April 28, 2016
Bank of Japan

Outlook for Economic Activity and Prices
(April 2016)

The Bank's View[1]

Summary

- Japan's economy has continued its moderate recovery trend, although exports and production have been sluggish due mainly to the effects of the slowdown in emerging economies. The outlook through fiscal 2018 envisages that, although sluggishness is expected to remain in exports and production for the time being, 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 beginning of fiscal 2017.[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 during 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 through fiscal 2017 with the previous ones, GDP growth is somewhat lower, influenced mainly by weaker exports that reflect the slowdown in overseas economies. The projected rate of increase in the CPI for fiscal 2016 is lower, mainly reflecting downward revisions in projections for GDP growth and wage developments.
- As for the conduct of monetary policy, the Bank will continue with "Quantitative and Qualitative Monetary Easing (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 April 27 and 28, 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; that is, fiscal 2018. 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 0.8 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 around the middle of 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 April 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 its moderate recovery trend, although exports and production have been sluggish due mainly to the effects of the slowdown in emerging economies. Overseas economies have continued to grow at a moderate pace, but the pace of growth has somewhat decelerated mainly in emerging economies. In this situation, the pick-up in exports has recently paused. On the domestic demand side, business fixed investment has been on a moderate increasing trend as corporate profits have been at high levels. Against the background of steady improvement in the employment and income situation, private consumption has been resilient, although relatively weak developments have been seen in some indicators. Meanwhile, the pick-up in housing investment has recently paused and public investment has been on a moderate declining trend, albeit remaining at a high level. Reflecting these developments in demand both at home and abroad, industrial production has continued to be more or less flat, and most recently it has been somewhat affected by the Kumamoto Earthquake. Business sentiment has generally stayed at a favorable level but has become cautious, mainly reflecting the slowdown in emerging economies. Financial conditions are highly 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. Although inflation expectations appear to be rising on the whole from a somewhat longer-term perspective, they have recently weakened.

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

A. Outlook for Economic Activity

Looking ahead, although sluggishness is expected to remain in exports and production for the time being, 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.

Against the backdrop of such outlook, the growth rate during the projection period is expected to be generally above its potential, although fluctuations due to a front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike planned in April 2017 are expected.[5]

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 highly accommodative, with real interest rates being negative throughout the projection period, and continue stimulating the economy.[6]

Second, overseas economies are projected to remain in a state of slight deceleration for the time being, but 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 has been on a moderate declining trend but is expected to gradually level off, mainly reflecting the earlier implementation of the budget for fiscal 2016, and then, from the middle of the projection period, it is likely to be more or less flat, partly because investment related to hosting the Olympic Games will become large.

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.

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[5] Japan's potential growth rate is estimated to be in the range of 0.0-0.5 percent 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.

[6] 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.

Given these assumptions, economic activity during the projection period can be elaborated on as follows. In fiscal 2016, although exports are likely to continue exhibiting sluggishness for the time being, they are expected to head toward a moderate increase thereafter on the back of emerging economies moving out of their deceleration phase. Corporate profits are expected to maintain their uptrend, especially in the nonmanufacturing sector, and be at record levels. In this situation, business fixed investment is projected to continue its uptrend, additionally pushed up by a further decline in real interest rates with the Bank's monetary easing. Private consumption is projected to rise moderately, led by steady improvement in the employment and income situation including continued tightening of labor market conditions and by the positive effects of energy price declines through raising real income. In addition, in the second half of the fiscal year, the front-loaded increase in demand prior to the consumption tax hike scheduled in April 2017 is likely to push up domestic private demand.[7] Reflecting these developments in demand at home and abroad, the economic growth rate is expected to be above its potential.

In fiscal 2017, while household spending is likely to be negatively affected by the front-loaded spending prior to the consumption tax hike, exports are projected to continue increasing moderately owing to overseas economic growth, and business fixed investment is likely to maintain its moderate increasing trend, supported by accommodative financial conditions, heightened growth expectations, and increases in Olympic Games-related demand. Reflecting these developments, the economy is projected to maintain somewhat positive growth, although at around a level below the potential growth rate.

In fiscal 2018, the growth rate is expected to exceed its potential again, as exports are expected to increase moderately and domestic private demand is likely to increase, while the effects of the demand decline after the consumption tax hike will dissipate.

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[7] The quantitative effects of the two rounds of consumption tax hikes on GDP growth in each fiscal year are re-estimated, partly because of the publication of the *Annual Report on National Accounts* for fiscal 2014: an increase of around 0.8 percentage point for fiscal 2013, a decrease of around 1.3 percentage points for fiscal 2014, around 0.0 percentage point for fiscal 2015, an increase of around 0.4 percentage point for fiscal 2016, a decrease of around 0.6 percentage point for fiscal 2017, and an increase of around 0.1 percentage point for fiscal 2018. 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.

Through the projection period, Japan's potential growth rate is expected to follow a moderate increasing trend, pushing up the economy's growth pace in the medium to long term.

Comparing the current projections through fiscal 2017 with the previous ones, GDP growth is somewhat lower, influenced mainly by weaker exports that reflect the slowdown in overseas economies.

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 beginning of fiscal 2017. 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 during fiscal 2017.[8] Thereafter, the year-on-year rate of change in the CPI is likely to be around 2 percent on average.

Comparing the current projections through fiscal 2017 with the previous ones, the projected rate of increase in the CPI for fiscal 2016 is lower, mainly reflecting downward revisions in projections for GDP growth and wage developments.

In formulating these projections, major factors that determine inflation rates are evaluated as follows. First, the <u>aggregate supply and demand balance (the output gap)</u>, which shows the utilization of labor and capital, is more or less unchanged, as the tightening of labor market conditions has continued while an improvement in manufacturers' capacity utilization rates has been delayed against the background of the slowdown in emerging

[8] On a simple assumption that the rise in the consumption tax scheduled in April 2017 will be fully passed on to taxable items, its effect on the year-on-year rate of change in the CPI for fiscal 2017 is estimated to be 1.0 percentage point.

economies.[9] Going forward, the tightening of labor market conditions is likely to continue, accompanied by a moderate decline in the unemployment rate, and upward pressure on wages such as part-time employees' hourly cash earnings is projected to heighten. Capacity utilization rates also are expected to increase again as exports and production are likely to pick up. Against this backdrop, the output gap is expected to move into positive territory and gradually increase further from the second half of fiscal 2016, albeit with fluctuations due to the front-loaded increase in demand prior to the consumption tax hike. Thus, upward pressure on wages and prices due to the tightening of supply-demand conditions is likely to steadily increase.

Second, medium- to long-term inflation expectations have weakened recently, although they appear to be rising on the whole from a somewhat longer-term perspective. Market indicators and survey results regarding inflation expectations have weakened recently. On the other hand, firms have maintained their willingness to increase prices since last year in spite of low all-item CPI inflation due to the decline in energy prices. Consumers seem to be accepting the price increases, benefitting from an improvement in the employment and income situation. Against this backdrop, the year-on-year rate of change in the CPI for all items excluding fresh food and energy has remained positive for 30 consecutive months, and been above 1 percent recently. In the meantime, this year's labor-management wage negotiations are likely to result in a base-pay rise for the third consecutive year, but one that would be somewhat less than last year's rise, mainly at large firms, due mainly to the low all-item CPI inflation. Nonetheless, employees have benefitted from the high corporate profits mainly through bonuses, and wage increases have been spreading to small firms on the back of the tightening of labor market conditions. These developments indicate that the high corporate profits have continued to positively affect employee income, and the mechanism in which inflation rises moderately accompanied by wage increases has been operating steadily. Nevertheless, given that corporate profits have been at record high levels

[9] 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.

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

Third, through import prices, low international commodity prices including crude oil prices will exert downward pressure on consumer prices. The past yen depreciation is likely to continue to have positive effects on CPI inflation indirectly through an improvement in the output gap and a rise in inflation expectations, while its direct positive effects are likely to wane gradually.

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. Developments in emerging and commodity-exporting economies including China are especially uncertain, due in part to negative effects of low commodity prices. Against this backdrop, global financial markets have remained volatile and due attention still needs to be paid to the possibility that business confidence will be negatively affected. 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. It is likely that 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 will depend 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 invest their ample cash flow arising from their profits at record levels; for example, 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, it is uncertain how the pace of increase in wages and inflation expectations will be affected during a prolonged period of low energy prices and no visible rises in annual all-item CPI inflation. On this point, it is crucial how firms' price-setting stance will develop in this fiscal year, depending on consumers' perception of wage developments and their associated attitude toward price increases.

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 particular concern about the continued dull responses of administered prices, some services prices, and housing rent, which might 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.[10]

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 during fiscal 2017 and thereafter gradually shift to a growth path that sustains such inflation in a stable manner.

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. At the same time, a risk of a gradual pullback in financial intermediation brought about by downward pressure on financial institutions' profits due to

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[10] 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."

low interest rates is judged as not significant, because financial institutions have sufficient capital bases that will allow them to continue healthy risk taking.[11] However, 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 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.

[11] For more details, see the April 2016 issue of the Bank's *Financial System Report*.

(Appendix)

Forecasts of the Majority of Policy Board Members

y/y % chg.

<table>
<tr><th></th><th>Real GDP</th><th>CPI (all items less fresh food)</th><th>Excluding the effects of the consumption tax hikes</th></tr>
<tr><td>Fiscal 2015</td><td>+0.7 to +0.7
[+0.7]</td><td colspan="2">0.0</td></tr>
<tr><td>Forecasts made in January 2016</td><td>+1.0 to +1.3
[+1.1]</td><td colspan="2">0.0 to +0.2
[+0.1]</td></tr>
<tr><td>Fiscal 2016</td><td>+0.8 to +1.4
[+1.2]</td><td colspan="2">0.0 to +0.8
[+0.5]</td></tr>
<tr><td>Forecasts made in January 2016</td><td>+1.0 to +1.7
[+1.5]</td><td colspan="2">+0.2 to +1.2
[+0.8]</td></tr>
<tr><td>Fiscal 2017</td><td>0.0 to +0.3
[+0.1]</td><td>+1.8 to +3.0
[+2.7]</td><td>+0.8 to +2.0
[+1.7]</td></tr>
<tr><td>Forecasts made in January 2016</td><td>+0.1 to +0.5
[+0.3]</td><td>+2.0 to +3.1
[+2.8]</td><td>+1.0 to +2.1
[+1.8]</td></tr>
<tr><td>Fiscal 2018</td><td>+0.6 to +1.2
[+1.0]</td><td colspan="2">+1.0 to +2.1
[+1.9]</td></tr>
</table>

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.

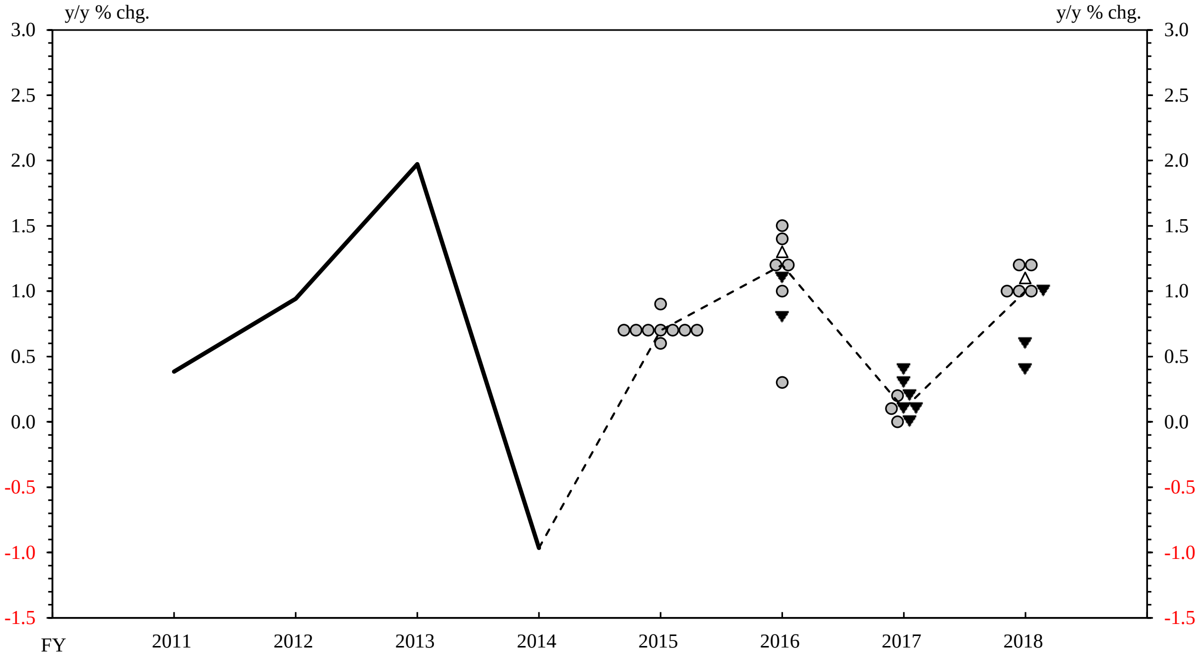
4. Dubai crude oil prices are expected to rise moderately from the recent 35 U.S. dollars per barrel to the range of 45-50 dollars per barrel toward the end of the projection period; that is, fiscal 2018. Under this assumption, the contribution of energy items to the year-on-year rate of change in the CPI (all items less fresh food) is estimated to be around minus 0.8 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 around the middle of 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 simply 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.

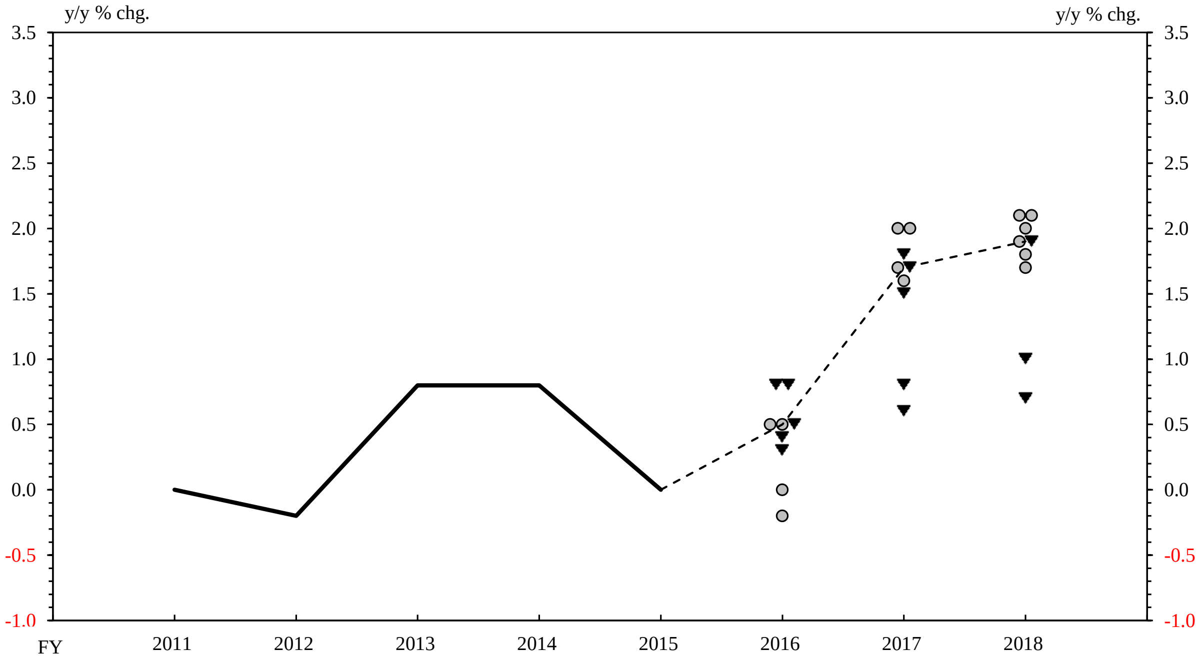
6. The CPI (all items less fresh food) for fiscal 2015 is an actual figure.

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.