: an increase of around 0.5 percentage point for fiscal 2013, a decrease of around 1.2 percentage points for fiscal 2014, an increase of around 0.3 percentage point for fiscal 2015, an increase of around 0.3 percentage point for fiscal 2016, and a decrease of around 0.7 percentage point for fiscal 2017. It should be noted that the effects of the consumption tax hikes are considerably uncertain, given that they depend partly on income conditions and price developments at each point in time, and therefore these estimates are subject to a considerable margin of error.

B. Outlook for Prices

The outlook for prices is as follows. The year-on-year rate of change in the CPI is likely to be about 0 percent for the time being, due to the effects of the decline in energy prices, and, as the underlying trend in inflation steadily rises, accelerate toward 2 percent. Meanwhile, assuming that crude oil prices will rise moderately from the recent level, it is likely that the contribution of energy items to the year-on-year rate of change in the CPI will decrease gradually from the current level of slightly more than minus 1 percentage point, but remain negative until the end of fiscal 2016. Based on this assumption, the timing of the year-on-year rate of change in the CPI reaching around 2 percent -- the price stability target -- is projected to be around the first half of fiscal 2017.[9] Thereafter, the year-on-year rate of change in the CPI is likely to be around 2 percent on average.

Comparing the current projections with the previous ones, the projected rate of increase in the CPI for fiscal 2016 is lower, and the projection for fiscal 2017 is more or less unchanged. The downward revision of the projection for the CPI and the delay in the projected timing of the CPI reaching around 2 percent are due to the assumption of lower crude oil prices.

In formulating these projections, major factors that determine inflation rates are evaluated as follows. First, the aggregate supply and demand balance (the output gap), which shows the utilization of labor and capital, has steadily followed an improving trend driven mainly by labor market developments, albeit under some downward pressure partly from the flattening of production against the background of the slowdown in emerging economies.[10] Specifically, the tightening trend in labor market conditions has continued, with the

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[9] The effects of the scheduled consumption tax hike in April 2017 on prices can be mechanically estimated by assuming that the rise in the consumption tax will be fully passed on to taxable items. On this basis, the year-on-year rate of change in the CPI will be pushed up by 1.0 percentage point in fiscal 2017.

[10] There are two approaches to estimating the output gap: (1) estimating potential GDP and then measuring its difference from actual GDP and (2) directly measuring the utilization of production factors (labor and capital). As the output gap in the Outlook Report has been estimated based on the latter approach, changes in the GDP growth rate do not have a one-to-one relationship with the expansion/narrowing of the output gap. It should be noted that estimates of the output gap could differ depending on the specific methodology employed and data used, and therefore they are subject to a considerable margin of error.

unemployment rate declining moderately to the range of 3.0-3.5 percent.[11] Capacity utilization rates are expected to increase as exports and production pick up. Looking ahead, the output gap is likely to turn positive (in excess demand) toward the end of fiscal 2015, and move further into positive territory in fiscal 2016; thus, upward pressure on wages and prices due to the tightening of supply-demand conditions is likely to steadily increase. In fiscal 2017, the output gap is projected to be more or less unchanged in positive territory.

Second, medium- to long-term inflation expectations appear to be rising on the whole from a somewhat longer-term perspective, although some indicators have recently shown relatively weak developments. Specifically, albeit with some market indicators and survey results showing relatively weak developments, firms' price- and wage-setting stance has clearly changed, particularly from the turn of the fiscal year. Consumers seem to be accepting price increases, mainly reflecting an improvement in the employment and income situation. Against this backdrop, price hikes by firms have been widespread and sustained. In the annual labor-management wage negotiations, movements toward making wages reflect price developments as well as corporate performance and supply-demand conditions in the labor market have been broadening since 2014, and such movements are likely to continue to be seen this year. These developments indicate the steady functioning of the mechanism in which inflation rises moderately accompanied by wage increases. Nevertheless, given that firms have been seeing record profits and the unemployment rate has declined to the range of 3.0-3.5 percent, it should be noted that the pace of improvement in wages to date has been slow and the labor share has remained on a downtrend.

Looking ahead, as the Bank pursues "QQE with a Negative Interest Rate" and the observed inflation rate rises, medium- to long-term inflation expectations are also likely to follow an increasing trend and gradually converge to around 2 percent -- the price stability target.

[11] One measure used in assessing the degree of tightness in labor market conditions is the *structural unemployment rate*. In the labor market, there is always some mismatch between job openings and job applicants, and thus there is a certain number of unemployed even when the economy is booming. The unemployment rate at which no excess labor force is found, excluding the unemployment due to the mismatch, is called the structural unemployment rate. This rate is calculated to be in the range of 3.0-3.5 percent recently under a specific methodology. It should be noted that the estimated structural unemployment rate tends to change over time.

Against this backdrop, firms' price- and wage-setting stance is likely to shift further toward raising wages and prices.

Third, through import prices, while past developments in foreign exchange rates will exert upward pressure on consumer prices, a decline in international commodity prices including crude oil prices will exert downward pressure on consumer prices. It is presumed that the effects of the yen's depreciation on prices are not limited to such direct ones resulting from raising import prices; the yen's depreciation raises prices by improving the output gap as well, and the resultant price increases push up inflation expectations. The effects through the output gap and the inflation expectations will likely be more persistent.

III. Upside and Downside Risks

A. Risks to Economic Activity

The following are upside and downside risks to the Bank's baseline scenario regarding the economy. First, there is uncertainty regarding developments in overseas economies. It is difficult to deduce the pace of growth in emerging and commodity-exporting economies, particularly China, and their impact on the global economy, given that the uncertainties surrounding those economies remain high and that there are negative effects of the declines in commodity prices. In addition, the following are considered as risks: developments in the U.S. economy and the influences of its monetary policy response to them on the global financial markets; prospects regarding the European debt problem and the momentum of economic activity and prices in Europe; and geopolitical risks.

The second risk is the effects of the consumption tax hike scheduled to take place in April 2017. Although it is likely that the recently announced introduction of a reduced tax rate on some goods will somewhat decrease the effects of the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike and of the decline in real income, the actual impact may differ depending on consumer sentiment, the employment and income situation, and developments in prices.

Third, firms' and households' medium- to long-term growth expectations may be either raised or lowered depending on future developments in regulatory and institutional reforms, innovation in the corporate sector, and the employment and income situation surrounding the household sector. It is desirable that firms more effectively allocate their ample cash flow arising from their record profits to investment such as in physical and human capital.

Fourth, 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 increasing 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

In case the aforementioned upside and downside risks to the economy materialize, it is likely that prices will also be affected to a certain degree. Other factors that could exert upside and downside risks to prices are as follows. The first factor is developments in firms' and households' medium- to long-term inflation expectations. The baseline scenario assumes that, amid rises in observed inflation accompanied by wage increases, people's inflation expectations will rise further and gradually converge to around 2 percent -- the price stability target. However, the pace at which they will rise is subject to uncertainty over developments in observed prices and to the extent to which they will affect inflation expectations. In the case where the effects of the decline in energy prices will persist and the year-on-year rate of change in the CPI will not easily increase for a long period, there is a risk that the pace of increase in inflation expectations might be different from what is envisaged. Regarding the relationship between wages and prices, the focal point is that rises in the underlying trend in inflation to date and the outlook for prices will be reflected appropriately in wage increases in the annual labor-management wage negotiations this spring. Moreover, recently, global financial markets have been volatile against the backdrop of the further decline in crude oil prices and uncertainty such as over future developments in emerging and commodity-exporting economies, particularly the Chinese economy. For these reasons, there is an increasing risk that an improvement in the business confidence of Japanese firms and conversion of the deflationary mindset might be delayed and that the underlying trend in inflation might be negatively affected.

The second factor is developments in the output gap, particularly in labor market conditions. The baseline scenario assumes that the recent increase in labor participation by the elderly and women and recent movements by firms to convert part-time employees into regular ones will underpin labor supply, but there are both upside and downside risks associated with this assumption.

The third factor is the responsiveness of inflation to the output gap. There is a risk that the pace of increase in inflation will deviate downward from the baseline scenario should movements toward raising wages among firms not become widespread, reflecting uncertainties over the business environment including developments in overseas economies, or should consumers mount stronger resistance to an increase in sales prices under such circumstance. In addition, while prices of food products and durable goods respond relatively clearly to improvements in the output gap, administered prices, some services prices, and rents for houses have been less responsive thus far, and therefore there is a possibility that those prices will continue to constrain the acceleration of CPI inflation.

Fourth, developments in import prices, reflecting fluctuations in international commodity prices such as crude oil prices and foreign exchange rates, as well as the extent to which such developments will spread to domestic prices, may lead prices to deviate either upward or downward from the baseline scenario.

IV. 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.[12]

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 around the first half of fiscal 2017 and thereafter gradually shift to a growth path that sustains such inflation in a stable manner.

[12] As for the examination from two perspectives in the context of the price stability target, see the Bank's statement released on January 22, 2013, entitled "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, risks are skewed to the downside, particularly those regarding developments in overseas economies. With regard to the baseline scenario for prices, there is considerable uncertainty, mainly in developments in medium- to long-term inflation expectations, and risks are skewed to the downside. 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, in a situation where the amount outstanding of government debt has shown a cumulative increase, due attention needs to be paid to the fact that financial institutions' holdings of government bonds have remained at an elevated level, although they have been on a declining trend on the whole.

As for the conduct of monetary policy, the Bank introduced "QQE with a Negative Interest Rate" in order to achieve the price stability target of 2 percent at the earliest possible time. It will continue with "QQE with a Negative Interest Rate," 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 risks to economic activity and prices, and take additional easing measures in terms of three dimensions -- quantity, quality, and interest rate -- if it is judged necessary for achieving the price stability target.

(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 2015	+1.0 to +1.3 [+1.1]	0.0 to +0.2 [+0.1]	
Forecasts made in October 2015	+0.8 to +1.4 [+1.2]	0.0 to +0.4 [+0.1]	
Fiscal 2016	+1.0 to +1.7 [+1.5]	+0.2 to +1.2 [+0.8]	
Forecasts made in October 2015	+1.2 to +1.6 [+1.4]	+0.8 to +1.5 [+1.4]	
Fiscal 2017	+0.1 to +0.5 [+0.3]	+2.0 to +3.1 [+2.8]	+1.0 to +2.1 [+1.8]
Forecasts made in October 2015	+0.1 to +0.5 [+0.3]	+2.5 to +3.4 [+3.1]	+1.2 to +2.1 [+1.8]

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.

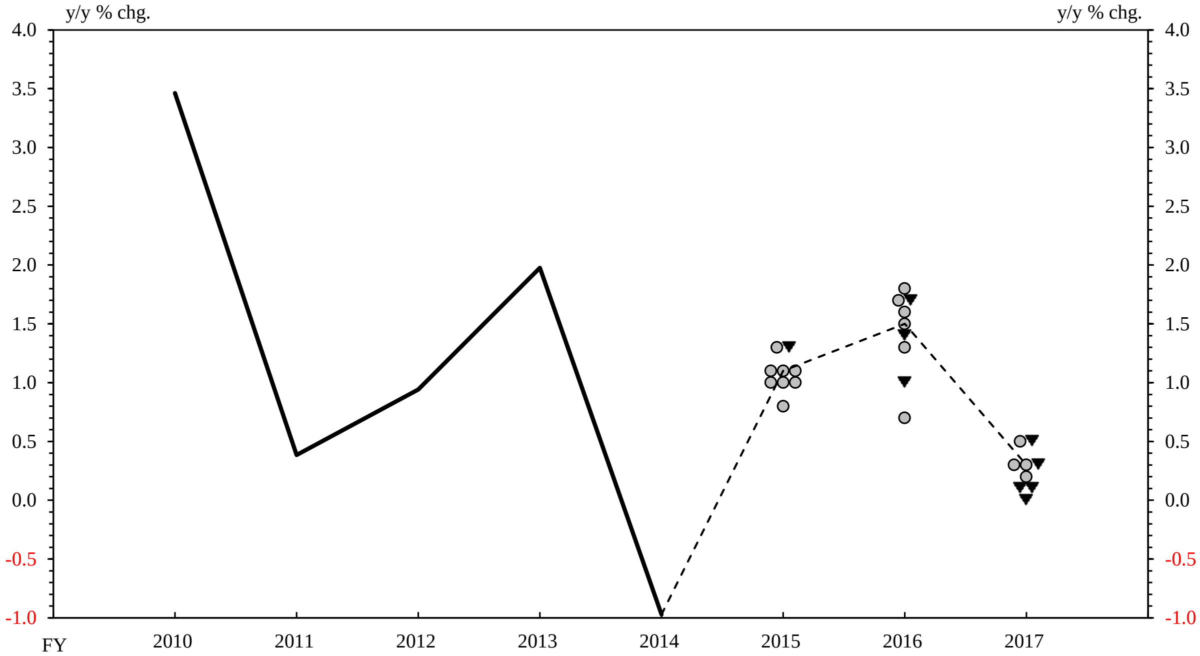
3. Individual Policy Board members make their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy. Specifically, each Policy Board member makes an assumption about the future path of short- and long-term interest rates based on their market rates, with the difference in the outlook for prices between that presented in the Outlook Report and that of market participants in mind, and also taking into account the effects of today's policy decisions.

4. Dubai crude oil prices are expected to rise moderately from the recent 35 U.S. dollars per barrel to the range of 45-50 dollars per barrel toward the end of the projection period. Under this assumption, the contribution of energy items to the year-on-year rate of change in the CPI (all items less fresh food) is estimated to be around minus 0.9 percentage point for fiscal 2015, and approximately in the range of minus 0.7 to minus 0.8 percentage point for fiscal 2016. More specifically, the contribution is expected to start to lessen in the second half of fiscal 2016 and reach around 0 percentage point during the first half of fiscal 2017.

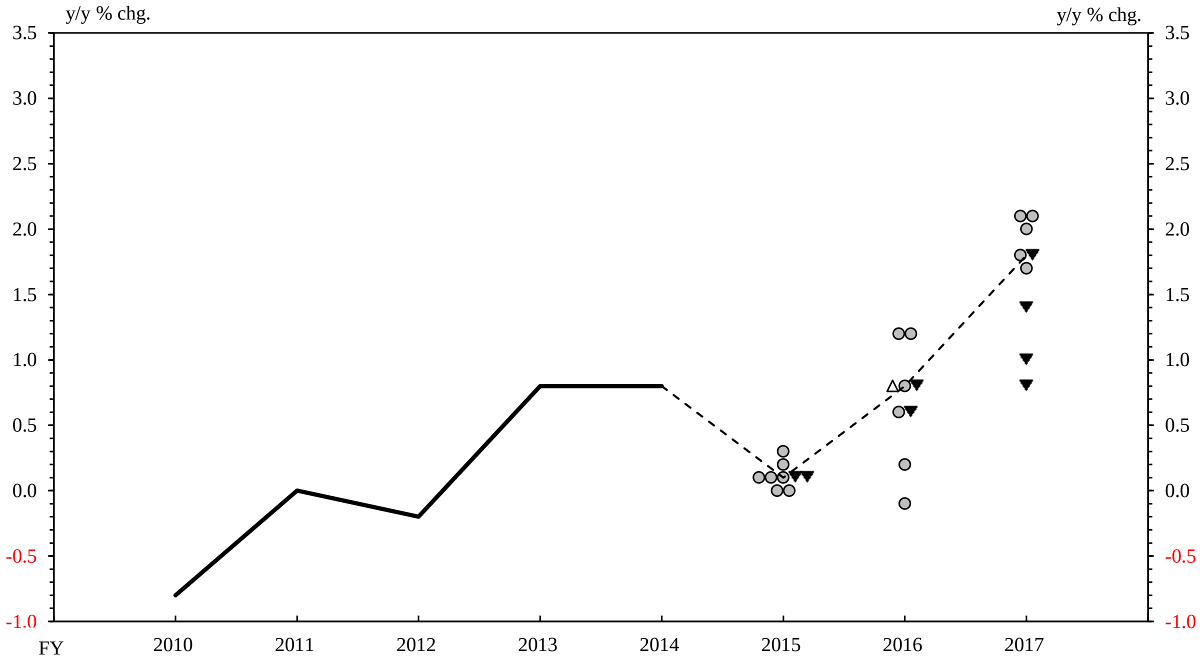
5. The consumption tax hike scheduled to take place in April 2017 -- to 10 percent -- and the reduced tax rate to be applied to food and beverages -- excluding alcohol and dining-out -- and newspapers are incorporated in the forecasts, but individual Policy Board members make their forecasts of the CPI based on figures excluding the direct effects of the consumption tax hike. The forecasts for the CPI for fiscal 2017 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 taxable items. The CPI will be pushed up by 1.0 percentage point. Second, this figure is added to the forecasts made by the Policy Board members.

Policy Board Members' Forecasts and Risk Assessments

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. Solid lines show actual figures, while dotted lines show the medians of the Policy Board members' forecasts (point estimates).

2. The locations of ●, △, and ▼ in the charts indicate the figures for each Policy Board member's forecasts to which he or she attaches the highest probability. The risk balance assessed by each Policy Board member is shown by the following shapes: ● indicates that a member assesses "upside and downside risks as being generally balanced," △ indicates that a member assesses "risks are skewed to the upside," and ▼ indicates that a member assesses "risks are skewed to the downside."

3. Figures for the CPI exclude the direct effects of the consumption tax hikes.