

Outlook for Economic Activity and Prices (July 2017)

The Bank's View¹

Summary

- Japan's economy is likely to continue expanding on the back of highly accommodative financial conditions and the effects of the government's large-scale stimulus measures, with the growth rates of overseas economies increasing moderately, and maintain growth at a pace above its potential mainly through fiscal 2018. In fiscal 2019, the economy is expected to continue expanding, although the growth pace is projected to decelerate due to a cyclical slowdown in business fixed investment and the effects of the scheduled consumption tax hike.²
 - The recent developments in the consumer price index (CPI, all items less fresh food) have been relatively weak, excluding the effects of a rise in energy prices, mainly against the background that firms' wage- and price-setting stance has remained cautious. Reflecting such developments, a rise in medium- to long-term inflation expectations has been lagging behind somewhat. Nonetheless, medium- to long-term inflation expectations are projected to rise as firms' stance gradually shifts toward raising wages and prices with an improvement in the output gap continuing. As a consequence, the year-on-year rate of change in the CPI is likely to continue on an uptrend and increase toward 2 percent.
 - Comparing the current projections with the previous ones, the projected growth rates are somewhat higher. The projected rates of increase in the CPI are lower, mainly for the first half of the projection period.
 - With regard to the risk balance, risks to both economic activity and prices are skewed to the downside. On the price front, the momentum toward achieving the price stability target of 2 percent is maintained as the output gap is expected to continue improving and medium- to long-term inflation expectations are projected to rise gradually; however, the momentum is not yet sufficiently firm, and thus developments in prices continue to warrant careful attention.
 - As for the conduct of monetary policy, the Bank will continue with "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control," 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 continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner. The Bank will make policy adjustments as appropriate, taking account of developments in economic activity and prices as well as financial conditions, with a view to maintaining the momentum toward achieving the price stability target.
-

¹ The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on July 19 and 20, 2017.

² The July 2017 *Outlook for Economic Activity and Prices* (Outlook Report) assumes that the consumption tax will be raised to 10 percent in October 2019 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 is expanding moderately, with a virtuous cycle from income to spending operating. Overseas economies have continued to grow at a moderate pace on the whole. In this situation, exports have been on an increasing trend. On the domestic demand side, business fixed investment has been on a moderate increasing trend, with corporate profits and business sentiment improving and across a wider range of industries. Private consumption has increased its resilience against the background of steady improvement in the employment and income situation. Meanwhile, public investment has been turning toward an increase and housing investment has been more or less flat. Reflecting these increases in demand both at home and abroad, industrial production has been on an increasing trend, and labor market conditions have continued to tighten steadily. 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 in the range of 0.0-0.5 percent. Inflation expectations have remained in a weakening phase.

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

A. Baseline Scenario of the Outlook for Economic Activity

With regard to the outlook, Japan's economy is likely to continue its moderate expansion. Through fiscal 2018, domestic demand is likely to follow an uptrend, with a virtuous cycle from income to spending being maintained in both the corporate and household sectors, on the back of highly accommodative financial conditions and fiscal spending through the government's large-scale stimulus measures. Business fixed investment is likely to continue increasing moderately, supported by accommodative financial conditions, heightened growth expectations, and increases in Olympic Games-related investment, as well as in labor-saving investment to address the labor shortage. Private consumption is also expected to follow a moderate increasing trend as the employment and income situation continues to improve. Public investment is projected to increase through fiscal 2017, due mainly to the positive effects resulting from a set of stimulus measures, and thereafter remain at a relatively high level with Olympic Games-related demand. Meanwhile, the growth rates of overseas economies are expected to increase moderately as advanced economies continue growing steadily and a recovery in emerging economies takes hold on the back of the steady growth in advanced economies and the effects of policy measures taken by emerging economies. Exports are expected to continue their moderate increasing trend on the back of such an improvement in overseas economies.

In fiscal 2019, Japan's economy is expected to continue expanding, supported by external demand, although the growth pace is projected to decelerate due to a slowdown in domestic demand. Specifically, business fixed investment is likely to decelerate, mainly

reflecting cyclical adjustments in capital stock after the prolonged economic expansion, as well as Olympic Games-related demand peaking out; household spending is likely to turn to a decline in the second half of the fiscal year due to the effects of the scheduled consumption tax hike.³ Nevertheless, the increase in exports on the back of the growth in overseas economies is expected to underpin the economy.

Reflecting this outlook, Japan's economy is likely to continue growing at a pace above its potential, mainly through fiscal 2018.⁴ Comparing the current projections with the previous ones, the projected growth rates are somewhat higher.

Looking at the financial conditions assumed in the above outlook, short- and long-term real interest rates are expected to be in negative territory throughout the projection period as the Bank pursues "QQE with Yield Curve Control."⁵ Financial institutions' proactive lending attitudes as well as favorable conditions for corporate bonds and CP issuance are both likely to be maintained and support firms' and households' activities from the financial side. Thus, financial conditions are likely to remain highly accommodative.

The potential growth rate is expected to follow a moderate uptrend throughout the projection period against the backdrop of the following: 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; and firms' continued efforts toward improving productivity. Along with this, the natural rate of interest is projected to rise, thereby enhancing monetary easing effects.

³ The consumption tax hike scheduled to take place in October 2019 will affect the GDP growth rates through the following two channels: (1) the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike and (2) the effects of a decline in real income. The negative impact on the projected growth rate for fiscal 2019 is expected to be smaller than that on the rate for fiscal 2014, when the last consumption tax hike took place. However, it should be noted that the impact of the consumption tax hike is highly uncertain and varies depending, for example, on the income situation and price developments.

⁴ Under a specific methodology, Japan's potential growth rate is estimated to be in the range of 0.5-1.0 percent. 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, bearing in mind the difference in the outlook for prices between that presented in the Outlook Report and that of market participants.

B. Baseline Scenario of the Outlook for Prices

Since the previous Outlook Report, the year-on-year rate of increase in the CPI has been accelerating, pushed up by energy prices. However, excluding the effects of energy prices, the recent developments in the CPI have been relatively weak, as evidenced by limited price rises at the start of the new fiscal year.

This is partly attributable to the fact that the mindset and behavior based on the assumption that wages and prices will not increase easily have been deeply entrenched among firms and households, as well as to temporary factors such as reductions in prices of and charges for mobile phones. Firms have been making efforts to absorb a rise in labor costs by increasing labor-saving investment and streamlining their business process, while limiting wage increases -- which correspond to the labor shortage -- mainly to wages of part-time employees. As suggested by these developments, firms' wage- and price-setting stance has remained cautious despite the steady tightening of labor market conditions and the high levels of corporate profits. A rise in medium- to long-term inflation expectations has been lagging behind somewhat, as such expectations are largely affected by the observed inflation rate.

Nevertheless, with regard to the outlook, the year-on-year rate of change in the CPI is likely to continue on an uptrend and increase toward 2 percent, mainly on the back of the improvement in the output gap and the rise in medium- to long-term inflation expectations. Comparing the current projections with the previous ones, although the projected rates of increase in the CPI are lower mainly for the first half of the projection period, a virtuous cycle between a moderate rise in the inflation rate and wage increases is likely to start operating gradually toward the end of the projection period -- that is, toward fiscal 2019. The timing of the year-on-year rate of change in the CPI reaching around 2 percent will likely be around fiscal 2019.⁶

The mechanism through which the virtuous cycle operates can be explained by the following three factors that determine inflation rates. First, the output gap -- which shows the utilization of labor and capital -- has improved steadily. In particular, the tightening of labor market conditions is becoming even more evident, as evidenced by the active job openings-to-applicants ratio exceeding the peak level observed during the bubble period, and by the unemployment rate having declined to around 3 percent. Going forward, as the economy continues its moderate expansion, the output gap is expected to widen further within positive territory through fiscal 2018 and remain substantially positive in fiscal 2019.

⁶ By assuming that the rise in the consumption tax will be fully passed on to taxable items excluding those to which a reduced tax rate will be applied, the effects of the October 2019 consumption tax hike on the year-on-year rate of change in the CPI (all items less fresh food) for October 2019 onward is estimated to be 1.0 percentage point; the effect for fiscal 2019 is thus estimated to be half that, at 0.5 percentage point.

Second, medium- to long-term inflation expectations have remained in a weakening phase, reflecting the year-on-year rate of change in the observed CPI having been at around 0 percent or in slightly negative territory since spring 2015; however, some indicators show a rise in such expectations recently. As for the outlook, medium- to long-term inflation expectations are likely to follow an increasing trend and gradually converge to around 2 percent on the back of the following: (1) in terms of the adaptive component, developments mainly in import prices are expected to push up the observed inflation rate for the time being, and firms' stance is likely to gradually shift toward raising wages and prices thereafter with the improvement in the output gap, and (2) in terms of the forward-looking component, the Bank will pursue monetary easing through its strong commitment to achieving the price stability target.⁷

Third, regarding import prices, a pick-up in international commodity prices, including crude oil prices, observed from last spring through early this year is expected to push up the year-on-year rate of change in energy prices in the CPI for fiscal 2017. As for the impact of foreign exchange rates on consumer prices through import prices, the past yen depreciation is likely to increase upward pressure on prices, mainly in fiscal 2017.

III. Upside and Downside Risks to Economic Activity and Prices

A. Upside and Downside 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. Specifically, the following are considered as risks: the U.S. economic policies and their impact on global financial markets; developments in emerging and commodity-exporting economies; negotiations on the United Kingdom's exit from the European Union (EU) and their effects; prospects regarding the European debt problem, including the financial sector; and geopolitical risks. If these risks were to materialize, they could exert downward pressure on economic activity. On the other hand, as market participants and economic entities factor them in to a certain extent, the economy could deviate upward from the baseline scenario depending on how they play out.

Second, firms' and households' medium- to long-term growth expectations may be either raised or lowered depending on the following: efforts to address medium- to long-term issues such as the aging population; developments in regulatory and institutional reforms,

⁷ Medium- to long-term inflation expectations can be regarded as consisting of two components: a forward-looking component, in which inflation expectations converge to the price stability target set by the central bank, and a backward-looking, or adaptive, component that reflects the observed inflation rate. For details, see the Bank's *Comprehensive Assessment: Developments in Economic Activity and Prices as well as Policy Effects since the Introduction of Quantitative and Qualitative Monetary Easing (QQE)* released in September 2016.

particularly in the labor market; innovation in the corporate sector; and the employment and income situation.

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 the rises in long-term interest rates associated with them. 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 concerns regarding the future are alleviated.

B. Upside and Downside Risks to Prices

Other than risks to economic activity, the specific 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. Although inflation expectations are likely to follow an increasing trend, there is a risk that a rise in inflation expectations will lag further behind if it takes time for firms' stance to shift toward raising wages and prices and inflation consequently remains relatively sluggish.

The second factor is the fact that there are items for which prices are not particularly responsive 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.

Third, developments in foreign exchange rates and international commodity prices going forward, as well as the extent to which such developments will spread to import prices and 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. The year-on-year rate of change in the CPI is likely to increase toward 2 percent. Although it is necessary to carefully examine the fact that firms' wage- and price-setting stance has remained cautious, the momentum toward achieving the price stability target of 2 percent

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."

appears to be maintained. This is because (1) firms' stance is likely to gradually shift toward raising wages and prices with the steady improvement in the output gap, and (2) while indicators of medium- to long-term inflation expectations have stopped declining and some of them are showing a rise, such expectations are projected to rise steadily as further price rises come to be observed widely.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. With regard to the outlook for economic activity, risks are skewed to the downside, particularly regarding developments in overseas economies. With regard to the outlook for prices, risks are skewed to the downside, especially concerning developments in medium- to long-term inflation expectations. Examining financial imbalances from a longer-term perspective, there is no sign so far of excessively bullish expectations in asset markets or in the activities of financial institutions. Furthermore, prolonged downward pressure on financial institutions' profits under the continued low interest rate environment could create risks of a gradual pullback in financial intermediation and of destabilizing the financial system. However, at this point, these risks are judged as not significant, mainly because financial institutions have sufficient capital bases.

As for the conduct of monetary policy, the Bank will continue with "QQE with Yield Curve Control," 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 continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner. The Bank will make policy adjustments as appropriate, taking account of developments in economic activity and prices as well as financial conditions, with a view to maintaining the momentum toward achieving the price stability target.

Forecasts of the Majority of Policy Board Members

y/y % chg.

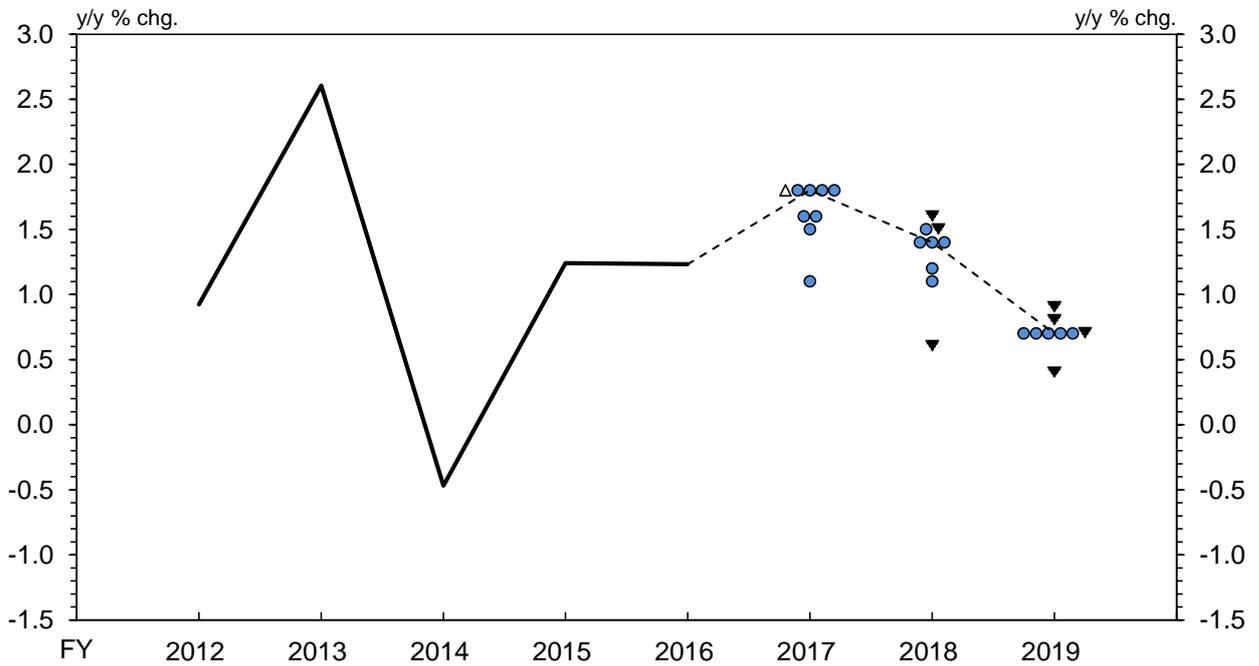
	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hike
Fiscal 2017	+1.5 to +1.8 [+1.8]	+0.5 to +1.3 [+1.1]	
Forecasts made in April 2017	+1.4 to +1.6 [+1.6]	+0.6 to +1.6 [+1.4]	
Fiscal 2018	+1.1 to +1.5 [+1.4]	+0.8 to +1.6 [+1.5]	
Forecasts made in April 2017	+1.1 to +1.3 [+1.3]	+0.8 to +1.9 [+1.7]	
Fiscal 2019	+0.7 to +0.8 [+0.7]	+1.4 to +2.5 [+2.3]	+0.9 to +2.0 [+1.8]
Forecasts made in April 2017	+0.6 to +0.7 [+0.7]	+1.4 to +2.5 [+2.4]	+0.9 to +2.0 [+1.9]

Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

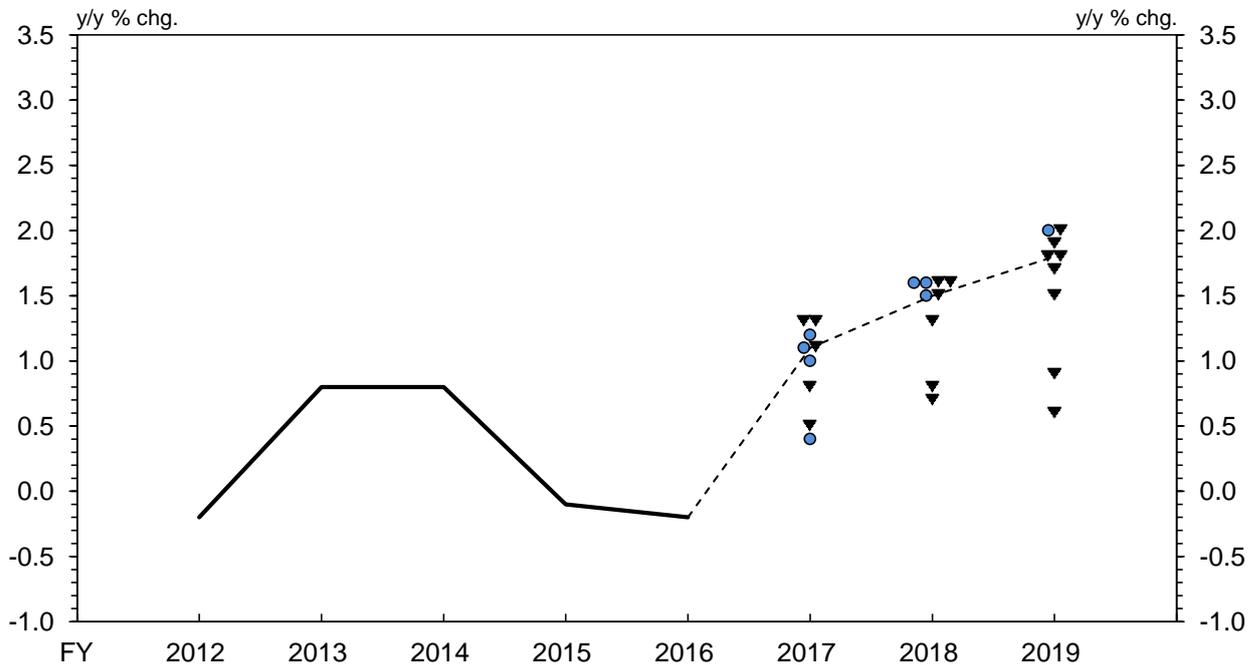
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the 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, bearing in mind the difference in the outlook for prices between that presented in the Outlook Report and that of market participants.
4. The consumption tax hike scheduled to take place in October 2019 -- 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 2019 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 0.5 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.