

Outlook for Economic Activity and Prices (October 2020)

The Bank's View¹

Summary

- Japan's economy is likely to follow an improving trend with economic activity resuming and the impact of the novel coronavirus (COVID-19) waning gradually, but the pace is expected to be only moderate while vigilance against COVID-19 continues. Thereafter, as the impact subsides globally, the economy is projected to keep improving further with overseas economies returning to a steady growth path.
 - The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is likely to be negative for the time being, mainly affected by COVID-19, the past decline in crude oil prices, and the "Go To Travel" campaign. Thereafter, it is expected to turn positive and then increase gradually, since downward pressure on prices is projected to wane gradually along with economic improvement, and the effects of such factors as the decline in crude oil prices are likely to dissipate.
 - Compared with the previous projections in the July Outlook Report, the projected growth rate is lower for fiscal 2020, mainly due to a delay in recovery in services demand, but is somewhat higher for fiscal 2021 and more or less unchanged for fiscal 2022. The projected rates of increase in the CPI are more or less unchanged.
 - The outlook for economic activity and prices provided in this Outlook Report is extremely unclear, since it could change depending on the consequences of COVID-19 and the magnitude of their impact on domestic and overseas economies. The outlook is based on the assumption that COVID-19 will not spread again on such a large scale that the wide-ranging public health measures will need to be reinstated. It also is based on the premises that, while the impact of COVID-19 remains, firms' and households' medium- to long-term growth expectations will not decline substantially and the smooth functioning of financial intermediation will be ensured with financial system stability being maintained. However, the assumption and premises entail high uncertainties.
 - With regard to the risk balance, risks to both economic activity and prices are skewed to the downside, mainly due to the impact of COVID-19.
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¹ "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 28 and 29, 2020.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has picked up with economic activity resuming, although it has remained in a severe situation due to the impact of COVID-19 at home and abroad. Overseas economies also have picked up from a state of significant depression. In this situation, exports and industrial production have increased. On the other hand, business fixed investment has been on a declining trend, against the background of deterioration in corporate profits. With the continuing impact of COVID-19, the employment and income situation has been weak. Private consumption has picked up gradually on the whole, although consumption of services, such as eating and drinking as well as accommodations, has remained at a low level. Housing investment has declined moderately. Public investment has continued to increase moderately. Meanwhile, business sentiment deteriorated significantly but subsequently has improved somewhat. Financial conditions have been accommodative on the whole but those for corporate financing have remained less so, as seen in weakness in firms' financial positions. 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, mainly affected by COVID-19, the past decline in crude oil prices, and the "Go To Travel" campaign. Inflation expectations have weakened somewhat.

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

A. Baseline Scenario of the Outlook for Economic Activity

Japan's economy, with economic activity resuming and the impact of COVID-19 waning gradually, is likely to follow an improving trend, supported by accommodative financial conditions and the government's economic measures. However, the pace of improvement is expected to be only moderate while vigilance against COVID-19 continues. Thereafter, as the impact subsides globally, the economy is projected to keep improving further with overseas economies returning to a steady growth path.

This baseline scenario is based on the assumptions that, with progress in efforts to take preventive measures against COVID-19 and improve economic activities simultaneously, COVID-19 will not spread again on such a large scale that the wide-ranging public health measures will need to be reinstated, and that the impact of COVID-19 will almost subside toward the end of the projection period. The outlook also is based on the premises that, in Japan, while the impact of COVID-19 remains, firms' and households' medium- to long-term growth expectations will not decline substantially and the smooth functioning of financial intermediation will be ensured with financial system stability being maintained.

Looking at the outlook for economic activity based on the assumptions and premises in more detail, overseas economies are likely to continue improving, partly supported by aggressive macroeconomic policies, but the pace is expected to be only moderate while

vigilance against COVID-19 continues. Then, with the impact of COVID-19 almost subsiding, they are likely to continue improving toward the end of the projection period as the production activity of the manufacturing industry is projected to continue recovering globally and face-to-face services consumption in particular is expected to recover gradually.

Japan's exports of goods are expected to increase for the time being, mainly for automobile-related goods, and then increase for a wide range of goods, including capital goods, with the impact of COVID-19 waning globally. Inbound tourism consumption, which is categorized as services exports, is expected to remain subdued while entry restrictions continue, but is likely to recover thereafter along with a gradual easing in such restrictions.

Private consumption is likely to continue picking up, supported also by the government's economic measures, but while vigilance against COVID-19 continues, the pace is expected to be quite moderate, mainly for face-to-face services consumption. Thereafter, with households and firms adapting to a "new lifestyle" and the impact of COVID-19 waning, an uptrend in private consumption is likely to become evident gradually, supported also by improvement in employee income. Although the government's economic measures and accommodative financial conditions are expected to support employment, the employment and income situation is projected to be under downward pressure for the time being against the background of deterioration in corporate profits and worsening labor market conditions. The employment and income situation is likely to turn to an improving trend thereafter, with domestic and external demand recovering.

Business fixed investment is expected to remain on a declining trend for the time being, mainly in industries affected strongly by COVID-19. However, with accommodative financial conditions being maintained, it is expected that the capital stock adjustment will not be as significant as that seen at the time of the Global Financial Crisis (GFC) and that, with the impact of COVID-19 waning, business fixed investment will return to a moderate increasing trend along with improvement in corporate profits. Meanwhile, public investment is projected to steadily increase, reflecting the progress in construction related to restoration and reconstruction following natural disasters, as well as to building national resilience. Thereafter, it is expected to be at a relatively high level.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of change in the CPI is likely to be negative for the time being, mainly affected by COVID-19, the past decline in crude oil prices, and the "Go To Travel" campaign.² With economic activity remaining at a low level due to the impact of

² The direct effects of the "Go To Travel" campaign on the CPI are estimated to be minus 0.2 percentage point for fiscal 2020 and 0.2 percentage point for fiscal 2021, based on assumptions such as in terms of the period (i.e., from August 2020 through January 2021).

COVID-19, it is expected that prices of goods and services that are sensitive to economic activity will be pushed down. The past decline in crude oil prices also is projected to push down the CPI through energy prices. Under these circumstances, medium- to long-term inflation expectations are likely to continue weakening somewhat.

Thereafter, downward pressure on prices is projected to wane gradually along with economic improvement. In addition, the effects of such factors as the decline in crude oil prices are likely to dissipate. Under these circumstances, the year-on-year rate of change in the CPI is expected to turn positive and then increase gradually. Medium- to long-term inflation expectations also are expected to rise again.

C. Financial Conditions

The Bank has pursued "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control." It also has conducted various powerful monetary easing measures since March in response to COVID-19 with a view to supporting financing, mainly of firms, and maintaining stability in financial markets.³ In addition, the government has conducted various measures to support financing, mainly of firms, through programs that provide loans guaranteed by the credit guarantee corporations and also quasi-capital funds. Private financial institutions have actively fulfilled the functioning of financial intermediation. In this situation, although firms' financial positions have been weak, the environment for external funding, such as bank borrowing and the issuance of CP and corporate bonds, has remained accommodative. Regarding financial markets, tension has eased, although they are still nervous. Owing to the Bank's and the government's measures, as well as efforts made by private financial institutions together with those measures, the Bank considers that financial conditions will remain accommodative and further downward pressure on the real economy from the financial side will be avoided.⁴

III. Risks to Economic Activity and Prices

A. Risks to Economic Activity

Regarding the baseline scenario of the outlook for economic activity, it is necessary to pay attention to the following three upside and downside risks in particular until the impact of COVID-19 subsides.

³ See "Enhancement of Monetary Easing in Light of the Impact of the Outbreak of the Novel Coronavirus (COVID-19)" released on March 16, 2020, "Enhancement of Monetary Easing" released on April 27, 2020, and "Introduction of a New Fund-Provisioning Measure to Support Financing Mainly of Small and Medium-Sized Firms" released on May 22, 2020.

⁴ Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

The first is the impact of COVID-19 on domestic and overseas economies. There are extremely high uncertainties over the consequences of COVID-19 and the magnitude of their impact on domestic and overseas economies. Until effective medicines and vaccines are developed, it is highly unclear how the COVID-19 pandemic will evolve and how long it will take for the impact to subside. In particular, if the wide-ranging public health measures are reinstated, economic activity is likely to be constrained significantly again. In addition, while vigilance against COVID-19 continues, households' and firms' behavior at home and abroad is uncertain, with people voluntarily making precautionary efforts.

The second risk is firms' and households' medium- to long-term growth expectations. If such expectations decline due to a shock caused by COVID-19 that pushes down the economy considerably, there is a risk that firms' and households' appetite for spending will not increase easily even after the impact of COVID-19 subsides. On the other hand, medium- to long-term growth expectations could increase if the issue of COVID-19 leads to, for example, active use of information and communication technology to prevent infection and an undertaking of investment to meet new demand, thereby having positive effects on economic activity such as further innovation.

The third risk is developments in the financial system. Although COVID-19 has affected the financial side as well, the Bank and the government have taken measures aggressively, with a view to supporting financing, mainly of firms, and maintaining stability in financial markets. In addition, financial institutions have considerable resilience in terms of both capital and liquidity. In this situation, the financial system has maintained stability on the whole and the smooth functioning of financial intermediation has been ensured.⁵ However, if COVID-19 has a larger impact than expected, there is a risk that deterioration in the real economy will affect financial system stability, thereby exerting further downward pressure on the real economy. Although this risk is judged as not significant at this point, it is necessary to pay close attention to future developments.

B. Risks to Prices

If the aforementioned risks to economic activity materialize, prices also are likely to be affected accordingly.

Risks that are specific to prices are as follows. The first is uncertainties over firms' price-setting behavior amid the impact of COVID-19 on both the demand and supply sides of economic activity. A decrease in demand due to constrained economic activity is likely to put downward pressure on prices of goods and services that are sensitive to economic activity. On the other hand, since one of the reasons for the current decrease is vigilance against COVID-19, price cuts that aim at stimulating demand have not been observed widely to date. In addition, economic activity has been constrained also from the supply

⁵ For details, see the Bank's *Financial System Report* (October 2020).

side, such as by limiting the number of customers to prevent infection. Under these circumstances, there are high uncertainties over how firms will set their prices and how this will affect general prices from a macro perspective.

The second is future developments in foreign exchange rates and international commodity prices, as well as the extent to which such developments will spread to import prices and domestic prices. These risks may lead prices to deviate either upward or downward from the baseline scenario, and thus continue to warrant attention.

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.⁶

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 achieving the price stability target, although it will take time. For the time being, downward pressure is expected to be put on prices with economic activity remaining at a low level due to the impact of COVID-19, and medium- to long-term inflation expectations also are likely to weaken somewhat. Thereafter, prices are expected to increase gradually since downward pressure on them is projected to wane gradually along with economic improvement. In addition, medium- to long-term inflation expectations also are likely to rise again.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. The outlook for economic activity and prices is extremely unclear, since it could change depending on the consequences of COVID-19 and the magnitude of their impact on domestic and overseas economies. The outlook is based on the assumption that COVID-19 will not spread again on such a large scale that the wide-ranging public health measures will need to be reinstated. It also is based on the premises that, while the impact of COVID-19 remains, firms' and households' medium- to long-term growth expectations will not decline substantially and the smooth functioning of financial intermediation will be ensured with financial system stability being maintained. However, the assumption and premises entail high uncertainties. With regard to the risk balance, risks to both economic activity and prices are skewed to the downside, mainly due to the impact of COVID-19. When examining financial imbalances from a longer-term perspective, prolonged downward pressure on financial institutions' profits could create a risk of a gradual pullback in financial intermediation, given the existing factors -- such as the prolonged low interest rate environment, the declining population, and excess savings

⁶ 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."

in the corporate sector -- as well as the recent impact of COVID-19. On the other hand, under these circumstances, the vulnerability of the financial system could increase, mainly due to the search for yield behavior. 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.

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 continue to support financing, mainly of firms, and maintain stability in financial markets through (1) the Special Program to Support Financing in Response to the Novel Coronavirus (COVID-19), (2) an ample provision of yen and foreign currency funds without setting upper limits mainly by purchasing Japanese government bonds (JGBs) and conducting the U.S. dollar funds-supplying operations, and (3) active purchases of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs).

For the time being, the Bank will closely monitor the impact of COVID-19 and will not hesitate to take additional easing measures if necessary, and also it expects short- and long-term policy interest rates to remain at their present or lower levels.

Forecasts of the Majority of the Policy Board Members

y/y % chg.

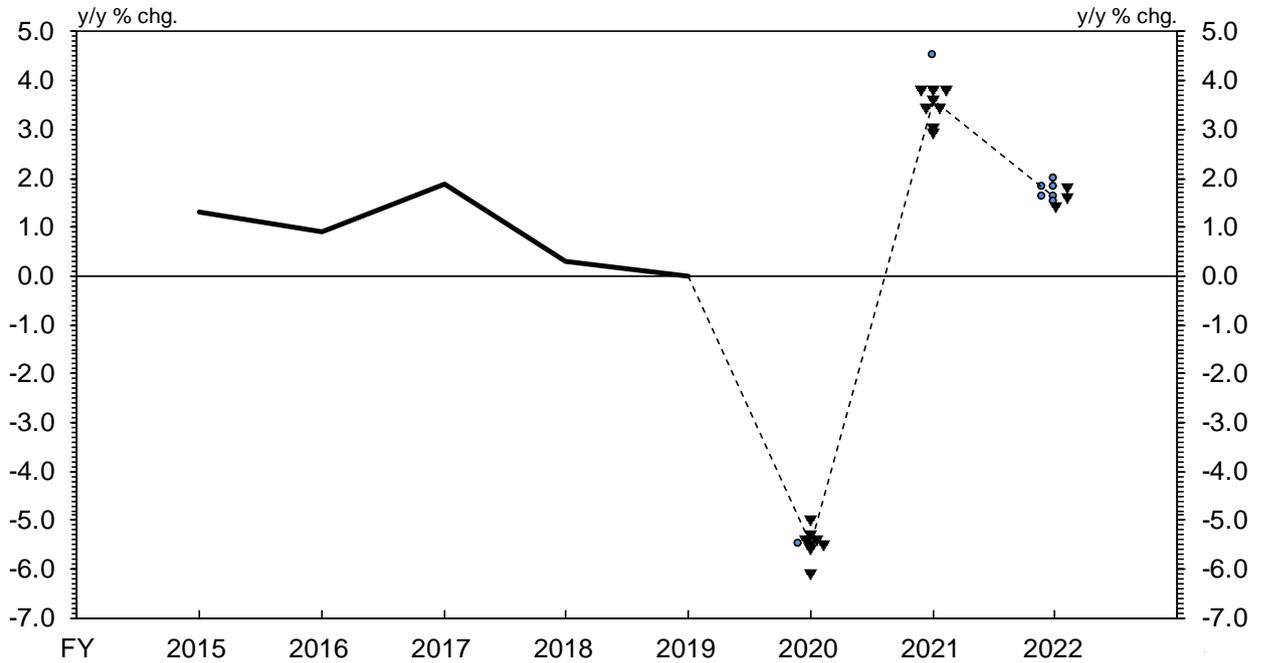
	Real GDP	CPI (all items less fresh food)	(Reference) Excluding the effects of the consumption tax hike and policies concerning the provision of free education
Fiscal 2020	-5.6 to -5.3 [-5.5]	-0.7 to -0.5 [-0.6]	-0.8 to -0.6 [-0.7]
Forecasts made in July 2020	-5.7 to -4.5 [-4.7]	-0.6 to -0.4 [-0.5]	-0.7 to -0.5 [-0.6]
Fiscal 2021	+3.0 to +3.8 [+3.6]	+0.2 to +0.6 [+0.4]	
Forecasts made in July 2020	+3.0 to +4.0 [+3.3]	+0.2 to +0.5 [+0.3]	
Fiscal 2022	+1.5 to +1.8 [+1.6]	+0.4 to +0.7 [+0.7]	
Forecasts made in July 2020	+1.3 to +1.6 [+1.5]	+0.5 to +0.8 [+0.7]	

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

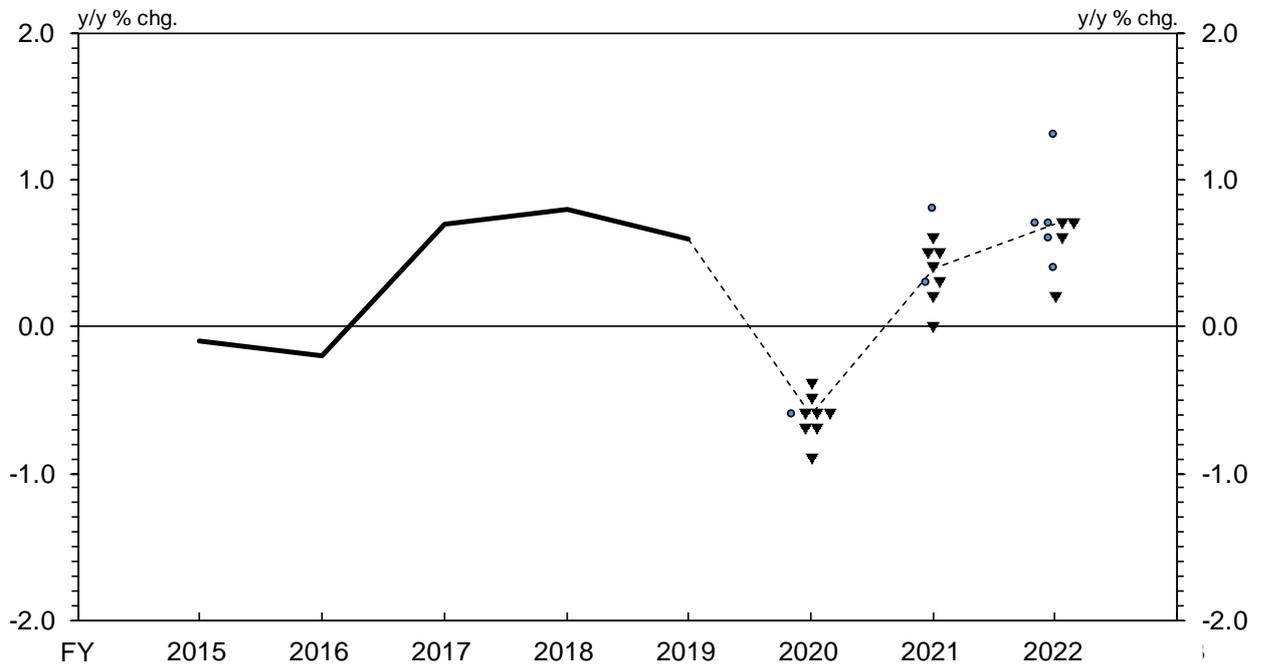
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.
3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.
4. The direct effects of the October 2019 consumption tax hike on the CPI for fiscal 2020 are estimated to be 0.5 percentage point. In addition, based on a specific assumption, the direct effects of policies concerning the provision of free education on the CPI for fiscal 2020 are estimated to be around minus 0.4 percentage point.

Policy Board Members' Forecasts and Risk Assessments

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. The solid lines show actual figures, while the 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. The CPI figure for fiscal 2015 excludes the direct effects of the April 2014 consumption tax hike.