October 31, 2018

Bank of Japan

Outlook for Economic Activity and Prices (October 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 on the whole. 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. This is mainly attributable to (1) such factors as firms' cautious wage- and price-setting stance not having changed clearly yet in a situation where the mindset and behavior based on the assumption that wages and prices will not increase easily have been deeply entrenched and (2) the large room for firms to raise productivity as well as the technological progress in recent years. Under these circumstances, a rise in medium- to long-term inflation expectations has been lagging behind. 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.
- Comparing the current projections with the previous ones, the projected growth rates are more or less unchanged. The projected rates of increase in the CPI are somewhat lower, mainly for fiscal 2018.
- 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 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 October 30 and 31, 2018.

[2] The October 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. 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 following their improving trend and business sentiment staying at a favorable level. 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 around 1 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 -- such as that intended for domestic capacity expansion in line with the economic expansion, Olympic Games-related investment, and labor-saving investment to address labor shortage -- is likely to continue increasing amid accommodative financial conditions. 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 Olympic Games-related demand and the supplementary budgets. Exports are expected to continue their moderate increasing trend on the back of overseas economies growing firmly on the whole. 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 overseas economies continuing to grow firmly on the whole. 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 been positive but has continued to show relatively weak developments compared to the economic expansion and the labor market tightening.

This is basically 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, and firms' cautious wage- and

[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.

price-setting stance as well as households' cautiousness toward price rises have not yet clearly changed. In addition, the large room to raise productivity, mainly in the nonmanufacturing sector, the technological progress in recent years, and the high wage elasticity of labor supply among women and seniors have allowed firms to maintain their cautious stance toward raising prices, even amid the economic expansion. Furthermore, such factors as technological progress have further intensified competition in some areas. The continued lackluster developments in administered prices and housing rent also are likely to have affected the sluggishness in prices. Under these circumstances, the situation likely has continued in which the responsiveness of prices to the output gap, as well as inflation expectations that are strongly affected by the adaptive formation mechanism, do not rise easily. Although an easing of upward pressure of costs on prices stemming from the yen's appreciation through early spring had pushed down the CPI in the short term, such downward pressure has been weakening recently.

With regard to the outlook, the year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent, mainly on the back of the output gap remaining positive and medium- to long-term inflation expectations rising. Comparing the current projections with the previous ones, the projected rates of increase in the CPI are somewhat lower, mainly for fiscal 2018.[6]

The mechanism through which the year-on-year rate of change in the CPI increases gradually toward 2 percent can be explained by the following factors that determine general price inflation. 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. As for the outlook, it is expected to remain substantially positive. Under such circumstances, further price rises are likely to be observed widely as households' tolerance of price rises increases, mainly reflecting a rise in wage growth rates, and firms' stance shifts toward further raising prices.

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, a rise in the observed inflation rate is likely to push up inflation expectations, 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

[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.

in pushing up inflation expectations.[7]

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

Meanwhile, the recent increase in labor participation by women and seniors, as well as firms' strengthening of efforts to absorb upward pressure of costs on prices by raising productivity, are expected to increase upward pressure on prices in the long term. Specifically, as the growth potential of the economy as a whole rises reflecting such moves, firms' and households' spending behavior can be expected to become active. In addition, as the natural rate of interest increases together with the rise in the growth potential of Japan's economy, monetary easing effects are likely to be enhanced.

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.

[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.

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 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 responsiveness of prices to the output gap. If firms' efforts to absorb upward pressure of costs on prices by raising productivity continue for a long time, or competition among firms intensifies further due partly to the technological progress in recent years and changes in the distribution system, downward pressure on prices stemming from these factors may last longer than expected. In addition, the lackluster developments in administered prices and housing rent also may continue to constrain the rise in CPI inflation for a long period.

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 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 is necessary to carefully examine the risks to economic activity and prices, the

[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."

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, risks are skewed to the downside, particularly regarding developments in overseas economies. 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. However, prolonged downward pressure on financial institutions' profits, with the low interest rate environment and severe competition among financial institutions continuing, could create risks of a gradual pullback in financial intermediation and of destabilizing the financial system. Although these risks are judged as not significant at this point, mainly because financial institutions have sufficient capital bases, it is necessary to pay close attention to future developments.[9]

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.

[9] For details, see the Bank's *Financial System Report* (October 2018).

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

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

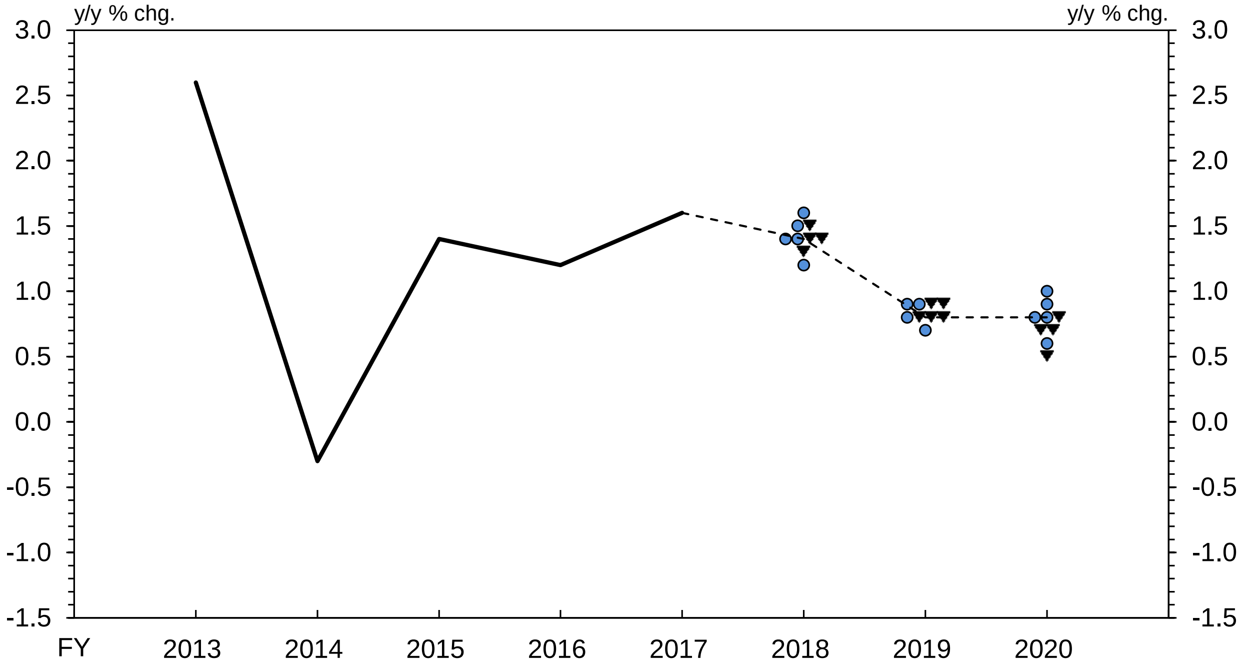
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the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

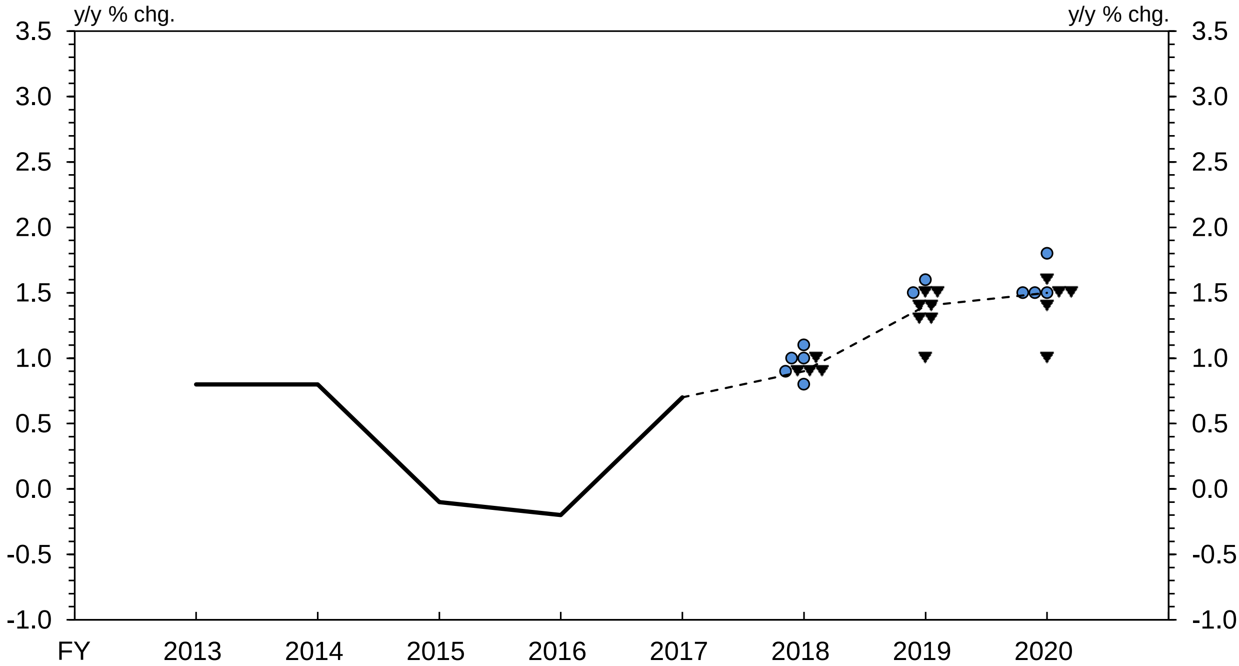
4. The consumption tax hike scheduled to take place in October 2019 -- to 10 percent -- and the reduced tax rate to be applied to food and beverages -- excluding alcohol and dining-out -- and newspapers are incorporated in the forecasts, but individual Policy Board members make their forecasts of the 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.