July 31, 2018

Bank of Japan

Outlook for Economic Activity and Prices (July 2018)

The Bank's View[1]

Summary

- Japan's economy is likely to continue growing at a pace above its potential in fiscal 2018, mainly against the background of highly accommodative financial conditions and the underpinnings through government spending, with overseas economies continuing to grow firmly. From fiscal 2019 through fiscal 2020, the economy is expected to continue on an expanding trend, partly supported by external demand, 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 year-on-year rate of change in the consumer price index (CPI, all items less fresh food) has been positive but has continued to show relatively weak developments compared to the economic expansion and the labor market tightening. Reflecting such developments, a rise in medium- to long-term inflation expectations has been lagging behind.
- It has been taking time for the inflation rate to rise compared to an improvement in the economic and employment conditions because the mindset and behavior based on the assumption that wages and prices will not increase easily have been deeply entrenched, due mainly to the experience of prolonged low growth and deflation. Under these circumstances, firms' cautious wage- and price-setting stance as well as households' cautiousness toward price rises have not yet clearly changed, and downward pressure on prices stemming from intensifying competition has been strong in some areas. The large room for firms to raise productivity, as well as technological progress in recent years, are some other contributing factors to these developments.
- Nonetheless, with the output gap remaining positive, firms' stance gradually will shift toward further raising wages and prices and households' tolerance of price rises will increase. In this situation, further price rises are likely to be observed widely and then medium- to long-term inflation expectations are projected to rise gradually. As a consequence, the year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent, although it will take more time than expected.
- Comparing the current projections with the previous ones, the projected growth rates are more or less unchanged and the projected rates of increase in the CPI are lower.
- With regard to the risk balance, upside and downside risks to economic activity are generally balanced in fiscal 2018, but risks are skewed to the downside for fiscal 2019 onward. Risks to prices are skewed to the downside. On the price front, the momentum toward achieving the price stability target of 2 percent is maintained but is not yet sufficiently firm, and thus developments in prices continue to warrant careful attention.

[1] The text of "The Bank's View" -- the outlook for economic activity and prices as well as the Bank's thinking on the conduct of monetary policy, both of which are based on individual Policy Board members' views -- was decided by the Policy Board at the Monetary Policy Meeting held on July 30 and 31, 2018.

[2] The July 2018 *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. It also factors in policies concerning the provision of free education based on information available at this point.

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 firmly on the whole. In this situation, exports have been on an increasing trend. On the domestic demand side, business fixed investment has continued on an increasing trend with corporate profits and business sentiment maintaining their improving trend. Private consumption has been increasing moderately, albeit with fluctuations, against the background of steady improvement in the employment and income situation. Meanwhile, housing investment has been more or less flat. Public investment also has been more or less flat, remaining at a relatively high level. 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 0.5-1.0 percent. Inflation expectations have been more or less unchanged.

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. In 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, mainly against the background of highly accommodative financial conditions and the underpinnings through government spending. Business fixed investment is likely to continue increasing amid accommodative financial conditions, led mainly by investment intended for domestic capacity expansion in line with the economic expansion, Olympic Games-related investment, and labor-saving investment to address 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 expected to remain at a relatively high level, mainly reflecting the supplementary budget for fiscal 2017 and Olympic Games-related demand. Exports are expected to continue their moderate increasing trend on the back of the firm growth in overseas economies. On this basis, the economy is likely to continue growing at a pace above its potential in fiscal 2018.[3]

In fiscal 2019 and fiscal 2020, Japan's economy is expected to continue on an expanding trend, partly supported by external demand, although the growth pace is projected to

[3] 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.

decelerate due to a slowdown in domestic demand. Specifically, the pace of increase in private consumption is projected to be moderate both in fiscal 2019 and fiscal 2020, mainly because it is likely to temporarily turn to a decline due to the effects of the scheduled consumption tax hike in October 2019.[4] However, exports are projected to maintain their increasing trend on the back of the firm growth in overseas economies. Meanwhile, the pace of increase in business fixed investment is likely to decelerate gradually through fiscal 2020, mainly reflecting cyclical adjustments in capital stock after the prolonged economic expansion, as well as Olympic Games-related demand peaking out; however, the deceleration is expected to be moderate, due partly to growing demand for fixed investment stemming from the increase in exports. Comparing the current projections with the previous ones, the projected growth rates are more or less unchanged.

Looking at the financial conditions on which the above outlook is based, short- and long-term real interest rates are assumed to be in negative territory throughout the projection period as the Bank pursues "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control."[5] Financial institutions' active 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.

Meanwhile, 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 seniors under such strategy; and firms' continued efforts toward improving productivity.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of change in the CPI has remained positive, with a positive output gap. However, it has continued to show relatively weak developments compared to the economic expansion and the labor market tightening, mainly against the background of firms' cautious wage- and price-setting stance. In this situation, medium- to long-term

[4] 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) a decline in real income. Although it is subject to considerable uncertainties, the negative impact on the growth rates is expected to be smaller than that on the rate for fiscal 2014, when the last consumption tax hike took place.

[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.

inflation expectations have been more or less unchanged with the rise in such expectations lagging behind.

With regard to the outlook, medium- to long-term inflation expectations are projected to rise gradually as firms' stance gradually shifts toward further raising wages and prices with the output gap remaining positive. As a consequence, the year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent, although it will take more time than expected. Comparing the current projections with the previous ones, the projected rates of increase in the CPI are lower.[6]

1. Reasons for a rise in inflation taking time[7]

Since the introduction of QQE in April 2013, Japan's economic and employment conditions have improved significantly, and the output gap also has improved clearly. Under such circumstances, a positive inflation rate, excluding the effects of energy prices, has taken hold, and thus Japan's economy is no longer in deflation, in the sense of a sustained decline in prices.

However, the pace of improvement in prices and inflation expectations has remained slow compared to the improvement in the economic and employment conditions. Basically, this is likely to be attributable to the experience of prolonged low growth and deflation.[8] After a severe adjustment phase, including the domestic financial crisis in the late 1990s and the global financial crisis, firms' cautious wage- and price-setting stance as well as households' cautiousness toward price rises -- in other words, the mindset and behavior based on the assumption that wages and prices will not increase easily -- became embedded in the economy, and it has been taking time for these factors to change. In addition, the large room to raise productivity, mainly in the nonmanufacturing sector, as

[6] Assuming that the rise in the consumption tax will be fully passed on to prices of taxable items, excluding those to which a reduced tax rate will be applied, the effect 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 and fiscal 2020 is estimated to be 0.5 percentage point for each year. It also is assumed that the effects of policies concerning the provision of free education will not be reflected in the CPI, as statistical treatment of these effects is not yet decided.

[7] The situation in which wages and prices do not increase easily and require time to rise compared to the economic and employment conditions also has been observed in major advanced economies, albeit to varying degrees. Although no consensus has been reached, many hypotheses have been pointed out, such as the potential pool of labor supply, the hysteresis effects of the global financial crisis, the expansion of the global supply chain that includes emerging economies, and technological progress such as digitalization. Taking account of this, as well as factors unique to Japan including the experience of prolonged low growth and deflation, this section examines the factors behind the continued relatively weak developments in prices in Japan. For a detailed analysis related to this point, see "Analysis on Wages and Prices" of this issue of the Outlook Report, which is released simultaneously with "The Bank's View" and will be presented as Boxes in "The Background."

[8] A slight deceleration in the CPI inflation rate after the turn of the fiscal year is partly attributable to temporary factors such as a decline in accommodation fees that tend to fluctuate significantly and a weakening of upward pressure of costs on prices stemming from the yen's appreciation through early spring.

well as the technological progress such as digitalization in recent years, are likely to have allowed firms to maintain their cautious stance toward raising prices and also further intensified competition in some areas, even amid the economic expansion.

In Japan, due to the experience of low growth and deflation coupled with other factors, such as the large room to raise productivity, it is likely to have been taking longer than expected for the responsiveness of prices to the output gap to increase and for inflation expectations, which are strongly affected by the adaptive formation mechanism, to rise. Such sluggishness in prices and inflation expectations also can be explained by households' and firms' following behaviors.

First, firms' wage-setting stance has remained cautious, and it has been taking time for wage increases to fully take hold. While hourly scheduled cash earnings of part-time employees have continued on a clear uptrend, scheduled cash earnings of regular employees have been sluggish. This is partly attributable to the fact that regular employees have a persistent tendency to place priority on the stability of employment over wage increases, due to the experience of employment adjustments under low growth. Firms also have remained cautious about raising wages, partly because medium- to long-term growth expectations are not rising sufficiently. Moreover, while a further increase in labor participation by women and seniors of late has led to a rise in household income as a whole, it has been slowing the pace of wage increases through high wage elasticity of labor supply. These factors result in the low responsiveness of wages to the improvement in the output gap, and are also some of the reasons why inflation expectations do not rise readily.

Second, households' tolerance of price rises has not been increasing clearly. The fact that it has been taking time for wage increases to fully take hold and that cautious views regarding the economic growth and the social security system going forward have been persistent is likely to be one of the reasons why an increase in households' tolerance of price rises has been lagging behind.

Third, firms' price-setting stance has remained cautious even though input prices have been rising and labor costs have been increasing moderately but steadily. In a situation where households' tolerance of price rises has not been increasing clearly, many firms are still concerned about possibly losing customers due to price rises, even with the improvement in the output gap, partly reflecting the experience of price competition under deflation. In these circumstances, firms have been strengthening efforts to absorb upward pressure of costs on prices, such as increasing labor-saving investment and streamlining their business process. These efforts by firms are likely made possible through, for example, the large room to raise productivity, mainly in the nonmanufacturing sector, and the progress in digital technology in recent years.

Fourth, downward pressure on prices stemming from intensifying competition has operated in some areas. For example, mobile-phone related prices have been reduced intermittently, and the price-setting stance of mainly supermarkets has remained cautious, reflecting in part the expansion of online shopping. Such price declines are regarded as negative sectoral price shocks in general, and are expected to dissipate in the long run. However, these developments have been continuing in a wide range of sectors recently, partly due to progress in digital technology, and are likely to have been exerting downward pressure on general prices for a long period of time, coupled with consumers' persistent preference for lower prices and the adaptive formation mechanism of inflation expectations.

While differing somewhat in nature from the aforementioned factors, continued dull responses of administered prices and housing rent, both of which have a substantial weight in the CPI, also are likely to be affecting the sluggishness in prices.

2. Mechanism through which the inflation rate rises

Due to a combination of several factors mentioned so far, it has been taking time for the inflation rate to rise. Nevertheless, moves to raise sales prices are starting to be observed recently at a wide range of firms regardless of industry and size. In addition, as suggested by the active business fixed investment plans, firms' views regarding future prospects appear to have been changing, with the economic and employment conditions continuing to improve.

With regard to the outlook, many of the factors that have been delaying inflation are likely to be resolved gradually as the ecomony continues on an expanding trend. Although the effects of technological progress, for example, may strengthen going forward, the increase in wages is expected to become more evident, with tight labor market conditions continuing. Under such circumstances, upward pressure on sales prices is likely to increase, as is starting to be observed in the services sector such as in dining-out, and an increase in distribution costs resulting from labor shortage may ease competition among retailers by weakening online retailers' cost competitiveness. In addition, as the effects of rises in labor productivity and non-regular employees' wage levels spread to regular employees' wages, households' tolerance of price rises is expected to gradually increase on the whole, and price rises by firms are likely to be more easily accepted. Furthermore, considering that the so-called baby boomers -- who have been supporting the increase in labor participation by seniors -- are reaching their 70s, the effects of the rise in labor participation constraining wage increases are likely to become moderate.

Thus, factors that have been constraining CPI inflation are expected to be resolved gradually and the year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent. This can be explained by the following factors that determine general price inflation, such as the output gap and medium- to long-term inflation expectations.

First, the output gap -- which shows the utilization of labor and capital -- has widened within positive territory on the back of the steady tightening of labor market conditions and a rise in capital utilization rates. Going forward, as the economy continues its moderate expansion, the output gap is expected to widen further within positive territory in fiscal 2018 and remain substantially positive in fiscal 2019 and fiscal 2020. As firms' stance shifts toward further raising wages and prices and households' tolerance of price rises increases with the output gap remaining positive, further price rises are likely to be observed widely.

Second, medium- to long-term inflation expectations have been more or less unchanged recently. As for the outlook, such expectations are likely to follow an increasing trend and gradually converge to 2 percent on the back of the following: (1) in terms of the adaptive component, as further price rises come to be observed widely, as mentioned earlier, inflation expectations are likely to increase through a rise in the observed inflation rate, 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, which will be effective in pushing up inflation expectations toward 2 percent.[9]

Third, regarding import prices, the recent rise in crude oil prices will push up the CPI for fiscal 2018, but this effect is likely to wane moderately.

Meanwhile, the increase in labor participation by women and seniors that has become clear recently, as well as firms' strengthening of efforts to absorb upward pressure of costs on prices by raising productivity, are likely to weaken upward pressure on wages and prices in the short term, as noted earlier. From a longer-term perspective, however, the two aforementioned factors are expected to increase upward pressure on wages and prices. Specifically, such moves may alleviate structural problems, including a decline in the labor force, and raise the productivity of Japan's economy as a whole, thereby strengthening its growth potential. As quite a few corporate managers have relatively low growth expectations, due in part to the population decline, firms' spending behavior can be expected to become active as the economy's growth potential rises. In addition, as the natural rate of interest increases together with the rise in the growth potential of Japan's economy, the effects of the Bank's monetary easing are likely to be enhanced.

[9] 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.

III. Risks to Economic Activity and Prices

A. Risks to Economic Activity

The following four factors are upside and downside risks to the Bank's baseline scenario regarding the economy.

The first is developments in overseas economies. Specifically, the following are considered as risks: the U.S. macroeconomic policies and their impact on global financial markets; the consequences of protectionist moves and their effects; developments in emerging and commodity-exporting economies including the effects of the two aforementioned factors; negotiations on the United Kingdom's exit from the European Union (EU) and their effects; and geopolitical risks.

The second risk is the effects of the consumption tax hike scheduled to take place in October 2019. 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 the following: efforts to address medium- to long-term issues such as the aging population; developments in regulatory and institutional reforms, particularly in the labor market; innovation in the corporate sector; and the employment and income situation.

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 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. 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 such expectations will lag further behind through the adaptive formation mechanism, if it takes longer than projected for firms' stance to shift toward further raising wages and prices and actual 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. The dull responses of administered prices and housing rent may continue to constrain the rise in CPI inflation for a long period. In addition, downward pressure on prices of mainly goods and services that are difficult to differentiate may last longer than expected if competition among firms intensifies further, due mainly to changes in the distribution system and deregulation.

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.[10]

The first perspective involves an examination of the baseline scenario for the outlook. The year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent, although it will take more time than expected. Even though it is necessary to carefully examine the risks to economic activity and prices, the momentum toward achieving the price stability target of 2 percent appears to be maintained. This is because (1) firms' stance is likely to gradually shift toward further raising wages and prices with the output gap remaining positive, and (2) medium- to long-term inflation expectations have been more or less unchanged and are projected to rise gradually 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, upside and downside risks are generally balanced in fiscal 2018, but risks are skewed to the downside for fiscal 2019 onward. Regarding 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. In addition, 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

[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."

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. As for policy rates, the Bank intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices including the effects of the consumption tax hike scheduled to take place in October 2019. It will examine the risks considered most relevant to the conduct of monetary policy and 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.

(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 hike
Fiscal 2018	+1.3 to +1.5 [+1.5]	+1.0 to +1.2 [+1.1]	
Forecasts made in April 2018	+1.4 to +1.7 [+1.6]	+1.2 to +1.3 [+1.3]	
Fiscal 2019	+0.7 to +0.9 [+0.8]	+1.8 to +2.1 [+2.0]	+1.3 to +1.6 [+1.5]
Forecasts made in April 2018	+0.7 to +0.9 [+0.8]	+2.0 to +2.3 [+2.3]	+1.5 to +1.8 [+1.8]
Fiscal 2020	+0.6 to +0.9 [+0.8]	+1.9 to +2.1 [+2.1]	+1.4 to +1.6 [+1.6]
Forecasts made in April 2018	+0.6 to +1.0 [+0.8]	+2.0 to +2.3 [+2.3]	+1.5 to +1.8 [+1.8]

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

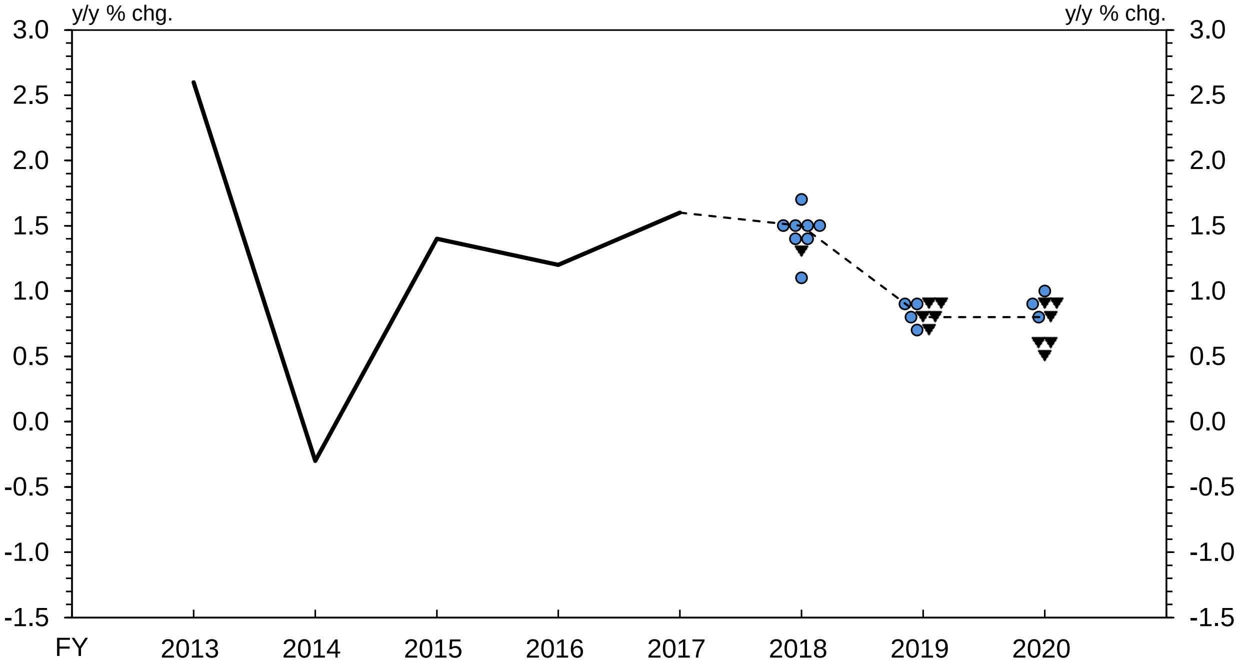
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the 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.

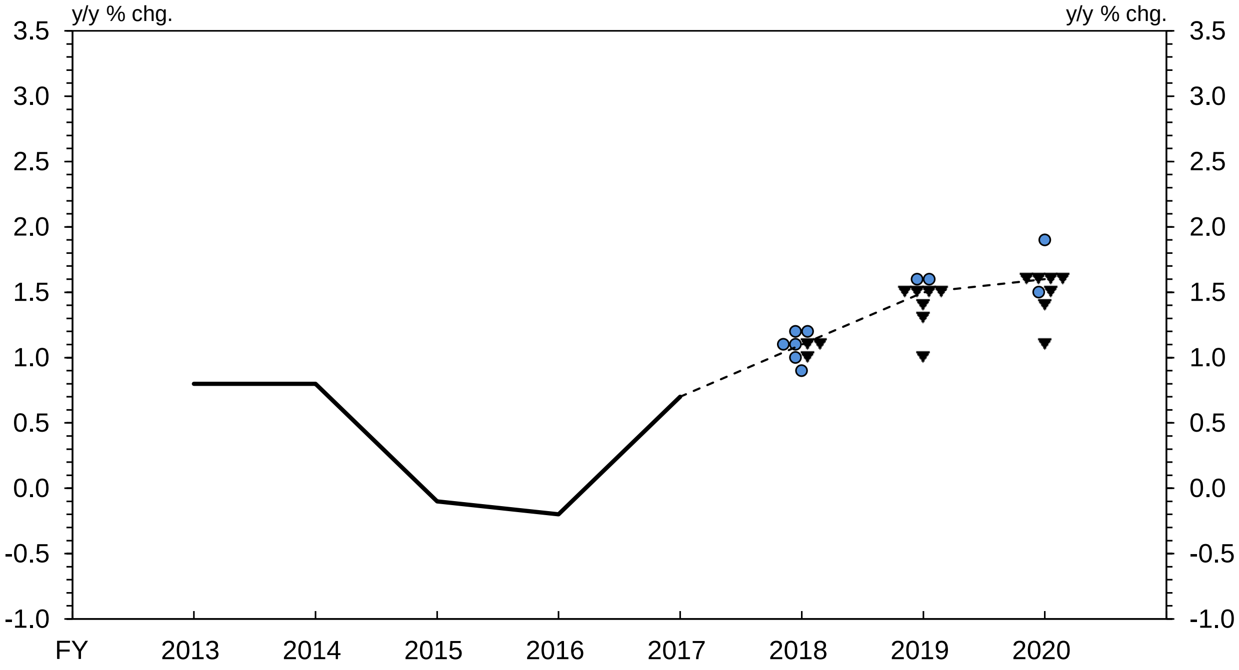
4. The consumption tax hike scheduled to take place in October 2019 -- to 10 percent -- and the reduced tax rate to be applied to food and beverages -- excluding alcohol and dining-out -- and newspapers are incorporated in the forecasts, but individual Policy Board members make their forecasts of the CPI based on figures excluding the direct effects of the consumption tax hike. The forecasts for the CPI for fiscal 2019 and fiscal 2020 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 for each year. Second, this figure is added to the forecasts made by the Policy Board members. While it is assumed that the effects of policies concerning the provision of free education will not be reflected in the CPI as statistical treatment of these effects is not yet decided, the effects of such policies are factored in by individual Policy Board members for their forecasts of the real GDP growth rates, based on information available at this point.

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.