July 29, 2016
Bank of Japan

Outlook for Economic Activity and Prices (July 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. Looking ahead, sluggishness is expected to remain in exports and production for some time, and the pace of economic recovery is likely to remain slow. Thereafter, 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 head toward a moderate increase as overseas economies move 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 slightly negative or 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 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 baseline scenario is that the timing of the year-on-year rate of change in the CPI reaching around 2 percent -- the price stability target -- will be during fiscal 2017, although this is accompanied by considerable uncertainties including those surrounding overseas economies going forward.[3] 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 higher, particularly for the first half of the projection period, due in part to the effects of economic stimulus measures from the fiscal side. The front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike that was planned to take place in April 2017 are likely to be smoothed out by the postponement of the hike. The projected rate of increase in the CPI for fiscal 2016 is lower, mainly reflecting the appreciation of the yen and the delay in the timing of improvement in the medium- to long-term inflation expectations, albeit with the higher growth projections; however, the projected rates of increase for fiscal 2017 and 2018 are more or less unchanged.
- 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 the 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 July 28 and 29, 2016.

[2] Individual Policy Board members make their forecasts assuming that Dubai crude oil prices will rise moderately from the recent 45 U.S. dollars per barrel to around 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 approximately in the range of minus 0.6 to minus 0.7 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 in early 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.

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, exports have been more or less flat. 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. Housing investment has resumed its pick-up, and the decline in public investment has leveled off. Reflecting these developments in demand both at home and abroad and the effects of the Kumamoto Earthquake, industrial production has continued to be more or less flat. Business sentiment has generally stayed at a favorable level, although it has been diminishing. 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) has been slightly negative. 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, sluggishness is expected to remain in exports and production for some time, and the pace of economic recovery is likely to remain slow. Thereafter, 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 head toward a moderate increase as overseas economies move out of their deceleration phase. Thus, Japan's economy is likely to be on a moderate expanding trend. Reflecting this outlook, the growth rate during the projection period is expected to be above its potential.[4]

The above projection assumes the following underlying developments.

First, as the Bank 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.[5]

Second, overseas economies are projected to remain slightly subdued for some time, and there is high uncertainty, mainly associated with the United Kingdom's vote to leave the European Union (EU). However, they are expected to moderately increase their growth rates going forward, as it is likely that advanced economies will continue to see steady growth and emerging economies will move out of their deceleration phase on the back of the developments in advanced economies and emerging economies' policy effects.

Third, the decline in public investment has leveled off recently and it is likely that public investment will start increasing, mainly due to the earlier implementation of the budget for fiscal 2016 and the positive effects resulting from a set of economic measures that are planned to be decided by the government before long. From the middle of the projection period, it is likely to remain at a relatively high level, partly because investment related to hosting the Olympic Games will become large.

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[4] 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.

[5] 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 for Economic Activity and Prices* (Outlook Report) and that of market participants in mind.

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. In fiscal 2016, exports are likely to continue exhibiting sluggishness for some time but head toward a moderate increase thereafter as overseas economies move out of their deceleration phase. Corporate profits are projected to decline compared to the previous fiscal year but are expected to remain at high levels, especially in the nonmanufacturing sector. 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. Some weakness has been seen recently in private consumption, partly due to the negative wealth effects brought about by a decline in stock prices; however, it is projected to rise moderately as the employment and income situation continues to improve steadily. Meanwhile, public investment is expected to start increasing moderately, mainly due to the earlier implementation of the budget for fiscal 2016 and the positive effects resulting from the set of economic measures that are planned to be decided by the government before long. Reflecting these factors with regard to demand at home and abroad, the economic growth rate is expected to be above its potential.

From fiscal 2017 through fiscal 2018, exports are projected to continue increasing moderately owing to a rise in growth rates in overseas economies. On the domestic demand side, 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. Private consumption is also expected to continue increasing moderately on the back of an improvement in employee income. Meanwhile, public investment is projected to increase through fiscal 2017, mainly reflecting the set of economic measures that are planned to be decided by the government before long, and thereafter remain at a high level with Olympic Games-related demand, although the effects resulting from the economic measures will diminish. In this situation, the economic growth rate is expected to be above its potential.

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 with the previous ones, the projected growth rates are higher, particularly for the first half of the projection period, due in part to the effects of economic stimulus measures from the fiscal side. The front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike that was planned to take place in April 2017 are likely to be smoothed out by the postponement of the hike.[6]

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 slightly negative or 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 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 baseline scenario is that the timing of the year-on-year rate of change in the CPI reaching around 2 percent -- the price stability target -- will be during fiscal 2017, although this is accompanied by considerable uncertainties including those surrounding overseas economies going forward. 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, mainly reflecting the appreciation of the yen and the delay

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[6] In the Basic Policy on Economic and Fiscal Management and Reform 2016 decided by the Cabinet on June 2, the government presented its plan to postpone the consumption tax hike that had been planned to take place in April 2017 by two and a half years, to October 2019. Projections presented in this Outlook Report factor in this government policy.

in the timing of improvement in the medium- to long-term inflation expectations, albeit with the higher growth projections; however, the projected rates of increase for fiscal 2017 and 2018 are more or less unchanged.

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, 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 economies.[7] Going forward, due in part to the effects resulting from the set of economic measures, the tightening of labor market conditions is likely to continue, accompanied by a 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 through the end of fiscal 2016. 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 in particular have declined. As the background to this, the decline in inflation expectations seems to have been brought about by the observed CPI having been at about 0 percent on a year-on-year basis for over a year; this could be understood as an "adaptive formation mechanism" of inflation expectations. Meanwhile, against the backdrop of relatively weak developments in private consumption observed recently, firms seem to be putting off price increases -- mainly those of goods such as food products and durable consumer goods -- since the turn of the fiscal year.

[7] 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.

As for the outlook, based on the aforementioned projections, firms' price-setting stance is expected to revert to raising prices accompanied by a pick-up in private consumption. Turning to their wage-setting stance, the results of the labor-management wage negotiations this spring show that wages increased at a smaller rate than last year, but base pay rose for the third consecutive year and wage increases have been spreading to small firms. In addition, wages of non-regular employees, which tend to be highly responsive to labor market conditions, have been rising clearly. 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 continued to operate. Looking ahead, the observed inflation rate is expected to rise, mainly due to the dissipation of the downward pressure of energy prices. In sum, as the Bank pursues "QQE with a Negative Interest Rate" with the aim of achieving the price stability target of 2 percent, medium- to long-term inflation expectations are likely to return to an increasing trend and gradually converge to around 2 percent.

Third, through import prices, the past decline in international commodity prices including crude oil prices will exert downward pressure on consumer prices for the time being, but the effects of such pressure are expected to wane. Meanwhile, the impact of foreign exchange rates on consumer prices through import prices is likely to restrain upward pressure on prices, due in part to the recent appreciation of the yen.

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. The impact that uncertainties associated with the United Kingdom's vote to leave the EU would have on the global financial markets and global economy warrant attention. Future developments in emerging and commodity-exporting economies including China are also highly uncertain. Moreover, 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 including the financial sector, and the momentum of economic activity and prices in Europe; and geopolitical risks. These developments in overseas economies and the global financial markets could directly affect Japan's exports and imports; in addition, it is necessary to pay attention to the possibility that these developments exert influence on firms' and households' sentiment and restrain spending behavior, such as business fixed investment and consumption.

Second, 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 high levels; for example, in physical and human capital.

Third, 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, as the pick-up in private consumption becomes evident, firms' price-setting stance is expected to revert to raising prices, and with a continued rise in wages accompanied by an improvement in labor market conditions, medium- to long-term inflation expectations will gradually converge to around 2 percent -- the price stability target. However, the following two points are subject to uncertainties: (1) the extent to which the acceleration in the expected inflation rates is contained through the "adaptive formation mechanism" of inflation expectations in a case where the rate of increase in the all-item CPI will be low for the time being due to the effects of the past decline in energy prices, and (2) the impact of uncertainties surrounding the economic outlook, mainly for overseas economies, on firms' price- and wage-setting stance.

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.[8]

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

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[8] 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."

economies. With regard to the baseline scenario for prices, risks are skewed to the downside as there is considerable uncertainty over both the outlook for overseas economies and developments in medium- to long-term inflation expectations in light of this outlook. 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 low interest rates is judged as not significant, because financial institutions have sufficient capital bases that will allow them to continue with healthy risk taking. 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 the 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 2016	+0.8 to +1.0 [+1.0]	0.0 to +0.3 [+0.1]	
Forecasts made in April 2016	+0.8 to +1.4 [+1.2]	0.0 to +0.8 [+0.5]	
Fiscal 2017	+1.0 to +1.5 [+1.3]	+0.8 to +1.8 [+1.7]	
Forecasts made in April 2016	0.0 to +0.3 [+0.1]	+1.8 to +3.0 [+2.7]	+0.8 to +2.0 [+1.7]
Fiscal 2018	+0.8 to +1.0 [+0.9]	+1.0 to +2.0 [+1.9]	
Forecasts made in April 2016	+0.6 to +1.2 [+1.0]	+1.0 to +2.1 [+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.

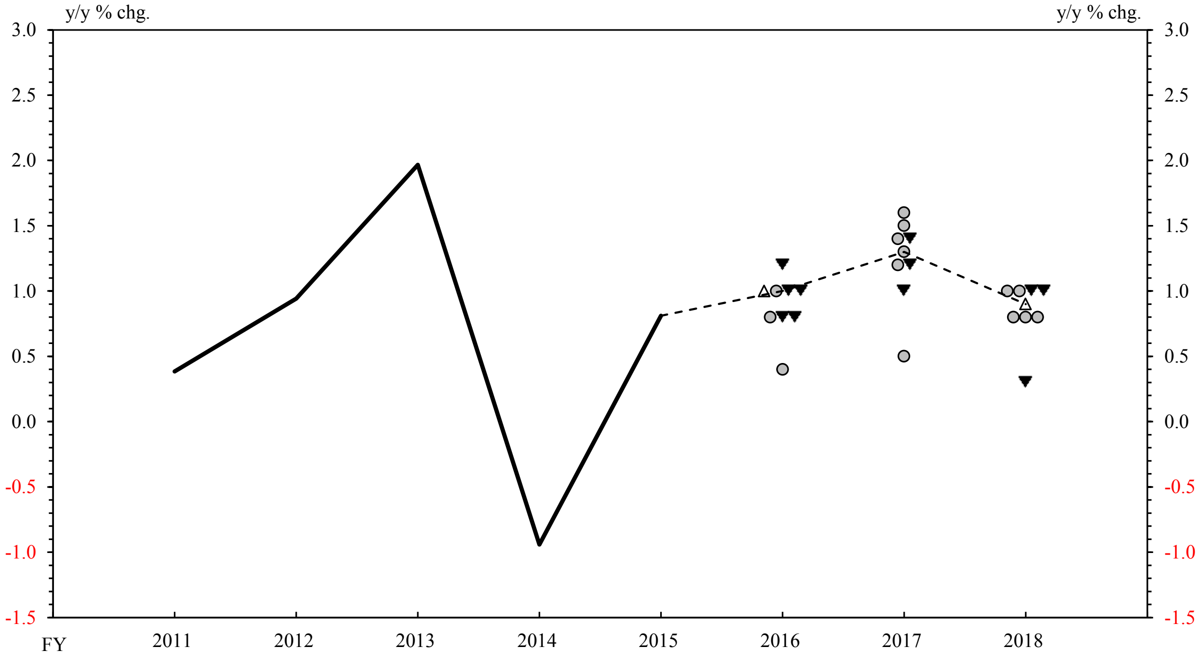
3. Individual Policy Board members make their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy. Specifically, each Policy Board member makes an assumption about the future path of short- and long-term 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 45 U.S. dollars per barrel to around 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 approximately in the range of minus 0.6 to minus 0.7 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 in early fiscal 2017.

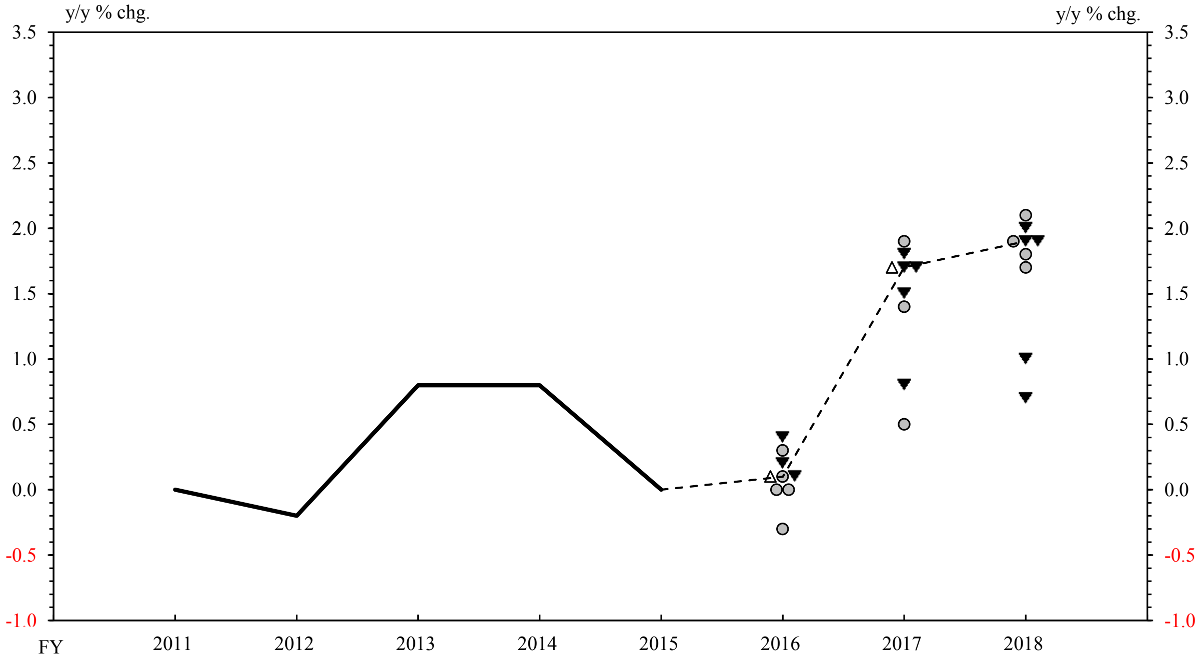
5. In the April 2016 projection, individual Policy Board members made their forecasts of the CPI based on figures excluding the direct effects of the consumption tax hike, assuming that the hike to 10 percent will take place in April 2017. Projections presented in this Outlook Report factor in the government's plan to postpone the consumption tax hike that had been planned to take place in April 2017 by two and a half years, to October 2019; this plan is presented in the Basic Policy on Economic and Fiscal Management and Reform 2016 decided by the Cabinet on June 2.

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.